ECONOMIC REFORMS IN NEW DEMOCRACIES: A SOCIAL-DEMOCRATIC APPROACH

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Introduction

Recipes for disaster seem quite clear. In recent years, whenever governments pursued left-wing economic programs, the result was inflation, fiscal crises, and balance-of-payment crises. Democratic governments that followed neoliberal tenets faced stagnation, increased poverty, political discontent, and debilitation of democracy. Peru under Alan García, Portugal during the first phase of the post-1974 regime, Greece under PASOK, as well as France during the first two years of Socialist rule provide evidence that a combination of economic stimulation with fiscal indiscipline generates economic crises. Argentina and Brazil, where several attempts at stabilization failed, as well as Poland and Bolivia, where stabilization was successful, show that the pursuit of can be counter-productive politically and economically.

Traditional postures which reject all attempts to stabilize, deregulate, and open the economy are untenable because of the social costs inherent in such programs once an overprotected, overregulated oligopolistic economy enters the spiral of fiscal crisis. Procrastination, socially more tolerable and politically safer, only aggravates the crisis and prolongs deprivation. In turn, programs based on the promise of immediate improvement ended in disaster.

Yet there is ample evidence that pursuit of the neoliberal ideological blueprint fares no better. When stability and efficiency become goals in themselves, government policies turn out to be economically either simply ineffective or counter-productive and politically explosive under democratic conditions. Stabilization attempts either fail or induce recessions so profound that they depress investment, undermine prospects for future growth, and generate social costs that make the continuation of reforms politically unpalatable in a democratic context. Moreover, the technocratic style in which these policies tend to be formulated and implemented undermines the consolidation of democratic institutions.

Hence, perhaps paradoxically, our conclusions make the case for leftwing governments to pursue a market-oriented program — that is, a pragmatic, "social-democratic" approach. This approach calls for reforms oriented toward growth, protection of material welfare, and full utilization of democratic institutions in the formulation and implementation of reform policies. Yet the specific recipe for such an approach is, unfortunately less clear, precisely because there have been few successful experiences.

In the first part of this chapter, we argue that the success of reforms can be judged only in terms of resumed growth and consolidation of democracy, not in terms of any intermediate goals. We also identify the generic difficulty faced by new democracies attempting such reforms. In the second part, we review logical and empirical arguments concerning our three central hypotheses: 1) the reforms that constitute the currently standard recommendation — stabilization and liberalization — are necessary, but they are not sufficient to restore the capacity to grow unless they are accompanied by active state coordination of the allocation process; 2) since any reform package must consist of discrete steps taken over an extended period of time, political conditions for their continuation erode unless social policies protect those whose subsistence is threatened by the reforms; and 3) consolidation of democracy may be undermined unless representative institutions play a real role in shaping and implementing reform policies. In the final part, we summarize and develop our prescriptive views.

Our intent is not to provide comparable inductive evidence for each of the points. Given the paucity of historical experience, such an attempt is not feasible at the present. Nor is it possible to develop a blueprint for a policy that could be applied everywhere. Reform strategies must trade off conflicting objectives to meet constraints which are specific to each situation. Yet we do argue that several trade offs — notably between stabilization and growth, between social expenditures and growth, between social expenditures and the sustainability of reforms, and between political participation and the sustainability of reforms — are misconceived within the model that underlies the currently fashionable policy prescriptions.

Growth and Democracy as the Goal of Reforms

The recent wave of transitions to democracy began in Southern Europe in mid-1970s, surged in Latin America in the mid-1980s, and swept Eastern Europe, including the Soviet Union, in 1989-1990. These transitions often occurred when the respective economies faced serious difficulties.

In several countries, the collapse of authoritarian regimes was accompanied by economic crises, caused typically by the exhaustion of state-led and inward-oriented strategies of development. The state grew 100 much, regulated in excess, protected beyond reason. In Latin America, the state was onerous; in Eastern Europe, overwhelming. Special interests of bureaucrats, managers of large firms, and private businessmen replaced the public interest. Populist practices, combined with inward-oriented developmentalist strategies, led to fiscal indiscipline and public deficits. The consequence, besides increasing inefficiency in the entire economic system, was fiscal Crisis: in many countries, the state was bankrupt. Hence, even though regimes varied in degrees of authoritarianism, the state became economically impotent.

Since transitions to democracy often coincide with economic crises, many new democracies face a double challenge: how to resume growth and consolidate nascent political institutions simultaneously? Moreover, the reforms necessary to restore growth inevitably engender a deterioration in the material well-being of many groups. Under such conditions, the consolidation of democratic institutions can be easily undermined. The question thus arises whether any reform strategy can lead both to resumed growth and to the strengthening of democracy.

Posing the question in this way does not assume that new democracies are less capable of managing economic crises than established democracies or authoritarian regimes. According to some arguments, the capacity of new democracies to undertake stabilization programs and to implement structural reforms is hampered by the vast expectation of economic improvements and by vulnerability to popular pressures and to interest-group influence. Electoral cycles and pluralist competition further undermine long-term planning in new democracies (Ames 1987; Stallings and Kaufman 1989; Marer 1991). Yet new democracies have imposed economic discipline in hard times. Comparative studies of economic reforms in the less-developed countries have shown no systematic differences among regimes in the choice of economic reform strategies (Nelson 1990) and in economic performance (Remmer 1986; Haggard et al. 1990). And even if it were true that authoritarian regimes are more capable of imposing and preserving economic reforms, we would not be willing to treat democracy as an instrumental value, judged by its consequences for economic performance. The question we pose is not how regimes affect the success of economic reforms but whether there are ways to resume growth under democratic conditions. The ultimate economic criterion for evaluating the success of reforms can be only whether a country resumes growth at stable, moderate levels of inflation.

Economic reforms comprise various mixtures of measures designed to stabilize the economy, steps oriented to change its structure, and, at times, sales of public assets. The central purpose of stabilization is to slow down inflation and improve the financial position of the state. The central goal of structural reforms is to increase the efficiency of resource allocation. The aim of privatization is less clear, since ostensible reasons for the sale of public assets are not always the true ones.[1] Yet even if all these measures are successful on their own terms, their effect on growth is not immediately apparent. While particular reform programs differ in scope and pace, stabilization and, in particular, structural reforms necessarily cause a temporary decline of consumption. To be sustained, stabilization must entail a transitional reduction of demand, due to a combination of reduced public spending, increased taxation, and high interest rates. Trade liberalization, antimonopoly measures, reductions of subsidies to industries and prices inevitably cause temporary unemployment of capital and labor. Privatization implies reorganization: again, a costly transition. Moreover, market-oriented reforms are often undertaken when the effects of the original shock are still present and while some important markets are still missing. Finally, architects of reforms make mistakes, and mistakes are costly. Hence, the effect of economic reforms on growth must be negative in the short run.[2] Indeed, for proponents of reforms, unemployment and firm closings constitute evidence that reforms are effective: if currently low unemployment fails to rise to between 8 and 10 percent this year, said the Czechoslovak economics minister, Vladimir Dlouhy, "It would be a sign that the reforms were not working" *(Financial Times* 1991). Reform programs are, thus, caught between the faith of those who foresee their ultimate effects and the skepticism of those who experience only their immediate consequences.

This is why interim evaluations of reform programs tend to be highly inconsistent and controversial. Given that market-oriented reforms inevitably entail a transitional decline in consumption, it is not apparent how to judge their success. There are three ways to think about "success." The first, followed by Joan Nelson (1990) and most of her collaborators, is to define it in terms of a continued implementation of reform measures, whatever they may be. These evaluators gave up on using economic criteria to measure the success of reforms and chose instead to explain "the degree to which policy decisions were carried out rather than economic outcomes of the measures taken." The second, implicit in most economic literature and in Stephan Haggard and Robert Kaufman (1992), is to conceptualize "success" in terms of stabilization and liberalization. The third, to which we adhere, is to remain skeptical until an economy exhibits growth under democratic conditions.

The first conception is untenable, since it is based on the assumption that whatever measures have been introduced must be appropriate. This conception admits no possibility of policy mistakes and — the point bears repetition — such mistakes are frequent and perhaps inevitable. The choice of anchor (the nominal quantity on which the stabilization program rests), the sequencing of deregulatory measures (capital account versus trade first), the method and timing of devaluations, the distribution of cuts of public expenditures are not obvious. There is no such thing as "the" sound economic blueprint, only alternative hypotheses to be tested in practice and at a cost. Indeed, the sequencing of reform strategies evokes sharp disagreements and, as the Chilean debacle of 1982 demonstrates, wrong decisions lead to costly mistakes.

The second conception is safer but still based on the conjecture that stability and competition are sufficient to generate growth, a conjecture we believe false. This posture assumes that partial steps eventually lead to growth and prosperity. Proponents of reforms argue as if they had a Last Judgment Archetype of the world — a general model of economic dynamics that allows evaluating ultimate consequences of all the partial steps. Yet this model is only a conjecture. Inflation may be arrested by a sufficient dose of recession, but the evidence that successful stabilization leads to restored growth is weak. Opening the economy and increasing exports may result in improved creditworthiness of a country, but the beneficiaries may be only the foreign creditors. The sale of public firms may fill state coffers, but the revenues may be stolen or squandered. Thus, the causal links between particular reform measures and their ultimate goal remain flimsy. As Karen Remmer (1986) reported with regard to the International Monetary Fund (IMF) Standby Programs, there is "only a moderate correlation between the implementation of IMF prescriptions and the achievement of desired economic results."

If the ostensible purpose of market-oriented reforms is to increase material welfare, then these reforms must be evaluated by their success in generating economic growth. Anything short of this criterion is just a restatement of the neoliberal hypothesis, not its test. Given that the reform process entails intertemporal trade-offs, conjectures about distant consequences cannot be avoided. Yet, unless we insist on thinking in terms of growth, we risk suffering a long period of tension and deprivation only to discover that the strategy which brought it about was erroneous. The argument that "the worse, the better" cannot be maintained indefinitely; at some point, things must get better. Resumed growth is the only reliable criterion of economic success.

While economic reforms have been pursued by some authoritarian regimes and by some well-established democracies, newly established democratic regimes face simultaneously an urgent need to overcome economic crisis and to consolidate their nascent institutions. Hence, the second criterion of successful reforms must be the consolidation of democracy. And if reforms are to proceed under democratic conditions, distributional conflicts must be institutionalized. All groups must channel their demands through democratic institutions and abjure other tactics. Regardless of how pressing their needs may be, political forces must be willing to subject their interests to the verdict of democratic institutions. They must be willing to accept defeats and to wait, confident that these institutions will offer opportunities the next time around. They must adopt the institutional calendar as the temporal horizon of their actions, thinking in terms of forthcoming elections, contract negotiations, or, at least, fiscal years. They must assume the stance put forth by John McGurk, the chairman of the British Labour Party, in 1919: "We are either constitutionalists or we are not constitutionalists. If we are constitutionalists, if we believe in the efficacy of the political weapon (and we do, or why do we have a Labour Party?), then it is both unwise and undemocratic because we fail to get a majority at the polls to turn around and demand that we should substitute industrial action" (cited by Miliband 1975, 69).

Regardless of their age, democracies persist whenever all the major political forces find that they can improve their situation if they channel their demands and their conflicts through democratic institutions. New democracies are more vulnerable because institutional issues often remain unresolved for a long period after the installation of a particular democratic system (Przeworski 1991). The choice of institutions is often problematic and conflicting when a dictatorship falls. Often the conflict about the institutional framework continues — as in the case of Poland — or institutions are adopted only as an interim solution. In order to put in place an institutional framework, a previous democratic constitution may be reinstated even if it did not work in the past, as in the case of Argentina. At other times, a foreign constitution may be grafted on, or a constitution may be elaborated that is expected in advance not to evoke compliance, as in the case of Brazil. These institutional frameworks are frequently inappropriate for the specific political and economic conditions. Moreover, as Russell Hardin (1987) has argued, habituation plays an important role in inducing political actors to stay within the existing institutional framework. Constitutions are often "contracts by convention."

Hence, democratic institutions can be consolidated only if they offer politically relevant groups incentives to process their demands within the institutional framework. But economic reforms inevitably engender at least a transitional decline in consumption. This is then the source of the dilemma faced by new democracies: how to create incentives for political forces to process their interests within democratic institutions when material conditions must decline for the foreseeable future.

Neoliberal Versus Social-Democratic Approach: Theory and Evidence

Our purpose is to investigate whether there is a space between these two constraints. We seek a strategy that would lead to resumed growth under democratic conditions. As everyone else who plunges into these muddy waters, we rely on historical experience, arguments from first principles, and conjectures.

If success means resuming growth under democratic conditions, the evidence for successful recipes is much thinner than it is for disasters. The case that establishes the possibility of success as we define it is Spain, which underwent a painful period of industrial reconversion and irreversibly consolidated democratic institutions. This experience is paralleled by Portugal after 1983, and perhaps also by Uruguay. Chile is growing under democratic conditions, but the reform process — undertaken by an exceptionally repressive military regime — was long and its economic and social costs were enormous. South Korea underwent a successful stabilization in 1981 with some slowdown of growth, but both before and after, it has grown with relative rapidity. Mexico, with its peculiar political regime, has been more attentive to social costs and may be on the brink of resumed growth, while not yet operating with democratic institutions. Finally, among Eastern European countries, Hungary, which proceeded prudently by building market institutions and a social welfare system before plunging into the liberalization stage, may prove successful. Yet these cases are so varied that it is not easy to determine to what extent their success has been due to policies versus circumstances. Spain did not need to stabilize, while inflation rates in Portugal, South Korea, Mexico, and Hungary have been quite moderate by the standards of Argentina, Bolivia, Brazil, Poland, or Yugoslavia. Foreign debt was an overriding consideration in the case of Argentina, Bolivia, Brazil, Mexico, Hungary, Poland, and Yugoslavia but not in Southern Europe. And the scope of reforms differed from country to country, combining differently those measures aimed at stabilization, liberalization, and industrial reconversion.

Hence, we do not pretend to have established the conditions for success. Historical experience is too thin to permit a solid empirical evaluation of the approach we propose.[3] Let us summarize and evaluate the evidence with regard to our three main hypotheses:

- Stabilization and liberalization are insufficient to generate growth unless targeted to redress fiscal crisis and to generate public savings.
- Without social policy to protect at least those whose subsistence is threatened by reforms, political conditions for the continuation of reforms erode.
- The technocratic style of policy making weakens nascent democratic institutions.

Before we examine these hypotheses, a comment is required concerning stabilization policies. Luiz Carlos Bresser-Pereira (1993) argues that these policies often fail because they do not redress "fundamentals" but also because they misdiagnose the causes of inflation and because they induce unnecessary social costs. This analysis is now widely shared. On the one hand, as Guido Di Tella (1991, 397) emphasized, trying to stop inflation solely by controlling nominal quantities is absurd. By failing first to correct fundamentals, which include above all the fiscal crisis of the state, heterodox policies simply postpone fiscal adjustment. On the other hand, inflation is often inertial. And, as Michael Bruno (1991, 2) observes, given this inertial character, "the orthodox cure is necessary but not sufficient. The correction of fundamentals does not by itself remove inflationary inertia.... Supplementary direct intervention in the nominal process, such as a temporary freeze of wages, prices, and the exchange rate, can substantially reduce the initial cost of disinflation," Correcting the fundamentals includes restructuring the flows of government expenditures and revenues and reducing the stocks of foreign and domestic debt, Breaking the spiral of inflation calls for policies targeted at nominal quantities, including income policies, Without correcting the fundamentals, stabilization policies are likely to be ineffective; without heterodox policies, they will be also inefficient. Exclusive reliance on the reduction of demand to break inflation engenders unnecessarily high social costs.

To examine the effect of market-oriented reforms on growth, we need to distinguish three questions: 1. Why do stabilization and liberalization of foreign trade and domestic competition induce recessions? 2. Why do some stabilization programs undermine future growth? 3. Are stability and competition sufficient for a resumption of growth?

Stabilization programs tend to induce profound recessions, even when they are not accompanied by liberalization. The reason is at least twofold: 1) stabilization is usually achieved by reducing demand, and 2) interest rates tend to soar beyond the targeted level during stabilization. The mechanism leading to excessive interest rates depends on the anchor that is being used (Blanchard et al. 1991), but one common effect is that successful stabilization makes holding money more attractive and the increased demand for money cannot be met by increased monetary emission without rekindling inflation. In turn, reductions of subsidies to industries and to prices, reduction of import tariffs, and domestic antimonopoly measures sharply lower rates of return and cause unemployment of capital and labor (Przeworski 1991, Chapter 4). Among the cases of successful stabilization,[4] unemployment increased sharply in the following countries: in Bolivia it rose after 1985;[5] in Chile, it climbed from 9.7 percent in 1974 to 16.8 percent in 1976; in Israel, from 5.1 percent in 1984 to 7.1 percent in 1986; and in Poland, from zero in 1989 to over 10 percent in 1991. In South Korea, the capacity utilization rate fell from 77.5 percent in 1980 to 69.4 percent by 1983.

While high interest rates may be transitory, their effect lasts beyond the stabilization period. As Stanley Fischer (1991, 404-405.) pointed out, "Investment will not resume until real interest rates reach a reasonable level, and prolonged periods of high real interest rates create financial crises and bankruptcies even for firms that would be viable at reasonable levels of interest rates." Or, in Jacob Frenkel's (1991, 403) words, "stabilization efforts are often associated with extremely high real rates of interest, which discourage investment and hamper growth." Indeed, to consider again successful cases of stabilization, in Bolivia, private investment declined from the already minuscule level of 3.8 percent of gross domestic product (GDP) in 1984 to 2.7 percent in 1985 and 2.5 percent four years later; in Chile, it fell from 8.7 percent of GDP in 1974 to 3.9 percent in 1975, and it surpassed the prestabilization level only three years later; in Israel, gross investment (private and public.) fell by 10.6 percent in 1985, recuperated a year later, and began to decline again in 1988. Only in Mexico did private investment grow rapidly throughout the stabilization period.

The second reason stabilization programs often undermine prospects for future growth has been highlighted by Vito Tanzi (1989): expenditure cuts, necessary to cope with fiscal crises, do not discriminate between government consumption and public investment. After having cited several instances in which stabilization policies undermined capacity for growth, Tanzi (1990, 30) concluded: "In all these examples, the *supply* has been reduced, thus creating imbalances that, in time, have manifested themselves as excessive demand. In these cases, demand-management policies alone would have reduced the symptoms of these imbalances but would not have eliminated the causes. Thus, stabilization programs might succeed stabilization programs without bringing about a durable adjustment...." Indeed, investment projects are often politically easier to cut than government consumption services or public employment. Both public infrastructure investments and measures to induce private investment are reduced, thus diminishing future supply. Evidence from successful stabilization experiences is uniform: in Bolivia, public investment declined from 8.4 percent in 1984 to about 3 percent after 1985; in Chile, public investment fell from 12.5 percent in 1974 to 4,8 percent in 1983, and it rose again to 7.1 percent by 1985;[6] in Mexico, public investment had already declined by 13.4 percent in 1987, and it continued to decline afterwards; in Eastern Europe, with the exception of Hungary, public investment simply collapsed.

Today, neither the observation that stabilization entails a recession nor even that stabilization programs often undermine conditions for future growth is controversial. Indeed, the voices we cite emanate from the World Bank and the International Monetary Fund (IMF). Where we depart from the neoliberal consensus is with regard to the point central in Bresser-Pereira's (1993) analysis. We argue that market-oriented reforms are not sufficient to generate conditions for growth.

Admittedly, the empirical evidence is inconclusive. In Bolivia, the total GDP declined during the year following stabilization and then grew anemically, while per capita product continued to fall through 1990. In Chile, GDP tumbled by 12.9 percent in 1975; growth resumed until the great crash of 1982, when GDP fell by 14.1 percent, and it resumed again after 1985. In Israel, GDP (of the business sector only) actually grew during stabilization but became stagnant three years later. In Mexico, signs of a recovery are evident, but per capita growth continues weak. In South Korea, growth slowed but continued to be high by comparative standards. And all over Eastern Europe, GDP continues to decline.

Systematic reviews of evidence generate mixed conclusions, John Williamson (1990, 406) showed that among ten Latin America countries which had pursued “full or partial” reforms, four were growing in 1988-1989, while six were stagnant or declining; among eleven countries which did not pursue reforms or undertook them only recently, one was growing and ten were stagnant or declining. This is a positive but not an overwhelming correlation. O.R. Blanchard et al. (1991, 61) reported that “Looking at the post-stabilization performance of countries that have stabilized, one concludes that, in most cases, economic growth has returned only gradually and unimpressively.” Scattered data concerning private consumption show the same. Clearly, these patterns lend themselves to differing assessments, particularly when they are juxtaposed to the experience of countries which continue to suffer from fiscal crisis and high rates of inflation. Yet the issue here is not whether countries that underwent a successful stabilization perform better than countries where stabilization attempts have failed. The question is whether a successful stabilization, when combined with other market-oriented reforms, is sufficient to generate growth.

Given the paucity of evidence, it is useful to review theoretical arguments. The neoliberal assumption — “the Washington consensus” (Williamson, 1990) — which underlies the program of market-oriented reforms is that once stability and competition are achieved, growth will follow. Yet, perhaps surprisingly, this neoliberal posture has shaky foundations even in neoclassical economic theory.

Markets may successfully orient individual agents to allocate resources efficiently, but they are not sufficient to coordinate individual actions toward intertemporal efficiency and other normatively and politically desirable goals.[7] “Market orientation” is not sufficient to generate “market coordination” toward collective prosperity.

To justify this assertion would call for a lengthy excursion into economic theory. The bare bones of our argument are the following: Those who expect the market to coordinate economic activities toward intertemporally efficient allocations of resources argue as if they could justify the proposition that competitive markets are sufficient to generate efficiency, at least in the absence of public goods, externalities, or increasing returns. But this proposition is based on the assumption that markets are complete, that is, that there is a market for every contingent state of nature. But, following Kenneth Arrow (1964) and Bruce Greenwald and Joseph Stiglitz (1986), this assumption is no longer tenable. And when some markets are missing, labor markets, capital markets, and goods markets do not clear, and the resulting allocation can be improved upon.[8] As the debate concerning public goods has shown, the mere fact tat "the market does not do it" does not imply that the state would do it better. We still need to rethink the role of the state in a decentralized economy in which some markets and some information are inevitably missing. Having reviewed the inefficiencies caused by different types of market incompleteness, David Newberry (1989) concluded that the scope of government intervention is limited. Yet the notion that, if only left alone, "the market" would efficiently coordinate the allocation of scarce resources is purely hortatory. In Peter Murrell's (1991, 73) devastating critique of reforms based on the neoclassical model, he notes "blanket prescriptions… surely do not deserve a place in the debates between economists."

Neoclassical economic theory has little to say about growth. Its preoccupations are mainly static. And anyone who has read Joseph Schumpeter knows tat static efficiency is a poor criterion of welfare. Indeed, several studies show that the Soviet economy was more efficient in the static sense than that of the United States: it was more efficient precisely because it generated little technical innovation. Dynamic economies are not efficient in the static sense; they use a number of techniques, with different cost-benefit ratios. In turn, the issue of whether a competitive market generates dynamic efficiency is already more complex. The theory of economic growth which emerged from neoclassical economics — the Solow-Swan model of exogenous growth — argued that competitive equilibrium is efficient but leads to stagnation of income in the absence of exogenous population growth and exogenous technical change. Recent models do provide an endogenous explanation of economic growth, but in these theories the competitive equilibrium is no longer efficient (Lucas 1988; Romer 1990; Becker, Murphy, and Tamura 1990).[9] The "engines of growth" in these models are externalities, whether in education, skills, or technology. And competitive markets, in which firms do not capture full return to their endowments, undersupply the factors that generate such externalities.

We need not get mired in the discussion of neoclassical economics to conclude that this theory's present state does not support the conclusion that stability and competition are sufficient to generate growth. Whether one takes the theory of incomplete markets, with their informational asymmetries, or the theory of endogenous growth, with constant returns to a single factor and dynamic externalities, or the theory of non-Walrasian trade, one will discover (still neoclassical) arguments that a certain degree of state intervention is necessary for growth. The neoliberal posture does not rest on any solid theoretical bases: to cite Stiglitz (1991, 12), "Adam Smith's invisible hand may be more like the Emperor's new clothes: invisible because it is not there."

Hence, in spite of the paucity of recent evidence, we consider that our first point is well supported: stability and competition are not sufficient for growth.

Economic reforms are inevitably a protracted process, and they necessarily induce a temporary reduction of consumption for a large segment of the population. Even if stabilization and liberalization programs are designed with a view toward resumed growth and even if the state adopts appropriate development strategies, the period between stabilization and resumption of growth is inevitably long. Sebastián Edwards and Augustín Edwards (1991, 219) estimate eight to ten years as an expected lag. In the meantime, per capita consumption will decline or stagnate, and some incomes will be pushed below the threshold of absolute poverty.

The typical argument of economists — that the economic blueprint is "sound" and only irresponsible "populists" undermine it — is just bad economics. A sound economic strategy is a strategy that addresses itself explicitly to the issue of whether reforms will be supported as costs set in. At the least, reforms must be credible (Calvo 1989). It must be in the best interest of politicians to pursue the measures they have announced, once they obtain support for these measures.[10] And credibility is not only a matter of economics: if policies are politically unsustainable, economic actors will not treat them as credible. But the difficulty is more profound. How can politicians persuade people to have confidence in a reform process that temporarily induces increased material deprivation?

If people are to make intertemporal trade-offs, if they are to accept a transitional reduction of consumption and to be impervious to "populist" appeals, they must have confidence that their temporary sacrifices will lead to an eventual improvement of material conditions. Policy style, about which more is said below, is an important factor in shaping this confidence. But even more important is that the imminent danger not threaten their livelihood. People whose physical survival is imperiled cannot think about the future: they have no intertemporal trade-offs to make.

Citizens of new democracies expect to be granted social as well as political rights. "Social citizenship" — in T.H. Marshall's (1964, 76) words, "a kind of basic human equality associated with the concept of full membership of a Community" — requires that security and opportunity be shared by all. Social policies respond to these demands through the provision of health and education and through income maintenance. This is limited when new democracies venture down the path of economic reforms: this is why short-term effects of stabilization and liberalization threaten the basic livelihood of those most adversely affected by moves toward a market economy. The question is whether these steps will be continued as a verdict of the democratic process.

Our evidence is extremely limited. We have one case, Spain, where social expenditures were considerably extended as industrial reconversion proceeded. In the case of Poland, they were drastically cut as the country simultaneously undertook stabilization and liberalization. Intermediate cases, such as Bolivia, developed, with foreign assistance, a narrowly targeted program of employment for the miners who lost jobs as a result of closing the mines. And Mexico, in a similar vein, developed a program of food subsidies for the groups most adversely affected by stabilization. The distinctive feature of Spain is that social policy was broad in scope — it comprised health, education, and income maintenance, and it entailed qualitative changes in the system of self-government and delivery — and that this policy was accompanied by an active labor-market intervention. Poland provides the clearest contrast: the pre-existing system of social services disintegrated, social expenditures were drastically reduced, survival was left principally to charity, and labor-market policy was limited to a compensation. The political effect was that in Spain the Socialist Party, which led the reform process, continued to win elections without a serious social upheaval. In Bolivia, parties supporting the continuation of reforms won a majority in the 1989 presidential elections; while in Poland, parties advocating that reforms be continued won about 20 percent of the vote in the October 1991 parliamentary elections. Yet, since the initial conditions and the challenges facing these three countries were quite different, it is hard to treat even these cases as paired comparisons.

Spanish social policy was sufficiently extensive that it could be conceptualized by the government and perceived by the population as progressing toward "social citizenship": a guarantee of reasonably adequate and equal welfare protection for all members of the political community. This policy was financed by a significant increase in fiscal revenues, originating from progressive taxation and distributed through a decentralized system of regional self-government. As José Maria Maravall (1993) demonstrates, the Spanish experience of "social citizenship" was distinctly tied to the consolidation of political democracy: in spite of widespread unemployment, people learned that political democracy brings social rights. As a result, one striking feature of Spanish public opinion data is the gradual disassociation between the evaluations of the economic situation and of political institutions.

Broad social policy may be unfeasible in countries with acute fiscal crises. Although welfare services in these countries are far from sufficient, they may have to be selectively reduced. Yet, from the purely economic point of view, such reductions will again undermine the capacity to grow. The central lesson of the endogenous-growth theories and, indeed, one of a few robust statistical findings concerning the determinants of growth is the importance of education, whether measured in terms of school enrollment rates or indices such as literacy (Meyer et al. 1979; Marsh 1988; Levine and Renelt 1991; Persson and Tabellini 1991). Primary education for women has particularly high returns in terms of per capita growth (World Bank 1991). And while no similar statistical studies seem to be available with regard to health expenditures, the 1991 *World Bank Development Report* (1991, 53-55*)* cites extensive evidence about the relationship of productivity to increased effects from health programs. Hence, stabilizations that occur at the cost of reducing expenditures on education and health are likely to be counterproductive with regard to growth.[11]

Short of guaranteeing social citizenship to everyone regardless of individual labor market status, there are three ways to secure basic incomes: maintain full employment, assure everyone of a minimum income, and insure against unemployment. Command economies relied on the first method; market economies on different combinations of all three, often with incomplete coverage. The safety net of welfare services has always been rudimentary and fragmentary in less-developed market economics, while it disintegrated along with central planning in the command economies.

Economic reforms cause unemployment, which is a new phenomenon among the command economics and increasingly widespread one where markets had previously allocated jobs. When unemployment rises, basic income protection becomes the paramount concern of large segments of the population. These segments are several times larger than the number of those actually unemployed at any particular moment. Active labor-market and income-insurance policies are thus substitutes: without a net of social protection and without income insurance, a loss of employment means the loss of livelihood. This is a cost no one can tolerate even in the short run.

In the face of mounting unemployment, an active labor-market policy is, thus, essential to reduce not only economic but also social costs of reforms. The neoliberal posture is based on the assumption that once the economy is deregulated and privatized and, thereby, the conditions for competition created, markets will emerge and their operation cause resources to be reallocated across sectors and activities. Yet, markets do not “emerge” out of competition: they must be created by policy. Even if unemployment is only frictional or structural, an elaborate and costly system of institutions is required to orient the newly unemployed toward new opportunities.[12] Without a well-functioning labor market, resources will not be reallocated across sectors. Yet even when basic markets are present, the reallocation of resources needed to make some economies efficient may be too massive to take place without extensive state involvement, Poland provides an example, albeit an extreme one. If Polish agriculture is to become as efficient as that of Western

Europe, the number of people dependent on agriculture would have to be reduced by at least 70 million, or about 20 percent of the population. A transformation of this magnitude cannot take place overnight, and all the OECD countries strongly support agriculture to avoid social and political effects of dislocation that competition would entail.

To the extent that widespread unemployment persists for extended periods, many people find themselves without a livelihood, and others live with the constant fear of unemployment.[13] And people who experience or feel threatened by unemployment are those most likely to oppose reforms. If their livelihood is not protected at least minimally by narrowly targeted income-insurance policies, resistance may assume explosive forms.

The political impact of market-oriented reforms may depend on 1) the initial income distribution, 2) the distributional effect of reforms themselves, and 3) the scope of social policies.

The effect of the initial income inequality is not obvious (Przeworski 1991). Consider two countries, one as unequal as Brazil — where the top quintile earns twenty-seven times more than the bottom one — and one as equal as the former Soviet Union, assuming the average income in both countries hovers slightly above poverty. Now, suppose that, as a result of reforms, average income temporarily declines without any change in distribution. Then the proportion of newly poor will be small in the income-unequal country, while in the income-equal country everyone might find himself in poverty. This seems to be the experience of Russia, where currently about 90 percent of the population is estimated to be below the poverty line. If the newly poor constitute the group most vociferously resisting reforms, then reforms are more likely to succeed politically in the initially less egalitarian country.

Our knowledge of the distributional effects of reforms is limited. On *a priori* grounds, it is expected that unemployment will hit less-skilled workers in some sectors and public employees, while the real value of pensions and other transfers will decline. The phenomenon of the *declassement* of the middle class — reductions in income that change class position, as when, for example, people are forced to move from an apartment to a *favela* — can be expected to be most explosive politically, while less educated, older, and socially isolated groups may be unable to express their reactions politically.

Social policies face the familiar dilemma between political effects and economic costs. On one hand, universalistic policies are politically more popular precisely because they are universalistic. But they are expensive, and when the level of provision is not sufficient to be effectively universal, access to social services must be rationed through administrative procedures that often deteriorate into clientelism and patronage. On the other hand, targeted, means-tested policies are cheaper but politically unpopular, since they are often perceived as gifts to those who do not want to work. Because universalistic policies entail higher taxes, policies that go a long way toward, but stop short of universalism are optimal in generating political support.

Admittedly, our evidence that absence of social protection, whether in the form of broad social policy or targeted income-insurance schemes, is transformed into effective political opposition to reforms is again very thin: It relies on the juxtaposition of Spain and Poland.[14] Yet the Polish case — the only country where we were able to study the political dynamic at the microlevel — seems most suggestive (Przeworski 1993). In Poland, unemployment turned people against reforms and overwhelmed the beneficial effects that had been anticipated.[15] If market-oriented reforms fail in Poland for political reasons — and this possibility is real — it will be because unemployment was introduced without a social safety net. But we are aware that the causal chain leading from individual discontent to organized reactions and from organized reactions to the abandonment of reforms is contingent and complex. Reforms may well continue against popular resistance, even under democratic institutions.

This point brings us to our third and final hypothesis; technocratic policy style weakens nascent democratic institutions. The generic dilemma facing governments that embark on the path of reform is that broad consultation with diverse political forces may lead to inertia, while reforms imposed from above may be impossible to implement in the face of political resistance and economic uncertainty. Faced with this dilemma, governments can adopt four different policy styles:

1. If convinced of the need for immediate reforms, persuaded about the technical soundness of the economic blueprint, and equipped with decree powers, the executive may force reform measures on society. This "decretism" is so widespread that it seems almost inherent in the neoliberal approach. An overwhelming proportion of legal acts concerning the economy in Argentina, Brazil, and Peru consist of presidential decrees. The decrees need not, and often do not, correspond to programs advocated by victorious candidates. From Victor Paz Estenssoro and Jaime Paz Zamora in Bolivia to Alberto Fujimori in Peru, recent years witnessed several cases of leaders who embraced the content and the style of reforms against which they had vigorously campaigned.

2. When the executive has no decree powers but enjoys a majority in the legislature, the same technocratic style appears as "mandatism." As Margaret Thatcher often observed, she told the people what she would do if elected. They voted for her, and thus she had a mandate to do what she believed appropriate; in the next election, the people could decide whether this is what they really wanted. This style is technocratic since, beyond the electoral campaign, it entails no consultation with opposing political forces in the parliament and no negotiation with forces outside it, either in policy formulation or implementation.

3. "Parliamentarism" is a policy style which can result either from a deliberate decision by the majority to consult and negotiate with opposing forces in the legislature or, frequently, from the fact that proportional representation fails to generate majorities, thus making coalitions and compromise inevitable. While the government enjoys some autonomy, it consults and negotiates at various stages airing publicly policy options and conflicting views. Political support is thus organized as policies are being formulated and implemented; indeed, when no party has a majority, policies can only be pursued given the approval of a coalition.

4. Finally, "corporatism," or perhaps better "concertation," is a policy style which extends consultation and negotiation beyond the parliamentary actors to unions, employers' associations, or other interest groups.

Our hypothesis is that policy styles matter. Three considerations are pertinent, however. First, consultation and concertation may improve the technical quality of reform programs. We realize that this is an unorthodox view, since the usual argument is that negotiating the economic program undermines its logical coherence. Yet this assumes that the program is coherent and free from mistakes to begin with. We have already seen that this is a questionable assumption. Neither the logical consistency of any particular reform strategy nor the design of specific measures are obvious even to professional economists and, in fact, many important decisions are made in a haphazard way when they are hidden from public scrutiny.[16] Moreover, professional economists advise opposing political parties and even unions: their voices can serve to warn about impending mistakes. We believe that the Hungarian reform strategy, which prepared for social costs, is more likely to succeed than the Polish one, which did not. The reason Hungarians opted for this strategy is that politicians and economists, within and outside the government, disagreed about the appropriate sequence and pace of reforms.

Secondly, discussion and negotiation may serve to build political bases of support for particular reform strategies. If a program is forged in negotiations involving diverse political forces, it will be easier for these forces to support. Such a program may retard the pace of reforms and may eliminate the element of surprise necessary for some stabilization measures, such as freezes, price deregulations, or capital levies. Yet — to argue again against accepted wisdom — such a program may be more, not less, credible, because it creates political conditions for the continuation of reforms. Contrary to frequent announcements by technocrats that they will proceed regardless of political pressures upon them, decrees are often simply ineffective, precisely because economic agents anticipate that particular policies are politically unsustainable.

Finally, if one cares about democracy, one must take the political criterion as autonomous. Policy styles matter because they have an effect of channeling political conflicts and of teaching political actors where the real locus of power lies. The Polish experience is eloquent. Most decisions were made outside the framework of representative institutions and people quickly learned this. Repeated surveys show that people do not perceive the locus of power to be in the properly constituted institutions. Consultation and negotiation among representative organizations within the framework of representative institutions are necessary to channel political conflicts. If decisions are made elsewhere, representative institutions wilt; they do not necessarily crumble. Experience thus far demonstrates that regular elections can take place and civil rights can be observed even in systems in which the executive, suspended above the representative organizations and unchecked by other branches of the government, makes repeated recourse to decrees (O'Donnell 1992). But anyone concerned with the quality of democracy will view such a political system as greatly impoverished. And, the experiment is not yet over: the question remains open whether democratic institutions can survive when decrees announce miracles that fail and are followed by demands for further sacrifice.

Hence, we find that subjecting reform strategy to the competitive interplay of political forces is superior on all three points: it improves policy, it builds support for the continuation of reforms, and it helps consolidate democratic institutions. We do not see a trade-off between public discussion and the soundness of economic plans. Yet our advocacy of this policy style must be tempered in several important ways.

First, even if a government is eager to consult and negotiate, it cannot be assumed that it will find willing partners. The dominant strategy of the opposition may be to let the government make its mistakes, so that it becomes unpopular and loses elections. Sharing as a minor partner the responsibility for a socially costly program may turn out to be politically detrimental. The Portuguese Social Democrats bet on this strategy and experienced spectacular electoral success, but the Peronist Party and Argentine unions repeatedly rejected overtures from the Radical government. Moreover, excessive consensus also threatens democracy: opposition political forces are needed to monitor the government from an adversarial position.

Secondly, since the combination of left-wing partisan control with institutionalized concertation with unions and employers' associations generally creates superior economic performance in the OECD countries, a question emerges whether this policy style would not also be successful in the case of new democracies. Yet this question is largely irrelevant, since the organizational preconditions for such a policy style are absent in the countries we consider. Having reviewed union membership in eighteen newly democratic countries, Davide Grassi (1991) found that the largest degree of unionization among them is about 35 percent and that union density is positively related to wage militancy. Norbert Lechner (1985) and Adam Przeworski (1991) discussed other reasons why concertation with extra-parliamentary actors is not a feasible option in less developed countries. Indeed, since in many new democracies employers' associations enjoy a disproportionate political influence through informal channels and tend to oppose vigorously some essential elements of reform — notably trade liberalization and tax increases — concertation may result in undermining reforms.

Another way to pose the issue of policy style is to ask whether a "strong" or a "weak" government is more likely to see reforms through to the end. State strength, however, is an ambiguous notion. Some governments that appear strong because they issue decrees (without previously building the political bases of support) end up simply ineffective, the experience of Fernando Collor de Mello being a prime example. In turn, minority governments, which must build coalitions before they can launch a reform program, may become highly successful, as was the case with Purtugal's socialist-social-democratic government. To be more precise, we must distinguish between constitutional constraints that bind all governments and the conjunctural outcomes of elections, which determine the majority or minority status of particular office holders. A government may be "weak" in the sense of not being constitutionally enabled to make certain decisions (because it must go through the legislative process, because legislation is subject to judicial review, or because some decisions are reserved for autonomous institutions, such as the Central Bank), or the government may be "weak" because it is politically unable to legislate without first persuading its own party or without building a coalition of several parties.

We have argued in favor of institutional structures that compel governments to discuss and negotiate while formulating and implementing policies. We see decree power as ineffectual economically and dangerous politically, and we see both political and institutional constraints as tempering technocratic proclivities.

Yet, as José Maria Maravall (1993) demonstrates, policy styles are not uniquely determined either by institutional framework or by majority status of a government, and given the paucity of successful cases, empirical evidence appears inconclusive. Moreover, we do not deny that governments cannot spend all their time consulting and negotiating: they must have the power to govern.[17] Nor do we underestimate the danger of self-serving, narrowly based opposition to reforms. Several sectors of society — notably, firms that enjoy oligopolistic rents, the bourgeoisie that resist fiscal pressure, employees in the public sector, low-skilled workers in the private sector, groups which traditionally enjoyed entrenched privileges, and peasants of

Eastern Europe — may see their interests hurt as the result of reforms. Separately or in often strange alliances, they resist reforms. Yet the idea that reforms can escape resistance or be conducted so swiftly that groups will not have time to organize and be heard or that the program must be concluded before "political fatigue" sets in is infeasible. This technocratic posture is counterproductive to continued reforms and risky for democracy.

Indeed, a central reason opposition to reforms often assumes the form of defending short-term, particularistic interests is that these reforms are not a product of political interplay among representative organizations on the terrain of the representative institutions. Proponents of reforms should not fear democratic institutions: while we understand little about the micro-foundations of individual postures with regard to reform programs, there is overwhelming evidence that such programs enjoy widespread support initially, even when it is recognized that they will induce hardships. The Balcerowicz plan in Poland, the Collor I plan in Brazil, the Cavallo plan in Argentina, and even the Fujimori program in Peru enjoyed overwhelming support in public-opinion polls. If the representative system were allowed to process conflicts about reforms, it is likely that only reasonable differences of opinions and responsible conflicts of interests would emerge, not as a threat to the idea of reform as such but only to its specific blueprint. By stifling public discussion, the specter of "populist reaction" serves mainly to defend particular groups of technocrats against alternative conceptions and competing teams.

Yet since the neoliberal strategy entails significant social costs, reforms tend to be initiated from above and launched by surprise, independent of public opinion and without the participation of organized political forces. Reforms tend to be adopted by decree or rammed through legislatures without modifications that would reflect diversity of interests and opinions. The political style of implementation tends to be autocratic: governments seek to demobilize their supporters rather than compromise the reform program through public consultation, In the end, society is taught that it can vote but not choose; legislatures are trained to think that they have no role to play in policy elaboration; nascent political parties, trade unions, and other organizations are taught that their voices do not count. Hence, the autocratic policy style characteristic of the so-called "Washington Consensus" reforms tends to undermine representative institutions, to personalize politics, and to generate a climate in which politics becomes reduced to quick fixes or to a search for redemption. Even if neoliberal reform packages make good economics, they are likely to generate voodoo politics. Either the executive, impatient with the political process, decides to ram reforms through by closing other branches of the government, as in Peru, or the opposition to reforms assumes an extra-parliamentary form, as in Venezuela. Both of these reactions are a predictable effect of technocratic policy style.

These consequences are not inevitable. Indeed, the reason the "stop-go reform" pattern sets in is that democracy is incomplete to begin with. In a country with constitutional provisions that force the executive to seek legislative approval for policies before they are launched, with effective representative institutions, and with widespread political participation, government initiates reforms dependent on the support it musters. Reforms emerge from consultations channeled through the representative institutions. The Spanish Socialist government did proceed in this fashion and succeeded with widespread support in conducting the country through a painful program of industrial reconversion.[18] It is precisely the strength of democratic institutions, not exhortations by technocrats, which reduces political space for the pursuit of immediate particularistic interests — that is, for populism. Populism is an endogenous product of technocratic policy styles.

A Social-Democratic Approach to Market-Oriented Reforms

With consideration to all the caveats required by the paucity of evidence, we are ready to summarize our analysis in a more prescriptive fashion. We support reforms aimed at stabilization, defined principally as a reduction of fiscal crisis with all its attendant consequences, because we see such reforms as inevitable once an economy enters an inflationary spiral Moreover, we believe that an increased reliance on national and international markets to allocate resources is required to enhance efficiency in economies that are monopolistic, overregulated, and overprotected.[19] We do not believe that such reforms can be pursued without a temporary decline of consumption, a rise in unemployment, or other social costs. Yet we have been critical of the standard neoliberal recipes since we believe that they are faulty in three fundamental ways: they induce economic stagnation, they incur unnecessarily large social costs, and they weaken nascent democratic institutions. This is why we seek to offer an alternative, "social-democratic," approach to market-oriented reforms.

This approach consists of three recommendations. First, social policy must be elaborated and put in place as stabilization or liberalization are launched. Secondly, the entire reform package must be efficient, in the sense of minimizing social costs, and must be designed with a view toward resumed growth. Finally, reform programs should be formulated and implemented as a result of political interplay of representative organizations within the framework of the representative institutions.

While in many countries the economic crisis is too acute to allow for the development of a universally oriented welfare system — as Spain was able to do — both labor-market institutions and basic-income protection schemes must be put in place simultaneously with reforms that cause unemployment and reduce consumption.

A social policy designed to protect everyone from the most dire effects must be an intrinsic part of any reform strategy that seeks continued political support under democratic conditions. Spain underwent a decade of unemployment hovering at about 16 percent and approaching 22 percent in 1985. During this time, the government repeatedly won elections, thanks to broad political support due somewhat to the absence of credible political alternatives but also to a considerable expansion of social policies. Social expenditure increased from 9.9 percent of GDP in 1975 to 17.8 percent in 1989. This expansion reduced the risk of reforms for groups most drastically hurt by the reform process and it convinced people that the extension of social citizenship is a credible promise of democracy.

Labor-market institutions must be appropriate for the distribution and the duration of unemployment. In countries with a large informal sector, they must facilitate access to the formal labor market or petty entrepreneurship. They must comprise an information system, perhaps a subsidized credit system to promote self-employment, and, where the housing market is thin, a relocation system. Income protection must be sufficient to cover basic needs and to facilitate job search and retraining, without creating incentives to remain idle.

There is overwhelming evidence (Nelson 1990) that stabilization efforts are normally undertaken as a result of a fiscal crisis of the state. By “fiscal crisis” we mean not only that the public deficit is chronic or the public debt excessive but that the state loses the capacity to finance its debt. in non-inflationary terms. The erosion of public savings deprives the state of the capacity to pursue any development strategy. Public savings are essential to stimulate investment and to allocate it more efficiently, to promote technological development, to protect the environment, and to pursue social policies.

Stabilization policies should be efficient in the sense of minimizing transitional costs, and must be highly attentive to the effect on growth. Expenditure cuts must discriminate between consumption and investment. In the spirit of Tanzi (1989), minimal public investment targets should be exempt from cuts and, following Mario Blejer and Adrienne Cheasty (1989), selective instruments that raise the rate of return to private investment should be preserved. Moreover, given the overwhelming evidence about the productive role of education, educational expenditures and preventive health programs should be treated as intrinsic aspects of public investment.

To put it bluntly, while public bureaucracies should be streamlined wherever they are excessive and public programs should be eliminated or reorganized when they are inefficient in delivering urgently needed services, stabilization should rely on a reduction of current consumption but not of investment, and this reduction should be targeted, via the tax system or a one-shot capital levy, at those who can afford it. This includes foreign creditors: in most countries, resumed growth is not feasible without a significant reduction of the external as well as the internal debt.

Tax reform which enforces compliance, broadens the income base, and significantly increases effective rates of collection must be an intrinsic ingredient of the reform package. Tax reform constitutes evidence that the distribution of burdens is equitable, but the immediate economic purpose is to raise state revenues instead of cutting expenditures that support future growth. We are unimpressed by arguments about the marginal deadweight cost of taxation. Empirical evidence is, at best, mixed[20] and present tax rates in most new democracies are abominably low, much lower than in the OECD countries (Cheibub 1991). Most resistance to taxation reflects a collective-action problem on the part of the bourgeoisie: while there is evidence that a financially healthy state, capable of pursuing consistent policies, would induce higher rates of return to private investment, firms and their stockholders, nevertheless, seek to escape their burden.[21] A recent study by the World Bank (1991, 82) shows that the rate of return to private investment projects rises from 10.7 percent when fiscal deficit is greater than 8 percent of GDP to 14.3 percent when the deficit is less than 4 percent. Hence, there is room for a Pareto-improving increase of state revenues; the rate of private after-tax return can go up as the effective tax rate is raised. To cite Blejer and Cheasty (1999, 46), "A tax system which is uniform and predictable, and which is associated with prudent macroeconomic management, may make higher rates more acceptable than they would be in a tax system with many exemptions that is associated with a fiscal position perceived to be unsustainable in the longer run.[22]

If growth is to be resumed, the goal of reform measures must be not only to reduce inflation and to increase competition but also to restore the capacity of the state to mobilize savings and to pursue development-oriented policies. Judicious and carefully targeted state intervention in allocating resources across sectors and activities is necessary to resume growth. Having examined the characteristics of financial markets in most developing countries, Blejer and Cheasty (1989) concluded that these markets do not efficiently allocate investments.[23] The state must acquire the capacity to mobilize savings. According to Blejer and Cheasty (1989, 45-47), the government should "aim to set its total tax revenues and its total expenditures (both current and capital) at levels that would yield an overall surplus, which could be made available, on a competitive and non-concessionary basis, to the private sector as well as to public enterprises. This would provide the government with a powerful and flexible tool that would facilitate ... the efficient allocation of investment." Moreover, they argue, "the government could increase domestic savings by undertaking actions which increase the perceived rate of return on private sector investments. One way of doing this would be to invest directly in projects which would result in positive externalities to the private sector."

We have nothing original to say about the content of state intervention: it is generally recognized that the state should engage in infrastructure investments, which is not supplied efficiently by private agents, and that it should pursue measures that increase the rate of return to private projects. This role includes a selective industrial policy that would comprise preferential credit rates for high-technology industries, in which the market rate of return is much lower than the social rate; for projects that suffer from high costs of entry, substantial economies of scale, or steep learning curves; and for projects which have potential spillovers across firms due to externalities and asymmetries of information between suppliers and buyers (Grossman 1990). The danger that the very capacity of the state to engage in productive activities and to favor private projects differentially would cause rent-seeking is real. The question of how to organize state institutions so that they would engage in activities that are socially beneficial and would abstain from responding to private interests remains central. Yet unless the state directly undertakes some investments and induces the private sector to undertake others, stabilization or liberalization will not lead to resumed growth.

If these arguments are valid, economic growth requires a significant and sizeable role for the state. Barro (1990) showed that the present utility of future consumption or, equivalently under a Cobb-Douglas production function, the rate of growth are maximized when the share of the public productive sector in output equals the marginal elasticity of public capital. Ronald Findlay (1990) presented a similar result wit regard to public employment. Barro used 25 percent as a rough guess for the optimal size of the public capital stock, and Cheibub (1991) found statistically that this number is somewhere around 20 percent, depending whether one includes education and defense. Hence, some intermediate role of public investment and employment —very far from 100 percent but also far from zero — is optimal for economic growth.

Finally, reform programs must be processed through representative institutions, We have argued that the democratic process can improve the technical quality of reform policies and can furnish the bases for continued support for reform. Yet democracy is an autonomous value, for which many people bore sacrifices when they struggled against authoritarian regimes. The quality of the democratic process, perhaps less tangible than material welfare, affects the everyday lives of individuals: it empowers them as members of a political community or deprives them of that power. And if democracy is to be consolidated — that is, if all political forces are to learn to channel their demands and organize their conflicts within the framework of democratic institutions — these institutions must play a real role in the shaping and the implementation of policies that influence their life conditions.

Hence, our "social-democratic" approach to market-oriented reforms calls for orienting reforms toward growth, for protecting material welfare against the transitional costs of reforms, and for making full use of democratic institutions in the formulation and implementation of reform policies. We realize that each of these recommendations involves costs. Industrial policies, social policies, and political compromises cost money,[24] and trade-offs are inevitable. We do not offer blueprints: the design of specific reform strategies must reflect local constraints, and the trade-offs must be determined by the democratic process. We do argue, however, that in order to be successful, reforms must explicitly aim at growth, income security, and democracy.

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[1] While the ostensible purpose of privatization is to enhance efficiency or to increase fiscal discipline (Lipton and Sachs 1990), a more likely reason is often the desperate need to fill state coffers or to attract new investment.

[2] For a detailed argument that market-oriented reforms necessarily cause a transitional decline of consumption, see Przeworski (1991, Chapter 4) and Blanchard et al. (1991, 10-11).

[3] Several research projects seek to explain inductively the “success” of economic reforms. Clearly, the feasibility of such undertakings depends on the definition of the dependent variable. Karen Remmer (1986) studied the compliance with targets set by IMF standby agreements – a sufficiently large sample to permit inductive inferences.

But if the implicit definition of the dependent variable is success viewed as resumed growth, then no rigorous quasi-experimental inferences are feasible. The Nelson et al. (1990) strategy of redefining success in terms of continuation of whatever reform measures is based on the false assumption that such measures are uniquely related to the ultimate goal. In turn, if success is defined iii terms of resumed growth, there is just not enough historical evidence to permit inductive inferences. Thus, for example, the debates whether authoritarian or democratic regimes are more likely to undertake and persevere with reforms which engender growth are based on four successful cases – authoritarian Chile and South Korea, democratic Spain and Portugal – and innumerable cases of failure. This is why we did not try to set up a quasi-experimental research design: controlled comparisons of case studies are not yet feasible, if one takes growth under democracy as the *explanandum.*

[4] With the exception of Eastern Europe and South Korea, the data cited here are derived from articles in Bruno et al. 1991. For Korea, see Rhee (1987). For Eastern Europe, see Przeworski (1991).

[5] The exact figures are disputed; see Morales (1991).

[6] Note that Edwards and Edwards (1991, 215) attributes the resumption of growth in Chile after 1985 to increased public investment.

[7] On the static bias of the neoclassical theory, see Fanelli, Frenkel, and Rozenwurcel (1990).

[8] As Newbery and Stiglitz (1981, 209) put it, "With so incomplete set of markets, the marginal rate of substitution of different individuals between different states of nature will differ; farmers (or producers, in general), in choosing their production technique, look only at the price distribution and their own marginal rates of substitution, which may differ markedly from those of other farmers and consumers. When they all do this, equilibrium which results may not be Pareto efficient; there is some alternative choice of technique and redistribution of income which could make all individuals better off".

[9] The "engines of growth" in these models are non-decreasing returns to some accumulable factor of production – typically, knowledge of some sort – and externalities. If the returns to this factor can be captured by the market, there will be some monopoly power, as in Romer's (1990) model. If they are not, the competitive equilibrium will be inefficient, since the market will undersupply the factors that give rise to externalities. See Ehrlich (1990).

[10] Suppose that at time t=0, a government promises to do A at time t=2 if it wins the election at time t=1. A strategy is credible if A is the maximizing strategy of the government at t=1. If a government says "reelect us and we will reduce unemployment", while it is clear that anyone who is elected must reduce public spending, the strategy will not be credible.

[11] More generally, but surprisingly, recent statistical evidence demonstrates that growth is faster in countries which enjoy a more equal distribution of income. The

1991 *World Development Report* (1991, 137) presents startling data to this effect, while Persson and Tabellini (1991) offer regression analyses for two distinct periods.

[12] Sebastian Edwards (1990) seems to be the only person who emphasizes the importance of active labor-market policy as an intrinsic element of a reform package, arguing that labor-market institutions should be created before stabilization-liberalization.

[13] It is worth noting that increases to unemployment that invariably accompany market-oriented reforms are not necessarily accompanied by a fall in real wages for those who continue employed. Wage rates to the private sector rose sharply after stabilization in Great Britain under Thatcher, in Spain, as well as in Bolivia after *1985,* and in Chile after *1975,* while to all these countries the rate of unemployment hovered to double digits. Only in Eastern Europe did wage rates fall sharply as the economies stabilized. This is a puzzling phenomenon: see the discussion of Bolivia in Bruno et al. (1991). One explanation is that stabilization followed a drastic fall of wages, another one is that the exchange rate was overvalued, and the third is that unemployment had a highly structural character.

[14] In an interesting study, Grassi (1991) found that among 18 new democracies wage militancy is negatively related to government spending, while it has no relation either to unemployment or investment. Hence, it seems that workers are willing to trade social spending for private wages.

[15] According to Morales (1991, 29), unemployment was also the central issue which preoccupied voters in the Bolivian electoral campaign of May 1989. Note that we are not arguing that the mere presence of unemployment will cause people to turn against reforms and governments that pursue them, but only that this will occur if the unemployed have few prospects of finding another job and no income security. In Spain, for example, 58 percent of employed workers voted for the PSOE in the elections of 1986 and so did 57 percent of unemployed.

[16] Zélia Cardoso de Mello, the former Brazilian Minister of Finance, recounts that to decide the amount of funds that should be the subject of a capital levy, she wrote three round numbers and pulled one of them out of a hat during a social gathering. See Sabino (1991).

[17] Moreover, institutional constraints operate effectively only if they are supported by political conditions: institutions do not function to a vacuum. Influenced by the political culture of the United States, some neoliberal economists call for constitutional restraint as the solution to the issue of credibility. Bemholz (1991, 50), for example, argues that instead of "prematurely" developing a welfare state, Bolivia should constitutionally restrain the power of government. To his view, "the discretionary power of the administration and of parliament have to be circumscribed.... An independent central bank that can refuse to extend credit to the government, constitutional limits on budget deficits and on maximum marginal tax rates, provisions against hidden expropriation without adequate compensation, and an independent judiciary are some of the institutional requirements necessary. Any violation of these rules should be prosecuted in the courts, and changes to the

corresponding constitutional rules should require, say, a two-.thirds majority to parliament". This kind of a program seems to be motivated by the idea that what we cannot get in the United States, we can introduce at least in Bolivia. But this idea cannot work to either country.

[18] Note that when the Italian Communist Party decided in 1976 to support the austerity policy of the government, it processed one million workers through night school courses that explained the economic necessity of austerity

[19] All throughout this chapter, we have said little about privatization because we think that it is largely motivated by the need to improve the short-term financial position of the state rather than by long-term efficiency considerations.

[20] Contrary to frequent assertions, the statistical evidence that taxes lower private investment is at best mixed. Saunders and Mau (1985) did not find any effects for the OECD countries, but Swank (1991) did. Blejer and Cheasty (1989) did not find it for the 1ess-developed countries.

[21] In the mid 1980s taxes on income, profit, and capital gains amounted to 4.9 percent of government revenue in Argentina and to 67.4 percent in Japan; the average for Argentina, Bolivia, Brazil, Chile, Mexico, Peru, and Uruguay was 13.7 percent, while for 10 industrial market economies it was 40.0 percent. These calculations are based in Teitel (1991, 138).

[22] For microlevel evidence based in interviews with Argentine businessmen, see López (1991).

[23] They cite three reasons: 1) the capital market is undiversified and fragmented, 2) financial returns to savings and/or investment are insufficient, and 3) financial assets bear uncompensated risks.

[24] To cite just one number, according to Morgan-Stanley Bank *(Financial Tímes,* December 19,1990), the cost of social policies that would maintain minimal protection in Eastern Europe over the next five years is between US$270 and US$370 billion.