

THE POLITICAL ECONOMY OF
REFORM IN LATIN AMERICA
Politics, Institutions, Ideas, and Context

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The Politics of Labor Reform in Latin America: Between Flexibility and Rights. By Maria Lorena Cook. University Park: Pennsylvania State University Press, 2007. Pp. xv + 231. \$45.00 cloth.

Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico. By Santiago Levy. Washington, D.C.: Brookings Institution Press, 2007. Pp. xiii + 357. \$27.95 paper.

The State of State Reform in Latin America. Edited by Eduardo Lora. Palo Alto, CA: Stanford University Press; Washington, D.C.: Inter-American Development Bank, 2007. Pp. xxi + 446. \$29.95 paper.

Democracies in Development: Politics and Reform in Latin America. Revised edition. Edited by J. Mark Payne, Daniel Zovatto G., and Mercedes Mateo Diaz. Washington, D.C.: Inter-American Development Bank; David Rockefeller Center for Latin American Studies, Harvard University, 2007. Pp. xvi + 332. \$27.95 paper.

Bounded Rationality and Policy Diffusion: Social Sector Reform in Latin America. By Kurt Weyland. Princeton, NJ: Princeton University Press, 2007. Pp. xii + 297. \$24.95 paper.

Research on the political economy of economic reform in Latin America has progressed quite tangibly in the past quarter century. The 1980s emphasized the relative success or failure of macroeconomic stabilization and market liberalization, a rather unsurprising fact given the economic crisis that enveloped the region at the time. These early studies emphasized the broad concepts of timing, sequencing, and political will to explain intraregional differences. Researchers were just beginning to think about the interplay between political and economic reform, and how this might affect policy outcomes, motivated in part by loudly expressed concerns about the compatibility between economic reform and the parallel rise of democratic governance. Analysis of the role played by democratic institutions in molding governance in Latin America's new democracies

and their consequent capacity to implement needed reforms remained formative. Policy recommendations, meanwhile, were dominated by universal proposals—initially as emergency measures and later as accepted wisdom—for dealing with common challenges, despite obviously diverse policy environments. Yet the clear hypotheses driving many of these studies and the expanding body of evidence they created about Latin America's varied experiences with reform established the foundation for what quickly became a rich field of study.

As understanding of the reform process progressed, research almost naturally incorporated narrower questions about the nature and operation of specific political and/or economic drivers of reform, as well as more complex questions about the interaction among them. Analysis employed deeply detailed single-case studies, well-structured comparative case studies that looked at a small number of regional cases and compared Latin American with non-Latin American cases, and quantitative analyses of a broader universe of Latin American cases. As Latin America gradually surmounted the immediate crisis, reestablished market-based economies, and managed to sustain new democracies, analytic attention shifted away from stabilization, liberalization, and privatization to the longer-term ability of market economies and democratic governments to enhance the well-being of their citizens. Absent the enormous economic distortions created by hyperinflation, excessive protection, and overregulation, other sorts of equally pernicious but previously less obvious market and government failures became more evident, more problematic for growth and development, and more visible in studies on reform. Analysis turned to questions about property rights, information asymmetries, resource mobility, human and capital infrastructure, and the quality and consistency of economic policy, their market impact, and their ability to either promote or retard sustainable and equitable development. Research took on the roles played by social assistance, education, labor systems, regulatory structures, monopolies, and oligopolies, and by energy, finance, transport, and telecommunications infrastructure in building efficient markets. And it began aggressively to consider the factors—such as political decentralization, judicial reform, public administration, civil society, and institutional structures of government—that determine the quality and effectiveness of democratic governance, and Latin America's consequent ability to implement needed policy reforms.

This second wave of research on political economy also evinces a developing consensus about the sets of factors that matter most in explaining reform. Put simply: politics matter, institutions matter, and context matters. Although this may seem exceedingly broad and less than earth shattering now that we are more than ten years into the process, that alone is a sign of how quickly and deeply the consensus has become ingrained in analytic thought and the literature on reform and develop-

ment. It is worth remembering that so-called first-generation reforms—macroeconomic stabilization, market liberalization, and privatization—ignored and often even denied the influence of politics, institutions, and context on the operation of a market economy. To an important extent, technocratic policy making allowed governments to sidestep democratic deliberation; the initial reforms could themselves be implemented without serious regard for either political or economic institutions, and the dominant strain of economic thought assumed the global applicability of market reform, making context largely irrelevant. With hindsight, it is unsurprising that these reforms, despite success in creating macroeconomic stability, failed to generate rapid and sustained growth and development in most of Latin America, while tangibly increasing economic inequality and corruption in many places. These failings led both policy makers and analysts to think hard about the sources of these undesirable outcomes. This opened the door to new voices previously absent from most policy-making circles, even as they gradually gained strength in the academic community. These analysts pointed directly to the neglect of politics, institutions, and context to explain many, if not most, of the evident shortcomings in the design and implementation in Latin America of the Washington Consensus package of reforms.

Developments on the ground in Latin America thus reinforced developments in the academic milieu to focus investigation and policy attention on improving the quality of economic policy making, building the competitive efficiency of Latin America's market economies, and adjusting policy recommendations to the unique conditions of each country. Moreover, this increased attention to politics, institutions, and context encouraged what has become a rich cross-fertilization among different fields of analysis examining the reform process and its impact on development—economics, politics, sociology, psychology, history, and beyond. This most recent wave of research has stimulated energetic and often divisive debates about the utility of different analytic methodologies; the relative importance of economic, political, social, cultural, and psychological factors in determining policy outcomes; and the wisdom of relying on the market to promote equitable and sustainable democratic development in Latin America. These debates have motivated and informed outstanding advances in the study of economic reform in recent years, even though their volume and tone have sometimes overshadowed these real analytic advances.

The books reviewed in this essay are a sampling of the latest contributions to this analytic effort. Their aim is to understand the role of politics, institutions, ideas, and context in the reform process: precisely how they matter; which matter most, why, and under what conditions; how they interact, and why and how this varies; how they consequently shape policy making and market efficiency; and, on the basis of this knowledge, which

policies are best suited to building sustained and equitable development in Latin America. Each of the research projects discussed in this essay takes on this huge analytic challenge from a slightly different angle, illuminates a different piece of the economic reform puzzle, and enhances our understanding of the phenomenon of potential policy solutions to market and policy-making inefficiencies.

INSTITUTIONS MATTER

The collections edited by Mark Payne, Daniel Zovatto, and Mercedes Mateo Diaz, and by Eduardo Lora form part of a multiyear project on political institutions and governance in Latin America sponsored by the Inter-American Development Bank (IADB). This research project is something of a departure for the bank, which traditionally focused on the economic drivers of reform and was motivated in part by its own experience in promoting first-stage reforms in the region. The project began with the understanding that governance and hence politics matter enormously to economic development, and with the conviction that democracy is the best system of government for a market economy. It is thus in the developmental interest of Latin America both to preserve democracy and to improve its operational efficiency. Each volume considers key institutional determinants of the state's ability to implement public policies likely to promote growth and development. *Democracies in Development* (an updated and expanded version of the original 2002 study) looks at the institutions shaping the quality of democratic governance; *The State of State Reform* examines the relative quality of other state institutions. (The IADB's *Politics of Policies*, not reviewed here, looks at the interaction between these institutions and broader political practices to construct a model of democratic policy making in Latin America.)¹

Both collections are enormously valuable reference books. *Democracies in Development*, in particular, presents a nearly encyclopedic overview of the institutional factors affecting the operational effectiveness of presidential democracies and discusses their value for eighteen Latin American countries. It includes a compact disc with a comprehensive compilation by country of all the rules and institutional structures discussed in the book, the distribution by party of votes and legislative seats for each election, and the level of electoral participation through 2005. The twelve chapters in the *State of State Reform* provide a less in-depth but wider-reaching look at the current operational capacity of Latin American states in areas ranging from political, fiscal, and social policy institutions to sectoral economic policy advances. The overarching takeaway from these two volumes is

1. Inter-American Development Bank, *The Politics of Policies, Economic and Social Progress in Latin America* (Washington, D.C.: Inter-American Development Bank, 2005).

mixed: Lora argues that, despite the persistence of real weaknesses and continuing challenges, Latin America has “silently revolutionized many aspects of the institutional landscape” (49). Payne emphasizes instead the “relatively low levels of confidence in democratic institutions and widespread dissatisfaction with their functioning” in Latin America (295) and the need to illuminate the institutional sources of these problems. Together, though, the two volumes provide a detailed picture of the current institutional structure undergirding governance in democratic Latin America. In the process, they identify how far Latin America has indeed come in the past generation, while also highlighting the still-significant institutional obstacles to efficient democratic governance.

Democracies in Development consists of two broad sections on institutions shaping governability, and on those affecting representation and participation. Drawing heavily on existing political science research, the first section develops a virtual checklist of laws and constitutional characteristics that mold a president’s ability to build an effective legislative majority, and explains how and why each factor matters. The second focuses on institutions that shape the government’s ability to respond to citizen concerns and thereby build confidence in and support for the democratic process. This organizational structure reflects another of the volume’s great strengths—its explicit recognition that effective democratic governance requires institutions that both enhance the country’s ability to legislate effectively and ensure that legislation reflects the interests of its citizens. Yet institutions that augment governability often undercut representation, and vice versa. Election rules that make it easier to establish a legislative majority by reducing the total number of parties, for example, are also apt to deny to a larger segment of the population a party option that represents their particular concerns. Equally, mechanisms of direct democracy can enhance citizen interest and participation in the democratic process, but they also tend to weaken institutions of representative democracy (parties and executive and legislative authority), which are essential to the stable and predictable decision process that is a hallmark of established democracies. By placing this fact at center stage, *Democracies in Development* helps emphasize the nature of the challenge to political reform in Latin America and the potential pitfalls that the region is apt to encounter as it strives to improve the efficiency and quality of democratic governance.

The *State of State Reform* describes the nature and reach of the reform of state institutions motivated by the 1980s “crisis of the state in Latin America” (1). The work begins with Lora’s extensive introduction and a chapter by Mark Payne describing regional political institutions, and it continues with chapters on the organization of public administration; the judiciary; institutions of fiscal, tax, and budgetary policy; institutions of privatization, deregulation, and financial and social policy; and new industrial

policy. Each chapter summarizes the objectives and scope of reform and identifies the principle obstacles to policy success. Throughout, the volume presents detailed data in comparative tables that illustrate the extent of reform in various areas, illuminate sharp differences among countries, and implicitly create a to-do list for institutional reform in the region. In the process, it develops initial hypotheses about the reform process and provides evidence in support of Lora's central conclusion that a great deal of reform of state institutions has quietly taken place, and continues to take place, in Latin America.

For all its contributions to the literature on institutions and institutional reform, however, *State of State Reform* can be frustrating for the reader. Lora freely admits that the emphasis on describing what has happened in state reform "does not do justice to the complexity of the process, or to the diversity of national experiences" (5). Nevertheless, the decision to ignore the roles of politics and context leaves the reader constantly wondering why, how, and under what circumstances reforms promoting efficiency have arisen and might continue to remain in effect. Ideally, this will motivate researchers to embed the data contained in these volumes into more complex case-study analyses. But in the meantime, Lora's exclusive focus on institutions undermines the volume's central conclusion that Latin America has experienced a silent and gradual revolution of state institutions, and that this process is "continuing to take place" (51). How can we be certain that Latin America will indeed persist in the pursuit of state reform when, as chapter after chapter argues, success depends on the unstudied variables of political capacity, public support, and the appropriate design of particular reforms? As if to underscore this point, a significant number of Latin American countries have backtracked on market-friendly, democratic reforms since the 2005 workshop on which this volume is based.

CONTEXT MATTERS

The books by Maria Lorena Cook and Kurt Weyland shift attention from a description of institutional inputs into policy making to the analysis of policy outputs—labor reform in the first instance and social policy reform in the second. Rather than measure the raw institutional capacity of the state to carry out all types of reform, Cook and Weyland ask what policies were actually implemented in specific areas and why. Instead of studying the entire region, they offer structured comparisons of the same causal mechanisms in different countries, analyze the consequently different policy outcomes, and explain the cause of this variance. In the process, they employ different methodologies, identify different drivers of reform, and ultimately make quite different contributions to the literature.

In *Politics of Labor Reform in Latin America*, Cook relies on a theoretical approach known as modern political economy to explain why the same ideas about labor reform have produced strikingly different outcomes throughout Latin America.² She argues that a government's resolve to increase labor market flexibility is not due mostly to institutions but is instead a direct reflection of the distribution of interests and power in society, specifically the incentives that unions and businesses have to shape labor law reform, and their ability to do so. Such interests and power are molded by the historical context in which they operate. Policy outcomes reflect the consequent mix of societal pressures on the government, a smattering of international pressure and ideas, and the point in time when policy decisions are made—a period dominated by democratic reform or by market reform.

Cook's use of history to explain important differences in both the power and interests of Latin American unions is particularly illuminating. She argues that the context in which each union was incorporated into democratic politics during the mid-twentieth century explains later variations in its policy preferences and ability to obtain the desired outcome. State corporatism in Argentina and Brazil, for example, created resource-rich unions concerned more with protecting union rights than with the rights of individual workers; radical pro-worker policies in Chile and Peru produced a pro-employer political reaction that dramatically weakened unions and encouraged a focus on individual rather than collective rights; and revolutionary states in Mexico and Bolivia created strong but politically controlled unions. Historical context also helps explain the different amounts of effort that Latin American employers devote to pressing their government to implement labor reform. Where economic reform and increased competition is delayed or truncated, and where controlled unions make labor laws easy to evade, employers have little incentive to fight for labor reform. Cook's discussion of the roots of employer power is somewhat less noteworthy for associating it with organizational unity, political alliances, and the ability to disrupt economic activity. Finally, when labor reform coincided with the initial establishment of democracy, it tended to favor worker rights and citizenship. When it took place in periods dominated by a focus on building competitive market economies, new laws instead favored labor market efficiency.

This framework lays the foundation for a rich analysis of six cases of labor reform in Latin America, a particularly satisfying result given the complete lack of attention to unions and labor markets in the volumes edited by Payne and Lora. It was refreshing to read about historical context,

2. On modern political economy, see Jeffrey A. Frieden, *Debt, Development, and Democracy: Modern Political Economy and Latin America, 1965–1985* (Princeton, NJ: Princeton University Press, 1992), chap. 1, "Modern Political Economy and Latin American Borrowing."

societal actors, and labor market institutions, and about the political processes through which policy is made, even though this richness is partially responsible for the evident weaknesses of Cook's study. Its conclusions are not generalizable beyond other instances of labor market reform. It points to the importance of international pressures and ideas without explaining the means by which they affect policy outcomes. And to an important degree, it commits the sin reverse to that of Payne and Lora by ignoring the institutional structure of the state and instead assuming that all states respond similarly to comparable societal pressures.

Weyland's *Bounded Rationality and Policy Diffusion* is one of the more ambitious and illuminating books on Latin American policy reform to appear in recent years. Weyland's project begins from the deceptively simple question that drives a great deal of research in the field: why do decision makers sometimes adopt economic reforms that are not well suited to their country's needs? In addressing this question, the study takes real strides toward answering an even larger and more complex problem: which among the wide array of causal mechanisms clearly relevant to economic reform matter the most, under what circumstances, and why? Weyland answers this by analyzing two drivers whose impact on reform is insufficiently understood—ideas and the public administration—and by comparing them across two contextual dimensions: different countries and different issue areas. The volume considers two areas of social sector reform—pension and health care—in which the impact of the legislature, political parties, and other traditional institutions of democratic politics are quite limited. Weyland demonstrates that, unlike reforms in areas such as budget and tax policy, social policy reform tends to reflect the diffusion of ideas and the policy discussions and bargaining that take place within the public administration, albeit in predictably distinct ways depending on the type of issue and national context.

This research focus and design also allow Weyland to address what seems to have been the real motivation for his study: to show that the rationality assumption that permeates much of modern social science research, and specifically political science investigation, is not merely flawed and at times misleading but frequently not necessary. The value of rationality as a simplifying assumption is that it allows analysts to identify generalizable trends in individual and group behavior (despite that irrationality is inevitably embedded in these broader trends) and thereby predict likely future behavior. By reaching into the psychology literature, Weyland builds a middle-range theory to explain how the predictably bounded rationality of decision makers shapes the diffusion of ideas across national boundaries and thereby the character of social policy reform in Latin America, albeit in conjunction with the policy deliberation and bargaining that takes place within the public administration. The application of this theory in five countries illuminates how pension and health-care

reform were shaped differently yet predictably by these causal factors, how the impact of the factors varied in distinct national settings, and how this culminated in different policy outcomes. In the end, Weyland does not simply bring to light the core drivers of social policy reform in Latin America. His study challenges the reader to think differently about the political economy of reform, to seek out cross-fertilization among the social sciences, to address the effect of context aggressively, and to allow the research puzzle to identify which institutions—and more broadly which causal mechanisms—actually matter.

INSTITUTIONS IN CONTEXT

Santiago Levy's *Good Intentions, Bad Outcomes* shifts our attention from the academic to the practical, from the comparative to the specific, and from pure politics to the interplay between the economic and the political. Levy is interested in understanding not why bad policies are adopted but why they fail to achieve their objectives, and how these failings can help us devise more successful alternatives. In the process, he reminds us that informal modes of action can be as important as formal institutions in shaping individual actions and thus policy outcomes. Levy highlights the interaction between the formal institutions of social policy in Mexico and the informal modes of behavior that define the Mexican labor market, and the perverse consequences this interaction has created—low-quality and high-cost social policy, greater incentives for informality in the labor market, and reduced productivity, growth, and formal job creation. On the basis of the resulting understanding of why current policy is failing to achieve its objectives, Levy develops an alternate strategy designed to avoid the pitfalls unique to the Mexican policy setting.

Levy's detailed analysis of the Mexican labor market shows that most workers flow easily between formal and informal jobs without favoring the former over the latter. The fact that formal-sector workers have access to health care through the Mexican Social Security Institute (Instituto Mexicano del Seguro Social, IMSS) should create a bias in favor of formal-sector jobs. Yet government provision of health care to informal-sector workers through social protection services obviates this bias, especially given the uneven quality of IMSS services and access to them. In this situation, it is rational for employers to pay workers a small premium to accept informal jobs in order to avoid the social security tax required for each formally employed worker. The untended bad outcomes of this interplay between social policy and the labor market are inefficient and fiscally unsustainable social policies, given lower IMSS tax payments and a growing demand for social protection services for informal-sector workers, and declining economic productivity and growth, given that the informal sector tends to be less productive than the formal sector.

Levy concludes that the solution to this conundrum is to eliminate the selection bias inherent in Mexico's dual social policy strategy by replacing it with a single, universal health-care system financed by an extension of the federal value-added tax. Levy recognizes that raising this tax will pose a significant political challenge and suggests that it may therefore be necessary to implement his recommendations incrementally. Although he eschews any explicit analysis of the politics of policy making and implementation, a clear political sensibility is evident in this recommendation. Levy has anticipated and addressed several of the complaints most likely to be aired against his proposal: that its real aim is to deprive workers of their social policy rights, that it is not redistributive, and that it is simply too expensive. He quite consciously links the universal health care that the left favors (and business dislikes) with a financing system that the left deplores (but business supports). This equation may not be enough to ensure that the Mexican legislature approve Levy's proposal. But it further evinces how deeply ingrained the understanding that politics matter has become in our thinking about the political economy of reform in Latin America, and especially in the thinking of the premier regional development institution, the Inter-American Development Bank (Levy is the bank's vice president for sector and knowledge).

WHERE DO WE GO FROM HERE?

Five volumes are hardly representative of the full complement of recent literature on the political economy of reform in Latin America, but this sample still provides an indication of where we are and a suggestion of where we ought to go. Payne's collection elucidates the substantial advances in our understanding of the ways in which constitutional provisions and laws affect the operation of democratic institutions, especially political parties and the legislature. The contributors to Lora's book illuminate how much reform has actually happened in Latin American states and how much remains to be done. Cook reminds us that in many cases the power and interests of societal actors can be determinative, while Weyland calls attention to the often overlooked role of the public administration. Weyland also encourages us to be imaginative and resourceful in building methodologies and theories, to take on complex analytic challenges, to reach well beyond the traditional confines of political science in search of answers, and to never forget that the impact and actual operation of the causal mechanisms behind reform decisions can vary according to issue area and national context. And Levy redirects attention back to the real objective of our analytic efforts: to design and implement reforms that produce equitable and sustainable growth and development.

Such are recent advances in the political economy of reform and development in Latin America. Making this information available to regional

decision makers in a useful, policy-relevant format, however, continues to be a point of weakness in the literature. The IADB's *Politics of Policies* was an important step in this direction, but much more needs to be done. We ought never to lose sight of the fact that research, especially social science research, should be dedicated both to generating knowledge and to transmitting it effectively to those who would put it to productive use.