CRISIS, POLITICAL INSTITUTIONS, AND POLICY REFORM
The Good, the Bad, and the Ugly

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Introduction

I was asked to write a paper on crisis and reform. Having written on those issues in the past, lately I have become rather skeptical of several of the maintained assumptions in some of the discussions on the political economy of reform, of which "crisis and reform" has been one component. In particular, I am inclined to take a more continuous, less episodic and less heroic view of the policymaking process than that implicit in some discussions of "reform." Furthermore, it is often thought that "the reforms" that countries need to undertake are technically obvious for any half-competent economist, and that it is just a matter of figuring out the political economy of reform. I have also come to question the obviousness of the received wisdom. Finally, even beyond definitional problems with regards to what exactly constitutes "a crisis," crises (in many plausible definitions) are perhaps not the best times for instrumenting solid, durable reforms, with the properties necessary to induce adequate changes in people's behavior and hence in societal outcomes.

The main point I make in the paper, is that even though crises might facilitate the introduction of some policy reforms, in general the qualities of the implementation of those policies is very much conditioned by the overall institutional environment of the country, and crises do not necessarily induce changes at this deeper politico-institutional level. The so-called first generation of reforms, sometimes introduced in the context of crises, even though important, were (for the most part) not reforms of the deeper determinants of the qualities of policies. The so-called second-generation reforms, even though containing some leap service to institutions and "governance", do not seem to be generating profound changes either.

* This paper makes liberal use of some pre-existing accounts of the relation between economic crises and economic reforms, in particular Tommasi and Velasco (1996), Corrales (1998) and Drazen (2000). I thank valuable comments by Robert Barros, Paolo Benedetti, Daniel Heymann, Guillermo Mondino, Valeria Palanza, and seminar participants at CEDI and at the Oslo ABCDE. Special thanks are due to my discussants Jorge Braga de Macedo and Guillermo Perry, to an anonymous referee, and to the editor, Bertil Tungodden, for excellent comments. I thank the Leitner Program in International and Comparative Political Economy at the Yale Center for International and Area Studies for its hospitality during the Spring Semester of 2003.

In the view sustained in this paper, attention has to be focused not so much on specific policies as on policymaking capabilities. Those capabilities, in turn, are conditioned by the political environment and by the rules of the political game, i.e. by political institutions.

For expositional purposes, let me use this introduction to present the notion of a hierarchy of rules.[1] "Policies" are rules that regulate, say, the behavior of economic agents; for instance a policy that defines tax bases and tax rates. Let us call those "lower level rules," belonging to the set RL. Let us call the rules that determine who has the power, under what procedures, to legislate on tax bases and tax rates, intermediate level rules (RM). These intermediate rules include also, for instance, whether the Central Bank has statutory independent, the allocation of power and design of regulatory agencies, etc. Finally, let us call high-level rules (RH) those that determine how RM and RL (as well as there enforcement) are determined. RH are deeper politico-institutional rules that determine the incentives of political actors and hence political behavior. They include the rules in the Constitution, electoral rules, and other related (including informal) practices of the policy.

RH together with a number of contextual and informal elements determine the actual workings of the policymaking system (i.e., is the Judiciary independent, is the bureaucracy professional, are legislators policy-oriented, etc.) For brevity, in the remainder of the paper I will use RH (or "deeper institutional determinants") to include the overall functioning of the political system. (Spiller, Stein and Tommasi, 2003, describe the underlying methodology in more detail).

At any given point in time, those higher level rules are given, but they are themselves a product of history and of previous choices. For instance, we include at that level those rules inherited from the history of democracy in the country. For the case of Argentina (studied in Spiller and Tommasi 2001 and 2003), the many military interruptions of the twentieth century left an imprint in several institutional spheres, such as the Supreme Court, the Bureaucracy, and Federal Fiscal Arrangements, that cast a long shadow even several years after the return to democracy in 1983.[2]

Using this language, "the reforms" were reforms in RL (like lowering tariffs) and RM (like privatization, or granting independence to the central bank). RH rules were for not necessarily affected. I argue in this paper that RHs heavily condition not only the choice of lower Rs but also the details of implementation and effectiveness of those lower level rules. For example, the capacity that the political system has to enforce certain rules, to make intertemporal commitments, is perhaps more important than the "title" of the policy in RM (such as "public enterprises" versus "regulated private utilities.")

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[1] This is developed in more detail in Acuña and Tommasi (2000). See also Levy and Spiller (1996).

[2] Furthermore, in some cases past policy choices might become themselves important determinants of political behavior. That is for instance the case with federal fiscal rules which in some federal countries are an important determinant of the political and policy incentives of key political actors. (In Tommasi 2002, I analyze that connection for the case of Argentina). Clearly, there are also feedback effects across these levels, since the performance of policies in RL, can potentially lead to changes in higher level rules, as it has indeed happened throughout the reform crusade, mostly at the level of RM. In the remainder of the paper I will follow the arbitrary convention of reserving the term "institutions" for higher level rules, and not for policies.

I will also argue that, even though the crises identified in the modern economic reform movement might have facilitated introduction of reform with good "titles," it is not obvious that they facilitated good implementation of those reforms and of the subsequent policies. More generally, it is doubtful whether crisis times are likely to foster the introduction of deeper reforms.

In Sections I to III, I provide a brief review of some of the arguments (and implicit assumptions) underlying the received wisdom on crisis and reform. In particular, I try to rationalize some of the main mechanisms of operation of the crisis-reform connection, since some of those mechanisms are a useful language for the points I make later. In Section IV, I suggest some weaknesses of the received crisis-reform wisdom. In Section V, I suggest an alternative approach which focuses on the ability that a polity has to undertake the political exchanges necessary to instrument good public policies, and at the role that political institutions have as the rules of that game of transactions. In Sections VI and VII, I tentatively apply that approach to one (unfortunately quite topical) case, Argentina.[3]

I. The Received Wisdom

In the last couple of decades, the notion that economic crises seem either to facilitate or outright cause economic reforms is part of a new conventional wisdom. Large amounts of ink have been devoted to the subject.[4] Rather than reviewing everything that has been said, I will present below a "stylized account" of the crisis hypothesis.[5] It is worth noting from the start that this conventional wisdom has evolved around some very specific circumstances faced by developing countries in the 1980's and 1990's. Some of that

[3] The Argentine case might be a relevant one because it has been considered a poster child by the Washington establishment throughout the 1990's, and it has recently switched into a basket case (Pastor and Wise, 2001). Since its precipitous fall in 2001, the Argentine case seems to be one of the battlefields in which technical and ideological battles are being fought, often in simplistic and dangerous ways.

[4] 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). 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). For more systematic accounts see, for instance, Nelson (1990), Williamson (1994), Tommasi and Velasco (1996), Rodrik (1996), and Corrales (1998). Reflecting on a broader notion of crises (see next footnote), Gourevitch (1989, p. 9) says, "it is the crisis years that put systems under stress. Hard times expose strengths and weaknesses to scrutiny, allowing observers to see relationships that are often blurred in prosperous periods, when good times slake the propensity to contest and challenge. The lean years are times when old relationships crumble and new ones have to be constructed."

[5] I refer to the crisis hypothesis circulating the 1980's and 1990's "Washington Consensus" circles, and related literature, or what Joe Stiglitz has dubbed "the modern reform movement" (Stiglitz 2000, p. 551)." This hypothesis is heir to a long-standing concern in political science about crisis as an independent variable in explaining *policy* and also *political* change. See for instance Binder (1971) and Habermas (1975), as well as Corrales (1998) for a brief introduction.

"wisdom" might not be too useful in the near future, under the new circumstances. In particular, it might happen that the possible effects of a crisis before market-oriented reforms have started, are very different from the effects of a crisis when MORs (more or less well executed) are already in course or in place. In addition to the intra-country temporal sequencing of crisis and extant policies, there are global contextual factors that are also different. It is not the same to have a crisis at a point in time in which you come from a closed economy and an interventionist policy stance while the Berlin Wall is falling, than to have a crisis after you have instrumented many MORs and the global financial architecture is being scrutinized.

The basic story runs as follows. There is a set of *"bad"* policies in place; and the economic situation is very bad and possibly deteriorating rapidly. This is supposed to put in motion several mechanisms that lead to the adoption of substantial policy changes, reforms, in the "*right*" direction. The mechanisms linking crisis to reform that have been put forth in the literature are varied. I review here, in a non-taxonomic way, some of the most common ones. These mechanisms operate over different stages of the policy process, and put their main focus on different actors. Some are complements to each other while other are alternatives.

1. Learning

Economic crises are supposed to contribute to Bayesian learning about the *"right"* model of the world. A period of intense economic disarray leads to a reassessment of <u>the mapping from policies to outcomes</u>, in particular to a realization of how costly some previous policies were. Harberger (1993) writes, "... practitioners go around with a certain world view in their heads. All sorts of crazy things 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 worldview 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."[6]

The fact that nobody understands completely the possible effects of policies on outcomes, that this mapping is stochastic, and that there are various asymmetries of information about it, leads to a series of policymaking and political gimmicks and tactics that are one of the core elements of the policymaking process. The tendency to oversimplify complex messages, and to bundle together policy reforms that are not necessarily inseparable from a technical point of view, are a consequence of this imperfect knowledge and have important implications for the path of future policies in political equilibria in which politicians construct messages attempting to differentiate themselves from supposedly bad policies.

The learning view of crises is one of the most important ones. It operates at several levels; the quote by Harberger above refers more directly to the technocrats ("practitioners"), but

[6] Bruno (1993, p. 190) describes the Argentine reform process of the early 1990's as the outcome of "a painful and protracted collective learning process." He adds, furthermore, that "[i]t is doubtful, considering the experiences of various countries that we have encountered so far, and given the complexity of Argentina's situation, whether any shortcuts are possible in this process."

learning does run through the whole process of "social reasoning," involving experts, policymakers, politicians, the media, and the general public. For instance, Williamson and Haggard (1994) write ".. belief in the benefits of economic reform is much less widely held among politicians than among economists, and it is even less widely endorsed by the general public, let alone by the specific interests that stand to lose ..."[7]

This distinction among several layers in the information channel is very important to understand several specific aspects of the dynamics of crisis and reform in particular cases. One important instance of this is found in the so-called "Nixon goes to China" effect. According to some renderings, politicians coming from the left of the spectrum might have a comparative advantage at convincing people of the long-run necessity of market-oriented changes, even if those changes have short-term costs for some constituencies (Cukierman and Tommasi, 1998a and 1998b).[8] Also, the media can play an important role in building up public opinion with regards to the diagnostic of a crisis and the possible remedies. Oversimplification of messages and coarsening of information are not uncommon, and possibly quite risky; for instance the bundling of several market-oriented reforms in the process going forward might now backfire, as politicians and the public might blame the overall package for undesirable outcomes.

2. Special Politics

"In extreme cases, such as Poland in 1989, the crisis of the ancien regime may be so profound as to create an opening for what Leszek Balcerowitz calls "extraordinary politics" – a widespread willingness to suspend the usual political rules. These worst of times give rise to the best of opportunities for those who understand the need for fundamental economic reform" (Williamson 1994.) "Reform will be easier where the opposition is discredited and disorganized (or repressed)" (Nelson, 1990, 335).

This line of reasoning contains several "branches," some emphasizing temporary reallocation of institutional power (for example in delegation from Congress to the executive), others emphasizing temporary or permanent reallocation of effective power among underlying interest groups, or (in connection to the informational point above) reallocation of space in public debate.

2.1. Delegation

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[7] The Williamson (1994) volume from which the quote is taken is a clear exponent of the most prevalent views on reform at the time. Notice the use of the generic expression "economic reform" to refer to a rather specific set of policies in the direction of market opening and liberalization (on this, see also Stiglitz 2000). Nelson (1997) is an interesting paper that explores some of the complexities in deriving generic propositions about (trade) reform, and that also emphasizes the asymmetries in understanding and argumenting about such complex processes. See also Lohmann (2000), who emphasizes the different degrees of understanding of the details of monetary policy by different audiences.

[8] This effect has been dubbed the Nixon-goes-to-China effect by analogy to the fact that "only" someone with impeccable anti-communist credentials like Richard Nixon could have opened the pathway to relationships with China, without risking his domestic credibility.

Several reform episodes included instances in which, for instance, Congress delegated to the Executive some unusual legislative prerogatives. (See the description in Keeler, 1993). Crises create a sense of urgency. *Something* needs to be done soon, for the crisis requires an urgent resolution, creating room for "special politics" for a period of time. In that context, Rodrik (1994) emphasizes the agenda-setting role of reformist governments.

The relation between crisis and delegation can be illustrated with the following metaphor. Imagine a town on fire, people running out of their houses towards the margins of a river beside the town. Exactly where the people are reunited there is a bridge, which is presumably going to catch fire as well, and a bus. The bus driver calls all the people inside the bus, and proclaims that he will save them by taking them across the bridge to the other margin of the river, a place where –he says, nobody knows for certain- there is no fire and everything is so much better. Jumping inside the bus is dangerous, the bridge could break, the driver could be a crazy maniac, not know how to drive, and nobody knows what things are like on the side of the river. More so, going inside the bus means leaving behind all belongings (needless to say, those belonging were sooner or later going be caught by the fire). Disregarding the many arguments one could make for not jumping inside the bus, the people accept the bus driver's proposal. In Argentina the economic, political and social situation was so dire, that people (i.e. Congress and the population) decided to trust Menem's promises and embark in actions that, in a normal context, they might have not accepted to do. [9]

2.2. The Opposition is Weakened or Muted

Oftentimes reform efforts at times of crisis come associated with reconfigurations of dominant coalitions, in such a way that the (core of the) reform coalition is able to (actively) mute the opposition. It is argued that in many cases, these reforms have tended to be associated with a relative weakening of, for instance, the labor movement. The classic war of attrition reform model of Alesina and Drazen (1991) can be seen as formalizing what might lay behind the weakening of those who oppose *a particular way of* instrumenting adjustment and reform. Laban and Sturzenegger (1994) argue that the capitulating group is most likely to be the poor, who have restricted access to financial technologies and therefore a lower ability to protect themselves from the costs of high inflation.

This notion sometimes comes bundled with learning-type arguments. In many policy decisions, the public goods / efficiency /valence dimensions come intertwined with distributive struggles. Particular groups (say, industrialists) build arguments buttressing policies that protect them. When things are going really badly, and somehow an image has related those poor outcomes to some pre-existing policies, those advocating such policies tend to loose ground in the public debate, and hence supporting such policies becomes less

[9] Using the language of procedural rules in legislatures (Baron and Ferejohn, 1989, Moser, 1999), the logic of delegation in crises situations can be understood as a switch from "open rule" to "closed rule." It also relates to the standard constitutional practice of granting presidents "emergency powers." For more on the logic of delegation see Epstein and O'Halloran (1999). Of course this delegation has several downsides (see for instance O'Donnell 1994b), that could have a negative impact on the quality of the reforms undertaken in criss scenarios, as we will stress below.

attractive for politicians. For instance Krueger (1993) argues that economic crises undermine the supporters of the status quo, rendering politics as usual no longer sustainable.

3. Switch in Equilibrium Behavior

There are many actors that participate in the policy process. The preexisting inefficient policies can be seen as the outcome of a non-cooperative outcome in the policymaking game among these actors. Crises can, then, be interpreted as a situation in which a very low expected future payoff of continued non-cooperation, might induce actors to switch to more cooperative policymaking, which is instrumented through the reform of some institutions. For instance, a reform of fiscal institutions might help to stop subsidies that, even though individually beneficial to each powerful group, were welfare reducing in the aggregate. Models that capture such dynamics are provided by Mondino et al (1996) and Velasco (1998).

Other stories present the converse argument, in which the pre-existing inefficient policies were sustained by the intertemporal cooperation among powerful groups, to the disadvantage of the general public. In those stories, crises break-up such oligopolistic behavior, allowing a reformist government to get rid of the previous policies. For instance, in Tornell (1995) the reduction of economic rents brought about by an economic crisis destroys the previous "cohabitational equilibrium" among rent-seeking groups. Rather than cooperate with one another in exploiting rents and blocking reforms, rent-seeking groups turn against each other; some of them even siding with the executive and accepting the costs of reform in order to inflict losses on other groups.

4. Risk-Taking Behavior

Crisis are often associated with downward economic paths. Situations tends to be such that, if nothing is done, the situation is likely to deteriorate to very low levels. In such circumstances, using "prospect theory" one can argue that risk-taking behavior becomes more likely. Prospect theory (Weyland, 1996) argues that people tend towards highly risky behavior when confronted to threats to their well-being, but are very cautious when facing auspicious prospects. Weyland (1996) argues that economic crises (worsening fiscal deficits, sharp external imbalances, or exploding inflation) place the government in the "domain of losses," and thus more inclined to adopt risky policies, such as market-oriented reforms.[10]

II. Some Clarifications

[10] Although Weyland focuses on the chief executive, the logic can apply to multiple layers of the policymaking process, including also public opinion and even technocrats This theory seems to apply to the many desperate attempts by Minister Domingo Cavallo in late 2001, when Argentina was entering a crisis of titanic proportions.

The quick listing presented above suggests several points that require more precision in order to operationalize the crisis hypothesis. First of all, it is not clear whether the role of crisis should be seen as *necessary*, *sufficient*, or simply *facilitating* reform (Drazen, 2000, p. 445). Second, it is not clear whether we are referring to *economic* crises in a somewhat narrow sense (which includes the narrower definition of *social* -- poverty, unemployment and the like, not the total rupture of the social contract that characterizes deeper crises), or whether we include full blown political and social crises, all of which sometimes come together. Even restricting us to a narrower definition, what is the threshold to declare a crisis? In a sense, "crisis is mental state" related to country-specific aspiration levels, something that is relatively hard to capture in empirical analysis. Lora (1997, 2000) attempt to implement the notion of crisis empirically.

Also, the varied accounts sometimes do not take care to distinguish different possible origins of crises (and/or the interpretation of the origin of the crisis being made). Is it the outcome of the endogenous deterioration induced by the pre-existing misguided policies (Argentina 1990)? Is it the outcome of savage exogenous shocks that hit a polity that has approximately sound policies (Argentina 1994)? Is it largely induced by an "endogenous" break up of confidence of economic actors on the sustainability of the (right or wrong) extant policies (perhaps Argentina 2001)? These three possible reasons for having a crisis - bad policies, bad luck, or bad institutions- might lead to different types of political responses.[11]

In the next section, we will take the easiest and most benign interpretation with regards to all the concerns of the last two paragraphs. We use the hypothesis that crisis are a *facilitating* factor for reform. Williamson and Haggard (1994, p. 565) argue that "crisis is clearly neither a necessary nor a sufficient condition to initiate reform. It has nevertheless often played a critical role in stimulating reform." We concentrate on *economic* crises, and we identify a crisis with a deterioration of status quo welfare, which is associated with prevailing policies. Yet, as we will see below, the "crisis & reform" story still contains many "ifs."

III. Crisis, Reform, and Living Happily Ever After

In this section I provide a stylized account of the steps involved in a crisis & reform story with a happy ending.

1. There is a set of well-identified inadequate preexisting policies.
2. The *economic* situation deteriorates substantially.

[11] I refer to the last case as 'bad institutions," in the sense that Argentina for most of the decade seemed to have what the Washington Consensus would have called good policies, yet in the end they did not work. I will argue below that even considering some peculiar aspects of Argentine policies, the crucial reason for the final failure has to be searched in the deeper determinants of political behavior in Argentina, and not so much in the policies implemented. Countries with "bad institutions" are more *likely* to suffer self-fulfilling confidence crises. The *actual* occurrence of crisis is the outcome of several other factors, combining in fact bad institutions and bad luck.

3. The deterioration, the crisis, is perceived to be caused by the preexisting policies; either because they were always inadequate, or because they are inadequate to handle some new states of the world.
4. There is a clear set of *"right"* prescriptions that can take care of the problem.
5. There is an adequate social learning of 3 & 4.
6. It becomes incentive compatible for an agenda-setting leader to act on that.[12]
7. The leader has the political capacity to "play" the reforms through the political process. (related to *special politics* above)
8. The reforms are sustained throughout the multiple stages of the policy process.
9. Details are dealt with properly (or are unimportant.)
10. Economic agents (rather soon) believe in the stability of the new set of policies and react accordingly.
11. Hence, economic outcomes turn out rather well.
12. It is sustained politically, and there are no major economic setbacks.
13. The End of History.

This highly stylized fable is obviously subject to several caveats. In the next section I raise some of those considerations, which are relevant for the later discussion.

IV. What is Wrong with the Fairytale?

The typical account of crisis and reform implicitly focuses on one-shot policy implementation. In reality, policies are complex objects, with multiple stages, and taking reform to full fruition is a process involving multiple actors through multiple stages of the policy process, requiring specific responses from economic and social agents, and hence requiring several forms of cooperation and requiring positive beliefs on the durability of the policy. That is, policies require a lot more than a magical moment of special politics in order to produce effective results.

Also, there is not such a thing as a universal set of right policies. Policies are contingent responses to underlying states of the world; what might work at one point in time in a given country, might not work in a different place or in the same place at other points in time. Furthermore, one has to go beyond the "title" of the policy into the details of its implementation. (In relation to point 9 in the previous section, *wonderful ideas* might be poorly implemented.)

More generally, (within reasonable bounds) what really matters is not the broad definition of a policy stance, but the details of implementation. For instance, Rodrik (1995) analyzes six countries that implemented a set of policies that shared the same generic title, "export subsidization," but had widely different degrees of success. Rodrik relates success to features such as the consistency with which the policy was implemented, which office was in charge, how this was bundled or not with other policy objectives, and how predictable

[12] The order of these steps is not necessarily chronological. Social learning might be induced by leadership, or more generally by "elite domination" (Zaller 1992, Chapter 12).

the future of the policy was.[13] This latter point highlights the fact that policies depend upon the expectations and beliefs of economic (and social) agents for their success.

Some of my own (mostly indirect) involvement with fiscal issues in Latin America suggests that the success of tax policies is much more a question of accountants, lawyers, and political will, than of the "optimal-taxation" advice of economists. Also, studying the process of "decentralization of education" (a beautiful Washington-sponsored policy title) one finds enormous variations in performance depending on many implementation details and on contextual variables (see for instance Tommasi 2002, section IV).

Similarly, Murillo (2002) describes the variety of policies undertaken under the title of "privatization of utilities" in five Latin American countries. She argues that different governments implemented privatization in different ways, according to their ideological leanings as well as to the nature of the coalitions they forged to make those policies possible.

The fact that there are no universally valid policy recipes is a point that was somewhat forgotten during the "reform epic" of the 80's and 90's. Recent work has, rightly, started to emphasize the importance of "home-grown" development strategies (see for instance North 1994, Evans 2001, Pistor 2000, and Lindauer and Pritchett (2002).[14] As emphasized in Mukand and Rodrik (2002), there is a tendency for countries to "imitate too quickly" formulas that have been successful elsewhere. Even though not the explicit focus of Mukand and Rodrik, I believe that part of the explanation has to do with the informational issues emphasized in Section I.*1*. here. The mappings between policies and outcomes are complex objects to apprehend, as illustrated by the debates among professional economists on the impact of trade liberalization on growth (Srinivasan and Bhagwati, 1999, Edwards, 1998, Rodríguez and Rodrik, 1999), or on poverty reduction (Kanbur, 2001). People (economic agents, politicians, policymakers) use mental shortcuts in order to organize the information of the world around them.[15] That is the reason why the statement "it worked in New Zealand" seems to carry a lot more weight in selling an idea to a politician or to the public, than a complex multivariate analysis which specifies the dependence of optimal policy responses on a large number of difficult-to-assess variables. These simplifying tendencies seem to be more pronounced in the general public than in politicians, in

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[13] Some of these policy features are the same identified in a more generic approach to public policies in Spiller and Tommasi (2001). See also Spiller, Stein and Tommasi (2003), Cox and McCubbins (2001) and Sabatier (1999). Certainly we would benefit from better (theoretically focused) studies of the determinants of the effectiveness of polices.

[14] In the words of North (1994, p. 8) "economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western economies to third-world and Eastern European economies is not a sufficient condition for good economic performance." Acuña and Tommasi (2000) make similar points with emphasis on the match between the policies (RL) or lower-level institutional reforms (RM) with the higher-level institutional endowment of the country (RH).

[15] For a more detailed elaboration of the notion of "mental models," see Denzau and North (1994). They argue that ideologies are the shared framework of mental models that groups of individuals possess that provide both an interpretation of the environment and a prescription as to how that environment should be structured.

politicians than in "policy experts," and in policy experts than in academics specialized in the subject matter.

This multi-layered imperfect knowledge about what the exact impacts of policies are (or, even more, are likely to be) in turn opens the door for manipulation, bundling, oversimplification and outright lying in policymaking games (Tommasi and Velasco, 1996). Some of the bundling and overselling played during the market-oriented reform epic might backfire in a second round of crises, in which sensible policies might be rejected by the polity because they have been (unnecessarily) bundled with other policies which might have failed. The degree to which such things happen, in turn, might be a function of the institutional determinants of the qualities of that "public space of policy making" (Nelson and Tommasi, 2001).

Putting together the notion of "policies as titles" with the issues of implementation, if a good idea is poorly implemented, it is not clear that the public or the political system will be able to tell the difference – i.e. that the "right" social learning will take place. In that sense, crises could lead to right reforms (the good), no reform (the bad), or wrong reforms (the ugly).[16] Adding the fact that (good or bad) reforms could also take place "in normal times," we have a two-by-three matrix of possible connections between crisis and reform, depicted in Table 1, which will be useful later.[17]

<Table 1>

Another point that needs more careful consideration is the notion of special politics (*delegation, muted opposition*, etc.) The fact that reforms are instrumented under those forced circumstances impinges some special characteristics to the type of reform that could emerge. These "negative special politics" do not seem the most adequate process in order to instrument deeper institutional reforms. The fact that a series of strategic tricks are used might have a negative impact on the quality of resulting reforms (as it will be illustrated in the Argentine case). This is even more important once we recognize the multi-stage nature of policy processes; points 8, 9, 10, 11 and 12 of the fairytale, and not just 7, do matter.

Furthermore, there is a sense in which crises are the worst conditions for the enactment of good collective choices. As O'Donnell (1994) argues, using the example of hyperinflation crises, "in the context of this crisis it becomes rational for everyone to act 1) at highly disaggregated levels ...; 2) with extremely short time horizons; and 3) with the assumptions that everyone else will do the same. A gigantic, national level Prisoner's Dilemma emerges .... The primary basic phenomenon is generalized de-solidarization.... For players of this game, broad, long-run economic policies, negotiated and implemented with the participation of highly aggregated interest associations, are not important." (O'Donnell, 1994, 170). Even though O'Donnell focuses on individual *economic* behavior, much of what he says could be applied to *political* behavior. That is to say that crises are perhaps

[16] The latter, again, could relate to learning in reverse, with adequate policies wrongly assigned guilt for poor outcomes.
[17] We leave the second row empty for now, as it was not a concern in the crisis & reform literature. We will come back to that later.

the worst of times to generate the conditions for the deliberative construction of bargains and consensus that are necessary to sustain quality policies and solid institutional reforms. This capacity for constructing intertemporal cooperation is, beyond the state of crisis or normalcy, heavily affected by the political institutions of the country, the institutional environment RH.

This brings us to the final point we want to re-emphasize in this section: many aspects of reforms have temporal dimensions that require substantial intertemporal cooperation. These intertemporal dimensions are the political analogy of the intertemporal characteristics of transactions in Transaction Cost Economics, and as in TCE, are a crucial entry point for the role of institutions, in this case *political* institutions. Applying such logic to the policy process, we enter the realm of Transaction Cost Politics, which can be encapsulated by thinking of a political version of the Coase Theorem. If reforms are so good, how come it is so hard to implement them? The answer has to include the (transaction) costs of enforcing the necessary intertemporal compensations.

Once again, Rodrik is the author who has opened that door in the application to policy reform. In closing his 1996 overview article, he argues that "[b]ecause distributional issues are at the heart of the literature discussed here, we need more progress on understanding why institutions for compensating losers from reform are not more common. There are very few papers where the difficulties of compensation are made endogenous to the analytical framework. This makes the literature somewhat incomplete in its diagnosis of the issues. It also opens up a natural avenue for future research." (Rodrik, 1996, p. 39) The next section takes us in the direction of transaction cost politics.

V. Institutions and Policy (and Policy Reform)

The reforms usually depicted in the reform epic are policy reforms (RL) and intermediate level institutional reforms (RM). The central point of the paper is that what really matters are some deep aspects of the workings of political institutions (RH), which condition not only broad policy choices (including "reforms"), but more importantly the effectiveness of policy implementation.

What determines a society's capacity to adjust its policies in the face of changed circumstances or in the face of the failure of previous policies? What determines the ability of a society to sustain policies long enough to create an environment of credibility and hence to elicit the adequate responses from economic agents? More generally, what determines the capacity of a society to decide and instrument effective polices both in crisis times and in more normal times?[18]

One good entry point to answering that question is provided by Rodrik (2000). His answer would be "democracy," or more precisely "participatory politics" or even more precisely

[18] It can also be argued that the likelihood of a given polity facing a crisis depends on its institutions and on (the more permanent and generic features of) its resulting policies. I illustrate this point in the Argentine case below.

"social cooperation." Rodrik emphasizes three channels by which "democracy" fosters better policies: 1) deliberation, 2) rules that prevent "too much redistribution," and 3) *procedural rules that facilitate intertemporal cooperation* (my wording.)

I believe that Rodrik's answer is basically right, but a little too "macro," too general in its depiction of political institutions. It would be nice to be able to develop more microanalytics of the effect of political institutions on policy processes, so that we can move beyond telling a dictatorship "you should become a democracy." What exactly determines the ability of generating these more cooperative societal outcomes that are necessary to sustain effective policies? The answer, I believe, lies in the ("general equilibrium") interactions of several specific details affecting the workings of the political system.[19]

Here I suggest one possible way of looking at the connection between some detailed aspects of political institutions and the resulting features of public policies, and below I apply it to the Argentine case. The framework, called a "transactions approach to public policy" in Spiller and Tommasi (2001), is an elaboration of previous work on transaction cost economics and its application to politics.[20]

Public policies are the outcome of intertemporal transactions among political actors who hold power at different points in time. If the equilibrium of that intertemporal policy game is cooperative, first best policies could be implemented. First best policies possess a number of features, such as stability throughout different administrations, adaptability to changing economic and social circumstances (i.e., capacity to instrument reforms), coordination across policymaking units, sufficient degrees of investment in policymaking capacity, etc.

Whether policies (and processes) with such desirable properties emerge, will depend on whether the political institutions (RH) underlying the policy process lead to cooperative behavior or not. In order to answer that question, it is necessary to enter a detailed investigation of the determinants of political cooperation in each polity. In the remaining sections, I will briefly sketch those details for the Argentine case. As an intermediate step, I suggest below the type of elements pertaining to the (abstract) description of a policymaking game that one needs to match to observed characteristics of the workings of political institutions. In doing that, we draw from insights of the analysis of intertemporal cooperation in the industrial organization context of oligopoly. (More details and

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[19] For brevity I will focus on formal political institutions, which are certainly very important, but by no means the unique determinant of societal outcomes. In particular, the main socioeconomic cleavages, and the way they are articulated (or not) via formal political institutions, are crucial aspects that need to be studied. More generally, beyond "formal political institutions of government," we should include the nature of cleavages, corporatist actors, public opinion, social actors, social capital, etc. Yet, the nuts and bolts of (professional) politics and its determinants are a very component of the broader picture, as well as a relevant entry point for analyisis.

[20] North (1990) and Dixit (1996) have labeled *transaction-cost politics* the use of transaction-cost reasoning to think about politics. While North and Dixit emphasize transactions among citizens and politicians, I emphasize here transactions among politicians. Related work in political science includes Weingast and Marshall (1988), Moe (1990a and 1990b), Moe and Caldwell (1994), Epstein and O' Halloran (1999), and Haggard and McCubbins (2001).

references are provided in Spiller and Tommasi 2001, and Spiller, Stein and Tommasi, 2003).

Payoffs of the stage game: The elasticity of per-period payoff to alternative spot actions will be an important determinant of whether cooperation is sustainable in equilibrium or not. In repeated games, if the spot payoff from deviating to non-cooperation is very high, cooperation is less likely. In repeated oligopoly games, this is the case with elasticity to price discounts: if a firm stands to gain very large short-term profits by lowering its price (for instance because there are a large number of competitors from where to steal customers), collusive oligopoly is harder to sustain. In the context of the Argentine federal fiscal system (Tommasi, 2002), a province's individual payoff to deviate from a cooperative agreement (for instance by attempting to get special benefits from the national government) is quite high, and hence the federal fiscal game has non-cooperation as its equilibrium outcome.

Number of political actors with power over a given decision: The theory predicts that the larger the number of players, the smaller the set of other parameters for which cooperation obtains. (Fudenberg and Tirole, 1991). This goes in line with traditional assumptions (such as those in Buchanan and Tullock, 1962) that depict the costs of making a decision as increasing in the number of players. It also relates naturally to the previous point, in that in many common pool situations the intra-period payoff structure is related to the number of players.[21]

Length of the horizons / intertemporal linkages of key political actors: The intertemporal pattern of interactions among specific individuals in formal political positions (such as legislators, governors, and bureaucrats) matters for developing cooperative outcomes. It is not the same to have a legislature in which the same individuals interact over extended periods of time, as to have a legislature where individuals are drawn at random from given populations (parties, provinces, etc) with frequent replacement. Cooperation is less likely in the latter. Also, historical events (such as past democratic history) can leave a legacy of short-termism.[22]

Timing and observability of moves: cooperation is harder to sustain if there is plenty of room for unilateral moves which are hard to observe or hard to verify.

Delegation: Other than self-enforcement through repeated play, certain forms of cooperation could be achieved by alternative institutional means. One alternative consists on fixing policy rules of the type analyzed above, which prevent future opportunistic behavior. Delegating policy to an independent bureaucracy is another alternative. Delegation has its problems, but there will be cases in which the cost of those problems is smaller than the cost of "partisan" policymaking.

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[21] The theory has interesting predictions also in terms of the stochastic process generating the exact institutional position of the different players over time. Dixit el al (2000), and de Figueiredo (2002) present interesting insights in that direction.

[22] Another dimension might relate to the history of the franchise and the type of interaction citizen-politician it tends to induce. It might be the case that in countries where large groups of citizens do not have a long tradition of voting, clientelistic practices might be more common, and such practices might induce more myopic behavior from both voters and politicians.

Availability of enforcement technologies: As in transaction cost economics, intertemporal cooperation is easier to achieve, if there is good third party enforcement. The presence and characteristics of a potentially impartial umpire and enforcer of political agreements, such as an independent Judiciary, will vary from country to country, providing variance in the degree of enforcement of intertemporal political cooperation. It is also possible that countries might have access to some external enforcement technologies, such as international treaties or international organizations, at least for some policy areas.

Characteristics of the arenas where key political actors undertake their exchanges: The complex intertemporal exchanges required for the implementation of effective public policies could be facilitated by the existence of exchange arenas that are organized in ways that make cooperation easier to enforce. Seminal work on the U.S. Congress debates the role that different institutional arrangements have in facilitating legislative bargaining, but it is agreed that *somehow* things are arranged in a way that facilitates some intertemporal cooperation in political exchanges -- see for instance Shepsle and Weingast (1995). Whether the legislature as the arena where these transactions take place is adequately institutionalized or not, depends on several factors including legislators' incentives and capabilities. There are some environments, in which legislatures are much weaker than the benchmark U.S. case. If political exchanges are actually undertaken, they take place in settings that are more informal, more uncertain, and harder to monitor, observe and enforce.

The above list is not a taxonomy, but a suggestion of the type of factors that one should look for when trying to characterize the incentives for or against cooperative policymaking in any given polity. Obviously there are many other factors which could be important in specific cases, including historical, cultural and socioeconomic configurations. Also, mapping a set of abstract variables as those enumerated above into real world political "observables" is not a simple task; which is complicated by the fact that one has to look not for the effect of individual variables in "partial equilibrium," but for the interactive effect of many institutions on political behavior. That requires a substantial amount of country-specific knowledge. For that reason, in the rest of the paper we illustrate our general points with focus on one country, Argentina.

VI. The Argentine Case as an Illustration of Crisis, Institutions, and Reform

Argentina, due to its history and to the workings of its political institutions (its high-level institutional endowment, RH), is a polity in which cooperative intertemporal agreements are very hard to realize. Because of this, even the reform process of the 1990s took very idiosyncratic characteristics. These characteristics, on top of the maintained incapacity to strike the intertemporal agreements necessary to implement good policies, together with several shocks to which the system was unable to adjust, lead to the (largely endogenous) crisis that is still unfolding at the time of this writing. From the point of view of this diagnostic, it is not very likely that the magic of "Crisis, Reform, and Living Happily Ever After" will operate this time in the Argentine case.

In this section I take a detour and describe briefly the workings of political institutions, of the policy process and of public policies in Argentina (applying the framework of analysis summarized in section V.) I argue that some very undesirable properties of public policies in Argentina are the outcome of a generalized incapacity to realize efficient intertemporal political transactions. That incapacity, in turn, is conditioned by the high-level institutional endowment of the country (RH). In section VII, I use those characteristics in combination with some of the specifics of the 1990's in order to understand Argentina's trajectory from crisis to reform to crisis again.

Public policies in Argentina have the following features: (i) they are oftentimes too volatile, being changed too easily with (sometimes minor) changes in political winds; (ii) oftentimes, precisely to avoid that opportunistic volatility, rigid mechanisms are put in place to instrument long term policies;[23] (iii) there is poor coordination among different governmental units operating over interrelated policy arenas (among levels of government in the federal structure, among departments within a given level, among subnational governments); (iv) some welfare enhancing reforms are not instrumented; and (v) there is underinvestment in capacity building for improving public policies. (Spiller and Tommasi, 2003, provide evidence of these policy characteristics).

All of the above features, in turn, could be explained as the non-cooperative outcome of an intertemporal policy game with conflict of interests and alternation in power. (Formal versions of this statement are provided in Spiller and Tommasi, 2003, and in an application to federal fiscal games in Tommasi, Saiegh and Sanguinetti, 2001). Non-cooperative equilibrium play leads enacting coalitions and individual policy makers to behave opportunistically. (Individual opportunism leads to poor coordination). To protect themselves from such opportunism, actors embed rigidities into policies, restraining not only opportunistic actions, but also efficient adjustments – those two elements cannot be separated due to the necessary incompleteness of legislative contracts. Closer to the main focus of this paper, most relevant reforms have an intertemporal path of implementation which is open to opportunistic moves, and the anticipation of such future moves, often derails reform efforts from the very start. Finally, in an environment of weak political property rights, actors (legislators, subnational politicians, bureaucrats) do not invest in capacities that could lead to better policies.

Having established the defective properties of Argentine public policies, and having argued that such properties could be explained as the non-cooperative outcome of a policymaking game, the next step is to explore why it is the case that non-cooperation is the outcome of such game. Or, in other words, we need to describe which exactly is the political game played to build public policies in Argentina.[24]

[23] A vivid illustration of that was provided by the Convertibily regime, rigidly tying the Argentine peso to the US dollar from April 1991 until its explosion in the first days of 2002. See Galiani et al (2003) for an analysis of the Convertibility experience.

[24] For brevity, we focus here on formal politico-institutional actors: President, Ministers, Legislators, Provincial Governors, party leaders, bureaucrats, etc. A more complete description should include other players such as unions, business associations, and other socioeconomic actors relevant for the policy game. Also for brevity and simplicity, we focus here on the transactional problems among political representatives, leaving aside the quality of representation (i.e., the democratic principal-agent problem).

Argentina shares some basic constitutional characteristics with the U.S. It has a Presidential, Bicameral and Federal organization of government (24 "provinces" with substantial constitutional powers). If a Martian who has read the institutional literature on American Politics were to land on Argentina and, without knowing anything about the country, were to grab a copy of the Constitution, he would form some expectations that would not be fulfilled upon closer scrutiny.

For instance, our Martian will start by exploring the role of Congress in the policymaking process. The first thing he would notice, is that Congress does not have such an important role in the making of policy. The actions and powers that he would expect to encounter in Congress, would fade in the direction of the Executive (not too surprising in Latin American perspective), but also, more surprisingly, in the direction of the governors of the provinces.

The fact that Congress is not such a hot place, is a general equilibrium result that depends on electoral rules that make legislators weak political actors; on Constitutional rules and historical (and equilibrium) practices that give the Executive much leeway to undo or modify legislative agreements, both at a "broader" legislative stage, as well as at the implementation stage; and on the lack of alternative (for instance, judicial) enforcement mechanisms for legislative agreements. Perhaps the most crucial factor for legislative weakness is the fact that electoral rules (broadly defined) take power away from legislators, voters, and national party leadership, and place that power in the hands of provincial party elites.

National deputies are elected in closed and blocked party lists under a system of proportional representation, with the provinces being the electoral districts. In spite of a strong overrepresentation of small provinces,[25] many of these provinces elect only 2 deputies at a time, given their allocation of five deputies and the staggered nature of elections. This gives, in fact, a median district size of 3, what breaks the representativeness of the system. It also turns out that provincial party practices are such that provincial party elites play a disproportionately powerful role in the making of those lists. (This is specially so when the party coincides with the provincial executive; as explained in De Luca, Jones and Tula, 2002, and Jones et al, 2003).

One of the implications of the incentives of provincial party bosses (analyzed in Jones et al 2003) is the very high rotation of Argentine legislators, most of which stay in Congress only one term, because their names do not appear on the list for reelection. Argentina presents duration figures that are similar to those of countries with term limits. This has the further implication that legislators do not have the incentive to develop strong legislative institutions, do not specialize, and are neither important policymaking actors, nor an effective control of the Administration (Jones et al, 2002).

[25] The 24 "provinces" are really 23 provinces plus the capital city. These provinces are extremely asymmetric in terms of population, with the city of Buenos Aires, the province of Buenos Aires, and two or three additional provinces containing a very large fraction of the population and economic activity, yet being severely underrepresented in the overall political system. Calvo and Murillo (2003) provide an excellent characterization of these features.

Congress has the constitutional right to generate national laws. The masters of (most) legislators are, then, the provincial governors. But what do these powerful political actors care about? They care about two related things. One is maintaining their power in the provincial party and in the province, and the other is to obtain resources from central taxes in order to finance spending in the province. It turns out that in Argentina, the federal fiscal system (fiscal federalism) is a crucial component of the political game and of the policymaking game, even for policies that, in principle, do not have much of a "federal" dimension.[26]

In Argentina, the national government is in charge of most of taxation, especially of the most productive taxes, such as value added, income, etc. Yet, provinces are in charge of a large fraction of total spending, specially the most politically sexy spending, such as public employment, social programs, etc. This last fact, in combination with the weaknesses of national Congress, helps to understand why the crucial axes of Argentine politics run through the provinces. The large vertical fiscal imbalance between revenue generation and spending obligations is covered through a politically sensitive system of tax-sharing and intergovernmental transfers, which generates all types of perverse incentives for provincial and national authorities. (It is analyzed in detail in Tommasi, 2002). One of the outcomes of the working of this system is a strange symbiosis between fiscal federalism and national policymaking. Whenever the national Executive needs to pass an important law, it requires the permission of most provincial governors, so that they instruct their congressional underlings to accompany the initiative. Those favors are usually exchanged for fiscal favors from the national to the provincial treasury through a variety of instruments and bailouts whose exact form keeps mutating and adapting to the successive "constraints and reforms" (usually under the institutional guise of "Fiscal Pacts") attempted under sponsorship of multilateral organizations (Tommasi, 2002, Braun and Tommasi, 2002).

All of this, plus a series of factor facilitating Executive unilateralism,[27] leaves the central arena of national policymaking in Argentina quite naked, with a bunch of short-term actors, plus some quite powerful actors which are only tangentially interested in national public goods (including intertemporal investment in policymaking capacities).

Furthermore, a potential enforcer of intertemporal political agreements, the Supreme Court, has not tended to play much of that role in recent Argentine history. For reasons analyzed in Iaryczower et al (2002), the Court has tended to be too aligned with the executive, and this has lead to a path dependent dynamics of loosing credibility to the point that today it is

[26] We use "federal" in the non-U.S. usage to refer to intergovernmental relations and to provincial matters. The "Federal" government is called, in Argentina, the "national" government.
[27] Constitutional features such as the ability to "*reglament*" laws from Congress, path dependency from military times which focused on the Executive actions and expectations of non-governmental actors that in normal circumstances would have focused on the legislature, general equilibrium implications of the lack of strong Supreme Court enforcement, weakness of Congress, budget capabilities, lack of strong Civil Service, etc.

not an effective warrantor of rights, independently of the political configuration of the moment.[28]

A professional bureaucracy, well supervised by Congress, could be another channel for the intertemporal enforcement of political agreements. Argentina, however, in part due to past political instability, but also to the current incentives of key political players, does not have such a bureaucracy either. A shortsighted Congress has left the bureaucracy without a long-term principal. In the absence of long-term political masters who can provide long-term incentives to invest in developing capabilities, the bureaucracy has become an unresponsive and hard to motivate organization. Political appointees, the so-called "parallel bureaucracy," have then been used to "fill the gap." These appointees, in turn, rotate very frequently and do not develop norms of cooperation across departments, contributing to the fragmentation and lack of coordination of public policies. (Bambaci et al, 2001).

In sum, and attempting to map back into the game-theoretic language of section V, what we have in Argentina is a configuration that fosters non-cooperative behavior in the policymaking process. Key actors have either short horizons, wrong incentives, or both. Some potentially important actors such as legislators, Justices, or key civil servants, have very short horizons. The potentially more long-lived and powerful governors, have only marginal incentives towards provision of national public goods. Furthermore, the political configuration of the last two decades has made almost all governors potential veto players, increasing the cost of political transactions (Spiller and Tommasi, 2003). The Executive has had excessive leeway for ex-post moves that can undo previous agreements, reducing the incentive to work towards those agreements in the first place. Third party or other enforcement technologies have been missing. The interaction of the capacity for unilateral moves, history, and the (endogenous) lack of institutionalization of Congress and of legislators' careers has moved the center of the political scene away from the national legislature and into other arenas. Political bargains take place in executive quarters, in meetings of the president with governors, or occasionally in meeting of national political party leaders. These informal arenas have not been structured for the institutional enforcement of bargains.

To summarize, public policies in Argentina (independently of their title) have several undesirable properties; this is the outcome of lack of intertemporal cooperation among political actors; which in turn derives from Argentine history and higher level political institutions (RH). Now we are ready to come back from the detour, in order to look briefly into Argentina's trajectory in the 1990's in the light of the main issues of this paper.

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[28] Iaryczower, Spiller and Tommasi (2002) show that, historically, the voting patterns of Supreme Court Justices in Argentina can be explained with a strategic behavioral model similar to the one used to explain the voting behavior of the US Supreme Court. The crucial difference has been in the values of the explanatory variables over time. Due to the many military coups replacing Justices, and to their replacement again during democratic restoration, Argentine Justices have tended to have short durations, to be nominated by the ruling executive, and to face fairly unified governments.

VII. Crisis, Reform, and Crisis again. The Argentine case

1. The Fairytale

Argentina in the early part of the 1990's was fortunate enough to undergo a process similar to (most of) the schematic 13-steps of section III. There was a deep economic crisis, including hyperinflation and looting (with poverty climbing to a then unprecedented 47.3% of the population in October of 1989).[29] That crisis was interpreted as the terminal stage of the inward-looking, state-led, fiscally irresponsible model of previous decades; its timing coincided with demonstration effects from other developing countries, abundant international funding and advice, as well as a reasonable amount of consensus among domestic economists on that diagnostic and on the general direction that a way out was supposed to take. There was a political leader who found in his best interest to steer such a market-oriented reform process. He had the institutional resources to carry it through, including the benefit of some explicit delegation mechanisms as a consequence of the crisis. So that Argentina underwent a very fast and profound process of economic liberalization, which included widespread privatization of public enterprises, substantial trade liberalization, deregulation of several markets, some tax reforms, and a very successful inflation stabilization plan which lowered inflation from 4923% in 1989 and 1343% in 1990 to 7.4% in 1992 and 3.9% in 1993, and which lead from negative growth in the 1980s to more than 60% cumulative growth in the 1990s (even including the severe downturn started in mid 1998, as well as the Tequila crisis of 1994-95.)

2. Some Catches

Even though the Argentine case has been considered a salient case of radical and *unconstrained* reform, a closer scrutiny of the process shows that the building and maintenance of support for the reforms involved several deviations from an "idealized" reform blueprint, and that those deviations (which left an important imprint on the economy) were conditioned by idiosyncrasies of political institutions and politics in Argentina.[30] Furthermore, even those reforms which were actually undertaken, were "done" in specific ways, also derived from idiosyncrasies of the Argentine political economy, and which also cast a long shadow on later events.

Argentina underwent an important transformation in intermediate-level institutions (whether utilities are private or public, for instance), a transformation of such magnitude that caught the world's attention. Yet, there was no transformation in the more fundamental institutions (RH) which are the deeper determinants of how policy actually works. The fact that the deeper determinants of the policymaking game had not changed was reflected in the precise manner in which these transformations were instrumented. As an example, there were allegations of corruption in the privatization process, where utilities went in part to the hands of some of the same economic groups which have been the input providers of the State monopolies, as a way of buying the support of those business groups

[29] That unfortunate record has been beaten in the 2002 crisis.

[30] The economic and political details of the reform process are narrated in Bambaci, Saront and Tommasi (2002).

for the overall reform process. Furthermore, the quality of the ensuing regulatory framework for privatized utilities was uneven and questionable, also for reasons relating to the deeper workings of political, administrative, and judicial institutions in Argentina (Abdala and Spiller, 2000). This highlights again one of the points I have been stressing: the details of policies (how you regulate) are perhaps more important than the grand titles ("privatization").

The political instrumentation of the reforms could be described as a "vote-buying" strategy, in which pivotal players for the government coalition received substantial benefits and exemptions throughout the reform process (Bambaci et al, 2002). The key pivotal actors were several provinces, mostly from the backward periphery, some union leaders, and some business groups. These concessions in timing and design left an imprint that included: insufficient fiscal reform, specially at the provincial level, insufficient labor market reform, no reform of the health sector (which is very inefficient and source of important rents for the unions, some provincial actors, and some business sectors), and no (deep) reform of the very distortive federal fiscal arrangement.[31]

Furthermore, even the reforms that were instrumented took very peculiar forms, also dependent upon political and historical features of Argentina. I already referred to the example of privatization. Let me focus on monetary / exchange rate / stabilization policy. The cornerstone of reform in that realm (and the cornerstone of the whole package) was the Convertibility Law, establishing one-to-one convertibility between the peso and the dollar, in effect eliminating (almost) any monetary or exchange rate policy. Needless to say, that very peculiar policy choice had a lot to bear with the events 10 years later leading to the terrible crisis we are witnessing these days. Yet, for all the cheap criticism at the regime by "airplane economists," there was a profound logic to that regime choice and to its (ex post, very costly) maintenance throughout the 90's, a logic that again is grounded in the details of Argentine political institutions and history.[32]

An institutional change complementary to Convertibility was the reform of Central Bank charters to make it an independent institution. Unfortunately, the first time that Central Bank independence really collided with the Executive will, in 2001, the Central Bank president was dismissed on the basis of some doubtful accusations of wrongdoing. This is evidence for the argument about the dependence of lower level institutions such as "central bank independence" (RM) on higher level political institutions, such as the capacity to enforce such independence (RH).[33]

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[31] For brevity I am narrating as if the Washington Consensus reform blueprint is the metric from which we measure deviations. Of course, this is an oversimplification, and my previous point that there are no effective universal blueprints should be kept in mind. (See also Acuña and Tommasi, 2000). Still, the WC blueprint was the "package" being played through this process; perhaps for the "signaling abroad" reasons argued in Mukand and Rodrik (2002) and Mukand (1999), in combination with the bundling/oversimplification reasons suggested here.

[32] See Galiani, Heymann, and Tommasi (2003). As we mention below, one of the key "maintained" features was the inability of the Argentine polity to instrument discretionary policies in a credible way.

[33] For an application of the same logic to fiscal rules, see Braun and Tommasi (2002). For related thoughts with regards to monetary institutions, see Lohmann (2000) and references there. This is consistent with the concerns of Posen (1998) , who argued that "central bank independence" just replaces the credibility of a promise not to inflate by the credibility of a promise to delegate.

3. *Fast Forward: The End of the Story*

The first administration of President Carlos Menem (1989-1995) undertook an important number of market-oriented reforms cum macroeconomic stabilization, in a manner that fits pretty much the fairytale described in section III above. After changing the Constitution in 1994, Menem was reelected in 1995. In his second term, this reformist impetus slowed down, but there was no major reversal of the main reform measures:[34] monetary stabilization, privatization, deregulation, trade liberalization, and some fiscal reforms. It is clear that no major change in the deep determinants of political practices did take place.

The Argentine economy during most of the 1990's performed spectacularly by international standards and by comparison to its own history of the second half of the twentieth century. Inflation was down from 4 digits to one digit, and per capita GDP in US dollars went from around $5000 in the 1980's to around $9000 in the 1990s.[35] In the late 1990's the economy started to show some of the limitations and inconsistencies of the overall macroeconomic framework, and was subject to a number of large negative shocks, including the depreciation of the euro and the real, term of trade shocks, and capital market shocks in 1998.[36] The hard peg imposed a protracted deflationary adjustment in response to these shocks. Such imbalances were aggravated by weak fiscal management, especially after 1995 (Perry and Serven, 2002). The need to address the rising concern with solvency – given a large debt, a weak primary fiscal balance and low growth – lead to tax hikes and budget cuts in 2000 and 2001 that deepened the economic contraction. The capital flow reversal and increased risk premium in 2001 amplified these problems by requiring a large external current account adjustment.

The overall cycle of despair, hope, great expectations, disenchantment, and despair again underwent by Argentina over the last 13 years is too complex to be resolved in a few paragraphs here. Galiani, Heymann and Tommasi 2003 constitutes a preliminary step in that direction, from where these brief remarks are taken.) The story is certainly a lot richer and nuanced than the quick interpretations of "airplane economists" criticizing the un-wise choice of exchange rate regime, or the lack of accompanying fiscal tightening. The Argentine convertibility experiment was a desperate bet for the economy to find a new growth trend. The role of that monetary system went much beyond its function as nominal anchor. It was more an institutional anchor, in which the promise of "One peso equals one dollar" became the mother of all promises. Over time, more and more contractual promises were predicated on the presumption that the economy could sustain real growth under

[34] Several important economists, analyzing the Argentine experience ex-post, argue that the second Menem administration was guilty of not taking additional measures in the macroeconomic realm which could have prevented (or at least ameliorated the costs of) the later disaster. See for instance Perry and Serven (2002).
[35] The last number, of course, conflates exchange rate overvaluation with real income growth, but as argued in Galiani et al (2003), it was a crucial variable to understand the behavior of the Argentine economy throughout the period.
[36] Later on, in the early 2000s, it also had the unlucky timing of falling into a confidence crisis at the time in which the U.S. (and hence the Washington-based multilateral organizations) decided to toughen its stance with countries undergoing financial crisis that were (in part) the outcome of domestic "misbehavior." According to some important Argentine economists, it was also partly a victim of the IFIs conversion to the "new" religion of floating exchange rates.

convertibility. In an economy still haunted by credibility problems, the authorities responded to macroeconomic disturbances by doubling the commitment to the fixed exchange rate and implicitly supporting the dollarization of contracts.

The lack of sustainable compromises among key politico-institutional actors hindered the development of credible alternatives to the rigid monetary regime of the currency board. Judicial, fiscal, monetary, or other institutions that might have alleviated the burden on the exchange rate regime so support the contractual system clearly were not present at the beginning and were not developed over time. Even though attempts were made to establish new fiscal and monetary institutions and to improve the workings of the judicial system, it all proved to be ink on paper when put to the test: fiscal responsibility laws, federal fiscal pacts, Central Bank independence, and deposit guarantees, were ignored at crucial times. Obviously not all of these episodes could be blamed 100% on institutional weaknesses. There were negative feedbacks from the economic situation that sometimes pushed political institutions to the limits. Economic instability and broken policy promises reinforced one another in an explosive spiral.

The shortcomings of the policy process (which often relied on the personal influence of particular individuals in the government) became salient during the crisis of 2001/2002. While the crisis would have been extremely difficult to handle in any case, the relevant actors (including international agents like the IMF) were unable to establish a precise policy course. At the same time, the urgent problems which emerged in rapid succession frequently led executive authorities to take measures of the greater importance "on the spot" (sometimes through "emergency decrees"), without going through a process of detailed discussion and legislative decision, which they judged unacceptably slow and uncertain. Parliament voted laws that questioned central elements of economic policies, and menaced to create unsolvable dilemmas. The Judiciary (itself without a reputation for impartiality) often reversed government decisions. The outcome was that policies did not follow a definite direction, being perceived as arbitrary and lacking legitimacy, causing further damage in an already very difficult situation.

The Argentine polity showed, once again, a deep incapacity to cooperate to generate the adjustments that might have prevented or at least mitigated the effects of the crisis. One of the compounding factors in the final dynamics leading to the implosion, were the "fiscal pacts" signed by the new (de la Rua) administration in 1999 and 2000 with provincial governments. To protect themselves from the opportunism of national government, the provinces were able to negotiate some fixed-amount transfers out of the pool of national taxation. During the steep downturn of 2001, it became virtually impossible for the national government to deliver on those promises, yet the provinces (most of them from the then opposition party), stubbornly insisted on those transfers, further damaging the credibility of fiscal adjustment in the eyes of international actors, fueling the downward spiral.[37]

[37] There are more details to these perverse political and fiscal dynamics, including the peculiar role of the Province of Buenos Aires, the largest in the country, which received a disguised bailout during 2001. A more detailed description is provided in Tommasi (2002).

On December 20 President de la Rúa resigned in the midst of popular protest of the middle classes whose bank deposits had been blocked, and of (partly spontaneous, partly organized by the political machinery of the province of Buenos Aires) looting of supermarkets and other stores. He was succeeded by a couple of temporary figures until January 1st 2002, when Eduardo Duhalde (the peronist *caudillo* of Buenos Aires who had lost the presidential election to de la Rúa) was named president by Congress. Default on the government debt was declared the last week of December, and the peso was devalued (without any solid alternative plan in mind) by the Duhalde administration upon taking office.

By then, the crisis had escalated to a full-blown political and social crisis in the broader sense of a disintegration of some basic aspects of the social contract. At this point, dimensions that we have ignored in the simplified account of the first part of the paper, become operational. We are not witnessing just an economic crisis, but a new rupture of the Argentine social contract, which is so fragile that in the last decade it was tied to a particular exchange-rate regime.[38] It is still too early, and the situation is too uncertain to make any predictions at this point. The game is open again at the level of economic policies and intermediate institutions (will the economy be closed again? will privatized companies be nationalized?).[39] According to some optimistic observers, the crisis is so deep that the higher-level institutional game might also be open. By the reasoning that I emphasized in the first part of the paper, it is far from obvious that the actual choices, at any given level, will be the best ones.

Table 2 summarizes in a sketchy way, the dynamics followed by Argentina throughout the 90's with regards to the crisis and reform "paradigm." The last step in the temporal sequence suggested by the arrows, indicates the possibility that the Argentine polity will end up doing the wrong type of learning from this experience. There are some clear hints in that direction at this point. For instance, Ruben Lo Vuolo, the key economic advisor of one of the current presidential candidates, said: "Argentina was the best pupil of the Washington Consensus, and see where we ended up. We have to change the model."

<Table 2>

VIII. Conclusion

The purpose of the paper was not to argue that crisis is irrelevant for reform. There are circumstances under which you might be "stuck" until some form of crisis might change the equilibrium play of the game, or even change the game, in a positive way. But the paper presents several caveats. The 13 steps from crisis to happiness described in Section III represent a very special set of circumstances, and make several implicit assumptions that are often not true. Furthermore, the reforms to which the fairytale refers are not the deepest level institutional reforms.

[38] That is, of course, quite a weak anchor for a social contract. For related thoughts, see Macedo, Cohen and Reisen (2001).

[39] The latter may come about not too much because of a vigorous public choice, but because private operators, especially foreign ones, are running away scared by the current scenario. It has pretty much already happened in the banking sector.

Also, the details of policies are perhaps more important than their titles. And those details are conditioned by the workings of the deeper political institutions of the countries. As illustrated in the Argentine case, the reforms derive features from the underlying policy game. This in turn, conditions the (stochastic path of) future success of the policies, and reflects the fact that underlying political games might still remain the same than those that generated inefficient policies in the first place. Both channels point to potential vulnerabilities of the system. In the Argentine case, those vulnerabilities manifested themselves a few years later, and in the face of severe shocks the Argentine polity was unable to adjust, leading to this "second crisis." It is not obvious that the 13 magical steps might be operational this next round; on the contrary, several conditions seem to point in the wrong direction.

That is to say, the "wisdom" developed during the "modern economic reform movement" might not be that useful for this new round of crises. Furthermore, some of the political and marketing strategies adopted in the previous round might backfire now.

I concur with several authors who have been emphasizing the importance of "good institutions" to produce good policy outcomes, including policy reform when necessary. I suggest a particular way of operationalizing what "good institutions" mean, those that facilitate intertemporal political cooperation. Such institutions can help avoid the cycles of crisis and (short-lived) reform. As the Argentine case illustrates, crises are partly endogenous to bad institutions, to some extent independently of the title of the specific policies in place.

How to go about improving deep institutions and policymaking process, is the million dollar question that I am not ready to answer here. Yet, an important step towards that lofty goal will be to recognize that the core of the problem lies in the process of making policies, and that we have to find ways of improving that, instead of keep pushing the "flavor of the month" policy recipe that the development consensus favors at any point. The starting point for that enterprise will certainly be to try to develop better diagnostics of how those policymaking process actually work.

"It is not the policy, it is the polity, stupid." This statement was the original subtitle of the paper. That subtitle was written in a pessimistic mood, which made it sound too deterministic. As Jorge Braga de Macedo correctly pointed out, the type of intertemporal cooperation games that I describe do have multiplicity of equilibria, and we should not stop our quest for ways out of inefficient equilibria like the one Argentina is suffering.

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<u>Table 1: The Good, the Bad, and the Ugly as a Response to a Crisis</u>

	Right Reform	No Reform	Wrong Reform
Crisis	good	bad	ugly
No-Crisis			

Table 2: The Good, the Bad, and the Ugly in Argentina

	Right Reform	No Reform	Wrong Reform
Crisis	Menem I (early 90's)	de la Rúa (2000-2001)	Today? (2002-2003)
No-Crisis		Menem II (late 90's)	