

**SEQUENCING OF ECONOMIC REFORMS
IN THE PRESENCE OF POLITICAL CONSTRAINTS**

Working Paper #701
July 1993

Cesar Martinelli
Mariano Tommasi

Department of Economics
University of California, Los Angeles
405 Hilgard Avenue
Los Angeles, CA 90024-1477
(310) 206-1256
tommasi@econ.sscnet.ucla.edu

Sequencing of Economic Reforms in the Presence of Political Constraints*

Cesar Martinelli

University of California, Los Angeles, CA 90024, USA

Mariano Tommasi

University of California, Los Angeles, CA 90024, USA

July 15, 1993

Abstract

In recent experiences of economic reform in Eastern Europe and Latin America, comprehensive and swift introduction of reforms seems to have led to (presumably) larger than necessary adjustment costs. We purport to explain these observations within a political-economic framework. Once we incorporate political sustainability restrictions into the problem, the optimal course of action may very well be quite different from the one we would infer from an “unconstrained” economic perspective.

Our model portrays the case of a country in a political deadlock over specific reform proposals that hurt strongly organized interests. We predict that, in such cases, under democratic conditions, only far reaching reforms accompanied by major political realignments are likely to succeed.

*Correspondence to Mariano Tommasi, Department of Economics, University of California, Los Angeles, CA 90024.

We thank Sebastian Edwards, Dani Rodrik, Michael Wallerstein and participants at the UCLA Political Economy Luncheon Group and the International Economics Seminar for helpful comments. We thank Maureen DeLucca for excellent editorial assistance and the Institutional Reform and the Informal Sector project at the University of Maryland for generous funding. M. Tommasi also acknowledges financial support from the Academic Senate at UCLA.

1 Introduction

In recent years, a number of countries in Eastern Europe and Latin America have embraced a wide range of market-oriented reforms, sometimes during macroeconomic crises of unprecedented proportions. Some examples are the Bolivian package of 1985, the Polish Balcerowicz plan, the Menem reforms in Argentina, the Plano Collor in Brazil, and the Fujimori reforms in Peru. (Comprehensive attempts at reform are also being pursued in Mexico and Venezuela, and, following Poland, throughout Eastern Europe.)

The radicalism of these programs stands in striking contrast with the recommendations of the economic literature on timing and sequencing of reforms. While there is no consensus on the optimal ordering of reforms, many (maybe most) authors agree that a carefully phased gradualist approach minimizes the costs of transition. It is typically stated that measures to restore state solvency and insure macroeconomic stabilization should precede full liberalization.

The strategy followed in the cases mentioned has been, instead, to introduce reforms as swiftly as possible. Such “bitter pill” reform strategies have indeed been painful, seemingly giving the reason to those advocating a more paused stance. The question posed by these experiences is, in Rodrik’s (1992) words: “If a period of macro instability is the worst time to undertake a trade reform, why are so many countries doing it?” More generally, why do countries attempt to initiate all sorts of reforms simultaneously?

We believe the answer to this question lies in the presence of political constraints motivating governments to go for comprehensiveness and speed in implementing reforms, even when this strategy entails some additional costs. Section 2 of this paper reviews the arguments in favor of gradualism given in the economic literature. Most of the literature assumes that the objective of a reforming government is to maximize social welfare. This suggests a first best strategy of removing all existing distortions simultaneously. Hence, formal arguments in favor of gradualism follow the logic of second-best: Given a distortion that cannot be removed, reform cannot simply consist in getting rid of all other distortions simultaneously. Section 3 presents the politico-economic objections against gradualism. Some of these objections relate to *credibility* problems, while others relate to *political sustainability* of step-by-step strategies. We provide some simple examples illustrating how these considerations can remove the advantages of a gradualist approach even when

purely economic reasoning calls for it.

Our argument rests on the distributive consequences of reform. By widening the scope of efficiency improving reforms, the government is more likely to gain the support of larger segments of the population, particularly if the losers of each particular measure are benefited by other measures. If the government needs to pass a threshold of popular support at each step, a gradual process risks being stopped at each stage by the group being hurt at that point. Hence, the government may need to implement all reforms simultaneously even if this entails some aggregate costs. Credibility and political sustainability are clearly intertwined.

The argument itself is hardly new (practitioners seem to be keenly aware of it); our purpose is to show its validity in the context of familiar economic models. We believe that this is necessary since some authors (notably Rodrik 1989) have advocated reforms that are "large in magnitude but narrow in scope." Section 4 presents some evidence (of admittedly anecdotal character) that suggests that wide-scope reforms have indeed been implemented, with reasonable political success, in spite of severe economic difficulties. Section 5 contains some concluding remarks.

2 The literature on gradualism

The early literature on the timing and sequencing of economic reforms was spurred by the experience of the Southern Cone of Latin America in the late 1970s and early 1980s. The attempted liberalizations under military rule in Chile, Argentina, and Uruguay led to a series of bank panics and financial collapses. Several authors attribute these difficulties to mistakes in the order of liberalization (Diaz Alejandro 1985, Corbo and de Melo 1985, and Edwards and Edwards 1987). The need to balance the central government finances before undertaking other reforms, was commonly emphasized. The debate centered on the order of liberalization of the trade and capital accounts, with the majority of authors favoring the opening of the former before the liberalization of the latter in order to avoid undesirable capital flows. (See, e.g., McKinnon 1991. For a dissenting view, see Lal 1987).

Most of the early literature was informal; the emphasis was in giving policy advice to avoid the difficulties that plagued efforts at economic reform in Latin America. Subsequent research has been more precise in making

statements about welfare gains or losses associated with different sequences (Edwards 1992).

Clearly, under competitive equilibrium assumptions, welfare maximization is obtained by removing all distortions simultaneously. As long as the perceived private costs and benefits correspond to the true social costs and benefits, private economic agents will choose the socially correct pace of adjustment following a full scale liberalization.¹ “Radical reform” is the *first best* reform strategy. Hence, arguments for gradualism must rely on the presence of distortions during the adjustment process or on distributive concerns. In this section we will focus on the former. In the next section we will touch upon distributive considerations, but we will argue that they might lead to radicalism, and not to gradualism as it is commonly believed.

One possible argument for gradualism is the presence of preexisting distortions in one or several markets that cannot be removed at the time the reform plan is announced. Potential candidates are labor market interventions, domestic capital market imperfections, and limits to foreign indebtedness that are not perceived as binding by individual - private - agents (See, for instance, Edwards and Van Wijnberger 1986 and Edwards 1992). In all of these cases, one can imagine circumstances in which the *second best* reform strategy will involve some degree of gradualism, for instance, in the speed of trade liberalization.

A related argument, put forward by Calvo (1989), emphasizes the equivalence of imperfect credibility to an intertemporal distortion. In one of Calvo’s examples, if the public wrongly believes that a trade liberalization will be reverted in the future, quantitative control of the capital account may be in order. The problem with this type of argument is that, in its simplest form, it assumes that credibility problems arise because the government “knows better” than the public what is going to happen in the future. A closer look at the source of the credibility problem is necessary to assess the right policy response. For instance, if imperfect credibility arises because the public is unsure about the “true preferences” of the government, overshooting can act as a signaling device (Rodrik 1989a). Or, as argued in the next section, if credibility problems are related to political sustainability of the reforms, a

¹It is important to make the distinction between economic reform and economic restructuring. In economies that have been highly distorted, economic restructuring is certain to take a long time, even if economic reform (a collection of policy decisions) occurs all of a sudden.

big bang may be the only way of cutting through the Gordian knot of implicit rents generated by government interventions.

Another argument in favor of gradualism is the absence or precariousness of a “safety net” to smooth the effects of massive redundancies of labor during the process of economic transformation. This safety net is to be understood as a public good needed to reduce costs such as losses of human capital. Both Latin American and Eastern European countries have had fragmentary and rudimentary systems for income maintenance and welfare delivery (Przeworski 1991).

A similar “capacity constraint” is given by the limited availability of loyal and qualified technocrats to carry on the process of reforms. It is true that capacity constraints of the economic team can be important in some cases, as in the process of privatization, where some “learning by doing” is likely to occur. According to Krueger (1992), the most sensible procedure, given the limitations of the economic team, is to emphasize the swift removal of distortions that inhibit the creation of new sources of income instead of focusing on the disposal of old public assets.

In sum, economic arguments in favor of gradualism are of a second-best nature. In the next section we will argue that, even in cases where some of the arguments above apply, a big-bang may still be the best *feasible* policy given political constraints.

3 The political economy case for radical reform

In section 4 we present some evidence that suggests that radical reforms can be costly, particularly if the urgency for “getting things done” leads to the adoption of bad designs. Comprehensive reform packages, however, not only have been adopted by a number of countries but they have also enjoyed considerable initial support. For an explanation, we turn now to political-economic arguments.

Rodrik (1989a) has argued that overshooting a reform may be useful for a government that wants to signal its seriousness to a jaded public that has lived through too many failed reforms. Although we find this reasoning compelling, we believe that, when they are not due to plain policy inconsis-

tencies, credibility problems are linked to political sustainability of economic policies.² Countries adopting radical reforms have been characterized for the most part, by weak states, vulnerable to pressures from large firms and organized interests. In these circumstances, policy actions with distributive consequences can be effectively blocked by the groups being hurt (if they have time to organize.) Lal (1987) and Krueger (1992) have emphasized the need for speed in the transition: A longer transition enables pressure groups to organize and successfully oppose the reforms.

To this reasoning in favor of speed in the process of reforms, we want to add one in favor of comprehensiveness. By widening the scope of efficiency-improving reforms initiated simultaneously, the government is more likely to gain the support of larger segments of the population. For many agents, losses from one reform can be more than compensated by gains from others. For instance, putting an end to a near hyperinflationary situation is going to benefit (almost) everyone. Hence, linking the fate of the reforms can be a way of weakening the opposition to them.³ That is to say, if the government is not able to credibly commit to a certain course of action, it may need to implement all reforms simultaneously, even when economic reasoning calls for a second-best gradualist approach. Even if high, the costs involved in a radical reform can be smaller than the costs involved in a truncated reform.

In 3.2, we develop a simple general equilibrium example to illustrate how political-economic considerations can revert the second-best argument in favor of gradualism. Before that, in 3.1, we use a sequential move game structure to show the logic of our argument.

3.1 The argument

Consider a government trying to implement reforms F (e.g., a fiscal reform needed to stabilize prices) and T (e.g., a trade reform). Besides the government, there are two interest groups: f and t . Reform F , if carried alone,

²In a paper that takes precisely this point of view, Van Wijnbergen (1992) argues against gradualism in the removal of price controls, on the grounds that resulting hoarding can lead the median voter to underestimate the efficiency benefits from the reform.

³The same idea underlies the discussion about economic reform in Buchanan (1991). A slightly different version of the same argument is made by Rodrik (1992b). He shows that an agenda setter may be able to sneak-in a reform with distributive consequences alongside one with across-the-board benefits by packaging the two together.

will hurt group f and will benefit group t . It is assumed that, on optimality grounds, reform T should be carried over after F is secure. (An example could be a trade reform that needs macroeconomic stability to minimize transition costs).

If the gradualist approach is pursued, that is, if T is undertaken after F is completed, both f and t end up being better off than in the initial situation. However, group t would prefer the reform process to be truncated after reform F is accomplished.

Alternatively, the government can start both reforms simultaneously. The payoffs of following this radical approach are higher for f and t than those from the initial situation, but lower than those obtained after a gradualist reform process.

The government is modeled as an *agenda-setter*⁴ who holds the initiative to offer reform plans at several points in time. Pressure groups have no capacity to articulate counterproposals, but can effectively veto any reform plan. In deciding a sequence of proposals, the government must take into account not only economic considerations (the payoffs associated with the final point) but also the possibility of pulling off the reforms. Neither the government nor the different interest groups has the capacity to precommit their actions.

Figure 1 shows schematically the extended form of this game. To illustrate, we have chosen the following payoff structure:

Table 1.-

Payoffs to the different agents

	Government	Group f	Group t
Status quo	0	0	0
Truncated reform	1	-1	3
Gradualist reform	2	2	2
Radical reform	1	1	1

⁴See Romer and Rosenthal (1979) for a discussion of the agenda setter game, and Dewatripont and Roland (1992) for another application to the problem of economic reform. For simplicity of the example, we are assuming a utilitarian government, but we can obtain the same results from a number of different specifications of government objectives. A predator government that takes a percentage of the total pie is also consistent with the payoff specification.

These payoffs reflect the following assumptions: 1) There is a need for reform (low payoff of status quo); 2) If feasible, a gradual reform is preferable to a radical reform due to its lower costs; and 3) A partial or truncated reform will favor one group and hurt the other.

The government has three choices at the initial node: proposing a gradual path (starting by reforming sector F), doing nothing, or proposing a big-bang. If the government makes a proposal, either group can either accept or reject it. The opposition of any group is enough to paralyze the government's proposal. If both groups accept a proposal, it is implemented (A); if either group rejects it (R), the status quo prevails.

Imagine for a moment that the government proposes F and that this is accepted by both groups. When T is proposed in the next period, group t will veto, since it prefers 3 over 2. Knowing that this path will lead to a payoff of -1, group f will veto the original proposal. Hence, gradual reform is not a subgame perfect equilibrium (A subgame perfect equilibrium requires rational choice by every decision making at every node). The government, understanding that a gradual reform is not feasible, will propose a radical reform, which will be accepted by both groups, constituting the unique perfect equilibrium to this game. Hence, even though gradualism is preferred to the radical reform outcome by everybody, it is not going to be proposed. Notice that if group t could commit to accepting the second stage proposal, everyone would be better off. In this sense, the problem is analogous to well known time consistency problems in games between the government and a unified general public.

For simplicity, we have ignored another possible strategy by the government: Starting reform T before reform F . This strategy could also be credible for certain payoff structures. That is, political considerations could lead to a reversal of the economically optimal reform path. The more general message we are trying to convey is that the introduction of political feasibility considerations may revert "technocratic" economic prescriptions. Of course, if the government had the power (and will) to change the rules of the game in order to make other outcomes feasible, that would be the recommended course of action.

In the next subsection we construct a simple example, to show that payoff structures as those assumed in Table 1, can be obtained from familiar general-equilibrium settings in which the existence of temporary distortions would call, on pure welfare theoretical grounds, for a gradualist path. The example

is not chosen by its realism but rather by its simplicity.

3.2 A general equilibrium example

Consider a two-sector economy in which each sector produces a distinct good, X (exports) or Y (importables), using one factor of production (L). The technology for producing exports is given by: $X = L_x^{1/2}$. We can think of the export industry as consisting of n firms using production function: $x_i = (l_{x_i}/n)^{1/2}$. Similarly, the technology for producing importables is given by: $Y = L_y^{1/2}$. Labor is supplied inelastically; the quantity of labor available in the economy is normalized to one. There are three different types of agents in this economy: Workers, who supply labor, owners of the export firms, and owners of the importable firms. Their (aggregate) income is given, respectively, by the total payroll, profits of the export industry, and profits of the importable industry. The exchange rate and the international prices of exports and importables are equal to one; agents in this economy only consume importables. Finally, in the initial situation, there is a tariff τ on imports and a subsidy s on exports. A fraction L_b of the labor force is employed in a bureaucracy. A certain number of bureaucrats is necessary to administer tariffs and subsidies.⁵ We will assume further that the initial level of bureaucratic employment is above the level required for such administration. Public deficit (superavit) results in lump-sum taxes (transfers) to the workers.

Profit-maximization under price-taking assumptions implies:

$$\begin{aligned} L_x &= \left(\frac{1+s}{2w} \right)^2 \\ L_y &= \left(\frac{1+\tau}{2w} \right)^2 \end{aligned} \tag{1}$$

The equilibrium condition in the labor market is:

$$L_x + L_y + L_b = 1 \tag{2}$$

⁵This captures the “cross-hauling” view that policy interventions that cancel each other in a distributive sense, imply extra losses due to Directly UnProductive activities (Magee et al. 1989).

From (1) and (2) we get:

$$w = \left[\frac{(1+s)^2 + (1+\tau)^2}{4(1-L_b)} \right]^{0.5} \quad (3)$$

From (1) we can also obtain the production of exports and importables:

$$\begin{aligned} X &= \left(\frac{1+s}{2w} \right) \\ Y &= \left(\frac{1+\tau}{2w} \right) \end{aligned} \quad (4)$$

Profits in the export and importable industries are, respectively,

$$\begin{aligned} \pi_x &= \frac{(1+s)^2}{4w} \\ \pi_y &= \frac{(1+\tau)^2}{4w} \end{aligned} \quad (5)$$

Since agents spend all their income in importable goods, real income of workers, exporters, and owners of the importable firms is, respectively,

$$\begin{aligned} I_l &= \frac{w}{1+\tau} - \frac{T}{1+\tau} \\ I_x &= \frac{(1+s)^2}{4(1+\tau)w} \\ I_y &= \frac{1+\tau}{4w} \end{aligned} \quad (6)$$

The term T represents lump-sum taxes to cover the fiscal deficit, and it is given by:

$$T = (s - \tau)X + wL_b \quad (7)$$

Equation (7) closes the model. It is implicit that exports equal imports. (Even though we will consider different periods, we will neglect intertemporal links, so that the trade balance will be in equilibrium at all times). It is straightforward (though tedious) to verify that:

$$I_l + I_x + I_y = X + Y$$

Let $I \equiv I_l + I_x + I_y$. This represents the total consumption of importables by the economy (and total production evaluated at international prices). Table 2 illustrates the real income or payoffs for the different agent types that obtain from different combinations of s , τ , and L_b .

Table 2.-

Payoffs per period under alternative (s, τ, L_b) scenarios

	O	Ia	Ib	IIa	IIb	IIc
s	0.2	0.2	0.2	0	0	0
τ	0.2	0.2	0	0.2	0	0
L_b	0.2	0.1	0.1	0.1	0	0.1
I_l	0.6325	0.6708	0.5952	0.7187	0.7071	0.6708
I_x	0.3162	0.3354	0.4373	0.2531	0.3536	0.3354
I_y	0.3162	0.3354	0.3037	0.3644	0.3536	0.3354
I	1.2649	1.3416	1.3362	1.3362	1.4143	1.3416

We want to show that there are circumstances in which a radical reform strategy will be pursued in lieu of a gradualist strategy, even if, due to some transitory distortion, it entails lower aggregate payoffs.

Suppose column O in table 2 represents the initial situation. Clearly, the *first-best* strategy would be to eliminate all distortions (that is, to set $s = \tau = L_b = 0$), leading the economy during period 1 to the position given by column IIb, where social welfare is maximized.

We introduce now the following institutional rules:

- (a) The government is the agenda-setter. During period 1, it can propose contemporaneous changes in τ and L_b and it can decide changes in s to be effective in period 2. During period 2, it can propose contemporaneous changes in τ and L_b . (Export subsidies are decided one period ahead, so that $s = 0.2$ during period 1; this is the distortion that introduces the second-best optimality of gradualism.)⁶
- (b) At least $L_b = 0.1$ is necessary to administer any tariff or subsidy.

⁶We choose this particular distortion for simplicity. As noted before, we are not interested in exploring the advantages of a gradualist stance in any specific case. Rather, we are interested in pointing out the political-economic difficulties of carrying out such a strategy even when it is desirable on some other grounds.

- (c) Each group of agents (workers, producers of importables, and exporters) has the power to block any policy initiative. In case of blockage, the resulting outcome is the status quo. (We could easily relax the veto power assumption and replace it with majority voting, and we would obtain the same results with appropriate assumptions.)⁷
- (d) The objective of the government is to maximize aggregate income.
- (e) There are no side payments.

Given that $s = 0.2$ is fixed during period 1, the *second-best* reform strategy consists of: (a) During period 1, lower L_b to 0.1, keep $\tau = 0.2$, and decide to eliminate subsidies during the next period. (b) When period 2 arrives, eliminate all remaining distortions. This strategy leads us from column O in period 0, to column Ia in period 1, to column IIb in period 2. We will call this strategy *gradualism*.

The problem with *gradualism* is the following. Suppose that everybody agrees with the prescribed decisions in period 1. When period 2 arrives, producers of importable goods and workers will not find it convenient to support a move towards free trade any longer: Vetoing any government proposal leads them to column IIa (tariffs-cum-bureaucratic employment), where they are better off than under column IIb (free trade). However, under column IIa exporters are worse off than in the initial situation. Anticipating that, exporters will not find it advantageous to support the prescribed decisions in period 1 in the first term. Gradualism is not credible because it is politically unsustainable.

Now consider the strategy of removing policy interventions as soon as it is possible. That is, in period 1 lower L_b to 0.1, reduce τ to zero (Ib), and decide to eliminate subsidies during the next period. In period 2, it only remains to disband the bureaucracy that served to pay subsidies during period 1. We will call this strategy *radical reform*. Even though it entails lower payoffs than *gradualism* during period 1 (in fact, it introduces a distortion by making tariffs to differ from export subsidies for a while), it is politically sustainable. Notice that vetoing the reform during period 2 would lead the economy to column IIc, where everybody is worse off than under IIb.

⁷Even though not necessary for our results, it is our view that policy-making at this frequency is (specially in Latin America) better modelled as the outcome of a (perhaps nested) pressure-group game, than as the outcome of a “western style” voting game.

While radical reform is credible (i.e., it constitutes a subgame perfect equilibrium), it is not the welfare maximizing credible strategy. The government could keep in period 1 a small but positive tariff to reduce distortions associated with remaining export subsidies. If the tariff is small enough, producers of importables will find it convenient to accept removing it, together with the burden of bureaucratic employment, in period 2. But in this way we get further and further following a second-best logic. We believe that, even if the strict case for radical reform fails, it ends up being the lesser evil among possible alternatives when considering the amount of resources that can end up being consumed in lobbying activity identifying sectors that should be the subject of “temporary” protection during the transition process.

4 Some evidence

Poland. Perhaps the best example of radical reform is the one undertaken by Poland under Deputy Prime Minister Leszek Balcerowicz. Poland’s strategy was to introduce economic liberalization, macroeconomic stabilization, and privatization as rapidly as possible. Substantial steps toward the first two objectives were given in a single package or “big bang” on January 1, 1990. Crucial decisions with respect to free trade, market pricing, end of state orders and central planning, key aspects of commercial law, large cuts in budget subsidies, higher tax collections, wage controls, and a sharp devaluation of the currency, occurred in the space of a few weeks at the end of 1989 and beginning of 1990 (Sachs 1992). A privatization law was put in place in June 1990. Since then, privatization has gone slowly in the case of the largest firms, but small and medium-sized businesses have been privatized with great success. Sachs (1992) characterizes the first two years as an end to inflation and shortages, a slight decline in average consumption, an increase in the quality and variety of goods available, and a sharp increase in the unemployment rate (though he attributes the rise in unemployment at least partially to the breakdown of trade relations with the Soviet Union). Not surprisingly, given his role as advisor to the Polish government during 1990-1991, Sachs suggests that the consistency and boldness of the reforms may have eased the “valley of tears” unavoidable after a profound economic transformation. What is surprising is that an overwhelming proportion of the population supported the government in spite of the painful first months

(Przeworski 1991, p.165, offers some evidence in this regard). It seems clear that a more paused stance would have hardly mustered as much political support as the radical program did, at least during the launching of the program.

Bolivia. Another clear example of radical reform was the Bolivian package of August 1985. The stabilization program, destined to stop a skyrocketing hyperinflation, relied on exchange-rate unification, supported domestically by tight monetary and fiscal policies and externally by a significant debt alleviation. The program included or was followed by an abrupt liberalization of credit and goods markets and deregulation of the labor market. Most price controls and other intervention were dismantled and significant layoffs occurred in the public sector, particularly in the state mining enterprises (Morales 1991). The reforms were undertaken during the Paz-Estensoro government. While the labor movement had been effective in vetoing previous reform plans, it was unsuccessful in organizing opposition to the Paz-Estensoro reforms. The government obtained the support of the two main political parties, which facilitated the approval of the program by Congress.

Peru. On August 8, 1990, ten days after its inauguration, the newly elected President Fujimori departed from his campaign promises by producing a shock-treatment stabilization package, while announcing his intention to launch major economic reforms. Main components of the *paquetazo* were huge increases in prices of publicly provided goods and services and other measures destined to put an end to the fiscal origin of hyperinflationary monetary emission. During the following months, and particularly during March of 1991, rapid and extensive liberalization of foreign trade and the capital account, and reduction of public sector employment, were undertaken. Paredes (1991) argues that the simultaneous introduction of these reforms probably increased the short-term costs of the program in relation to a well-designed (i.e., piecemeal) stabilization program. He is particularly critical of the fact that tax reform, needed to insure fiscal stability, was not completed before the opening of foreign trade. (Another example of the difficulties associated with the adoption of far-reaching reforms before stabilization is secure, were the difficulties of exporters and producers of importable goods in the face of an overvalued currency.)

Fujimori's popularity declined immediately after he embraced a bitter-pill strategy, and has fluctuated ever since, following economic as well as political developments. However, the orientation of his economic program has

remained widely accepted, as attested by the popular confidence, according to survey data, on Juan Carlos Hurtado (the minister of the economy who directed the paquetazo) and his successor, Carlos Boloña (See Przeworski 1991, p.165, for survey data on the popular confidence on the minister of the economy after the shock).

Argentina. Contrary to the case under Alfonsín, Argentina under Menem is a case of orthodox and synoptic path of economic liberalization (Armijo 1992). Stabilization was undertaken in March 1991 with the Convertibility Plan. An ambitious fiscal reform, including a significant reduction of public employment, allowed the government to double its real revenues from 1989 to 1991. On the trade front, the average tariff was reduced from 28% in 1985-87 to 15% in 1991-92. In the same period, the maximum import tariff fell from 55% to 22%, and the coverage of non-tariff barriers went from 32% to 8%. Deregulation was also pervasive: In 1991, one single piece of legislation (the possibly unconstitutional "Deregulation Act") cleaned out an entire range of limitations to free-market activities, such as regulations of professional activities, of transportation and telecommunications, of retail hours (stores used to be forbidden from operating on Sundays and Saturday afternoons), etc. But perhaps the most impressive record of the government is on the privatization issue. From 1992 on, privatization has proceeded at breakneck speed (Dornbusch 1992). Without much regard for price, the government has sold airlines, steel companies, part of the state petroleum exploitations, refineries, public services such as phone, water and electricity distribution in major cities and even military production facilities. The list for 1993 includes major savings institutions and other entities.

Some of the costs of such a speedy process have been related to "learning by privatizing" (or, rather, the lack of it). The privatization of public utilities was implemented even before the development of an adequate regulatory framework. Another major cost of simultaneous reforms is the current account deficit induced by an overvalued currency (fixed nominal exchange rate and positive, though very low by Argentine standards, inflation). In spite of all these difficulties (plus a few corruption and personal scandals) the Menem administration seems to be doing quite well in terms of popularity. In particular, the Finance Minister Domingo Cavallo (clear leader of the technocratic team) seems to have such a strong image that he is rumored to be a possible presidential candidate for the next election.

5 Conclusions

An understanding of the conditions under which political considerations induce biases toward radical reform is essential in order to evaluate recent experiences in Latin America and in terms of the design of new reform programs.

From a positive point of view, we want to explain why Latin American countries that failed when implementing gradualist programs in the early 80's, have been relatively successful in later undertaking more comprehensive attempts at reform. This is somewhat surprising given the increased economic and administrative costs of such attempts in relation to more paused, "orthodox" reform processes. A key element seems to have been the building of political support through a wider scope of the reform process. Thus, reform has been usually accompanied by political realignment. Since no sector of society wants to be first in renouncing to its apportionment of special privileges, reformist governments felt necessary to cut through the "Gordian knot" of government -created rents. By providing an explanation for this behavior, we will make progress in answering the more general question of why political leaders in some countries have been able (and willing) to win popular support for market-based policies whereas interventionist programs still prevail in other countries. As noticed by Robert Bates (1990), investigating a question like this will lead us closer to the Smithian root of development studies: The political introduction of markets.

From a normative point of view, our main insight is that even in circumstances in which economic reasoning indicates that reforms should be made sequentially, political considerations can make them "complementary". In implementing reform programs, policymakers should be aware of these considerations. This result stands in contrast to Rodrik's (1989) recommendation of undertaking deep reforms with a narrow scope. On the other hand, we agree with Roger Douglas's (1990) reflections on the principles of politically successful structural reform, inspired by his experience as New Zealand's Finance Minister: "Large packages provide the flexibility to ensure that losses suffered by any one group are offset by gains by the same group in other areas [...] It is uncertainty, not speed, that endangers structural reform programs." With respect to the role of international agencies promoting the use of markets in developing countries, it is our contention that these agencies should carefully assess political restrictions when assisting countries under-

taking liberalization processes. More optimistically, these institutions might play a role as commitment devices to permit the implementation of reforms with lower transition costs.⁸

Where do we go from here? Our model portrays the case of a country in a political deadlock over specific reform proposals that hurt strongly organized interests. Our prediction is that, in such cases, under relatively “democratic” conditions, only far reaching reforms accompanied by major political realignments have hope of success. Wei (1992) constructs a case (with ex-ante uncertainty and majority voting) where a gradualist approach is politically more sustainable. Clearly, we need a more general model in order to identify the conditions under which different sequencing strategies are optimal in a politico-economic sense; and we need to carefully study several reform experiences to fill in the cells of such a general case.

References

- [1] Armijo, Leslie (1992), “Sequences of Economic and Political Liberalization,” USC, mimeo.
- [2] Bates, Robert (1990), “Macropolitical Economy in the Field of Development,” in J. Alt and K. Shepsle, **Perspectives on Political Economy**, Cambridge University Press.
- [3] Buchanan, James (1991), “Achieving Economic Reform,” chapter 9 in J. Buchanan, **The Economics and the Ethics of Constitutional Order**. Michigan.
- [4] Calvo, Guillermo (1989), “Incredible Reforms,” in G. Calvo et al., eds., **Debt, Stabilization and Development: Essays in Memory of Carlos Diaz Alejandro**, Basil Blackwell.

⁸Sebastian Edwards suggested to us that the prospective approbation of NAFTA might have played the role of a commitment device in the case of Mexico, allowing the government more flexibility in choosing the pace of reform. Interestingly, as pointed to us by Michael Wallerstein, NAFTA was supposed to go through the U.S. Congress following the fast track to avoid the interplay of different interest groups, much in the same way reformist governments have rushed their programs through their legislatures.

- [5] Corbo, Vittorio, and Jaime de Melo, eds., (1985), "Liberalization with Stabilization in the Southern Cone of Latin America," **World Development**, August.
- [6] Corbo, Vittorio, and Stanley Fischer (1990), "Adjustment Programs and Bank Support: Rationale and Main Results," The World Bank, mimeo. August.
- [7] Dewatripont, M. and G. Roland (1992), "Economic Reform and Dynamic Political Constraints," **Review of Economic Studies**, 59, 703-730.
- [8] Diaz Alejandro, Carlos (1985), "Good Bye Financial Repression, Hello Financial Crash," **Journal of Development Economics**, 19, 1-24.
- [9] Dornbusch, Rudiger (1992), "Progress Report on Argentina," Working Paper. December.
- [10] Douglas, Roger (1990), "The Politics of Successful Structural Reform," **The Wall Street Journal**, January 17.
- [11] Edwards, Sebastian and Alejandra Cox-Edwards (1987), **Monetarism and Liberalization: The Chilean Experiment**, Ballinger Publishing Co.
- [12] Edwards, Sebastian (1992), "Sequencing and Welfare: Labor Markets and Agriculture," NBER WP No. 4095.
- [13] Edwards, Sebastian and Sweder van Wijnbergen (1986), "Welfare Effects of Trade and Capital Market Liberalization: Consequences of Different Sequencing Scenarios," **International Economic Review**, February.
- [14] Krueger, Anne (1992), **Economic Policy Reform in Developing Countries**, Blackwell.
- [15] Lal, Deepak (1987), "The Political Economy of Economic Liberalization," **The World Bank Economic Review**, January, 273-299.
- [16] Magee, Stephen, William Brock and Leslie Young (1989), **Black Hole Tariffs and Endogenous Policy Theory**. Cambridge.

- [17] McKinnon, Ronald (1991), **The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy**, Johns Hopkins.
- [18] Morales, Juan Antonio (1991), "The Transition from Stabilization to Sustained Growth in Bolivia," in M. Bruno, S Fischer, E. Helpman and N. Liviatan with L. Meridor, eds., **Lessons of Economic Stabilization and Its Aftermath**, MIT.
- [19] Paredes, Carlos (1991), "Epilogue: In the Aftermath of Hyperinflation," in C. Paredes and J. Sachs, eds., **Peru's Path to Recovery: A Plan for Economic Stabilization and Growth**, Brookings.
- [20] Przeworski, Adam (1991), **Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America**, Cambridge University Press.
- [21] Rodrik, Dani (1989), "Credibility of Trade Reform: A Policymaker's Guide," **The World Economy**, 12, 1-16.
- [22] Rodrik, Dani (1989a), "Promises, Promises: Credible Policy Reform via Signaling," **The Economic Journal**, 99, 756-772.
- [23] Rodrik, Dani (1992), "The Limits of Trade Policy Reform in Developing Countries," **The Journal of Economic Perspectives**, Winter, 87-105.
- [24] Rodrik, Dani (1992b), "The Rush to Free Trade in the Developing World: Why so Late? Why Now? Will it Last? NBER Working Paper 3947.
- [25] Romer, T and H. Rosenthal (1979), "Bureaucrats versus Voters: On the Political Economy of Resource Allocation by Direct Democracy," **Quarterly Journal of Economics**, 93, 563-587.
- [26] Sachs, Jeffrey (1992), "The Economic Transformation of Eastern Europe: The Case of Poland," **The American Economist**, 36, 2, 3-11.
- [27] van Wijnbergen, Sweder (1992), "Intertemporal Speculation, Shortages and the Political Economy of Price Reforms," **The Economic Journal**, 102, 1395-1406.

[28] Wei, Shang-Jin (1992), "Gradualism versus Big Bang: Speed and Sustainability of Reforms," Mimeo, Harvard University, December.

FIGURE 1

payoffs: (Gov, Group f, Group t)

