Where Are We in the Political Economy of Reform?*

Mariano Tommasi
UCLA and
Harvard/MIT RTG in Positive Political Economy

Andrés Velasco
NYU, NBER and
Harvard/MIT RTG in Positive Political Economy

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Department of Economics
University of California, Los Angeles
Bunche 2263
Los Angeles, CA 90095-1477
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Abstract

We review the experiences of developing countries with market-oriented reforms, using the tools of modern political economy. We impose intellectual discipline by requiring that actors behave rationally using available information and that basic economic relationships such as budget constraints be accounted for. We attempt to integrate two approaches, one based on dynamic games played by interest groups, with one that focus on limited information and the dynamics of learning.

We describe the "starting point" as the set of "old" policies and we attempt to explain the dynamics (political, economic and informational) that lead to reform (section II). We analyze strategies for reformers subject to political constraints (section III). We evaluate the aggregate and distributional costs of reforms, emphasizing the importance of looking at the right counterfactuals (section IV).

We conclude by pointing to the challenges ahead: the *second-stage* institutional reforms necessary to take off from underdevelopment.

I. Introduction

A Fable

Once upon a time, in a farming country far away, producers watched in awe as world prices for their commodities plummeted in the midst of serious international turmoil. In the decade that followed, the farmers witnessed with increasing dismay the collapse of foreign financial institutions, an ensuing depression in their main export markets, growing protectionism abroad, and finally a world war. It was not a good decade for the pursuit of the export-led growth strategy that the country had followed until then. Authorities in the small faraway country reacted with surprising alacrity, first abandoning the peculiar gold-based exchange arrangement the rich countries of the north had earlier persuaded them to adopt, and then reacting to foreign protectionism with tariffs, quotas and licenses of their own. At first such measures proved spectacularly successful. Domestic industry developed, foreign exchange availability became less of a constraint, and the local economy grew more quickly than the economies of wealthy foreign powers caught up in interminable wars, both hot and cold. Politically, the little country also did well: growing industrialization gave rise to a middle class that increasingly raised its voice in the local debates. While short of a perfect democracy, the little country became more liberal, tolerant, and less hierarchical than it had ever been before.

But the citizens of the small faraway land were not to live happily forever after. With the passage of time, domestic industry began to show its weaknesses. Sheltered from external competition, its products did not make the locals proud. The shoddy and expensive goods were not attractive to foreign buyers either; as imports grew and exports stagnated, foreign exchange scarcity reasserted itself. Other troubles were also evident. Because imported machines were cheap (they enjoyed low tariffs) and local labor increasingly expensive (unions were gaining strength), companies chose capital-intensive technologies which left growing numbers of workers in the pool of the unemployed. The problem was exacerbated by the stagnation of agriculture, which labored under the weight of manifold taxes, both explicit and implicit.

Peasants migrated to the cities in search of work they did not found, quickly overwhelming the fragile urban infrastructure the small country had just begun to build.

The government once again reacted quickly, this time with a second round of strictures and controls. Import procedures were tightened, price controls imposed, and bureaucratic procedures proliferated. But this only made matters worse. The controls were an invitation to evasion, and the local citizenry became internationally famous for its ingenuity in over-invoicing imports and under-declaring taxable income. The powerful industrial conglomerates that had grown up in the previous two decades began devoting more energy to securing favors from the government than to improving the quality of their products. Local politics suffered, becoming increasingly fraught with factionalism, rent-seeking and even corruption.

Matters were complicated by the ongoing changes abroad. As world conflicts became increasingly of the cold variety, international trade grew phenomenally. Local citizens increasingly felt that they could ignore trade only at their own peril, but failed in their attempts to join in. Again and again, import surges that could not be matched by the corresponding export expansion were the cause of balance of payments crises. Large devaluations, inflation and fiscal disorder became increasingly common, with the government having to borrow large sums abroad to make ends meet. Sporadic attempts at closing the fiscal deficit or lowering protection foundered, blocked by powerful interests operating in an environment of political deadlock.

The straw that broke the *burro*'s back came in the early 1980s, when foreign creditors, alarmed by the debt moratorium declared by one neighboring country and the needless war started by another, completely cut off lending. With no more credit to close the fiscal gap, the government had to turn wholeheartedly to the printing press. Attempts at closing the trade deficit by devaluation and aggregate demand contraction led to firm bankruptcies and bank collapses. This, in turn, only meant more work for those running the *peso* printing press. As the country was hit by hyper-inflation, local production became paralyzed. Unsurprisingly, politics also deteriorated sharply, with talk of a possible *coup d'etat* and impending violence becoming quite

common. Many felt this was the end of the road for our beloved little country.

But there was still one chance left. Presidential elections were to be held at the end of the year. An obscure politician with a left-of-center background was able to put together a ramshackle coalition, eking out a close victory against better known opponents. On the day of his inauguration, he surprised everyone (frankly, his campaign platform had not been too explicit) by announcing a drastic plan of deregulation, trade liberalization, and fiscal reform. At first, his only obvious allies were a band of young technocrats fresh from graduate study abroad. Pundits, mindful of the interests of powerful industrialists, state enterprise managers and unions, did not give his plan much of a chance. But public opinion polls said otherwise; especially after fixing the exchange rate and causing inflation to vanish, the new president became immensely popular. Private industrialists began backing liberalization as a way to curtail the power of the unions and the state. Union leaders reluctantly went along, realizing that the alternative (ongoing inflation and mass layoffs) was even worse. Within a year, the country seemed to have been reborn.

Yet that was not the end of history --at least not yet. As we spin out the end of this tale, the president's honeymoon appears to be ending. The macroeconomy is stable, but still vulnerable to the wave of financial distress now engulfing another reforming country in the neighborhood --especially so since the local currency is deemed grossly overvalued by experts. The easy initial phase of reform may also be over. Stopping inflation was easy compared to the impending task of reforming the country's regulatory, judicial, health and educational bureaucracies. Such reforms will hurt entrenched interests that have not yet been affected. To win that fight, the president will need a substantial congressional majority and a resounding public mandate. Parliamentary elections are scheduled at the end of the year, and the government is running neck-to-neck against a newly coalescing alliance opposed to reform. The opposition gets the bulk of its support from the ranks of the unemployed, victims of state restructuring. Polls are rife with reports of "reform fatigue" and a yearning for the better days of the *ancien regime*.

Will our reforming heroes prevail? Will this rivetting tale come to a happy ending?

The Issues

If this fable is reminiscent of the real world, we offer no apologies. We do apologize, however, to readers who hail from lands where the *burro* is not the main means of transportation, for our stylized account is unduly influenced by events in Latin America. But the point is not to offer a comprehensive or representative account of this statism-and-then-liberalization sequence (nor to remind the reader of a story that is surely well known) but simply to fix ideas on some features --common to most developing countries and to some formerly socialist ones as well-- that require a political economist's attention. A very partial list includes:

- If the *ancien regime* was quickly deteriorating due to excessive rent-seeking, why did groups persevere in such short-sighted behavior? In particular, why did clearly harmful stop-go macro cycles happen so often? More generally, what are helpful frameworks for thinking about the relevant political-economic equilibrium?
- The fable (along with most popular accounts) singles out an exogenous shock and the associated economic crisis as having triggered reform. Is this a sensible account? Even under crisis conditions, why did entrenched interest groups which had opposed reform for decades suddenly go along?
- One might have expected authoritarian right-wing governments would be the ones to carry out market-friendly reforms. Yet our reforming president is described as the left-of-center leader of a ramshackle coalition. If this is a fact (however stylized), how do we explain it?
- Why did the new president go in for the big bang approach to reform? Even if economic theory suggests that all distortions be eliminated as quickly as possible, caution and political constraints may argue otherwise. To the extent that quick and simultaneous application of reforms is common (and we argue below it is), it needs to be explained.
- Who was hurt by the process, and what does this say about the political sustainability of the reforms? Many accounts (our fable included) stress the immense short run costs of the

process. Reform fatigue[1] and other similar syndromes get top billing. Nonetheless (we argue below) once launched, reforms almost always are retained (though perhaps the pace of change may be slowed-down). How do we explain this?

- What is next for reformers? Are there reforms still ahead that are highly complementary with the early ones? If so, what is the political economy of that process?

It is on such issues this paper focuses, providing both a survey of the literature and a good deal of unsubstantiated speculation. Throughout we endeavor to use the tools of modern political economy, attempting to impose intellectual discipline on our speculation by requiring that actors behave rationally using available information, and that basic economic relationships such as budget constraints be accounted for. We also endeavor to go beyond a summary of existing abstract arguments, and try to extract the relevant practical implications at each point along the road. In doing so, we permit ourselves doses of guesswork about which (we hope) readers will prove forgiving.

Two caveats are in order. The first has to with the definition of reform. We have in mind the usual things: macroeconomic stabilization, trade liberalization, privatization, de-regulation and so on. To avoid definitional quarrels we simply point to the list supplied by John Williamson's (1994) account of the "Washington Consensus," summarized here as Table 1.

The other caveat has to do with coverage. The list of topics we neglect is too large even to mention. Some omissions --little attention to external factors, even less to political institutions-- may be regarded as particularly egregious by some. Our survey of the huge recent literature on the political economy of reform is also spotty and rather idiosyncratic. Interested readers could do worse than glance at the volumes edited by Ranis and Mahmood (1992), Bates and Krueger (1993), Haggard and Webb (1993), Taylor (1993), Bradford (1994), Nelson (1994a), Williamson (1994) and Sturzenegger and Tommasi (forthcoming), and the individual

[1]The term is due to Bruno (1993).

contributions by Krueger (1992), Harberger (1993b), Edwards (1994), Graham (1994), Rodrik (1994b), Naím (1994), Nelson (1994b), Hausmann (1994), and Sachs (in Williamson, 1994). There are also many fascinating country studies, some of which we allude to in the text.

II. The Rocky Road to Reform[2]

Tackling the political economy of reform begs the question of what the political economic equilibrium was like *before* reform. In turn, a reform can be thought of as a change in that equilibrium. This section surveys some ideas on such heady matters.

The Dynamics of Deterioration

Carlos Díaz-Alejandro, no fan of state-led development, wrote about the early days of inward-looking policies in Latin America:

> The 1940s ... witnessed the golden age of import-substituting industrialization in Latin America. Particularly during 1945-52 the economic performance of Latin America outshone not only that of Africa and Asia, but also that of Europe and Japan. The acceleration of industrialization and urbanization started in the early 1930s and continued through the 1940s into the early 1950s. An increasingly confident public sector also continued trends during the 1940s that had started during the preceding decade.[3]

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[2]With apologies to Lance Taylor, the title of whose (1993) volume we could not resist stealing for the title of this section.

[3]"Latin America in the 1940s," in Díaz-Alejandro (1988).

And he added: "...any observer looking around the world during those years could find few areas where the future looked more promising, both economically and politically, that in Latin America." By the 1980s that future had arrived. Not only was country after country suffering from inflation, real income stagnation and chronic balance of payments problems; the state itself, weak, captured by interest groups, often corrupt, and incapable of delivering the most basic of services, was at the core of the problem.

While the cycle of initial-success-followed-by-disaster seems particularly clear for Latin America, similar ups and then downs characterized the flirtation with state-led development in places as diverse as Southern Europe, sub-Saharan Africa and South Asia (particularly India). This is certainly not the place to revisit the well-known accounts of economic failure caused by illiberal policies. The more interesting (and largely neglected) question is why politics became so deadlocked and ineffectual that the useful policies of the 1930s were not updated as circumstances in the world economy changed in the 1960s and afterwards. Similarly, one hopes for an account of how Díaz-Alejandro's "confident public sector" of the 1940s became the weak and sometimes corrupt entity of the 1970s and 1980s.

The academic literature has provided some (but not many) comprehensive accounts of the relevant dynamics of deterioration. Perhaps best known is the one by Krueger, nicely summarized in her (1993) *A.E.R* survey. Hers is a story of "vicious cycles": given economic policies (such as import protection) lead to some economic outcomes (local industrialists make fat profits) which in turn alters the political equilibrium (the import-competing sector gains influence to the detriment of agricultural exporters) which finally causes the strengthening of the initial policies (protection is enhanced). The reliance on planning and controls leads to an analogous vicious cycle: a set of controls which sharply distorts a market creates incentives for people to evade it; evasion gets worse, which leads the government to enact even more stringent controls, and so on. The global outcome is clear: over time distortions and inefficiencies rise while national welfare (however defined) declines.

Such "Krueger dynamics" are reminiscent of the evolution of interest-group conflict in advanced industrial societies described by Mancur Olson (1982). Both accounts predict that interest groups and distributive coalitions become powerful over time (in Olson, predictably, the emphasis is on the time that it takes to solve collective action problems). Since these groups fail to internalize the dead-weight losses created by their rent-seeking, eventually "social rigidities" and "stagflation" (in Olson's terminology) set in.

But while these are compelling characterization of the dynamics of deterioration in different societies, the rationality of individual and group behavior in these situations remains to be established. The basic puzzle is this: if under "Krueger dynamics" the deterioration was propelled by the rent-seeking actions of powerful groups, and these groups could see that they themselves could eventually be made worse off, why did they persevere in such behavior? Maybe from the vantage point of the 1940s the net present value of payoffs under that rent-seeking strategy was positive, but was this also the case form the vantage point of the 1970s or 1980s? As Rodrik (1994b) points out, in Krueger's account the undesirable consequences of their actions are simply unanticipated by rent-seekers and other groups. The same is true of many standard accounts of unsustainable populist policies.[4]

This is an important point, for it is not farfetched to conjecture that in some situations almost everyone (including many of the powerful rent-seekers) ended up worse off than they would have been in some plausible cooperative counterfactual. In the midst of the some of the Latin American hyper-inflations, even the recipients of large state subsidies would have been well served by the end of both the subsidies and the inflation; similarly, the proliferation of import-substituting measures in places like India had an ambiguous effect on the effective protection enjoyed by some sectors, which could well have been almost as sheltered and suffered less excess burden under free trade. In short, the existence of an inefficient equilibrium has to be

[4]For a sample, see the papers in Dornbusch and Edwards (1991) and Ranis and Mahmood (1992).

explained, hopefully without simply assuming myopia on the part of groups. And this explanation must ideally be a dynamic one, in that changes in groups' behavior and welfare over time are accounted for.

Some recent papers in the literature provide a more formal and detailed account of this point. In this class of papers, the political economy of a stylized country has the following ingredients: there are powerful pressure groups (sectoral interests such as urban industries, trade unions, agricultural producers, public employees, etc), all of which can influence public policies (subsidies, tariffs, etc.) that redistribute income toward them[5]; groups interact strategically because they share a common resource constraint (either the government budget or the economy's aggregate resource balance); finally, there are dead-weight losses associated with the redistributive policies. The game among the pressure groups typically has the feature that each sets a policy (demands a net government subsidy, for instance), taking all other groups' demands as given. In an essentially static setting, such as that studied by Aizenman (1993), Velasco (1994) and Tornell (1995), it is not hard to see how this can lead to a Pareto-inefficient Nash equilibrium: each group would be better off if all reduced their demands, but unilaterally demanding a small subsidy is not rational for each individual player. These papers share the same logical structure with the theoretical literature that has emerged to explain chronic fiscal profligacy within industrialized countries: for instance, Weingast, Shepsle and Johnsen (1981) and, more recently, Cole and Chari (1993) have characterized equilibria in which voting by congressmen who represent different districts or constituencies leads to "pork barrel" spending and inefficiently large budgets. This literature is surveyed by Alesina and Perotti (1994).[6]

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[5]Collective action problems within groups are typically ignored.

[6]These models differ on whether groups are symmetric or not. Papers that aim to explain fiscal profligacy in developed countries typically assume that the whole society is organized in groups of comparable size and influence. At the other end of the spectrum, Tornell (1995), who studies Mexico, assumes that there are two organized and powerful groups that interact strategically, and a large mass of powerless taxpayers. Aizenman and Yi (1994) also present an asymmetric model, which focuses on China The model in Velasco (1994), motivated by the Chilean experience, is somewhere in between: some groups have access to redistributive policies

A few papers also provide explicit dynamics. Such models focus on macroeconomic variables, for it is there that the destabilizing effects of misguided policies is clearest.[7] A particularly stark example arises when sustained fiscal deficits cause debt to accumulate, which in turn increases debt service costs and tends to inflate future deficits.[8] In a highly influential contribution, Alesina and Drazen (1991) argue that debt is allowed to accumulate because warring fiscal groups do not want to shoulder the cost of fiscal adjustment; a "war of attrition" occurs, with each group waiting for the others to concede and accept to bear the burden. As a result, a necessary fiscal stabilization can be delayed.

In Alesina and Drazen (1991) the delay is endogenous, but the existence of the initial fiscal deficit is not.[9] Recent work by Velasco (1993 and 1995) and by Mondino, Sturzenegger and Tommasi (1993) develops simple dynamic models that can explain such deficit- and inflation-prone fiscal policies. In Velasco (1993 and 1995), fiscal policy is modelled as the outcome of a political process in which spending power is in the hands of several controllers who represent different interest groups and behave non-cooperatively. The key is that the benefits of spending are group-specific, while the costs (in particular, debt service) are borne by all jointly.

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and some do not, but the latter can gain access over time.

[7]Rodrik (1994b) has stressed this point: "Consider for example two trade-related policies: import restrictions (e.g. import quotas) and overvalued exchange rates. These two have rather different implications for economic stability and long-run performance. The effect of import restrictions is to repress trade (imports as well as exports in the longer run). While this is costly insofar as it engenders some resource misallocation, it does not inherently generate economic instability, nor does it necessarily reduce long-term growth. Overvalued exchange rates are different. By definition, they result in trade deficits that are **unsustainably** large, and therefore in balance of payments crises...Consequently, exchange rate misalingments are closely associated with economic instability and with the deterioration of economic performance over the medium-to-long-run.

[8]Notice that static models of the kind described above can explain the size of the budget, but not the decision to borrow nor the evolution of debt over time.

[9]The result also hinges on the unattractive assumption that groups do not know how much the current inefficient policies (say, inflation) hurt the other group.

In this decentralized system, the benefit from public savings, as perceived by each group, is not the rate of interest, but the rate of interest minus what other groups spend. As a result, incentives are distorted, each group overspends, and debt accumulates over time.

Mondino, Sturzenegger and Tommasi (1993) also analyze the dynamics of inflation that arise from fiscal deficits that are caused by the non-cooperative behavior of interest groups. In their case, the "state" variable is the degree of financial adaptation, which is a proxy for the share of their wealth agents hold in foreign currency or in the underground economy and hence beyond the reach of the taxman. As financial adaptation becomes widespread, the costs of financing a given budget deficit rise. In this context, there can be fully rational cycles of increasing inflation and financial adaptation, followed by stabilization and remonetization; under some conditions, such cycles can display increasing amplitude over time. Labán and Sturzenegger (1994) investigate the (realistic) case where the access to financial adaptation is asymmetric; in particular the rich have better financial alternatives. They show that delayed stabilization à la Alesina-Drazen can occur, with the poor giving in when the cost of inflation becomes unbearable.

Zarazaga (1993) is another attempt to explain inflation cycles in countries like Argentina and Brazil. He argues that the "low"-inflation stages represent a Nash equilibrium across competing seignorage units (local governments); and that the bouts of hyperinflation are the equivalent of price wars in models of oligopolistic collusion with imperfect monitoring. The simulations of his model are able to replicate inflation patterns within the ranges observed in some "megainflationary" experiences.

Finally, Perotti (1992) presents a model with three classes (rich, middle class and poor), where the rich are the only that can move their wealth abroad, and the poor have no wealth at all. He shows that an alliance of the rich and poor against the middle class may cause adjustment to a terms of trade shock to be postponed in an unsustainable way. When the day of reckoning arrives, only the middle class is left behind to pay the bill.

Another way of accounting for "rational" deterioration focuses on limited information and the dynamics of learning. According to this view, the key thing about which people have limited information is the way in which alternative policies map into **aggregate** economic performance. In Latin America and much of the developing world, there have been roughly two models of the world: one in which extensive state intervention is the best policy, and one in which focused (and minimal) state intervention is the best policy. The former world view tended to lead to inward-looking polices, while the latter often involved an outward orientation. However discredited the former model may be today, it was once (and not long ago) embraced by Western experts and even the multilateral financial institutions. It is important to remember that even among professional economists there wasn't always (not even today) a full consensus on which is the best set of policies. If highly trained intelligent people who spend their lives thinking about these problems often disagree, imagine what the situation is like for the average citizen, who only gets sparse (and often biased) information from the mass media, after-dinner conversations and political rallies.[10]

The informational view, without denying the existence of an underlying game among interest groups, stresses that, at any point in time, the vector of economic policies is also the result of how much Bayesian learning has taken place about the "correct" model of the world.[11] In this view, the dynamics of deterioration evolve in the following way. At first the world changes --trade grows, technology becomes more important-- in such a way that the older model

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[10]For instance, Bruno (1993, Chapter 4) provides a wonderful account of the evolution of the views on exchange-rate-based stabilization of Israeli academics, politicians and the public. Bruno makes the perceptive point that economists' dissent about "details" can lead to the political system failing to implement even the obvious measures.

[11]This idea is laid out by Harberger (1993b) and formalized, in part, by Perktold and Tommasi (1994). Colander and Coats (1989) contains some useful suggestions on how to think about the transmission of economic ideas. Our view owes a great deal to work in (rational choice) political science, by Gilligan, Krehbiel, Lupia, McCubbins and others. Accessible references are Krehbiel (1991), Matsusaka (1995) and Lupia and McCubbins (1995). See also North (1994).

of development becomes less and less adequate. Perceptions about the world also change, but very sluggishly, as the world evolves: people only observe economic outcomes, and cannot readily ascertain whether bad outcomes result from bad policies or simply from adverse random shocks. Learning can only take place over time as a process of gradual updating of beliefs. Finally, even when ideas about what represents good economic policy evolve in the direction of less government intervention and more market-friendly approaches, two key obstacles remain to be overcome. First, those advocating these new ideas must be able credibly to convey them to the population (which could conceivably simply interpret them as a scheme to favor the rich or a particular section of the population). Second, market advocates must overcome the formidable opposition of those groups that actually benefit (at least temporarily) from the status quo. As a result, "bad" policies can rationally remain in place for long periods of time, allowing for a gradual but nonetheless painful deterioration of economic performance. Exactly how and when this process comes to an end by means of a reform is the subject to which we now turn.

Do Crises Cause Reform?

That economic crises seem either to facilitate or outright cause economic reforms is part of the new conventional wisdom on reform.[12] But while everybody talks about the role of crises, few authors are specific about what exactly is a crises, and what is the mechanism by which a crisis is supposed to bring about reform.

Let us see what some prominent analysts mean by pre-reform crisis. Bresser Pereira argues that "[w]hen populist leaders in Argentina, Bolivia, Venezuela, Peru and Brazil adopted non-populist policies it was because the crisis in these countries was so deep that even the costs of sticking to populist policies became higher than the costs of adjustment" (1993, p. 57).

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[12]Williamson (1994) asked his contributors to consider the "crisis hypothesis" --that public perception of crisis is needed to create the conditions under which it is politically possible to undertake extensive policy reform-- in their case studies.

According to Bates and Krueger "...[i]n all cases, of course, reforms have been undertaken in circumstances in which economic conditions were deteriorating. There is no recorded instance of the beginning of a reform program at a time when economic growth was satisfactory and when the price level and balance of payments situations were stable. Conditions of economic stagnation (and the recognition that it is likely to continue) or continued deterioration are evidently prerequisites for reform efforts" (1993, p. 454). Guillermo de la Dehesa writes "...only when the level of reserves was sufficiently low and/or the current account was in large deficit have necessary economic adjustment and structural reform measures been taken" (1994, p. 137). Explaining why Australia undertook fewer reforms than New Zealand, Max Corden writes "[t]he reforms have been less dramatic than New Zealand's because things never got so bad: inflation did not rise so high ..." (in Williamson, 1994, p. 112).

All of the statements clearly illustrate one notion: things have to get very bad before they get better. This notion is appealing and intuitive, but it is not without problems. Rodrik (1994b) provides the most cogent criticisms. First, there is an element of tautology in the explanation: "Reform naturally becomes an issue only when policies are perceived to be not working. A crisis is just an extreme case of policy failure. That reform should follow crisis, then, is no more surprising than smoke following fire." Second, "...the hypothesis is virtually non-falsifiable: if an economy in crisis has not yet reformed, the frequently proffered explanation is that the crisis has not yet become 'severe enough'."

To make sense of the crisis hypothesis it is necessary to be clear about the mechanisms that link crisis and reform. The game-theoretic models surveyed in the previous section offer some concrete examples of how the politico-economic equilibrium changes to permit reform, and of what role crises can play in this context. In all these models, agents (groups) decide what to do by comparing expected streams of payoffs. Typically, the (flow) payoff associated with "non-reform" is expected to deteriorate. This deterioration can come about because of exogenous (terms of trade and other) shocks as in Velasco (1994) and Tornell (1995) or because of the endogenous evolution of state variables --financial adaptation in Labán and Sturzenegger (1992

and 1994)) and Mondino, Sturzenegger and Tommasi (1993), or government debt in Alesina and Drazen (1991) and Velasco (1993). A reform occurs in this context when the payoff associated with the policy change first exceeds that associated with the status quo.

What role do crises play in all of this? Two papers deal with the point explicitly. Drazen and Grilli (1993), using the model in Alesina and Drazen (1991), look at a case in which the cost of inflation increases exogenously, and show that by making delay more costly this shock can accelerate the arrival of stabilization. Velasco (1993) shows that an adverse shock to government revenue can cause debt to accumulate more quickly and thereby bring forward in time the occurrence of fiscal reform. More strikingly, both papers show that crises can be "good" for welfare: if the indirect (beneficial) effect of reducing delay outweighs the direct (adverse) effect of the crisis, then a "bad" shock can make everyone better off. Neither paper is immune to criticism. The notion of crisis they use is probably not what most observers have in mind: in the models a crisis entails an increase in the costs of wrong-headed policies that is in force throughout the pre-reform period, rather than a sharp and unexpected increase in such costs (e.g. a sudden hyper-inflation) shortly before reform takes place. More generally, this class of papers relies on dynamic game models which yield multiple equilibria or unique equilibria whose features may not be robust to small modelling alterations. The exact link between crisis and reform may very much hinge on which specification or which equilibrium we focus on.

There is another aspect of crises which is also important. Crises create a sense of urgency. **Something** needs to be done soon, for the crisis requires an urgent resolution. In the language of some analysts, this creates room for "special politics" for a finite period of time. How exactly does this work? Rodrik (1994a and 1994b) emphasizes the agenda-setting role of reformist governments. He asks: how could wide-ranging trade and industrial policy reforms be rendered palatable to the interest groups that had been their beneficiaries for so long? How were they persuaded to go along? According to Rodrik, crises enabled reformist governments to package fiscal reforms --which were absolutely crucial for the return to price stability-- with trade and industrial policy reforms --which may have been desirable in the longer run but were incidental

to the immediate crisis. Policy makers presented domestic interests with a package of **both** macroeconomic and microeconomic reforms. Since high inflation and macroeconomic instability hurt pretty much everyone across the board, influential interest groups felt compelled to go along.[13] They may have preferred to have only the macroeconomic component of the package, but that was not the choice that they faced.

Still, the question remains: if the agenda-setting game confronted the powerful groups with unattractive choices, why did they not choose to change the rules of the game? Why did the powerful minotaurs (in Naim's (1994) wonderful metaphor) agree to behave as paper tigers? Their decision could be rationalized by using insights from the literature on the choice of procedural rules in legislatures.[14] Our reading is that policymaking in developing countries is normally done by "open rule," allowing a saying (counter-proposals) to a number of key institutional actors, such as trade associations, banking associations, trade unions, rural interests, etc. Such a rule is preferred by these powerful interests as long as the costs of the status quo (or of delay, more generally) are not too high. In a crisis situation the costs of delay become enormous, and it is then optimal for the key players to move to a closed rule, in which an agenda-setter makes a proposal which is then accepted or rejected, without room for counter-proposals. It is only natural that the agenda-setter be the administration then in office.

A recent example of the way in which a crisis gives special powers to the technocrats is provided by the recent reforms (February and March of 1995) that Finance Minister Domingo

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[13] Rodrik views macroeconomic adjustment as a win-win proposition. We believe that his view misses the cost side of macroeconomic adjustment. It is true that everybody prefers low inflation to hyperinflation, but successful stabilization programs require tough fiscal adjustments which in some cases fall more heavily on some groups (public employees, retirees, sectors benefiting from cheap government credit, etc.) Nonetheless, the main thrust of his argument goes through even if fiscal adjustment is not Pareto-improving. One of the main points in the agenda is to document the exact distributional impact of each of the reform measures.

[14]There is a healthy literature here. Our intuition is based mostly on Krehbiel (1991), particularly chapter 5: "Information and the choice of rules."

Cavallo of Argentina was able to get through Congress in the aftermath of the so-called "Tequila Shock." The reforms include three key and previously almost untouchable issues: pension reform, labor market flexibilization and privatization of provincial banks. The Pension Super-Bill allowed the executive to place a cap on the maximum pensions as well as to delay payment of amounts due to pensioners who had won lawsuits against the state. This is a key step since Social Security accounted for 48% of government expenditure in 1994. Even though labor reform is the single most difficult reform to get through (Edwards, 1994, stresses this point), Cavallo was able to pass a law that significantly lowers hiring and firing cost for small and mid-sized companies. Last but not least, the forthcoming privatization of provincial banks will eliminate the source of subsidized credit to provincial governments, one of the main leaks in Argentina's fiscal accounts. The episode highlights how the threat of financial collapse enabled Cavallo to obtain approval of policies that are only indirectly related to the immediate maintenance of the pegged exchange rate.

Finally, economic crises also contribute to Bayesian learning about the "right" model of the world. A period of intense economic disarray leads to a reassessment of the mapping from policies to outcomes, in particular to a realization of how costly some previous policies were. Harberger (1993b) writes: "...practitioners go around with a certain world view in their heads. All sorts of crazy things can happen -- like hyperinflations and huge recessions and wrenching debt or exchange rate crises. All of these ... can occur and still leave seasoned practitioners unruffled, because their world view already contains sensible explanations for them. Every now and then, however, something happens that does not fit the previous image -- something that shakes our Bayesian faith in what we used to think." Of course, it isn't Harberger's faith in free markets that has been shaken by crises in the last two decades; rather, it's been the other way around. The center of the intellectual debate in most developing countries has shifted drastically toward a market-friendly view. Peruvian novelist and former presidential candidate Mario Vargas Llosa -- himself once a run-of-the-mill leftist intellectual and today an ardent free-marketeer-- claims that "[a]n intellectual revolution has taken place in Latin America. For the first time in our history there is a broad consensus in favor of a predominant role for civil society and private enterprise:

a consensus in favor of privatization not only in the economic sphere, but in the institutional life of society as well. This is new. Our tradition has been that all aspects of life must fall under the responsibility of the state. The state was seen as the solution for everything; it was thought to be the only guarantor of efficiency and justice ..." (1993). The views of Vargas Llosa and of many other people have changed not so much from a heavenly revelation that the market is wonderful, but from the practical, painful and grudging realization that the state --at least in its current shape -- is an unreliable means of achieving their desired social objectives.

This "learning" view is consistent with other two other features of the reform process. First, there is the spillover effect from the policy choices and outcomes in other countries, particularly those perceived to have similar economic structures. The "informational cascades" model in Perktold and Tommasi (1994) generates dynamics consistent with the timing of reform in Latin America: first Chile, after several years a couple of other countries, and finally a stampede (Edwards, 1993). Second (and as we discuss more fully in Section III below), the fact that many successful reform efforts under democratic conditions were undertaken by populist politicians, who had a strategic advantage in transmitting such information to the public (Cukierman and Tommasi, 1994), seems to confirm the view that dynamics are to some extent informational.

What Are the Practical Implications, if Any?

Suppose that we accept the view that the status quo before reform can be thought of as an uneasy equilibrium among competing and imperfectly informed interest groups, with the payoffs accruing to each changing endogenously over time. Suppose, moreover, that an exogenous shock (a "crisis"), by changing expected payoffs associated with different courses of action, can cause reform to be the "new" equilibrium of the underlying game. What are the practical implications of such a view? Are there any policy lessons lurking within? We mention two possibilities here.

The practical implications of the crisis hypothesis are not easy to ascertain. Even if one

believes that little will happen "until conditions are ripe," it is hard to accept the recommendation that advocates of reform simply sit on their hands waiting for the right time to arrive. Much less does one want to advocate the deliberate fabrication of a crisis to accelerate the process --as the Leninists of yesteryear used to do, pushing for the swift decline of capitalism as the surest way to precipitate the advent of socialism. Still, assuming that reformers have limited political and financial capital at their disposal, some attention to when to spend such capital may well be warranted. Take the case of Venezuela; it may be wise to take a back seat and wait for the unwanted consequences of current policies to unfold, as Venezuelan reformers and the Washington multilaterals are allegedly doing today.

The "informational" view offers an encouraging practical message. The experience of many reforming countries (assuming a modicum of success) will hopefully be imitated by others before having to experience themselves a crisis and the associated economic pain. International development agencies have an important role to play, for the dissemination of information and the conveyance of the right policy lessons can costlessly accelerate the reform process and increase welfare. Of course, this possibility hinges on the multilaterals having credibility in the eyes of a yet unreformed country: they must be perceived as disinterested parties, and not as agents of large shareholders whose interests may be opposed to those of the country in question.

III. Reform-Mongering Strategies[15]

We now come to the actual execution of reforms. Of the many issues that arise, we focus on just two questions. Does the identity of the reformers make a difference? Should the reforms be put into place gradually or cold turkey?

Does it Matter Who the Reformers Are?

[15]Of course, the expression is due to Hirschman (1963).

One might have conjectured that typical free marketeers --that is to say, right-wingers or conservatives of some type[16]-- are the most likely to carry out market-friendly reforms. Following such an expectation, Williamson (1994) asked his contributors to comment on whether, in their respective countries, market-oriented policies had been creatures of right-wing governments. The summary paper by Williamson and Haggard (1994) reports finding little support for such an association. Indeed, in only 3 out of 13 cases was market-oriented reform implemented by what they classified as right-wing governments. Interestingly, these three cases included the two military dictatorships in their sample: Chile and Korea.

If anything, the puzzle seems to be the opposite one: in many cases "left-wing" politicians have been the ones implementing the reforms. The most salient case is that of Carlos Saúl Menem in Argentina. According to Rodrik "[i]t is ironic that these reforms were instituted under a Peronist president, Carlos Menem, since Peronism has been virtually synonymous with populism and protectionism. Within a year, Argentine reforms had already gone further than those adopted over a period of decades in the outward-oriented East Asian countries which long served as the example of choice for countries like Argentina. While Argentina may be an extreme example, many other countries have gone through similar flip-flops" (1993, p.356). The recently reelected Alberto Fujimori of Peru is another example of a candidate elected (in 1989) for being to the left of the opposing candidate Mario Vargas Llosa, yet who nonetheless ended up implementing tough market-oriented reforms. In Bolivia, the orthodox 1985 stabilization was successfully implemented by Victor Paz Estenssoro --leader of the MNR, an avowedly revolutionary movement of populist leanings-- who had pursued inflationary policies in his previous presidency. Conversely, Packenham (1992) argues that the failures of Argentina's Alfonsin and Brazil's Collor de Melo in their reform attempts were partly due to their structural location in the political spectrum: they were not "left" enough.

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[16]Conservatives in the Western sense, that is; in formerly communist countries, a conservative may well be someone who longs for the good old days of central planning.

The puzzle is addressed by Cukierman and Tommasi (1994), who argue that since voters are not fully informed about the way in which policies map into outcomes, the identity of those proposing a given policy conveys valuable information. This leads to conditions under which policies are more likely to be successful if proposed by "unlikely" characters. The conditions Cukierman and Tommasi identify -- asymmetric information and large and rare policy switches, the impact of which will only be fully know only far into the future-- seem to have been at work in the reform experiences under analysis, as well as in celebrated foreign policy episodes (Nixon and China, Begin and Egypt, Sadat and Israel, etc.).

The statement "we have to undertake these tough adjustment measures today in order to improve our future" has more credibility with the working class when heard from the lips of a populist than from the lips of a "Chicago Boy." As argued above, a large part of the dynamics of economic policy reform is informational, and this information tends to flow from above. In cases like Argentina's Menem, his advocacy of market reforms can speed up the adoption of the necessary policies by helping convince the populace about the costliness of staying with the previous policies.[17] Similar reasoning can help us understand some cases where the ordering of reforms was different from the conventional wisdom purveyed by international lending institutions. The best feasible (time-consistent) strategy may require that policymakers implement first those measures that hurt their natural base of support (the people with whom they have a stock of credibility), even if there is no economic rationale for that particular ordering. The vigor with which President Patricio Aylwin of Chile pursued fiscal austerity and made it a top priority (often at the expense of public sector employees who had overwhelmingly voted for him), may be read as an attempt to shore up its credentials as an inflation-fighter. The same could

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[17] Mora y Araujo (1993) provides evidence on the evolution of public opinion on alternative economic policies in Argentina from 1985 to 1992. He also show that public support for Menem's policies increased after the main announcements. Even public views on foreign relations (which countries should Argentina strengthen relations with?) have varied systematically under Menem's administration: 40% of the respondents believed in 1985 that it was important to strengthen relations with the U.S., Western Europe and Japan; the corresponding figure was 70% in 1991.

be said about the fervor with which President Fernando Henrique Cardoso of Brazil, a former socialist, is advocating wholesale privatization.

In fact, the issue of the identity of the reformers is a subset of a much larger issue, already discussed at length in the literature: credibility.[18] The argument, made for instance by Rodrik (1989), is that in order to build credibility reformist governments may be required to go overboard in their reform efforts, doing even more than what would be strictly necessary in a full credibility world.[19] This argument seems helpful in explaining why reforms have been so radical in some cases. The recent establishment of currency boards in Argentina and the Baltic countries may be interpreted in this light. Bartolini and Drazen (1994) present a similar argument to explain the (costly) early opening of the capital account in several episodes.

Tortoise or Hare?

Once, for one reason or another, a government is willing and able to pursue market-oriented reforms, a whole set of issues arises on how to proceed. Two questions have been at the forefront of the academic and policy discussion: (1) the order in which to implement reform on different fronts (**ordering**), and (2) the appropriate **speed** of reform in each front (for instance, how fast should one remove tariffs and NTBs?). These issues have given rise to heated controversy. Sachs (1994), among others, has passionately argued that going full speed on all fronts in often not just the best, but also **the only** strategy available to reformers. Skeptics, such as Desai (1995), have argued that shock therapy imposes unbearably high transitional costs and hence weakens political support for reform.

In what follows we survey recent contributions on the subject. In discussing ordering, we

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[18]More on credibility below.

[19]Besides Rodrik (1989), Calvo (1989) provides a good survey and discussion of credibility issues in stabilization and reform.

use the terms **big-bang** and **unbundling** to refer to situations in which reforms are introduced all at once versus situations in which they are introduced one after the other. In discussing speed, we use the self-explanatory terms **shock therapy** and **gradualism**. Notice that the literature uses many of these terms interchangeably; for instance, gradualism can mean (depending on the context) going slow on a particular reform or implementing reforms in different sectors one after another rather than simultaneously.

The optimal sequence of reforms depends on both economic and political criteria. The neoclassical economics benchmark is simple: do all reforms simultaneously. Radical or big-bang reform is the first best reform strategy, argued Mussa (1982) early on in the debate. 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. The only caveat applies when one can clearly identify a distortion that places the economy in a second best world; if that is the case, one might be able to design a particular sequencing strategy that can take care of the second best problem. Put differently, arguments for unbundling must be based on the existence of an unremovable distortion or market failure and of a sequencing second-best solution.

The early literature on the 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 eventually led to a series of devaluations and bank panics. One influential view attributed these unfortunate outcomes to mistakes in the order of liberalization (Díaz Alejandro, 1985; Corbo and de Melo, 1985; and Edwards and Cox Edwards, 1987). The need to balance government finances before undertaking other reforms was commonly emphasized. Debate centered on the order of liberalization of the trade and capital accounts, with the majority of authors in favor of opening the former before the latter in order to avoid destabilizing capital flows (Edwards, 1984; McKinnon, 1991).

Most of the early literature (summarized in Edwards, 1992) was informal; the emphasis

was in giving policy advice to avoid the difficulties that plagued early efforts at economic reform in Latin America. Subsequent research has been more precise in identifying potential welfare gains or losses associated with different sequences. One possible argument for gradualism is the presence of preexisting distortions (policy-induced or otherwise) 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 agents (Edwards and Van Wijnbergen 1986, 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 sequencing of trade and capital account liberalization.

A related argument by Calvo (1989) emphasizes that imperfect credibility is equivalent to an intertemporal distortion. If the public wrongly believes that a trade liberalization will be reverted in the future, quantitative control of the capital account may be called for. The problem with this type of argument is that, in its simplest form, it just assumes the credibility problem. A closer look at its source 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 1989).[20]

So far in this discussion exogenous political constraints have sometimes been invoked to claim that a certain distortion cannot be removed, but beyond that political economy has played no role in determining the optimal sequence. Dewatripont and Roland (DR, 1994) provide a political-economy case for unbundling in the implementation of economic reforms. Their basic point is that, when there is uncertainty about the outcome of economic reforms, unbundling has lower experimentation costs than does a big bang. One of their findings is that, contrary to common belief, complementarity of reforms may be a necessary condition for unbundling to be

[20]Even more to the point of Calvo's, Bartolini and Drazen (1994) argue that opening the capital account in itself may signal the government type, buying credibility for the whole package.

the best strategy. If partial reforms are unstable (in the sense they cannot yield full results unless complemented by other reforms), at each stage of the transition the choice is between accepting the next set of reforms or reversing the previous one. If the initial reforms have been a success, people are more willing to accept less popular reforms so as not to lose the gains of the first reforms and to save on reversal costs.

Another argument in favor of unbundling is advanced by Wei (1993). He argues that gradual sequencing may allow the building of constituencies for reform, in the presence of individual specific uncertainty, as in the framework of Fernández and Rodrik (1991). Wei's point is illustrated with a simple example: consider an economy with two import-competing sectors (which comprise the majority of "votes") and an export one. After trade liberalization, a fraction of workers from each of the two import-competing sectors is able to switch successfully to the export sector, which is the obvious beneficiary of reform. While the proposal to remove trade barriers in both import-competing sectors may be opposed by a majority, the removal of barriers on imports in just one sector will have the support of the other two sectors. After some labor has been reallocated from the adversely affected sector to the export industries, it is possible to remove trade barriers favoring the second import-competing sector --enjoying the support of the (now larger) export sector and the import-competing sector hurt by the first reform. It is interesting to notice that Wei's argument does not need (even though it is not inconsistent with) the assumption of individual-specific uncertainty in Fernández and Rodrik (1991). Even if we eliminate ex-post heterogeneity (of people coming from the shrinking sectors) and we think of just three types, X, M1 and M2, with reform 1 harming M1 and helping the other two and reform 2 harming M2 and helping the other two, gradualism is still feasible while a big bang is not. In fact, unbundling is equivalent to a divide-to-reign strategy, pitching current majorities against future ones.[21]

[21]Our discussant John Williamson suggested that, under some institutional arrangements, such a strategy can be beaten by a (time-consistent) coalition of M1 and M2.

On the other side of the debate, Martinelli and Tommasi (1993) argue that political economy considerations suggest implementing all possible reforms simultaneously. Their point is that in societies with powerful interest groups and characterized by a cobweb of redistributive and distortionary policies, "optimal" unbundled plans will be time inconsistent: winners of early reforms who are hurt by later reforms have an incentive to stop the gradual path in its later stages. Knowing that, losers from early reforms will oppose the earlier measures. In such an environment, a big bang is the way of cutting through the Gordian knot of rents implicit in previous policies.

How do we explain the contrasting results in these papers? Martinelli and Tommasi (1995) note that the argument of DR (1994) is based on a planning problem that does not take political constraints explicitly into consideration. MT (1995) show that even if the conditions necessary for gradualism to have lower experimentation costs are in place, the distributional implications of the different reforms can lead to the gradual path being time inconsistent in a political game. The key difference between MT (1993) and Wei (1993) is that Wei's analysis assumes that majority support is sufficient to guarantee the completion of reforms, while MT emphasize the presence of veto players.[22] We are not sure which of the two institutional setups best captures the politics of reform in Eastern Europe, but in Latin America (at least until very recently) there are several minotaurs without whose acquiescence no policy is feasible.[23] This suggests the veto model may be more relevant.

We now turn from issues of sequencing to issues of speed. Because in the real world

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[22]The same assumption (veto players) is implicit in Dewatripont and Roland (1992 and 1992b). In a model of industrial restructuring which we discuss below, they assume that the government cannot fire workers form the inefficient sectors, but has to bribe them to exit.

[23]Burgess and Stern (1993) in their study of tax reform in a broad sample of developing countries, conclude that "reforms facing strong and active opposition cannot be imposed upon countries. For government commitment to tax reform to be credible, the likely behavior of gainers and losers needs to be taken into account and a broad consensus arrived at."

adjustment is often costly and time-consuming, it has often been suggested that policy reform should be gradual. Yet the neoclassical benchmark in this area is also stark; as persuasively argued by Mussa (1982), the mere presence of adjustment costs does not imply that policy should adjust gradually. If the private cost of adjustment reflect the true social costs, the optimal policy is to set the distorting policy instruments to zero at the beginning of the planning horizon (the definition of shock therapy in this context) and let rational, forward-looking agents adjust their behavior optimally. Eliminating the distortions gradually would needlessly lead to efficiency losses without any compensating gain. Hence, arguments for gradualism need to be based on the presence of distortions that lead to violations of the first welfare theorem. Note that, following the logic of the second best, this is a necessary but by no means sufficient condition for gradualism to be preferable to immediate and full elimination of distortions.

The cleanest argument for gradualism along these lines is provided by Gavin (1993), who argues that congestion externalities create too much transitional unemployment (relative to the market optimum) after a big bang. Avoiding the problem may involve gradual restructuring. The problem with this view is that it implies that people voluntarily choose to change jobs too fast. We are inclined to believe that the evidence does not seem to point in this direction. More likely, the problem is slow job creation, along the lines suggested by Caplin and Leahy (1994).[24] They emphasize informational externalities: firms may be too slow in moving into new ventures, waiting for the revelation of information contained in the moves of other firms. A possible way of dealing with those problems might be to foster information sharing via activities such as government sponsored visits to other countries by business associations. More generally, the "distortions" can be addressed in two ways: directly (by affecting information flows, for instance) or by tinkering with the speed of reform. Hence, the sole existence of externalities does

[24]Another explanation for slow job creation is the lack of perfect credibility of the reforms emphasized by Guillermo Calvo. Obviously the solution to such a problem is by no means gradual tariff reduction. One could also construct an argument by which higher unemployment reduces credibility because of a higher chance of a political backlash. Still, for that to be tied to a policy prescription for gradualism one needs a good understanding of whether (and why) gradual reform reduces unemployment.

not constitute a *prima facie* case for gradualism, especially if other considerations call for rapid action.[25]

More explicitly political-economy arguments for gradualism have been made by Dewatripont and Roland (1992 and 1992b). They provide a case for gradualism in industrial restructuring that is based on budgetary considerations. They model a reform-minded government facing an inefficient sector with a work force which is heterogeneous in outside opportunities. A move towards allocative efficiency requires a major shift to higher productivity activities and massive layoffs. If outside opportunities are private information, in order to make quick reform politically acceptable, all workers have to be paid the same (high) exit bonus. In such a case, a sequence of increasing exit bonuses (gradualism) may enable restructuring to proceed at a lower fiscal cost.[26]

What are the Policy Lessons, if Any?

Theoretical work on optimal sequencing and speed of economic reforms suggests the following lessons:

- Aggregate uncertainty about the outcome of economic reforms (if it gets resolved early enough) makes gradualism less costly than a big bang strategy from the point of view of experimentation and learning costs. This point seems relevant to explain the long road

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[25]Auernheimer and George (1994) show that gradual trade liberalization induces a distortion in consumption-accumulation decisions and results in welfare costs that, if the gradual change is extended over "too long" a period, may even exceed the long run benefits of liberalization.

[26] It is interesting to note the contrast between the assumption in DR (1992 and 1992b) and that in Fernandez-Rodrik/Wei. Workers know their chances of getting a job in the growing sectors all too well in DR, while they have no clue in FR/W. It would be desirable to try to establish empirically whether the successful movers have some observable distinguishing characteristics (age, employment history, education, location, etc.)

towards market liberalization followed by countries such as China.[27]

- The political rules of the game matter in the choice of big-bang versus unbundling. Countries with deeply ingrained distributive conflicts and with powerful interest groups endowed with *de facto* veto power are well advised to bundle reforms in order to "offer something to everyone" and to avoid time-inconsistency. But in cases where majority rule applies, unbundling of reforms might help divide the opposition.
- Somewhat surprisingly, the more complementary are the reforms (in terms of their sustainability), the better for unbundling strategies. This result can helps us understand why successful Latin American cases seem to take a big-bang approach, while the picture form Eastern Europe is less clear. In socialist countries, where the basis of a market economy are completely absent, partial reform may be unsustainable in the long run (Murphy, Shleifer and Vishny, 1992); political sustainability then (paradoxically) argues for unbundling. In many developing countries, in contrast, macroeconomic stabilization could easily be achieved without reforming the trade or regulatory regimes; in that case, political approval of the whole package requires that it be bundled.
- The theoretical case for gradualism in the implementation of any given reform is mixed. If externalities exist, it may be best to operate on these directly. Under some circumstances gradualism might make reform politically more palatable, but these circumstances seem rather special.
- Lack of credibility cuts both ways. Persuading skeptics may require both a big bang of reforms and shock treatment for each policy setting; if may even require going overboard, as Rodrik (1989) as argued. But if such extreme therapy proves unconvincing and lack of credibility remains, having done all the reforms at once (in particular, having opened up the capital account early on) may be the cause of much trouble.

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[27]On the other hand, we believe that the true merits of wide ranging economic reforms are not fully revealed in the first couple of years. Hence, the arguments that emphasize resolution of uncertainty along the transition path are not very relevant (except for cases such as China where gradualism spans over a few decades). More on this in Section VI.

A short (and somewhat unfair) summation could claim: there are some arguments for gradual sequencing and for going slow. How do these sophisticated theoretical claims stack up against what countries have actually done? Not too well. As Table 2 suggests, big bang reforms have been a surprisingly popular choice. There are of course caveats; slow privatization in portions of Eastern Europe is one; delays in pushing for labor market and other institutional reforms constitute another (more on this in section IV.) But the degree to which micro and macroeconomic reforms have been pursued jointly, and in vastly different countries, is certainly substantial.[28] The evidence on gradualism is more mixed. In the realm of macroeconomic stabilization (particularly if hyperinflation is the initial condition), going fast is common. In the micro realm, and particularly concerning tariff liberalization, slow phase-in periods are often the rule.

We suspect that two rather commonplace factors (on top of the formal ones of special politics and time-consistency) tilt the balance in favor of going "cold turkey." The first is fear -- fear of what the future may bring. Reforming administrations often face a great deal of uncertainty, and a non-trivial likelihood of being ejected from office. In that situation, the only strategy is "do as much as you can."[29] The second is incompetence: fine-tuning of reform requires great technical capabilities and --as Anne Krueger (1992) and Moisés Naím (1993) have

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[28]Also, Rodrik (1989, p. 758) refers to the "apparent empirical regularity that trade reforms are more likely to be successful when they are undertaken wholesale and in such a way as to create a major break with the past." In a review of 37 liberalization episodes, Choski and Papageorgiou (1986) conclude that "the likelihood of survival of a liberalization attempt is substantially higher where the initial policy measures undertaken are major and significant: halting or hesitating policy actions leading to a very gradual liberalization are much more likely to cause a collapse. This is particularly true in instances of countries (characteristic of most of Latin America) in which the history of restrictions on trade policy is long and pervasive."

[29]Some analysts (most notably Anne Krueger) have offered a related argument, claiming that moving fast prevents opposition from forming. We do not believe this to be an important point in developing (especially Latin American) countries, since the relevant pressure groups have likely been organized for decades. In formerly socialist nations the argument may carry more weight.

convincingly argued-- reforming governments seldom have the required personnel and resources. The upshot is similar: keep it simple --and do it soon.

IV. Costs and Sustainability of Reform

How economically and socially costly is reform? By what yardstick should such costs be evaluated? What do these costs imply about the political sustainability of reform? This section tackles these ambitious questions.

Two views can be distinguished on the costliness of reform. The traditional view (which one might also label pessimistic) stresses that reform is very costly indeed.[30] The first set of costs arises from macro stabilization: tight monetary and fiscal policies mean recession and Keynesian unemployment. The second set of costs arises from relative price changes and structural reform: adjustment means transitional unemployment; fiscal consolidation means drastic cuts in public services and an end to food and fuel subsidies that benefitted almost everyone. Under this view, the time profile of costs is particularly troubling: costs are paid up-front and benefits only accrue with time. As a result, losers immediately take to the streets, while winners emerge and acquire a political voice with substantial delay.[31] Finally, costs are unequally distributed: the poor pay the most, for they had been the largest beneficiaries of government largesse and are now the least equipped to find jobs in a newly competitive labor market.

By contrast, optimists stress that the recessionary consequences of stabilization have been much milder than anybody anticipated --in fact, countries disinflating through fixed exchange rates have often gone through periods of early boom. This view does not deny the possibility of

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[30]See, for instance, Cornia, Jolly and Stewart (1987) and Przeworski (1991).

[31]A cogent statement of this view is in Joan Nelson's paper in Williamson (1994).

transitional unemployment as relative prices shift and the state sector shrinks, but stresses that it is the whole present value of payoffs under reform, not just some temporary losses, that should be taken into account; accordingly, if temporary unemployment is driven by the search necessary to match jobs and skills, the total net payoffs may well be positive.[32] Moreover, according to optimists few tears should be shed over the consequences of state retrenchment: under the *ancien regime* subsidies had gone to powerful rent-seekers, not to the truly needy; governments were so badly mismanaged that hardly any public services were provided, particularly under conditions of fiscal crisis.[33] Finally, the very poor need not be net losers: for people whose meager wealth is largely held as cash, the benefits of slashing inflationary taxation may well swamp any other costs.

Sorting out which view has a greater correspondence with reality is largely --but not exclusively-- an empirical question. In sifting through the evidence, it helps to keep two ideas handy. The first one is an economist's favorite: opportunity costs. Outcomes under reform should not be compared with an idealized *belle epoque* of national development, but with what might have happened to the economy in the absence of reform. Indeed, specifying the right counterfactual is the most important (and hardest) task. The second is the concept of present value: optimists are right in emphasizing that it is the whole flow of payoffs under reform (suitably discounted) that should be used in evaluating possible costs. Of course, these two helpful concepts should be handled with care when dealing with the political consequences of economic events. For instance, Naím (1993) argues that the Venezuelan population compared the early 1990s to the heady days of the 1970s oil bonanza during the first Pérez administration, and

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[32]Rodrik (1994b) argues this point vehemently: "But the transitional unemployment that results --as workers and entrepreneurs switch from import-competing sectors to export-oriented ones-- is nothing other than an investment. Just as we do not think of an individual making a profitable long term investment as being worse off on account of the investment, we should not view the resulting unemployment as signalling a deterioration in living conditions (save for those that will be worse off in the long-run as well)."

[33]For an excellent account of state collapse in Venezuela, see Naím (1993).

failed to appreciate what would have occurred had the second Pérez administration not undertaken a shock treatment in 1989. Similarly, it is of little help to tell an unemployed worker who cannot feed himself that in present value terms he is better off: the worker in question may simply not be around when that glorious future arrives, and he might have good reasons to mistrust those who try to persuade him that the future will be brighter.

But then again, many links between economic outcomes and the corresponding political struggles may be quite paradoxical. We argue below that, even if reform is shown to be costly, this does not mean it will prove unsustainable. If anything, reforms are proving to be both more popular and more lasting *ex post* than many analysts predicted *ex ante*.

The Economic Cycle Associated with Reform

The notion that reforms necessary involve a slump in economic activity and welfare and other short-run costs is commonplace. Przeworski (1991) writes: "Such reforms necessarily cause a temporary fall in aggregate consumption." Williamson and Haggard (1994), in their summary of the conference volume, take it for granted that "...the costs are short-term while the benefits are long-term." But as Rodrik (1994b) argues, this view is far from self-evident.

Calvo and Vegh (1994) have compiled a set of stylized facts on the macroeconomic cycle that follows inflation stabilization. Their most striking conclusion is that in a sample of 11 cases[34] of countries attempting disinflation through controlling the exchange rate, all eleven underwent a consumption boom in the first two years of the program, with the boom lasting a third year or more in most cases. As can be seen in Table 3, the increases in consumption are non-trivial, and in some cases --such as Israel post-1985 and Argentina post-1991-- quite phenomenal. Only after a few years do we see indications of recession in some of these countries. Money-based stabilization programs, on the other hand, do seem to induce a sharp

[34]All from Latin America, except for Israel.

decrease in consumption; but the contraction is short-lived : in a their sample of five programs in Latin America, consumption always begins recovering (some times quite rapidly) in the second year of stabilization. While the sample is limited and one can certainly think of counterexamples elsewhere in the planet, such findings are nonetheless remarkable. The presumed fall in consumption is certainly not the rule; if anything, it is a short-lived consequence in a handful of cases. The political economy implications are clear. Indeed, some analysts have gone as far as to suggest that the initial consumption booms in places such as Argentina and Brazil are the main reasons for the enduring popularity of ongoing economic reforms.[35]

It could be argued that such possibilities are largely limited to middle-income countries with well established capitalist institutions, such as those in Latin America or Israel. The experience of Eastern Europe, while massive restructuring is needed, must surely be different. Once, again, that conjecture proves less than self-evident. In such countries, much has been made of large recorded declines in industrial production (see Table 4). Real wages have also typically fallen as restructuring proceeds and unemployment soars. But such measures say little about individual welfare, especially in economies saddled with shortages and primitive markets. The story told by consumption numbers is different. Take the case of Poland after the Big Bang program of January 1990. Sachs (1993) reports that "...the weighted volume of consumption fell in 1990 compared with 1989 by around 4 percent, *not taking into account the rise in product variety, product quality, or the end of queuing time*...If we take the additional gains in real consumption between 1990 and 1991, which even official statistics put around 2 percent, we can safely conclude that, counter to the superficial judgements based on the statistical real wages, living standards in Poland were higher in 1991 than in 1989."[36] While we know too little to offer definitive conclusions, the notion of a **sharp and inevitable** drop in consumption and welfare in

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[35]"See, for instance, "The Tequila Hangover" *The Economist*, April 8-14, 1995.

[36]Emphasis in the original. On welfare in the Polish case, see also Berg and Sachs (1992).

reforming post-communist societies does not hold up very well under scrutiny.[37]

The issue of counterfactuals is of particular importance for both Latin America and Eastern Europe. In Latin America and Israel, as Table 3 shows, consumption had been falling in 7 of the 16 cases considered, and it had been stagnating in 6 of the remaining ones. Indeed, many of these economies were in a free fall at the time stabilization programs were put into place. Several (such as Brazil in 1964 and Chile in 1975) were reeling after bouts of populism and economic chaos; others (such as Peru before 1990 and Argentina in 1991) had been living under hyper-inflation. For most, therefore, the relevant counterfactual in the absence of reform was ongoing deterioration and perhaps collapse.[38]

Much the same can be said about Eastern Europe. As Przeworski (1993) shows, living standards --including the gross mortality rate and consumption of a number of services-- showed an important decline in Poland between 1978 and 1988, the decade before the adoption of reforms. Moreover, in the post-communist world we can directly compare the fate of countries that embraced reform to varying degrees. Table 4 shows the evolution of industrial production in five countries. While all show a collapse, the cumulative decline is least steep in shock-therapy Poland. Slightly trailing Poland are the other two (somewhat more gradual) reformers, Hungary and Czechoslovakia. The largest declines by far have occurred in largely non-reforming Bulgaria and Romania. This conclusion would be strengthened if we included in the sample the former

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[37]For other accounts of the macroeconomics of transition in East-Central Europe, see Bruno (1992), Blanchard, Dornbusch, Krugman, Layard and Summers (1991) and Aghion and Blanchard (1994).

[38]This does not mean, however, that all of Latin-America has faced a stark "reform-or-die" choice. Many of the smaller economies in the region, such as Uruguay, Paraguay, Ecuador and some in Central America, have muddled through with mediocre growth rates and moderate inflation in the absence of comprehensive reform.

Soviet republics, where delayed reform has brought about precipitous declines in output.[39]

But as pointed out above, the implications of all this for the politics of sustainability are subtle. Why did Venezuelans riot, twice attempt to overthrow and eventually impeach a president (Carlos Andrés Pérez) who in 1990-92 brought them an average growth rate of 7.8% (the highest in Latin America), while Peruvians massively reelected Alberto Fujimori, under whose stewardship consumption dropped by 15.3% in 1990? One possibility is that the ever-handy "crisis hypothesis" (in its "learning" interpretation) has some applicability here. Naím (1993) persuasively argues that because Venezuela never experienced hyper-inflation, and because the program was put into place after a few years of mediocre growth and moderate inflation, Venezuelans had the wrong counterfactual in mind. The fact that the country had mounting current account deficits, dropping reserves and repressed inflationary pressures was unbeknown to the citizen on the street. By contrast, in Argentina and Peru in the early 1990s memories of the recent hyperinflations may have been enough to force citizens seriously to ponder the alternative to continuing reform --a factor that may enable President Menem to join Alberto Fujimori in the pantheon of the handily reelected reformers. This fact has almost certainly also played a part in Chile. Frieden (1991) and Velasco (1994) argue that in that country not only the experience of high inflation, but also of sharp class struggle, political turmoil and violence have prompted traditionally militant unions and business groups to converge on an uneasy but lasting consensus on the need to consolidate market reforms.

Notice that such claims need not be based just on accounts of collective memory of past suffering. Velasco (1994) and Tornell (1995), for instance, build models where, if things get bad enough under the old regime, it is rational for interest groups to pay the costs of adjustment in order to force other groups to accept the new set of economic policies. In short, it may well be

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[39]The EBRD reports that, in 1994, measured GDP dropped by 15% in Russia, 24% in Ukraine, 22% in Belarus, 36% in Georgia, 25% in Kazakhstan, 22% in Azerbaijan, 25% in Moldova and 20% in Turkmenistan. The other republics also experienced sharp (if somewhat less spectacular) declines.

that the crisis hypothesis has a role in explaining not just when reforms occur, but also when they may be sustained through time.[40]

Poverty and the Distributional Consequences of Adjustment

The discussion so far fails to recognize that not all citizens are alike, and that adjustment affects some more than others. In particular, there has been great concern over the effects of reform on poverty and income distribution. Such concerns have given rise to mega research projects at the OECD, the World Bank, The IMF and UNICEF.[41] Predictably, results are mixed. In the 1980s, there is evidence of worsening poverty and distribution, particularly in Africa and Latin America (Cardoso and Helwege, 1992; Stewart, 1991, Lustig 1990 and 1995). While trends clearly vary from country to country, there are many instances of increasing shares of population living below a given poverty line, and deterioration in the relevant Lorenz curves and Gini coefficients. But since the 1980s were a decade of external shocks and (often) unsustainable populist policies, distentangling causes and effects is particularly difficult.

Unsurprisigly, the IMF is quite sanguine about the social effects of its policies. Heller et al (1988) argue that "...by providing growth and efficient resource allocation, adjustment programs on the whole play a constructive role in safeguarding the long-term interests of the poor." Emphasizing the effects of relative price changes, the Fiscal Affairs Department at the

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[40]Haggard and Webb (1993) also discuss what they term the effects of "collective memory" on public behavior, and discuss several cases, including Germany, Indonesia, Taiwan and Chile.

[41]Results from the OECD project are contained in Vol.19, No.11 of *World Development*, and are summarized in Bourguignon, de Melo and Morrison (1991). Results from World Bank research are contained in the 1990 *World Development Report*, which focused on poverty, and in Vol.5, No.2 of the *World Bank Research Review*; they are summarized in Squire (1991). IMF work on the subject is to be found in Heller et al (1988) and IMF (1986). The earlier UNICEF studies, which appear in Cornia, Jolly and Stewart (1987), are updated by Stewart (1991). Such projects focus primarily on traditional developing countries; evidence on former socialist countries has been slower to emerge.

IMF maintains that a real devaluation "could enhance the position of traditional agriculture at the expense of urban dwellers" and that "in general, Fund-supported programs have improved rather than worsened income distribution." But such enthusiasm must be tempered by the recognition that, in primarily urban and more industrialized countries such as those in Latin America, a real devaluation essentially means a cut in real wages, and thus a temporary reduction in income for those at the lower end of the scale. For this reason and others, simulations in models such as those by Bourguignon, de Melo and Suwa (1991) and Bourguignon, Branson and de Melo (1993) may easily (though not necessarily) yield a deterioration in income distribution and an increase in the share of the population in poverty following adjustment.

There are two factors that seem particularly important in determining poverty and distribution outcomes. The first is unemployment, and the other is the reduction in public services often resulting from fiscal consolidation. Not only has unemployment (of both the efficient and inefficient variety) occurred in many reforming economies, achieving a particularly controversial role in the former socialist economies of Eastern Europe. Two factors make it especially costly from a social and political point of view. First, in Eastern Europe there has been little turnover among the unemployed, leading to unusually long unemployment spells. Blanchard and Aghion (1994) report that in 1992 Poland the monthly exit rate from unemployment (to employment) was 2.3%; in the United States the corresponding figure was 25%. In addition, the incidence of unemployment is unevenly distributed. In 1982 Chile, for instance, Meller (1991) reports that in the lowest income quintile 25% of heads of household were unemployed; in the higher quintiles the corresponding figures were 30%, 30%, 5% and only 2% among the top group. There is broad consensus that this was the main factor behind the increase in the Chilean Gini coefficient from 0.49 in 1970 to 0.54 in 1982-84.[42]

In the realm of social spending and public services, there is also evidence of declining

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[42]For a detailed econometric analysis of the causes of rising inequality in Chile, see Marcel and Solimano (1994).

shares of social spending in total government expenditure, at a time when the total size of government was itself being cut. The literature is filled with accounts of public hospitals with no medicines, declining quality of education and crumbling infrastructure. The effects of such trends on the poor, on the other hand, is somewhat harder to gauge. Of course, the extent to which government expenditures carry out a net redistribution toward those at the end of the income scale has long been heatedly debated. In an early study of Chile, Foxley et al (1979) find a net redistribution in the desired direction, in spite of leaks toward middle-class users; Hausmann (1994) surveying several Latin American countries and focusing in particular on Venezuela, is a great deal more skeptical.[43] In addition, improved targeting on the very poor can actually increase the flow of services this particular group receives, even if overall and per capita social spending decline. Something like that seems to have happened in Chile, where indicators such as infant mortality continued to improve in spite of the economic crisis of the early 1980s and the subsequent adjustment[44]. Nonetheless, the lessons from that experience remains controversial, particularly since not all welfare indicators for the poor moved in the same positive direction.[45]

Public and political reaction to such trends has been varied. Once again, the role of past experiences seems to be pivotal. Unemployment has been most politically lethal in Eastern Europe, a region that had practically no memory of the phenomenon. As Prezworski (1993) argues, in Poland "..fear of unemployment is enormous" and "...in the end ...overwhelms all other considerations." By contrast, public debate over jobs has been relatively muted in Latin America, despite extremely high unemployment rates in some countries --higher in fact than what is observed in Eastern Europe.[46] Perhaps the exception is Argentina, where joblessness currently

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[43]See the essays in Hausmann and Rigobón (1993) as well.

[44]See Graham (1994) and Cardoso (1994).

[45]For a much more critical view of social policy under Pinochet, see Meller (1991).

[46]This is a statement one makes with some trepidation, for unemployment numbers in Latin America are notoriously unreliable. In March 1995, for instance, Mexico claimed an open unemployment rate of under 6%.

running at 14% has been extremely controversial.[47] But then again, Argentina has historically had very low unemployment, so it may well be closer to the Eastern European experience in this regard.

Similarly with the issue of social services. From a political economy point of view, it makes sense to distinguish between countries with a record of reasonably efficient government and decent service delivery, as for instance Chile and Costa Rica,[48] and others where social policy was either bankrupt or non-existent. In the efficient countries, budget cuts affecting services have been extremely controversial. In Chile, dissatisfaction with the dismal state of the public health system was the problem most often cited to pollsters, and it seems to have played a key role in Pinochet's two electoral defeats in the late 1980s, which occurred in spite of a booming economy. Matters were very different in countries in which allocated social spending was traditionally poorly delivered or ended in the pockets of the deliverers; if poorer citizens had seldom enjoyed reliable health care at the local clinic or regular rubbish pickup from their streets,[49] announced budget cuts could not make that much difference to their livelihood.

What are, more generally, the consequences of changing levels of poverty and inequality on the politics of sustainable reform? The short answer is: pretty ambiguous. Inequality often gets blamed for a great deal of bad economic policy. Berg and Sachs (1988) found that the probability of default on foreign debt obligations was an increasing function of a country's degree of inequality. Alesina and Rodrik (1994) and Persson and Tabellini (1994) argued that higher inequality leads to more distortionary redistributive taxation, which in turn leads to lower economic growth. But such alleged links always retain an important doses of ambiguity,

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[47]Another exception is Chile, where extremely high unemployment in 1982-83, reaching over a quarter of the labor force, did provoke an outcry.

[48]See Graham (1994) on Chile and Rottemberg (1993) on Costa Rica.

[49]See Hausmann (1994), for a vivid account of how widespread such problems have traditionally been in Latin America.

particularly at the empirical level. Perotti (1995) has shown that in cross country regressions the "correct" sign of the coefficient linking high inequality and low growth may be the result of two "wrong" signs linking inequality and size of government one the one hand and size of government and growth, on the other. Moreover, estimations attempting to associate inequality and macroeconomic outcomes may be subject to important regional variations. Figures 1 and 2 show cross country plots for Latin America, involving income distribution and growth and income distribution and inflation, respectively. The slopes are the opposite to what theory predicts: inequality in 1960 seems to be associated to high growth and low inflation in the 1960-85 period.[50] Below we return to some possible explanations for this preliminary finding.

Matters are just as complicated when trying to link inequality and the sustainability of reform. The consequences of initial inequality, for one, may be surprising. Przeworski (1991) claims that an equitable initial distribution, of the kind enjoyed by Eastern European countries, can be politically tricky. Imagine that people oppose the continuation of reform if they see their income (or welfare) fall below a certain threshold; if enough people express opposition, reform is aborted. If reform reduces everybody's income by a small percent, but everybody had been close to the threshold to begin with, now the whole society falls below the threshold, and reform runs into political trouble. By contrast, in a society with a skewed initial distribution, reform may simply push a minority of the population beyond the brink; in spite of serious human suffering, reform will prevail politically. Notice that this argument can also be made concerning the distribution of the costs of adjustment, and not only concerning the initial distribution of income.

Of course, the reason why distributional outcomes do not map easily into political outcry and the corresponding policy responses is that not all citizens and groups have equal political voice and power --whether it be the basic franchise, lobbying power, or access to informational

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[50]The point can be made less casually. In Tommasi and Velasco (1994) we reproduce the analysis of Alesina and Rodrik (1994) for the subsample of Latin American countries. After controlling for all the necessary factors, the "wrong" sign for the coefficient of inequality on growth remains.

or decision-making networks. This may be at the root of the peculiarities in Figures 1 and 2, which suggest that inequality is "good" for growth and price stability. We conjecture that this relationship appears because in highly unequal societies, such as those in most of Central America and perhaps Mexico, the poor simply have little political weight. As a result, they cannot impose the distortionary taxes or obtain the necessary subsidies that are required to lower growth and to generate fiscally-driven inflation. By contrast, it is in the more egalitarian societies in the Southern Cone of Latin America (Argentina, Chile and Uruguay) that we find politically organized lower and middle classes and (perhaps not coincidentally) dismal macroeconomic performance during much of the twentieth century.

This matters very much for the politics of sustainability. Graham (1994) puts it succinctly: "Few governments have immediate political incentives for helping the economically poor, who also tend to be poor with respect to political voice. Institutions that in theory should represent the poor, such as parties and unions, rarely reach them. Common sense dictates that a precarious government implementing economic reform will be more concerned with the political sustainability of its program --and ultimately with its ability to remain in power-- than with implementing the optimal poverty policy." Hausmann (1994) puts it even more drastically: "As in other aspects of life, the poor are usually too poor to be politically important." Indeed, the poor are seldom the pivotal group in determining the fate of adjustment programs. The often-predicted "social explosion" that would presumably follow the application of drastic reforms has, with some notable exceptions, never materialized.[51] It is also sadly revealing about the state of politics in the developing world that the two most successful attempts at targeting the poor through safety nets in Latin America were made by Pinochet in Chile and by the (far less harsh but still authoritarian) government of Mexico under Carlos Salinas.

A far more useful distinction, made by Graham (1994) and Lustig (1995), is between the

[51]In Latin America, the key --and highly localized-- exceptions are the Chiapas uprising in 1994, the Venezuelan riots of 1990 and the much less serious upheaval in northern Argentina (Santiago del Estero province) in 1993.

"old poor"[52]and the "new poor" --with the latter being the state workers or small entrepreneurs in the import-competing sector who have been displaced by restructuring. In fact, it is the "new poor" --basically those in the third and fourth quintiles in the distribution-- whose share of total income typically drops in response to adjustment.[53] Such groups are better educated and organized than are the "old poor," and in some cases are extremely vocal. The efficiency case for subsidizing such people may be weak, for they are often semi-skilled workers who could be expected to find employment in the growing private sector.[54] They may also have long been recipients of monopoly rents, which limits sympathy for their plight. Politically, however, their presence cannot be that easily ignored. The tradeoff between tending to the needs of the old and the new poor is likely to be at the center of any government's attempt to make its reforms palatable and sustainable.

Direct compensation for the new poor --as in generous severance benefits for public employees-- may serve as stop-gap measures, but are unlikely to turn the displaced into supporters of reform. The reason is simple: a coal miner in a state-owned pit in Poland, Britain or southern Chile who is fired loses not just the present value of his salary but also membership in the union, a network of contacts, etc., all of which amount to both access to rents and to an insurance mechanism. As a result, compensation would have to be very large fully to offset the loss to the worker. There is also a time inconsistency problem: while the miner is still in the pit, the government has incentives to promise all sorts of benefits (retraining, housing and educational subsidies, and other things which are disbursed through time); once he has gone home, left his union, lost his political clout, the government may well renege. Understanding

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[52]Also sometimes referred to as the "structurally poor."

[53]In fact, it is this decline, rather than a decline in the share of the poorest quintile, that explains the deterioration of income distribution in Argentina, Brazil, Chile and Mexico in the 1980s. See Lustig (1992 and 1995).

[54]Perhaps, if the labor market is imperfect, a retraining or searching subsidy may be called for.

this, the miner may well choose to remain on strike at the bottom of the pit.[55]

But such a conclusion strikes too negative a note. In spite, of the difficulties listed, many governments have been remarkably successful at persuading the new poor not to block reform. The examples of drastic stabilization and the "hardening" of the state budget constraint in Argentina under Menem and in Poland under the Solidarity-based governments, suggest that in practice the task is achievable. Note that both examples involve labor-based governments --a fact that may lend additional credence to the Nixon-in-China hypothesis.

What Does this Tell Us About the Sustainability of Reforms?

It is not hard to detect some pessimism --both in journalistic and academic accounts-- about the chances for political survival and sustainability of reform. The return to power of former Communist is several Eastern European countries, coupled with the macroeconomic turmoil in Mexico and earlier in Venezuela, has done much to shape this view.

The standard account goes something like this. Initially everything is fine: the "honeymoon" enjoyed by reformist governments extends to the months and even years after the first wave of reforms is implemented. There is broad consensus among analysts as to why this is so. Those citizens who had felt that "something must urgently be done" have their anxieties relieved by the display of active reform-mongering. After what was in many countries a period of political vacuum characterized by increasing economic chaos (and sometimes even a breakdown of law and order), the vision of a new government firmly in control can be deeply reassuring, almost regardless of what the government actually does. In addition, if high inflation had been the problem, the benefits of ending it are quickly and massively felt. It is almost axiomatic that if the rate of inflation had been over 5% a month, the government that quashes it enjoys substantial

[55]Dixit and Londregan (1994) make this point.

short-run popularity --once again, almost independently of costs. Lenin's famous warning about the corrosive effects of a debauched currency and Keynes' no less famous endorsement of this view must be complemented by another dictum stressing the politically healing properties of the end of currency debauchery.

But, the conventional wisdom goes, "reform fatigue" soon sets in, especially after unemployment and the effects of budget cuts begin to manifest themselves; polls indicate declining popularity for the reforms, and the political opposition begins to regroup.[56] Hence, once can observe the paradox that people who had initially supported the reform program with enthusiasm begin to turn against it. Ingenious and fairly persuasive accounts of why this is so can be found in the literature. Rodrik (1995) argues that at the beginning of the process pivotal Central European state workers are for reform, for they stand a good chance of moving to the higher paying new private sector; but as reform progresses, the prospects of those who are still left in the public sector become dimmer, for they are now more likely to be stuck there forever. "Consequently, (a state worker) will be more inclined to tax the private sector and slow down the process of reform at this later time. This is even though this likelihood of becoming actually unemployed is lower at a later tie than it was at the outset, and therefore his expected utility under shock therapy is higher than previously."[57]

Mau (1994)[58] focuses on the interests of the numerically weak but politically influential managers of state enterprises in former socialist countries. Early on, managers supported the weakening of the planning system, for it gave them greater autonomy to run their enterprises as

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[56]Notice that the alleged connection between unemployment and declining popularity of reform is less than airtight. Przeworski (1991, 1993), makes much of this link, but his empirical analysis is not fully convincing (see Rodrik (1994b) for a critique). Moreover, one still has to explain why unemployment is so important if consumption and other indicators of welfare seem to be rising.

[57]Rodrik (1995), pp. 4-5.

[58]In Williamson (1994).

they saw fit, increasing wages and sale prices, lowering tax payments and diversifying both buyers and suppliers.[59] In some cases, an attractive (to the managers) feature of the process was "spontaneous privatization," with the bosses ending up the owners of the enterprise. But as time passed, their interests shifted: further reform meant the definitive hardening of the firm's budget constraint, plus pressures to allow outside stakeholders. As is well know, particularly in the Russian case, this has led managers eventually to become opponents of further reform.

Does the cycle of early honeymoon and later fatigue bode badly for the sustainability of reforms? We are skeptical. To justify such skepticism we try to give some empirical content to the concept of sustainable reform. Table 5 shows election dates and outcomes for a sample of 16 highly-studied reforming countries. Since elections are the criterion, these countries have to be reasonably democratic, but this restriction does not leave out many interesting candidates (Indonesia may be the foremost exception).[60] Because there had to be something to sustain, only serious reformers are considered (this eliminates all former Soviet republics plus a number of Latin American countries such as Brazil). The table also draws the distinction between cases where political pressures have led to a slowdown of reforms vis à vis those cases where reforms have been actually reversed.

Three striking facts emerge from this sample. First, there is only one country out of 16 where reforms can be said to have been undone: Venezuela. And even here the evidence is mixed, for while price controls have been reimposed and macroeconomic populism has returned, privatization and tariff reductions remain untouched.[61] Second, there is a small share of countries (3 out of 16) where changes in government or in political circumstances have led to a slowdown in the pace of change; in some cases, such as New Zealand's, the slowdown may have been slight

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[59]Lipton and Sachs (1991) offer a fascinating account of this process in Poland.

[60]Mexico is included in spite of the obvious potential objections.

[61]See Navarro (1994) for a recent and detailed account.

and temporary; in other cases, such a Poland's and Hungary's, its real magnitude is yet to be determined; in none of these, however, do we see real backsliding.[62] Third, in several countries --Bolivia, Chile, Korea, New Zealand, Turkey, perhaps some in Central Europe-- reforms have continued **even after the opposition to the initial reforming government has come to power**.

These considerations suggest a tentative definition of sustainable reform: **a reform is sustainable if national elections have taken place since the beginning of the process and the election outcome has not caused backsliding.** By this criterion, 15 out of 16 cases would seem to be sustainable. One can perhaps go even further and suggest: **reform is strongly sustainable if it has been pursued by both governments of the right and left in the same country, or if the reforming coalition has been ratified in power in at least two national elections**. By this additional criterion, reform is strongly sustainable in Australia, Bolivia, Chile, Colombia, Korea, Mexico, New Zealand, Portugal, Spain and Turkey --10 out of 16 cases.[63]

How can this be so? How are such outcomes compatible with the reported public opposition to reform? To begin with, two jabs at polling results seem inevitable. First, many economic issues may be complex enough to make expressions of support for this or that policy not very informative. In the early 1990s, close to three-quarters of Chileans polled systematically opposed "measures that would restrict the availability or increase the price of imported goods." In the same set of polls, roughly the same proportion strongly endorsed the notion that "government should take the appropriate measures to protect national producers from foreign competition." Results of this sort emerge with even greater absurdity in Eastern Europe, where the population has no previous experience of a market economy and the policies necessary to

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[62]The sample does not include the Baltics, where the return to power of former communists may also have the consequence of slowing down reform.

[63] Following the Nixon-in-China reasoning of Cukierman and Tommasi (1994), we should also strengthen our estimate of sustainability in cases where governments from the left have either initiated or advanced the reforms. We also note that we include Mexico with some trepidation, for the 1987 elections were less than fully transparent.

administer it. This has lead Jeffrey Sachs (in Williamson, 1994) to argue that in such countries it is pointless to seek consensus in the early stages of reform; people are simply too confused.

Second, the fact that people may express dissatisfaction with one set of policies (or, more often, with one set of economic outcomes), need not imply that they are ready to advocate (much less struggle for) a different policy course. As mentioned above, unemployment has become an immensely contentious issue in Argentina recently. In poll after poll citizens single it out as the most important public policy problem. Nonetheless, the same polls, particularly in the run-up to the May 1995 presidential election, suggest that large numbers of the unemployed are nonetheless planning to vote for reforming president Carlos Saúl Menem.

Is voter irrationality implicit in the fact that not only many of the unemployed, but also many of those initially hurt for reform, vote for the continuation of change? Not necessarily. To think about this question, it helps to recall the two broad frameworks used earlier to think about the causes and mechanics of reform: the interest-based model and the information-based model. In the framework that thinks of reform as a change in the equilibrium to a game among several groups, it may well be the case that groups that were content in the old equilibrium may be content in the new one as well. That is more clearly seen in cases in which the bad old equilibrium was the result of coordination failure, so that by coordinating in some suitable way and changing behavior everyone is better off. This may be the case, as argued above, in which high inflation made everyone very badly off, but it was rational not to ask for a fiscal transfer if and only if a group expected all others would do the same. More generally and realistically, it may be the case that groups oppose and are hurt by a particular feature if a reform package, but nonetheless support the package as a whole because it makes them better off in net terms. This may be the case, as we argued above, when reforms are bundled, so that everyone is hurt by some policy change but also aided by some other innovation.

Insights into this question can also be gleaned from the information-based framework. Under the *ancien regime*, people may have been particularly unsure about the mapping between

policies and outcomes. They could see welfare deteriorating, but could not be sure whether this was caused by the wrong policies, external shocks, foreign embargoes, or plain bad luck. The drastic change in policies can sometimes enable them to make a drastic updating of their beliefs, rendering clear the connection between, say, repeated fiscal deficits and inflation. In practice, this is manifested in the fact that essentially no political entrepreneurs advocate a return to central planning in Eastern Europe or to reliance on the printing press in Latin America: such policies have been just too thoroughly discredited in the eyes of the public. Even the current Venezuelan government pays lip service to the virtues of fiscal austerity and price stability.

A related story emerges from the influential paper by Fernández and Rodrik (1991). In their setup, there is pervasive uncertainty about the effects of economic reform on each individual. Under some plausible assumptions, this gives rise to a "status quo bias." Reforms that could be beneficial to a majority *ex post* are not adopted because of the uncertainty *ex ante*. But if this bias is overcome somehow (a distasteful possibility is an authoritarian government), so that uncertainty is dissipated and a majority is indeed better off, the reform will be popular and will become consolidated. Rodrik (1994 and b) claims that such logic could well explain the current enthusiastic public endorsement of the initially unpopular trade liberalization in places such as Chile and Turkey.

Haggard and Williamson (1994), in their conference summary paper, term this the "Sachs-Haggard phenomenon": "...reforms that initially met with intense opposition won wide-spread endorsement as they came to yield results." Indeed, this phenomenon seems to be at least as pervasive as the "honeymoon-and-then-fatigue" syndrome. According to Haggard and Williamson, Chile, Korea, New Zealand and Turkey conform to it. We would venture to add Argentina, Bolivia and Peru to the list. In *toto*, such cases provide grounds for optimism about the political sustainability of economic reforms.

IV. **What's Next?**

Ending hyper-inflation, doing away with mercantilism in foreign trade and privatizing endemically money-losing state enterprises are necessary but not sufficient conditions for turning developing and transitional countries into developed ones.[64] Sustained capitalist growth requires (among other things) functioning health and educational systems, independent judiciaries, transparent regulatory apparatuses, and a reasonably incorruptible civil service. Few, if any, of the countries that have recently undertaken radical reforms enjoy such blessings. Acquiring them will put into motion a wholly different political economy process.

Table 6 presents a summary of what, following Naim's helpful characterization, can be called Stage 1 and Stage 2 reforms. The list is essentially self-explanatory, and we will not describe it in detail here. We do want to highlight, however, some special characteristics of the challenge ahead. The first striking feature of Stage 2 reforms is their sheer technical difficulty. Any economist can tell you that curtailing inflation requires lower money growth; fewer are prepared to put forward a proposal for supervising operations in derivatives by banks and other financial institutions.

Differences in the politics between the two stages are no less striking. To begin with, the affected interest groups are very different. With the important exceptions of import-competing industrialists facing lower tariffs and unions in parastatals facing privatization, the "victims" of the first stage reforms were often atomistic or, as we argued in the previous section, too poor to matter politically. By contrast, the set of interests potentially affected in the next stage reads like a *who's who* of highly organized and vocal groups: teacher's and judicial unions, the upper echelons of the public bureaucracy, state and local governments, owners and managers of newly-privatized utilities and Bill Clinton's nemesis --the medical establishment. The complications are

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[64] Perhaps a more appropriate wording is that of De Pablo and Martinez (1989): conditions for turning "underdeveloping" countries into "developing" ones.

already evident in countries attempting to move forward: public school teachers and (especially) public health sector employees have been in a state of semi-permanent warfare against Presidents Aylwin and Frei of Chile, and the same is becoming true of Bolivia under President Sánchez de Losada. Similarly, cleaning up the finances of free-spending provincial governments has been a major headache for Menem and Cavallo in Argentina, and will be one of the most delicate tasks faced by Cardoso and his team in Brazil.

Also striking is what Miles Kahler (1990) has termed the "paradox of orthodoxy": while the first stage reforms involved a dismantling of the state apparatus in many areas, second stage reforms involve "bringing the state back in." Regulation, judicial adjudication and (to a lesser extent) the provision of social services are, almost by definition, government activities. The question, then, is how to strengthen the state without allowing it to become bloated again. Naím (1994) usefully cites Peter Evans' (1995) distinction between "predatory states" (the paradigm of which is Zaire under Mobutu) and "developmentalist states" (Japan and South Korea are good examples). How to steer the newly reformed countries away from the former and toward a streamlined version of the latter is a key question for both academics and policymakers.

Third and last, the political process required by Stage 2 reforms is likely to be very different as well. The first wave of changes was often carried out in unique emergency situations. Many of the measures (such as monetary and exchange rate stabilization) did not require parliamentary approval; in areas which normally should (such as deregulation or fiscal reform) even democratic governments were able to resort to "emergency rule by decree." By contrast, deep changes in judicial and regulatory systems (for instance) can hardly be carried out without lengthy discussion and the participation and technical expertise of the affected parties. Rule by committee and consensus will have to be the norm from now on. Which brings to mind another useful distinction --that between the initiation and consolidation of reforms-- stressed by Rodrik (1994b) and Haggard (1994). In the words of the latter, consolidation of reform requires "...building of legislative and interest -group bases of support" (in Williamson, 1994). Put differently, the strengthening of democracy is also a necessary component of the next stage of

reform.[65]

We end with a conjecture. The fork ahead in the road is not between sustaining or abandoning the first stage reforms. To the dismay of academics looking for sharp breaks and clean categorizations, there will be few (if any) examples of wholesale return to price controls and protectionism, much less to central planning.[66] The real dividing line will be between those nations that forge ahead with the changes necessary to become prosperous capitalist democracies and those that linger in a heterogeneous status quo often characterized by mediocre economic performance. Some countries --certainly Spain, Portugal and Korea, maybe Chile and the Czech Republic-- seem to be well on their way to making this second and more difficult transition. Others --Argentina, Colombia, Mexico, the other countries in Central Europe-- with luck could be there soon. But the road, clearly, remains as treacherous as ever.

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[65]This point is also discussed by Nelson (1994b).

[66]The question of macroeconomic soundness is a trickier one, for even highly advanced countries such as Italy and the United States and not invulnerable to the siren call of fiscal populism. On the difficulties of sustaining tight monetary and fiscal tightness in a newly-reformed economy, see Sachs, Tornell and Velasco (1995).

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Table 1: The Washington Consensus on Reform

1. Fiscal Discipline
2. Reorientation of Public Expenditure Toward Building Human Capital and Infrastructure
3. Tax Reform: Broaden Base and Cut Marginal Rates
4. Financial Liberalization: End Interest Rate Controls, etc.
5. Exchange Rates: Unified and Competitive
6. Trade Liberalization: Reduce Tariffs and Eliminate NTBs
7. Foreign Direct Investment: Welcome
8. Privatization: Do
9. Deregulation: Stop Only for Environmental, Safety or Prudential (Banking) Reasons
10. Property Rights: Secure

Source: Williamson (1994).

Table 2: Timing of Stabilization and Structural Reforms

	Stabilization	Structural Reform
Bolivia	1985	1985
Mexico	1987-88	1985-88
Argentina	1991	1987-1991
Peru	1990	1990
Brazil	1994	1990-94
Chile	1974-75	1974-75
India	1991	1991
Poland	1990	1990
Hungary	1991-92	1990
Czech Republic	1991	1991
Estonia	1992	1992
Latvia	1993	1993
Lithuania	1993	1993

Table 3: Aggregate Consumption Growth During Stabilization
(percentage terms)

Program	Period	Three Years Before Program (average)	First Year	Second Year	Third Year
Exchange Rate-Based					
Argentina	1967-70	6.8	2.6	4.0	6.4
Brazil	1964-68	3.6	3.3	0.7	4.3
Uruguay	1969-71	0.5	8.2	6.4	1.0
Argentina	1979-81	-4.2	14.4	5.6	-3.6
Chile	1978-82	1.0	7.5	6.5	6.8
Uruguay	1979-82	0.2	9.0	5.0	2.4
Argentina	1986	1.2	7.9	0.7	--
Brazil	1986	2.8	6.4	-0.9	--
Israel	1986-90	0.6	14.8	9.0	4.3
Mexico	1988-92	0.3	1.8	6.3	5.7
Argentina	1991-92	-0.6	6.7	10.8	--
Money-Based					
Chile	1975-77	-6.3	-11.4	0.3	16.0
Argentina	1990	-1.2	-1.8	6.7	--
Brazil	1990	-0.5	-2.5	3.9	--
Dominican Republic	1990-92	-0.3	-12.9	7.5	--
Peru	1990-92	1.5	-15.3	10.8	-.11

Source: Calvo and Vegh (1994)

Table 4: Industrial Production in Eastern Europe, 1989-92

	1990	1991	1992	Cumulative Change 1989-1992
Poland	-24.2	-11.9	3.5	-30.1
Bulgaria	-12.6	-23.3	-15.0	-43.0
Czechoslovakia	-3.5	-21.2	-10.6	-32.0
Hungary	-4.5	-19.1	-9.8	-30.3
Romania	-19.0	-22.7	-22.0	-51.2

Source: United Nations Economic Commission for Europe, cited in Sachs (1993).

Table 5: Political Performance of Economic Reforms

	Year of Reform	Year of Elections	Govt. Backed	Reforms Advanced	Reforms Frozen	Reforms Reversed
Argentina	1991-94	1995	Y	Y(?)		
Australia	1983-90	1984 1987 1990	Y Y Y	Y Y Y		
Bolivia	1985-89	1989 1994	N N	Y Y		
Chile	1974-81 1984-88	1989 1993	N Y	Y Y		
Colombia	1989-92	1990 1994	Y Y	Y		
Czech Republic	1990-94	1992	Y	Y		
Hungary	91-94	1994	N		Y	
Korea	1980s	1987 1992	Y N	Y Y		
New Zealand	1984-88	1987 1990	Y N	 Y	Y	
Mexico	1983-1994	1987 1994	Y Y	Y Y(?)		
Peru	1990-94	1995	Y	Y(?)		
Poland	1990-1994	1991 1993	N N	Y 	 Y	
Portugal	1987-1994	1991	Y	Y		
Spain	1982-86	1986 1989 1993	Y Y Y	Y Y Y		
Turkey	1980-86	1983 1991	Y N	Y Y		
Venezuela	1990-94	1993	N			Y

Table 6: The Two Stages of Economic Liberalization From Changing Rules to Changing Institutions

	Stage 1: Launching	Stage 2: Consolidation
Priorities	o Reduce Inflation o Restore Growth	o Improve Social Conditions o Increase International Competitiveness o Maintain Macro Stability
Reform Strategy	o Change Macro Rules o Reduce Size and Scope of State o Dismantle Protectionism and Statism	o Institutional Creation and Rehabilitation o Boost Competitiveness of the Private Sector o Reform Health, Education and other Public Services o Create the "Economic Institutions of Capitalism" o Build New "International Economic Insertion"
Typical Instruments	o Drastic Budget Cuts and Tax Reform o Price Liberalization (including Exchange and Interest Rates) o Trade and Foreign Investment Liberalization o Private Sector Deregulation o Creation of "Social Emergency Funds" o "Easier Privatization" (Hotels, Airlines, some Manufacturing)	o Labor Market Reform o Civil Service Reform o Restructure Government (especially social ministries) o Overhaul Administration of Justice o Upgrade Regulatory Capacities (for privatized utilities and other monopolies, anti-trust, anti-dumping, financial sector, environment, labor, etc.) o Improve Tax Collection o Sectoral Restructuring o Build Export Promotion o Restructure Relations between State and Federal Governments

Principal Actors	o Presidency o The Economic Cabinet o Central Bank o Multilateral Financial Institutions o Private Financial Groups and Foreign Investors	o Presidency and Cabinet o Congress o Public Bureaucracy o Judiciary o Unions o Political Parties o The Media o State and Local Govts. o The Private Sector
Public Impact of Reforms	o Immediate o High Public Visibility	o Medium and Long Term o Low Public Visibility
Technical and Administrative Complexity of Reforms	o Moderate to Low	o Very High
Nature of Political Costs	o "Temporary Corrections" widely distributed among the population	o Permanent Elimination of Special Advantages for Specific Groups
Main Governmental Challenge	o Macro Management by Insulated Technocratic Elites	o Institutional Development Highly Dependent on Mid-Level Public Sector Management.

Source: Naím (1994)

Figure 1

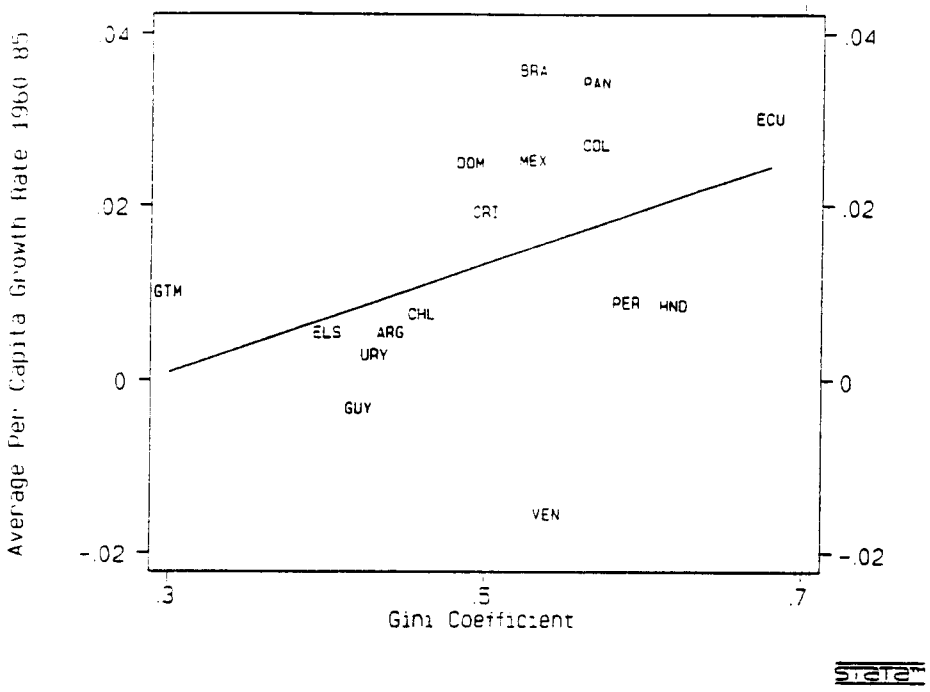

Figure 2