PART 1
Institutional Reform: Why and How

CHAPTER 1

Institutions Matter for Development

THE SANTIAGO CONSENSUS ACKNOWLEDGES THAT THE POLITICAL AND ECONOMIC ENVIronment is ripe for launching a new set of institutional reforms in education, finance, justice, and civil service. One of the most difficult challenges, however, is to develop a coherent framework for analyzing and designing these new institutions. In this chapter (combined with the Technical Appendix), we attempt to clarify key concepts—discussing why institutions matter for development and examining empirical evidence that links institutional development to economic performance.

What Do We Mean by Institutions and Organizations?

A variety of meanings are commonly attached to the word "institution." Although it is often used as a synonym of "organization," we find useful the distinction made by the "new institutional economics" literature. It defines **institutions** as *formal and informal rules and their enforcement mechanisms that shape the behav of individuals and organizations in society*.[1] By contrast, **organizations** are entities composed of people who act collectively in pursuit of shared objectives. Thus, *organizations* and individuals pursue their interests within an *institutional* structure defined by formal rules (constitutions, laws, regulations, contracts) and informal rules (ethics, trust, religious precepts, and other implicit codes of conduct)—see Boxes 1.1 and 1.2. Organizations, in turn, have internal rules (i.e., *institutions*) to deal with personnel, budgets, procurement, and reporting procedures, which constrain the behavior of their members. Thus, institutions constitute the incentive structure for the behavior of organizations and individuals.

For economic analysis it is useful to distinguish between two sets of institutions: markets and hierarchies. **Markets** are a set of institutions (rules and their enforcement mechanisms) that set the stage for conducting discrete and impersonal transactions, without requiring a continuous contractual relationship. These rules can range from definitions of location and timing for conducting certain transactions, to more complex rules set out by contract law, financial-credit laws, and courts and arbitration procedures that attempt to enforce such rules. Some of these rules regulate actors who provide market-enhancing services, such as accountants, auditors, lawyers, and others.

Hierarchies are sets of rules for making transactions based on vertical lines of decision-making authority. For example, organizations often operate under internal rules that establish levels of responsibility and accountability, where some members are entrusted to monitor the performance of others. The specialized literature on institutional economics has pointed out that hierarchies are set up to establish contractual obligations—such as those between managers and their employees in private and public organizations—to produce goods and services with lower transaction and monitoring costs than would be required in pure market transactions (see definitions in the Technical Appendix) (T. Moe 1984, O. Williamson 1981).

BOX 1.1

Examples of Formal Institutions

Laws and regulations are formal rules that determine the incentive structure and thus affect the behavior of individuals and private organizations, such as firms, in the operation of markets.

Contracts of civil servants, as is the case with contracts among private individuals or organizations, and personnel, budgetary, procurement, reporting, and audit procedures are the formal rules that affect the incentives within public organizations.

Constitutional laws, which also affect the incentives of politicians at the various levels of government, are the formal rules that determine the political and fiscal responsibilities of and the relations among the various levels of government (i.e., federal, provincial, city, and other governments).

Examples of Informal Institutions

Trust or the tendency to cooperate among individuals who encounter each other infrequently is an informal rule based on the fact that individuals usually have a good sense of what type of behavior will ensure mutual cooperation. Trust plays an important role in the functioning of large public and private organizations.

Ethics or **values** also tend to constrain individual behavior by establishing informal codes of conduct.

Political norms that are often implicit usually constrain the behavior of politicians and civil servants.

In practice, however, there are many sets of rules for making transactions within organizations and elsewhere that fall somewhere between markets and pure hierarchies. By way of illustration, consider the New Zealand model of civil service reform, where public servants now face a set of incentives that reward or punish performance relative to explicit objectives or outcomes, which is complemented by a system for reporting and monitoring performance (see Bale and Dale 1998, Schick 1998). In this way, public servants must operate in a hierarchy, but with institutional features that mimic the incentives of competitive markets, namely by establishing a link between performance and rewards. (See Chapters 6 and 7.)

BOX 1.2

Examples of Organizations

Political organizations include legislative chambers and committees, political parties, government agencies, and the judiciary.

Economic organizations include private firms, trade unions, and business associations.

Social organizations include non-governmental organizations (NGOs), schools, and parent-teacher associations (PTAs).

Why Do Institutions Matter for Development?

Neoclassical economics assumes, among other things, that markets are "perfect"; all actors are assumed to have complete and freely acquired information about the quality and prices of the goods and services in all transactions, as well as about other actors' reliability. So individuals and firms can choose efficiently what to buy or sell and from whom. It also assumes that there are no enforcement problems; that is, once a decision is made it is carried out smoothly and cost-free. In this ideal situation, the supplier would indeed deliver the product and service in the agreed quantity and quality, and the buyer would pay the corresponding amounts in a timely fashion.

There are a few markets for which this description is reasonably accurate—what institutional economists call spot-market trading (Williamson 1994). For example, shopping for groceries at supermarkets on a periodic basis is usually done in circumstances that closely mimic the neoclassical assumptions. Shoppers consume the products over a few days and over time become familiar with the quality and prices of different goods—sometimes we are even allowed to taste them in the store. Shoppers can even try a few different supermarkets and get information from neighbors and friends. Though we may make some mistakes in the process, basically we can choose what we want. And we get what we pay for, as we take the goods with us when we leave the market. If we don't like them we won't buy them again; in some cases we may even return them. The supermarket, in turn, gets compensated on time, as shoppers are not allowed to leave the premises without paying, though there may be a few cases of shoplifting, bad checks, and credit cards (which are actually issues associated with the more complex world of finance).

Many markets—in fact, some of the most important ones—are a long way from this bucolic description of spot-market transactions. This is especially true with capital and durable goods and services that are consumed over a long time. In such cases, transactions are not repeated often enough among a fixed number of partners to permit perfect and cost-free information-gathering through feedback, and enforcement is often a more complex and costly matter. In extreme cases, the problems of **information and enforcement** may be so severe as to preclude the existence of markets and leave no option besides the direct provision of certain goods or services by the government, or people must live without such goods or services. In the following paragraphs we consider a few examples of long-term contracting in two of the most important services for growth and development in today's global economy—the financial and the education sectors.

Information and Enforcement Problems in a Market: The Financial Sector

Before approving loans, bankers want to be sure that their clients will be able and willing to pay them back. Borrowers' ability to pay depends on the quality of the investments that the borrowers make with the funds, and also on their overall earnings and wealth, so to assess these factors banks require potential borrowers to provide financial statements and describe how they will use the loans. Bankers then charge fees and interest rates according to their credit-risk analysis; consumer credit is normally riskier and commands a higher premium, and poor or small firms either do not get credit approved, or get it at higher costs than wealthier individuals or firms. When clients have an established reputation with the bank, this fact alone may be sufficient to get loans approved. When clients and the bank do not have an ongoing relationship, the bank will try to get information on their past behavior from other sources, such as credit bureaus, rating agencies, or commercial references. Also, the bank probably will require such borrowers to put down collateral, which is why there needs to be an enforcement mechanism to ensure the bank that it will be able to collect the collateral in the event the clients default on the loan.

Both formal and informal institutions are crucial for the operation of credit transactions like the one described above. If there is a culture of "non-payment" in a society, if there are no credit bureaus, if creditor rights are weak, and if the courts take forever to foreclose on collateral, a lot of potential borrowers with the ability and willingness to pay will be cut off from credit altogether—either because banks will not be able to distinguish between "good" and "bad" potential clients, or because they will be less willing to take chances. From the point of view of the banker, the perceived risks may simply be too high because of inadequate information and enforcement procedures.

In this type of situation, bankers will lend only at very high rates. But at very high interest rates few creditworthy businesses can afford to borrow. Thus, only businesses with very high potential returns, or very risky ventures, or those that do not intend to pay will demand credit. (This is the **adverse selection** problem discussed in the Technical Appendix.) Knowing that only risky borrowers will come knocking at the door, bankers may not lend at all—or they may lend only to clients they know personally or ones that are economically related to the bank. The economy as a whole, therefore, will face massive credit rationing (or **incomplete markets**; see the Technical Appendix), which will severely limit its growth potential.

The availability of information regarding the past behavior and credit-worthiness of potential borrowers may go a long way toward reducing the extent of credit rationing in an economy, because it helps banks distinguish among different types of clients. Nevertheless, having all the relevant information, through private or public services that provide credit and earning histories, will not solve the problem of enforcement; every now and then a "good" client defaults on a loan. Moreover, when the stakes are high enough in any given transaction, the borrower may have an incentive to cheat. Bankers know this, and thus credit rationing is not eliminated as long as there is a problem with enforcement.

Bank depositors face even more acute problems of information and enforcement. They usually do not have enough information to evaluate the quality of the bank's overall loan portfolio, and thus have to "trust" the bank, either because they know it well or because they have faith in those who supervise it. Imperfect information can lead to a loss of trust, and can cause depositors to withdraw their deposits even from solvent banks. Such panics can cause those sound banks to fail and may lead to a systemic financial crisis. This realization has led to the creation of various types of explicit safety nets, including deposit insurance institutions, as well as implicit safety nets that often are

implemented during times of banking distress. As will be discussed in Chapter 3, such safety nets should be accompanied by effective systems of information collection, client monitoring, and risk management in order to ameliorate the effects that such schemes have on the incentive of depositors not to monitor the banks by themselves (Kane 1989)—which leads to the **moral hazard** problem discussed in the Technical Appendix.

Even more difficult information and enforcement issues are present in the equities markets. Unless there are good disclosure rules, rating agencies, and specialized investment assistance services, potential buyers of equities can know little about the financial status and prospects of a firm issuing stock. They will be likely to presume that company managers are offering new stock above its "real" price and either will not buy it at all, or will offer to buy it at a price too low for the managers to accept. Thus, equities markets do not develop without solving the information problem. And even then, if shareholders' rights are not protected and guaranteed through an effective enforcement mechanism, equities markets tend to remain shallow.

In general, financial sectors are highly regulated and tightly supervised everywhere, and banking safety nets, financial laws, and practices are crucial for the depth, efficiency, stability, and the very existence of financial markets. These and other issues will be discussed in more detail in Chapters 3 and 4.

Information and Enforcement Problems in Hierarchies: The Education Sector

Information and enforcement problems are even more severe in the case of education. "Consumer" choice is limited, among other things, by the fact that quality and relevance can be fully evaluated only after the individual has finished the educational process. There are no repeated transactions to learn from, and it is extremely costly to change schools. Parents usually have to rely on certifications, evaluations, and statistics provided by governments or non-governmental agencies—or just on casual information—to decide where to send their children to school. Once they make a decision (if indeed they *can* choose) they have to rely on the school director and on the government, or on their own participation in the management of the school, for "enforcement." Households implicitly rely on school managers and government policies to ensure that their children are receiving minimally adequate education.

Hence, the education system can be viewed as a series of **principal-agent** relationships (see the Technical Appendix): The households and parents are the principals who entrust civil servants, teachers, or school managers (the agents) to defend the interests of their children. In so doing, monitoring and enforcement institutions are crucial for ensuring that the agents will indeed act according to the children's interests.

Due to the severity of informational and enforcement problems and to the character of education as a "public good," many societies rely on hierarchical governmental organizations to deliver educational services, at least for basic education.[2] The existence of such governmental organizations, however, does not automatically resolve the information and enforcement problems. There must be adequate ways for the civil servants in a ministry of education to know how well a particular school or teacher is performing and to take appropriate corrective actions or create appropriate incentives for school managers and teachers. In addition, bureaucratic appointments and rules are often designed with political purposes in mind, which do not always result in efficient institutions that allow this to happen (see the section on political-economy issues below). Indeed, as will be discussed later in Chapter 5, Latin American and Caribbean educational systems suffer from numerous problems that are symptomatic of a lack of information and enforcement, including teacher absenteeism and even illiteracy, high desertion and repetition rates among students, and blatantly poor instruction.

The problems of information and enforcement of commitments are also present in large private corporations. Indeed, economics and legal literature on **transaction costs** (see the Technical Appendix for definitions), dating back at least to the 1930s, has been preoccupied with the effects of such costs on organizational choices for private business rather than governments (Coase 1937). In particular, the transaction-costs literature has focused on the key question of when firms should procure services and inputs in a market and when they should produce them themselves. For example, should a firm that makes automobiles also make auto parts, or should it buy the parts from external suppliers? To make this type of decision, managers must consider the frequency with which the firm requires auto parts, the degree of uncertainty affecting the delivery and quality of the parts, and the specific investments that are required to produce such parts. On the one hand, the production of

auto parts may require certain machines and workers with specific skills that are expensive to acquire, but on the other hand, the outside suppliers may work with unknown quality controls and may have commercial interests that do not necessarily coincide with those of the auto-producing firm. It is not surprising, therefore, that automobile producers across the globe have chosen different strategies for acquiring auto parts; some produce them in house, others have a pre-determined pool of suppliers, while others try their luck in the auto-parts market without having made specific commitments with any particular supplier. The right decision can only be based on accurate information and on the ability to enforce contracts or commitments with suppliers.

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At this point it should be clear that information and enforcement problems underscore the need for appropriate institutions both for markets (for their efficiency and in many cases for their very existence) and for hierarchies, or organizations. *Institutions matter for development because they determine the efficiency and existence of both markets and organizations, public or private.*

In addition, institutions determine the level of investment in both physical and human capital and the dynamics of innovation, since they determine the perceived risks by individuals and other economic agents of conducting investments and undertaking risks. Thus, both the rate of capital accumulation (physical and human) and their quality and efficiency depend on formal and informal institutions. And thus, we expect institutions to influence the rate of economic growth.

Finally, institutions are absolutely necessary with respect to the production and quality of public goods, like clean air or security in the streets. Unlike private goods, there are no efficient ways to exclude these public goods from people who do not help finance them; this generates the well-known problem of free riders and "market failures" that require specific institutions (rules) and organizations to collect taxes or contributions, as well as to ensure the quantity and quality of the public goods and to deliver them. *Good institutions, in summary, should provide rules that are clear, widely known, coherent, applicable to all, predictable, credible, and properly and evenly enforced.*

Institutions Matter: The Evidence

We have already discussed how institutions matter for economic performance. Here we will provide some empirical evidence about the relationship between institutional development and economic growth, stability, and poverty reduction; we will review some contributions to the emerging empirical literature, and we will evaluate LAC in relation to other regions of the world.

Issues of Measurement and Some Illustrations

A first issue that arises is how to measure institutional development. The recent empirical literature on the subject has tended to rely on subjective and objective indicators of the quality of institutions around the world. The **subjective indicators** come from surveys of international and domestic investors (Brunetti et al. 1997a) or from international economic and political consultants who deal with the business climate of numerous countries on a daily basis (many studies listed in Table 1.1 use this type of indicator). Some studies have used **objective indicators**, too; they assess whether certain legal provisions are present to get a broad measure of the overall quality of institutions in the financial sector and in corporate governance structures (La Porta et al. 1998a).

In this chapter (Figures 1.1–1.17) we rely on the subjective measures provided by the *International Country Risk Guide (ICRG).* Given our understanding of the importance of contract enforcement, property rights, and the incentives affecting the behavior of bureaucrats, we have chosen five individual indicators to measure institutional development: (1) the perceived risk of expropriation of property, (2) the perceived degree of contract enforceability, (3) the extent to which there are mechanisms for peaceful dispute-resolution or the perceived degree of the rule of law and order, (4) the perceived quality of public bureaucracies, and (5) the perceived incidence of corruption in government. In addition, we constructed a composite index of institutional development, which is the sum of the scores given to each country for each of the five indicators listed above. The Technical Appendix at the back of this publication details the variables used in our analysis.

Despite the fact that these subjective indicators have been used in a plethora of empirical studies (to be discussed below), they suffer from a number of noteworthy weaknesses. Two of them are particularly important for our current purpose of examining the link between these indicators and economic activity: First, these indicators reflect the perceptions of ICRG analysts, which undoubtedly are affected by objective economic or political conditions. Conse-

quently, the indicators may be contaminated with the influence of factors or events that are not necessarily reflections of institutional quality. Second, among the factors that may influence the perception of the analysts is economic performance, which may bias estimates of the relationship between these indicators and economic growth. It is also important to note that the five indicators tend to be correlated with each other, and with other indicators of institutional quality and political stability (see Knack and Keefer 1995). These considerations should be kept in mind while interpreting the evidence presented below.

Figures 1.1a and 1.1b illustrate the relationship between our composite index of institutional development and economic growth (the rate of growth of GDP per capita). The upward sloping line shows that, on average, higher scores in institutional development are associated with higher rates of growth. Figure 1.1a shows the fitted line from a simple linear regression. While this method is straightforward, it suffers from several weaknesses, including the fact that growth is determined by a variety of factors not limited to institutional development—factors which may be caused by economic growth.

To deal with these issues, Figure 1.1b shows what could be considered the "true" relationship between growth and institutional development. We have followed Greene (1993, p. 180) to estimate the partial correlation coefficient between growth and our composite index of institutional development. In a nutshell, we followed a three-step econometric procedure that attempts to isolate the impact of institutional quality on growth. The intuition of the procedure is that we must first determine how much of the variation in growth rates across countries is due to other economic factors (such as inflation, trade, the size of the financial sector, the terms of trade, and its volatility). Then, we must determine how much of the variation in our composite index is also associated with these other economic factors. Once we have isolated the portion of growth and institutional development that is

FIGURE 1.1a

Institutional Development and Economic Growth

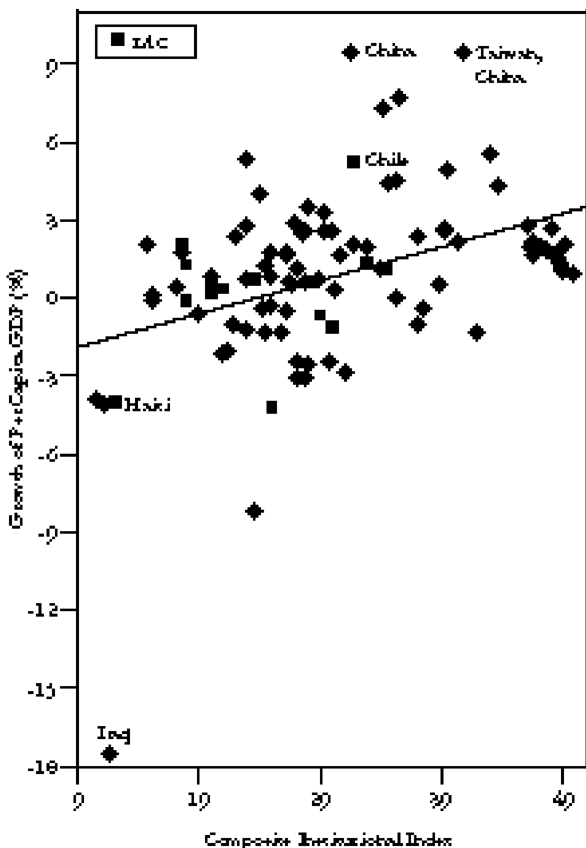
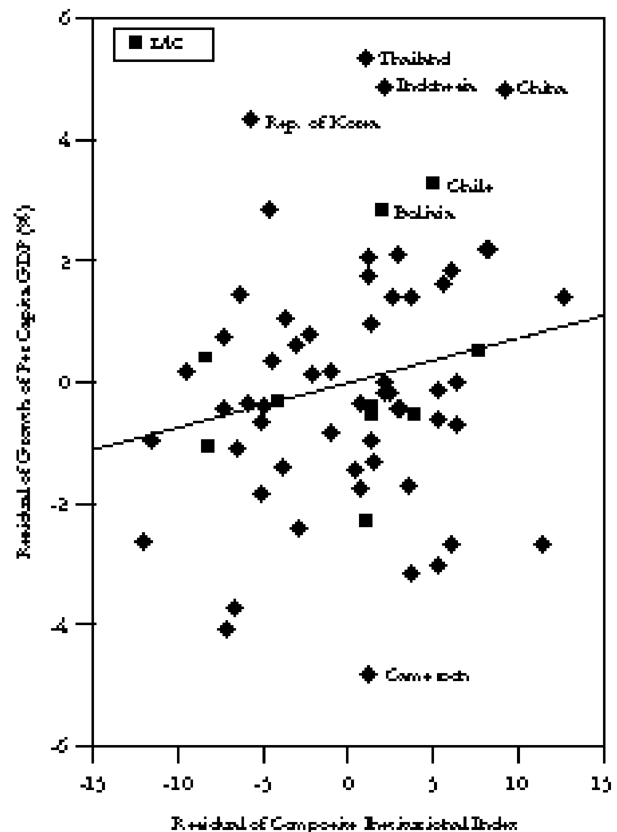


FIGURE 1.1b

The "True" Partial Coefficient Between Growth and Institutional Development



not associated with these other factors we can attempt to measure the extent of the "true" relationship between economic activity and institutional development.[3] As you can see in Figure 1.1b, this more elaborate procedure confirms the positive relationship between growth and institutional development.[4]

A Brief Review of Recent Empirical Studies

Table 1.1 lists recent empirical studies that examine the relationship between various indicators of institutional development and economic performance. The evidence is clear regarding the relationship between institutions and economic growth: Improvements in institutions promote economic growth, thus confirming our own estimates.

The first section of Table 1.1 lists studies that have evaluated the relationship between various institutional indicators and economic growth. Most of these studies have found evidence that the subjective indicators of the quality of formal institutions are positively associated with indicators of economic performance. Moreover, there are two (La Porta et al. 1997b and Knack and Keefer 1997b) that examine the effects of informal rules, namely trust, on economic performance, and find that trust (more than formal social organizations) tends to promote economic growth.

The second part of Table 1.1 lists studies that have examined the relationship between institutional measures (mostly objective qualitative measures compiled by La Porta et al. 1998a) and financial development and stability. Levine (1997c) took the extra step of estimating the indirect effect of these measures on economic growth by assessing the effects of institutions on financial deepening, which in turn promotes economic growth. In the area of financial development, we have included one study that examines the role of institutional development on the probability of experiencing a financial crisis (Demirgüç-Kunt and Detragiache 1998), and another on the impact of explicit deposit-insurance schemes on financial development (Cull 1998). The former confirms our contention that institutions are important for maintaining financial and macroeconomic stability, because the authors show that institutional development (measured with our same subjective indexes for the rule of law, corruption, and contract enforcement) reduces the probability of financial crises after financial liberalization (defined as the elimination of interest-rate ceilings). Cull found that explicit deposit insurance schemes tend to promote financial development in subsequent periods of time *ONLY* when the general subjective indicators of institutional quality, such as the rule of law, are sufficiently high.

The third and final part of Table 1.1 lists two recent studies by Chong and Calderón who have analyzed the relationship between institutions and inequality and poverty reduction. In this respect note that the subjective indexes of institutional development tend to reduce poverty, despite an apparent ambiguous relationship between institutions and inequality.[5]

LAC's Progress in Institutional Development

After this brief review of the empirical evidence, it is worthwhile to assess where the LAC region stands in terms of institutional development relative to other regions and relative to its recent past.[6] Figures 1.2–1.7 show the evolution of the six institutional indicators (the composite index plus its five components) for the various regions of the world, based on the simple averages of the indicators by region. (Note that for negative criteria, such as repudiation of contracts and corruption, a high score in these indexes means a *lack* of them; for positive criteria, such as law and order or quality of bureaucracy, a high score means *more* of them. For a more detailed explanation, see the Data Appendix. Also see the Data Appendix for the list of countries in each regional group.) From Figure 1.2 we can see clearly that LAC is lagging behind most regions of the world, except for Sub-Saharan Africa, in terms of the composite index of institutional development, despite the significant recent progress achieved since 1990. Also, it is apparent that other regions, namely the Middle East/North Africa and Asia, have experienced rapid improvements, also since the late 1980s, thus showing that institutional development can actually occur quickly.

Figures 1.3 and 1.4 show the evolution of the indicators related to the risk of repudiation of contracts and expropriation, respectively. They show clearly that LAC has made very rapid improvement, probably because of structural reforms, including privatization, that have been implemented across the region since the late 1980s.[7] However, it is also clear from these two figures that while LAC has experienced progress on both fronts, it is still lagging behind other regions, especially regarding contract enforceability, as shown in Figure 1.3.

In contrast, Figures 1.5–1.7 show that LAC's progress in terms of corruption, law and order, and the quality of

TABLE 1.1

Empirical Evidence of the Role of Institutions for Economic Growth, Financial Development, Inequality, and Poverty

AUTHORS	METHODOLOGY	MAIN FINDINGS
	I. INSTITUTIONS PROMOTE ECONOMIC GROWTH	
Knack and Keefer (1995)	Cross-country regressions using two subjective indexes of institutional development. One composite index combines variables such as quality of the bureaucracy, corruption in government, rule of law, expropriation risk, and repudiation of contracts by government. The other combines variables such as bureaucratic delays, nationalization potential, contract enforceability, and infrastructure quality.	Institutions that protect property rights are crucial for economic growth. Institutional development increases the rates of convergence between developed and developing countries.
Mauro (1995)	Cross-country regressions using subjective indexes of corruption, the amount of red tape, the efficiency of the judicial system, and various categories of political stability.	Corruption is negatively linked with economic growth.
Brunnetti, Kisunko, and Weder (1997a)	A survey of business establishments around the world to construct an index of the "credibility of rules," composed of "the predictability of rule-making, subjective perceptions of political instability, security of persons and property, predictability of judicial enforcement, and corruption." Cross-firm and cross-country regressions test the relationship between the credibility index and economic growth.	Credibility promotes investment and economic growth.
Chong and Calderón (1997a)	Geweke decomposition to test the causality and feedback between institutional measures (such as contract enforceability, nationalization potential, infrastructure quality, bureaucratic delays, and a composite index of the above four) and economic growth.	Improving institutional development promotes economic growth in developing countries.
Knack and Keefer (1997a)	Cross-country regressions using institutional variables such as the rule of law, the pervasiveness of corruption, the risk of expropriation, and contract repudiation.	Institutions are important determinants of "convergence"—weak institutional systems prevent poor countries from "catching up."
Knack and Keefer (1997b)	Cross-country regressions using indicators of trust and civic norms from the World Values Surveys by Inglehart (1994). The indicators can be interpreted as proxies for the quality of informal institutions.	Trust and civic cooperation have significant impacts on economic performance.
La Porta et al. (1997b)	Cross-country regressions using measures of trust from the World Values Surveys.	Trust has important effects on economic performance.

the bureaucracy has been much less pronounced than that achieved in terms of contract enforceability and expropriation risk. Indeed, the region has barely made any improvements on the corruption and bureaucratic-quality fronts. These indexes highlight the critical importance of reforming the public administration in LAC (see Chapter 7).

However, the regional averages mask the diversity that exists within the LAC region. Figures 1.8–1.13 show the evolution of these indicators for four sub-regional groupings within LAC. Figure 1.8 shows that all sub-regions have experienced moderate progress in terms of the composite index, with no apparent laggard among the sub-regions, though the Southern Cone countries stand clearly above the rest.

Figures 1.9 and 1.10 confirm our previous statement that the LAC region has made substantial progress in terms of reducing the risk of contract repudiation and expropriation, and this progress has been evenly distributed across LAC sub-regions, though the Southern Cone fares better, and the countries of the Andean Community (i.e., the Northern Cone countries) are second. Figures 1.11–1.13 also confirm our contention that LAC's progress in terms of the other three institutional indicators has been modest across the board, with some clear exceptions. For example, Figure 1.11 shows that Central American countries fare better than the rest of the region in terms of lower levels of perceived corruption, and that they and the Caribbean countries have experienced the most significant improvements in terms of reducing the extent of perceived corruption. Figures 1.12 and 1.13 shows that the Southern Cone countries fare better in terms of rule of law and quality of the bureaucracy, but that Central America and Panama as

TABLE 1.1
(Continued)

AUTHORS	METHODOLOGY	MAIN FINDINGS
	II. INSTITUTIONS PROMOTE FINANCIAL DEVELOPMENT (AND ECONOMIC GROWTH)	
La Porta et al. (1997a)	Cross-country regressions using measures of legal rules protecting investors and the quality of their enforcement (measures include rule of law, shareholder rights, one-share equals one-vote, and creditor rights). The data on these qualitative, but objective variables (except for rule of law) are presented in La Porta et al. (1998a).	Countries with better investor protections have bigger and broader equity and debt markets.
Levine (1997c)	Panel regressions using institutional variables (such as creditor rights, enforcement of contracts, and accounting standards) as instrumental variables.	Countries with more developed institutions (legal and regulatory systems) have better-developed financial intermediaries, and consequently grow faster.
Cull (1998)	Cross-country regressions in levels and differences.	Explicit deposit insurance is positively correlated with subsequent increases in financial depth if adopted when government credibility and institutional development are high.
Demirgüç-Kunt and Detragiache (1998)	Panel logit regressions using rule of law, corruption, and contract enforcement as measures for institutional development as determinants of the probability of financial crisis after interest-rate liberalizations.	Banking crises are more likely to occur after financial liberalization. However, the effect of financial liberalization on the fragility of the banking sector is weaker when the institutions are more developed.
	III. INSTITUTIONS, INEQUALITY, AND POVERTY	
Chong and Calderón (1997b)	Cross-country regressions using measures of risk of expropriation, risk of contract repudiation, law and order, corruption in government, and quality of bureaucracy for institutional development, and measures proposed by Foster, Greer, and Thorbecke (1984) for poverty.	Improvements in institutional efficiency reduce the degree, severity, and incidence of poverty.
Chong and Calderón (1998)	Cross-country regressions using a composite index of institutional efficiency based on measures of corruption of government, quality of bureaucracy, law-and-order tradition, risk of expropriation, and risk of contract repudiation.	For poor countries, institutional efficiency is positively linked with income inequality, and for rich countries it is negatively linked with income inequality.

a group experienced the fastest improvement in terms of the quality of its bureaucracy.

Figures 1.14–1.17 show the evolution of the composite institutional indexes by country, and some outliers are worth mentioning. Chile, first, and Costa Rica, second, stand out in their groups, and in the overall sample, as having better institutions than the rest. In contrast, Haiti, Honduras, and Paraguay stand at the bottom of their groups. Rule of law and corruption have improved substantially in some countries, while they have strongly deteriorated in others.

So far we have focused on our subjective indicators of institutional performance. The *World Development Report 1997* (World Bank 1997a) presented other subjective indicators based on worldwide private-sector surveys conducted in 1996 (see Brunetti et al. 1997b). Figures 1.18–1.20 respectively show the percentage of respondents to the surveys in each region of the world who thought that the authorities tend to be incapable of protecting persons or property from criminal actions, that unexpected changes in laws and policies affect business, and that the unpredictability of the judiciary materially affects business practices. Clearly, LAC also seems to be behind other developing areas, especially with regard to the insecurity of property and the reliability of the judiciary. This evidence, combined with the aforementioned gap in terms of our law-and-order indicator, reinforces the need to consider innovative approaches to reforming LAC judicial systems (see Chapter 6).

As a whole, the evidence presented here shows that the LAC region still suffers from an "institution gap," relative to other developing countries, despite recent accomplishments

FIGURE 1.2

Composite Institutional Index by Regions, 1984–97

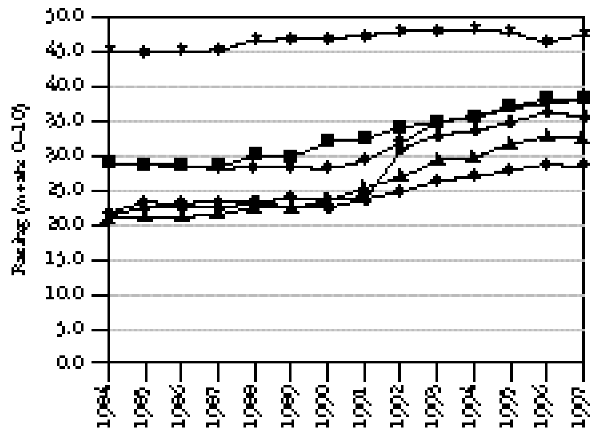
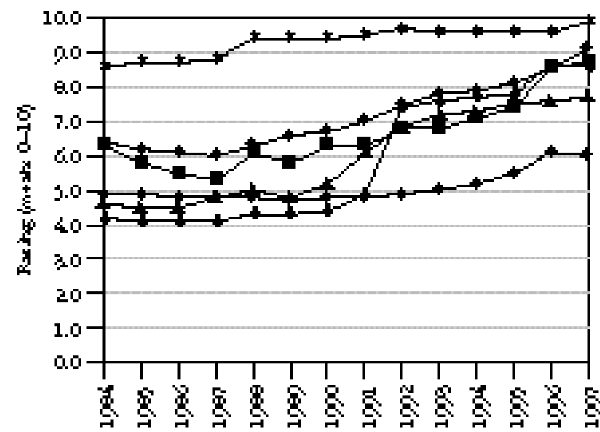


FIGURE 1.3

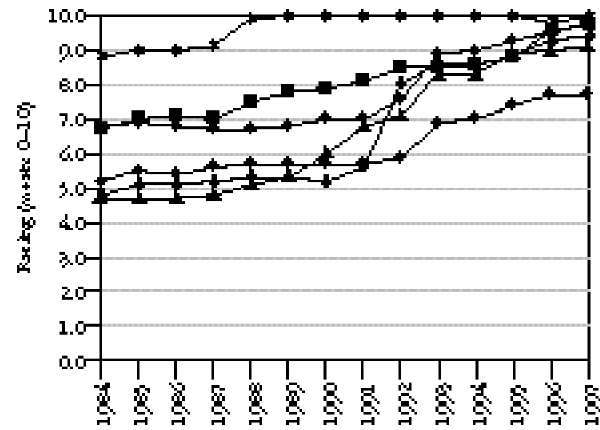
Risk of Repudiation of Contracts Index by Regions, 1984–97



Note: A rise in the index represents a reduction in the risk of contract repudiation.

FIGURE 1.4

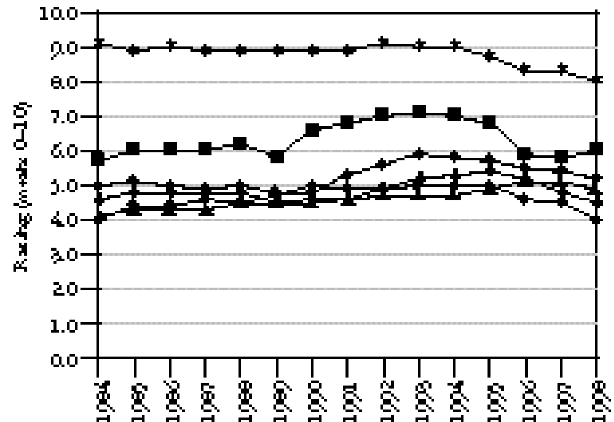
Risk of Expropriation Index by Regions, 1984–97



Note: A rise in the index represents a reduction in the risk of expropriation.

FIGURE 1.5

Corruption in Government Index by Regions, 1984–98



Note: A rise in the index represents a reduction of corruption.

FIGURE 1.6

Law-and-Order Index by Regions, 1984–98

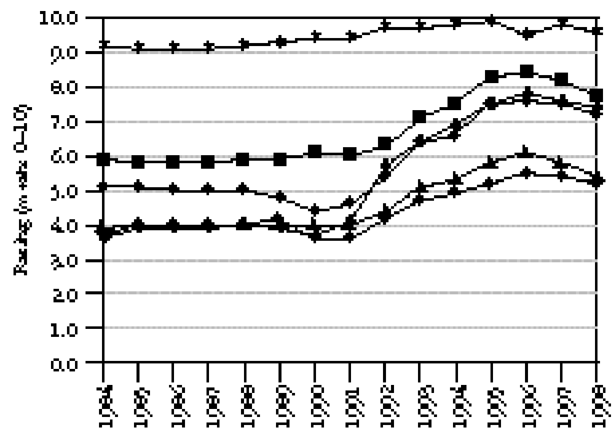
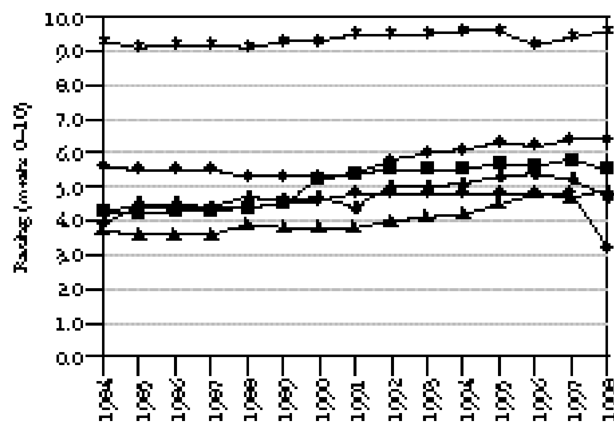


FIGURE 1.7

Quality of the Bureaucracy Index by Regions, 1984–98



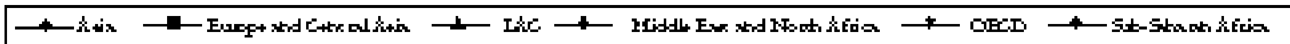


FIGURE 1.8

Composite Institutional Index by LAC Sub-regions, 1984–97

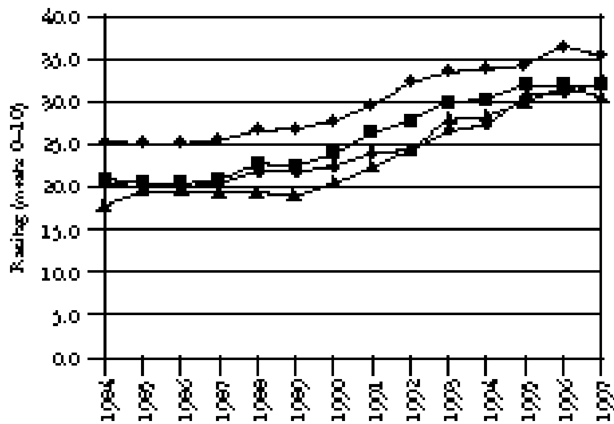
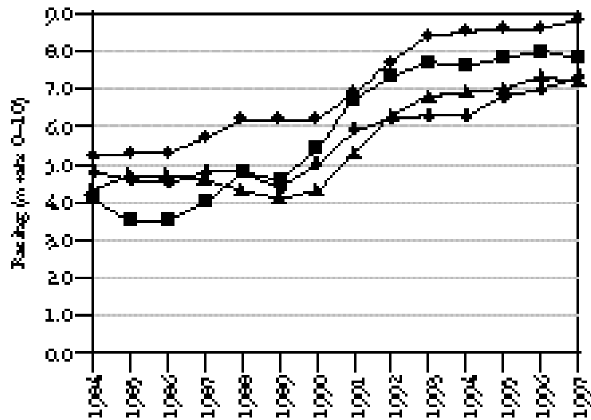


FIGURE 1.9

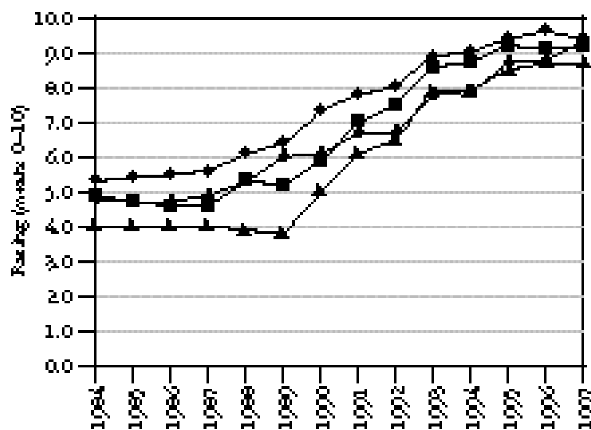
Risk of Repudiation of Contracts Index by LAC Sub-regions, 1984–97



Note: A rise in the index represents a reduction in the risk of repudiation of contracts.

FIGURE 1.10

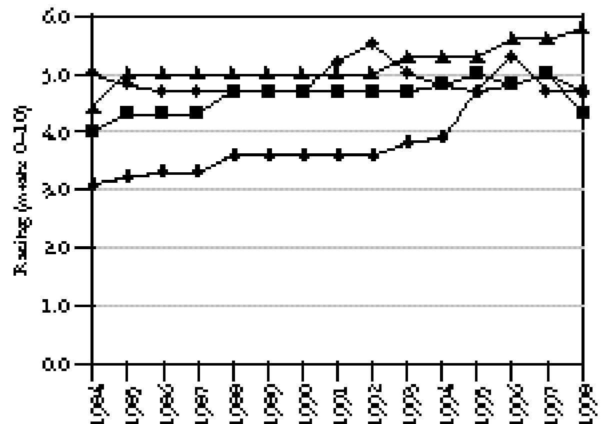
Risk of Expropriation Index by LAC Sub-regions, 1984–97



Note: A rise in the index represents a reduction in the risk of expropriation.

FIGURE 1.11

Corruption Index by LAC Sub-regions, 1984–98



Note: A rise in the index represents a reduction of corruption.

FIGURE 1.12

Law-and-Order Index by LAC Sub-regions, 1984–98

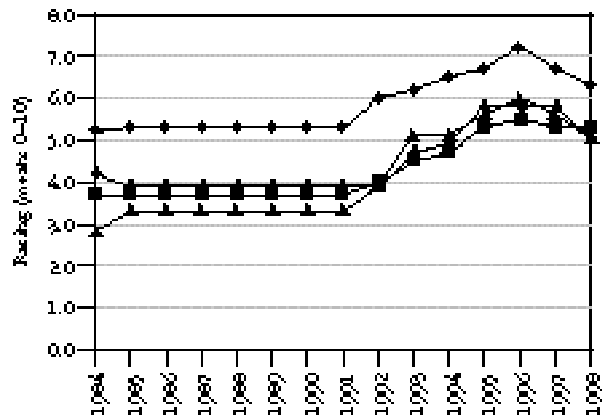
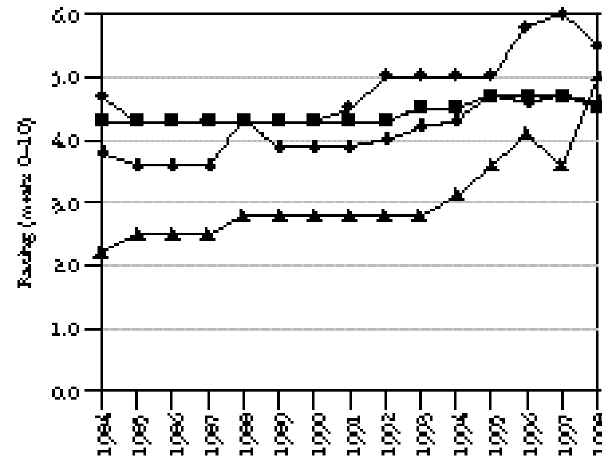


FIGURE 1.13

Quality of the Bureaucracy Index by LAC Sub-regions, 1984–98



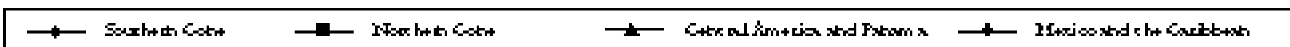


FIGURE 1.14

LAC: Southern Cone Composite Institutional Index, 1984–97

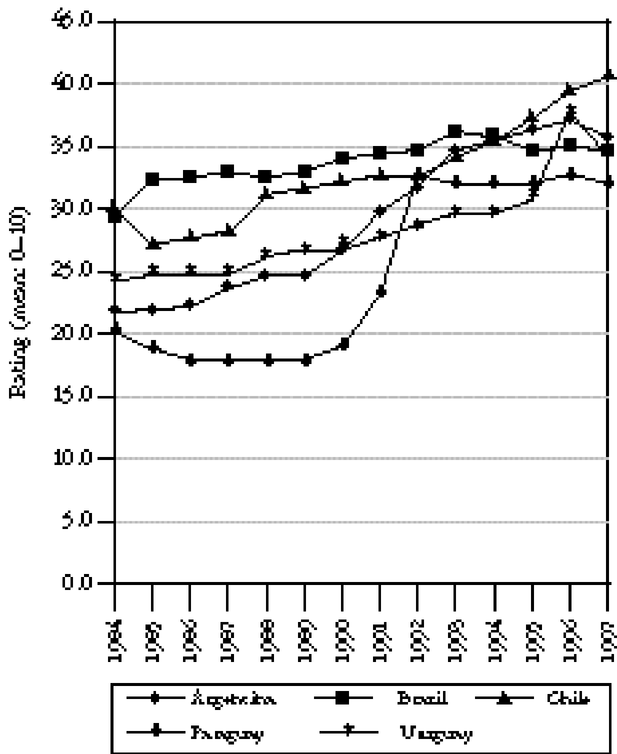


FIGURE 1.15

LAC: Northern Cone Composite Institutional Index, 1984–97

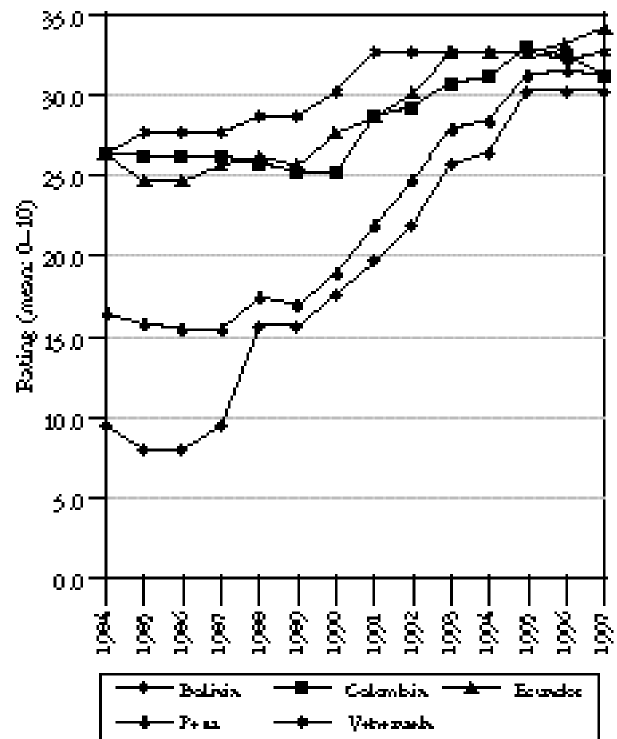


FIGURE 1.16

LAC: Central America and Panama Composite Institutional Index, 1984–97

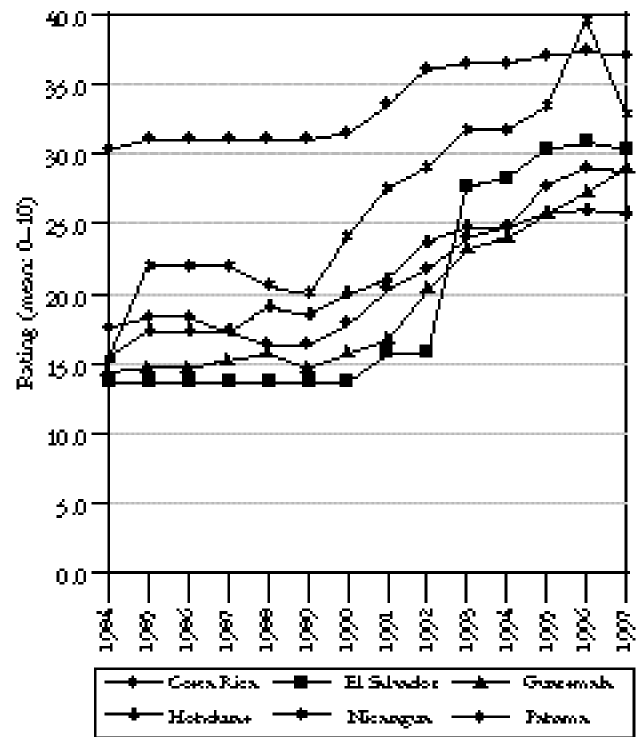


FIGURE 1.17

LAC: Mexico and the Caribbean Composite Institutional Index, 1984–97

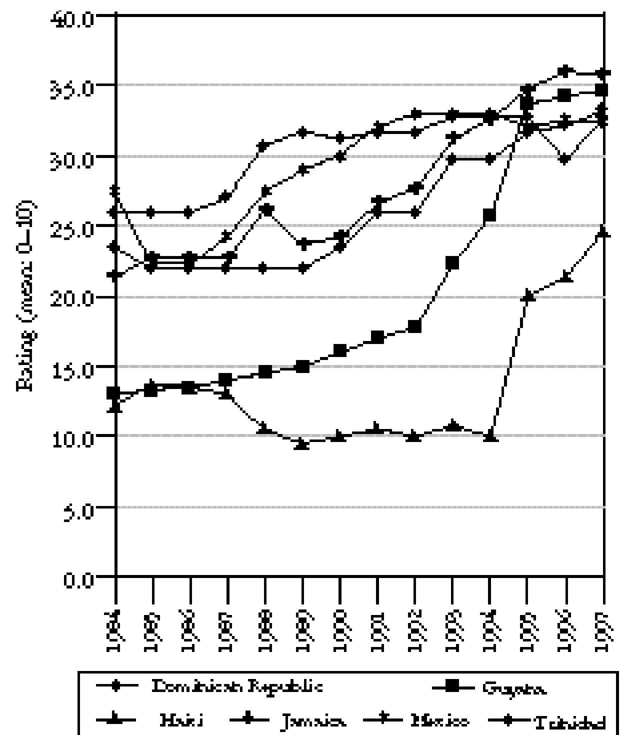


FIGURE 1.18

Insecurity of Property Index by Regions

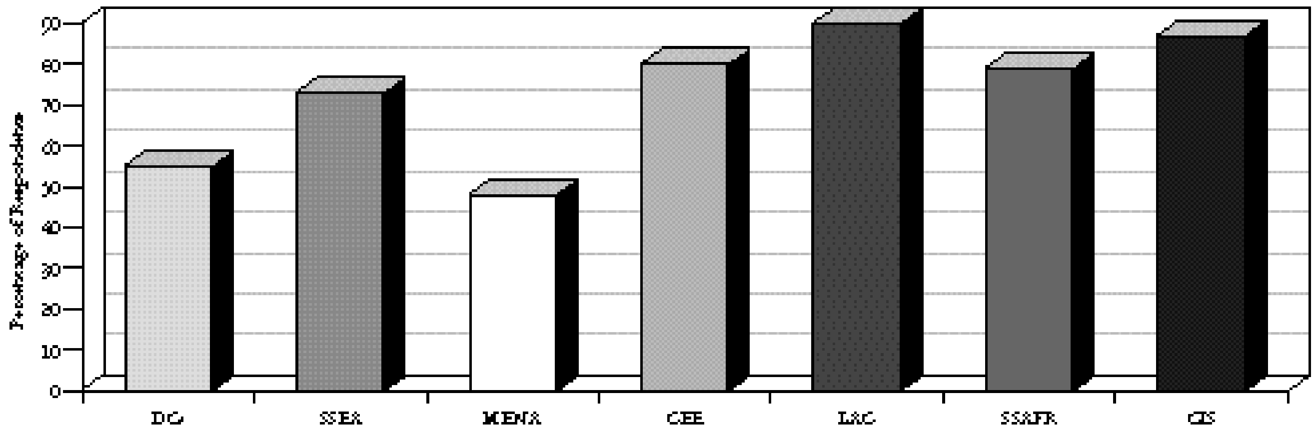


FIGURE 1.19

Unpredictable Changes in Laws and Policies Index by Regions

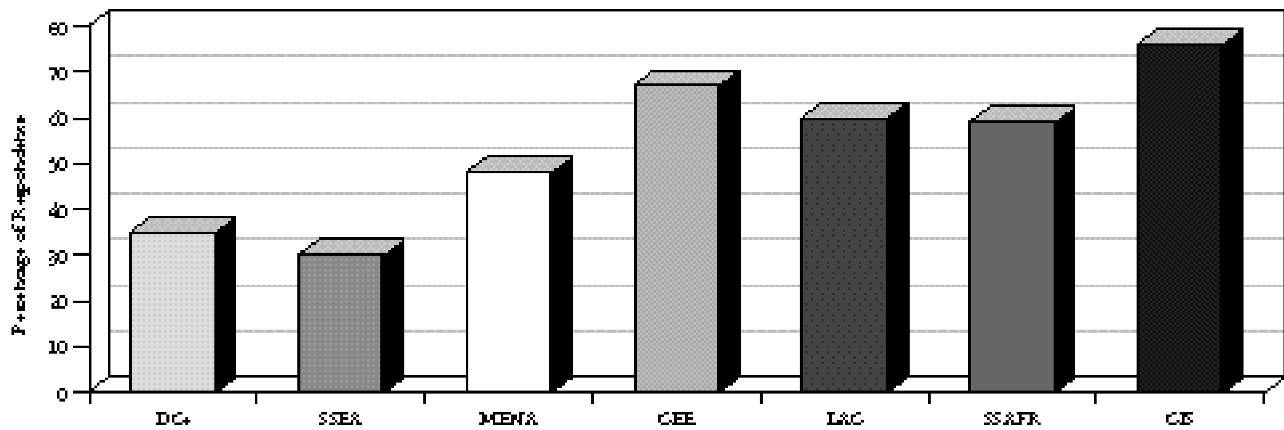
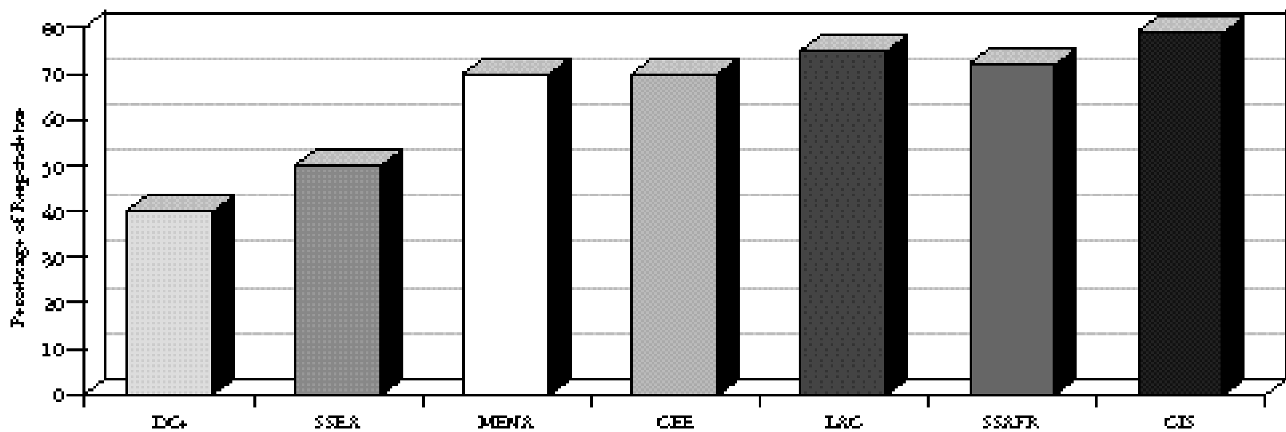


FIGURE 1.20

Unreliable Judiciaries Index by Regions



Note Indexes reflect the percentage of survey respondents who thought that this consideration was an important obstacle to conducting business.

Key: DCs = Developed Countries; SSEA = South and Southeast Asia; MENA = Middle East and North Africa; CEE = Central and Eastern Europe; LAC = Latin America and the Caribbean; SSAFR = Sub-Saharan Africa; CIS = Commonwealth of Independent States

in the areas of expropriation risk and contract enforcement. So, much remains to be done to improve the quality of institutions—and thus to help accelerate the pace of long-term growth and reduce short-term instability. The remaining question is how policy-makers can promote institutional change, which can be a challenging task indeed.

Notes

1. North (1990) and O. Williamson (1985) are well-known contributions to this extensive literature. North (1990, p. 73) defines organizations as "purposive entities designed by their creators to maximize wealth, income, or other objectives defined by the opportunities afforded by the institutional structure of the society."

2. Education is a "public good" in at least two aspects: First, when a public school is set up, all households in that jurisdiction can benefit from it. Second, and more generally, education tends to promote social peace and economic prosperity in the long run, which benefits all households, regardless of whether they have contributed to the financing or administration of the schools, or even whether they have children in school.

3. The econometric procedure was the following: First, we estimated the relationship between growth and a set of standard explanatory variables—the initial level of educational attainment in the population, the initial level of GDP per capita in constant dollars, the initial ratio of investment-to-GDP, the average ratio of trade over GDP, the average inflation rate, the initial level of M2 to GDP, the average variation of the terms of trade, and the standard deviation of the terms of trade. (See the Data Appendix for a detailed description of these variables.) From this procedure, we calculated the portion of the growth rate that was not associated with these control variables (the residuals). Second, we ran a similar regression that estimated the effects of these control variables on the composite index of institutional development, and similarly estimated the portion of institutional development that was not explained by the control variables (again, the residuals). Finally, we estimated the linear relationship between the two sets of residuals, which gives us a measure of the "true" relationship between growth and institutional development. It is worth pointing out that to some extent we have dealt with the issue of causality by using the initial level of the composite institutional index (corresponding to the year 1984) in these regressions.

4. The coefficient of the composite institutional index in the simple regression shown in Figure 1.1a is significant at the 1 percent confidence interval. The "true" partial coefficient shown in Figure 1.1b is significant at the 11 percent confidence interval. The residuals exercise was also done using data for two sub-periods separately (1984–89 and 1990–95), and on the pooled data for both subperiods. The results of these exercises confirmed the positive and significant relationship between growth and institutional development.

5. According to Chong and Calderón (1998), one potential explanation for the apparent positive relationship between formal institutional development and inequality is that in some developing countries informal institutions tend to predominate in the business transactions of the poor. Hence it is possible that the development of formal institutions benefits the formal sector more than the informal sector. But this is just an untested hypothesis, and the results of this study are based purely on cross-country regressions, which do not tell us anything precise about the potential dynamic effects of institutional development on poor countries over time.

6. In last year's *The Long March*, we also used ICRG data to assess LAC's progress in institutional reform (or governance), and in that occasion we complemented the analysis with indicators provided by the *Business Environment Risk Intelligence (BERI)*. Unfortunately, this latter service has been discontinued, and thus we were unable to update that data.

7. See Burki and Perry (1997) and Inter-American Development Bank (1996) for a review of progress achieved in structural reforms.

CHAPTER 2

Institutional Reform Is Possible

CHAPTER 1 DISCUSSED HOW IMPORTANT EFFECTIVE INSTITUTIONS ARE FOR ECONOMIC performance, and how urgent institutional reform is for Latin American and Caribbean countries. It demonstrated that efficient institutions should provide clear, widely known, coherent, predictable, credible, and properly and evenly enforced rules. Although predictability and stability of institutions are important for promoting investment, stimulating growth, and reducing poverty and inequality, institutional adaptation and change also are important. Such adaptability ensures that the incentive structure accommodates changes in technology, social preferences, external factors, and institutional innovations elsewhere.

Given the importance of institutional change, this chapter turns to the question of how such change occurs and how to accomplish institutional reform. Political economy becomes a crucial consideration in this regard, as it often has a determining impact on the nature and extent of institutional reform at different times and under different circumstances. The political economy of institutional change in Latin America and the Caribbean remains a relatively underexplored area of inquiry. Nevertheless, disparate studies in recent years have pointed to some key factors that appear to facilitate institutional change in the region as well as those that might impede it. This chapter attempts to point out some of the most salient political-economy factors likely to affect the potential for institutional change, and to show how these factors, if taken seriously into account, can enhance both the analysis and the undertaking of such change.

Factors Increasing the Demand for Institutional Change

An increase in the effective demand for institutional change comes from many sources, not all of them political—technological innovations; external economic shocks; natural or manmade disasters; and foreign experiences, good or bad, that have powerful demonstration effects.

One prominent example in contemporary Latin America and the Caribbean that has already been discussed is globalization. Countries in the region now trade a higher share of domestic production with the rest of the world and receive greater volumes of foreign investment as a share of domestic investment than they did two decades ago. As noted in the introduction, this increasing activity in the global economy has led entrepreneurs and firms to realize that their international competitiveness is critically affected by the quality of domestic institutions. Both the spread of the Mexican peso crisis of 1994–95 and the more recent Asian financial crisis demonstrated the increased vulnerability of national economies to external shocks in a world characterized by rapidly increasing financial integration. In addition, globalization has brought with it potentially adverse distributive effects, which need to be offset by new institutional structures (i.e., social safety nets and improved access to quality education for vulnerable groups).

On another front, the end of the Cold War and the global and regional emphasis on democratization and the

advancement of human rights have created demands for more accountable and transparent political institutions and a reformed judiciary. In Latin America and the Caribbean, the devolution of power to local governments, the popular election of mayors, the increased importance of national legislatures, and the emergence of grassroots organizations and new political parties are all manifestations of these increased demands.

Developments such as globalization act as facilitators of institutional change; they provide the dynamic context in which such change takes place. They increase the societal perception that it is "time for a change." For example, the economic crises of the 1980s led to the widespread acceptance and subsequent adoption of liberal trade and investment regimes recommended by technical experts inside and outside the region. In turn, the adoption of these new policies required changes in the rules governing international trade, and even led to the dismantling of some organizations, such as import-licensing agencies, and to the creation of new ones, such as antitrust agencies and those that evaluate the impact of "unfair" trade practices. In short, the prevailing institutional structure can become widely perceived as incongruent with the way the world (or a country or region or sector) is evolving. Factors that might previously have narrowed the parameters for change—most notably the accumulated weight of history and culture—become, or appear to become, less constraining. The effective demand for institutional change is thus increased.

In the long run, the main factor propelling the demand for institutional change is learning or the accumulation of knowledge (North 1990). Over time, actors evaluate the functioning of institutional arrangements based on their own experiences. Accumulated knowledge helps actors develop more effective rules to overcome the underlying problems that existing rules were designed to solve and enables them to identify new problems requiring institutional solutions. Without social learning a society can be trapped for decades or more in a perverse equilibrium characterized by low-quality institutions, slow accumulation of knowledge, and meager growth and institutional change. The role of social learning in institutional change points to the crucial importance of education over the long run. Regardless of the underlying forces increasing the effective demand for institutional change, education is critical for promoting an adaptive institutional structure.

The Supply of Institutional Change: The Role of Societal Actors, Interest Groups, and Collective Action

The factors affecting the "supply" of institutional change—including how much change takes place, at what pace, and along what dimensions—are numerous and varied, and we do not attempt to present a comprehensive list. There are many complex technical issues involved, but we focus here on the political-economy factors affecting the likelihood that increased demands for change actually will yield results. This is because the nature of the institutional changes undertaken is likely to turn significantly on how the demands for change previously cited are (or are not) processed by the political system. The ensuing discussion focuses on three broad areas: societal actors and the factors affecting their ability to act collectively; political organizations like political parties that serve an important intermediary role between such societal actors and the formal institutions and organizations of government; and some characteristics of the formal institutions themselves.

Societal Interests in Change

In attempting to understand why and how institutional change takes place, it is necessary to identify and accurately characterize the major societal-level interests at stake in such change. Obviously, these will vary from country to country (and even from region to region within countries) as well as from sector to sector.

In this connection, it is necessary to understand what societal actors—with what interests—are attempting to effect institutional change. It is necessary to assess what resources—financial, organizational, and political—they are capable of bringing to the table of reform. And it is necessary to assess who benefits and who loses from current institutional arrangements, and who would benefit and lose from the changes. In short, it is essential to have a clear understanding of the major social cleavages surrounding institutional change, and to know the nature and intensity of the demands of the main societal actors.

Bardhan (1997) explains how a society's institutional arrangements "are often the outcome of strategic distributive conflicts among different social groups," and how, therefore, inequality in the distribution of power and resources can sometimes block necessary reform of these institutions. The flip side of this, of course, is that changes in the relative capacity of organizations to influence insti-

tution-building may *lead* to institutional changes. Emerging powerful organizations may deem the existing institutional structure to be inconvenient for their own interests; or existing organizations or interest groups see either their net benefits derived from the existing institutional structure sharply reduced or their own capacity to oppose institutional change weakened (both of these effects appear in times of economic or financial crisis). In addition, economic crises and other exogenous developments such as technological changes can change the perceptions of interest groups or organizations about the costs and benefits of particular institutions. Hence, not only can changes in the relative capacity of organizations bring about institutional change, but also changes in the perceptions of influential organizations can lead them to support or reduce their opposition to institutional reforms.

The recognition that organizations may lead the way in changing institutions is an important ingredient of institutional change. Of particular importance is the political concept we can call the "private interest" theory. This theory emphasizes that private interest groups can seek policy and institutional changes (or prevent such changes) to serve their own interests. This approach thus echoes that of Bardhan in emphasizing the role of distributive conflicts among interest groups as an important determinant of institutional change.

Collective Action

One prominent way of addressing these concerns in the economic literature on institutions is through a focus on the costs for individuals and, especially, organizations to act collectively in pursuit of their interests (see Olson 1965). "Collective action" is costly for each member of a group, yet the benefits from collective action accrue to all members. Thus, there is an incentive for individuals or organizations to be free riders and let others pay the organizational and coordination costs for group activities, including political lobbying (Becker 1983).

Olson (1965) identified several characteristics of interest groups that affect the likelihood of a group's being formed and how effective such a group would be. For example, the smaller the number of members, the greater the likelihood that collective action will take place, because the smaller the group, the lower the costs of coordinating and enforcing membership requirements. Likewise, if the members are geographically concentrated, the costs of collective action are smaller. Hence, the costs of collective action are associated not only with the resources needed to pursue a particular objective (e.g., political campaign contributions, lobbying, etc.) but also include the costs of monitoring the behavior of members to prevent free riders. Any factors that may reduce such costs usually enhance the ability of members to act collectively as a group.

In addition, the pattern of distribution of the costs and benefits of particular institutional reforms also influence the likelihood that affected interest groups will act collectively to support or oppose such reforms. It is often argued that reforms that yield benefits to a large number of people but that have negative consequences for specific groups will be especially difficult to implement. When the benefits are dispersed, according to the argument, they will seem small relative to the costs of acting collectively (Becker 1983), so support for the reforms will tend to be weak and poorly articulated. To clear and concentrated losers, however, there will be strong incentives to cover the costs of collective action to oppose the reforms.

Latent Interest Groups

An important implication here is that in any society we may find groups of individuals or organizations that have a common interest but are unable to organize themselves as an effective interest group; Olson (1965) referred to these groups as "latent" interest groups. That is, for many potential beneficiaries of a particular institutional reform the costs of collective action may be too high, and their collective voice will not be heard in policy debates. The costs of collective action and the resources necessary to promote it, however, are not the only impediments to collective action. Lack of information regarding the details and consequences of policy prescriptions is often an obstacle, too. In other words, voters may clearly understand what their interests are, but they may not know the specific details and technical issues of policy debates.

Such latent interest groups seem especially numerous in Latin America and the Caribbean and may be linked to many factors, including the inequality in the distribution of income and wealth for which the region is unfortunately well known. Indeed, such inequality may be the key barrier to collective action for many actors in Latin American and Caribbean society. Many potential interest groups have lacked both the incentives and the resources to engage in effective collective action.

Within Latin America and the Caribbean, many such latent interest groups have historically been "bought off" or co-opted by the clientelistic distribution of ad hoc and piecemeal "pork" and favors on the part of politicians, particularly at the local level. Such patron-client ties, arguably the prevalent form of political representation in much of the region over an extended period of time, are antithetical to the development of more structured, broader-based, and more effective political organizations. The proliferation of grassroots organizations throughout the region in recent years, however, has the potential to significantly alter the pattern just described. It could greatly intensify the effective demand for institutional change stemming from the societal level and could greatly increase the possibilities for constructing pro-change coalitions.

Coalition Building

An emphasis on the constellation of societal forces at play, and on how such forces do or do not engage in collective action in pursuit of their interests, leads to a concern with coalition building and the construction of pro-change or pro-reform coalitions. The key concern is how to build such pro-change or pro-reform coalitions in specific countries and sectors. What is the role of compensation mechanisms, and what are the roles played by timing, sequencing, and uncertainty?

A number of analysts have examined the factors that seem to account for the building of "pro-poor" coalitions in the context of the political economy of poverty reduction. A central conclusion of these analyses is that it is necessary to include payoffs for non-poor groups as well (Ascher 1984; World Bank 1990). Some institutional changes appear to pit the poor against the non-poor directly, but frequently the fortunes of both groups are linked, and coalitions can be formed that cut across the poor/non-poor divide. Coalitions may form, for example, along sectoral lines (e.g., agriculture vs. industry) or geographic lines (e.g., the interests of Brazil's Northeast versus those of the more developed southern region). Where institutional reforms to benefit the poor have been effected in Latin America and the Caribbean, their success has generally turned on the stance of white-collar workers, professionals, and small- and medium-size business interests.

Compensation Schemes

More generally, there are various types of compensation schemes that can be used to compensate losers and winners from reforms to reduce their opposition and raise their support (Edwards and Lederman 1998). Table 2.1 describes five types of compensation mechanisms that have been used in various situations.

- The first type is *direct compensation*, which is usually in the form of fiscal transfers or subsidies to losers from specific reforms. For example, adjustment assistance schemes are commonly implemented jointly with trade liberalization programs. In the case of Chile, for example, the government offered a minimum employment program in the 1970s to alleviate (although meagerly) the unemployment caused by trade liberalization and cutbacks in public employment.
- *Indirect compensation* may emerge out of economic forces (such as the devaluation of currencies that usually follows the implementation of stabilization and trade liberalization policies), or may be deliberate policy measures that compensate groups affected by a particular reform through the adjustment of a different policy instrument that indirectly raises their revenues or reduces their costs of production or organization. In several cases of education reforms, for instance, the centralized structure of collective bargaining of teachers' salaries and salary levels have been maintained in order to reduce the opposition of teachers' unions to other education reforms.
- *Cross compensation* entails changes in other policies that raise revenues or reduce costs of potential supporters not affected by the change in the policy under consideration. For example, Bolivia's capitalization program raised public support for privatizations, while the privatizations themselves would not necessarily have negatively affected the population at large (in fact, they should provide overall benefits).
- *Exclusionary compensation* relies on exemptions from reforms to certain groups that would otherwise block the reform effort. A case in point is the Chilean military's non-participation in the privatized social security system.
- Finally, *political compensation* can be achieved, for example, by incorporating leaders of opposition groups into reform-oriented governments.

The fact that winners and losers can be compensated for either not opposing or actually supporting institutional reforms also implies that reform proposals can include several policy changes in a single package. Hence, proposed

reform packages can have "built-in" compensation mechanisms, whereby one element hurts the interests of one group, but another offers compensation.

Time-Inconsistency and Other Complications

The consideration of compensation schemes, however, brings further political complications. For example, are "promised" compensation schemes to be implemented in the future sufficient to placate opposition to institutional reforms? This type of question is the so-called "time-inconsistency" problems that are common in discussions of macroeconomic policy choices (Kydland and Prescott 1977). Promised compensation schemes can be derailed if the initial reforms strengthen certain interest groups that subsequently oppose the implementation of the compensation mechanisms. Time-inconsistency (i.e., when elements of the reform package or compensation schemes are not credible over time) can also produce a status quo bias as potential supporters may withdraw from the coalition when promises of benefits are not credible. Box 2.1 discusses how a technically optimal sequence of financial-sector reforms can suffer time-inconsistency problems due to political factors.

Graham and Naím (1998) have also argued that the timing of the costs and benefits of institutional reforms presents special political challenges. For example, they argue that a key difference between stabilization programs and institutional reforms is the timing of the costs and benefits of the reforms in question. Macroeconomic stabilization has immediate positive consequences embodied in the reduction of inflation and perhaps in the acceleration of growth. In the case of institutional reforms, it can be argued that some of the benefits become apparent only after an extended gestation period, while the costs of the reforms (felt mainly by well-organized interest groups) are absorbed up front. In this context, it may be politically difficult to implement institutional reforms—more difficult, at least, than macroeconomic stabilization programs.

However, it should also be noted that stabilization in Latin America and the Caribbean (or "first generation" reforms) has been accompanied by a variety of other reforms, including trade liberalization, which also produce up-front costs and delayed benefits. Moreover, some institutional reforms may have immediate positive effects for their main beneficiaries. For example, the introduction of education vouchers immediately helps the families that can

TABLE 2.1

The Political Economy of Reform and Compensation Mechanisms

MECHANISMS	MAIN FEATURES AND SOME EXAMPLES
A. Direct Compensation	*Groups directly affected by the reform policy are compensated through the transfer of cash or financial securities.* In this way the authorities expect to see a reduction in the extent of opposition from that group to that particular reform. Examples of this type of compensation mechanisms include the distribution of shares of privatized firms to workers in that particular firm, and adjustment assistance programs to workers who lost their jobs as a consequence of trade liberalization. The increase in take-home pay following a social security reform is another good example of this type of direct-compensation scheme.
B. Indirect Compensation	*This mechanism implies compensating groups affected by a particular reform through the adjustment of a different policy that indirectly raises their revenues or reduces their costs of production.* In some cases this type of indirect compensation is "automatic," and is the result of normal economic forces at work. In others it is the result of specific policy measures. One of the most important indirect compensation mechanisms is the real exchange rate. By devaluing the real exchange rate, import-substituting sectors are partially compensated, while exporters experience an additional boon. Providing tax exemptions to sectors affected by deregulation constitutes another common form of indirect compensation.
C. Cross Compensation	*This mechanism entails transferring resources—either directly or indirectly—to groups not directly affected by the reform,* in order to obtain their political support. Transferring shares of privatized firms to the population at large—as in Bolivia's capitalization program—is a good illustration of this mechanism at work.
D. Exclusionary Compensation (i.e., Exemptions)	*This mechanism entails excluding certain powerful groups from the effects of a reform, or implementing policies that in effect exempt some sectors from the reform in order to diffuse their political opposition.* By allowing these groups to maintain certain privileges, they are not likely to become active antagonists. The special treatment given to the Chilean armed forces regarding that country's social security reform is a classic example of this type of compensation mechanism.
E. Political Compensation	*This mechanism encompasses political "carrots and sticks"*—for example, the appointment of influential representatives of certain groups to high-level government jobs, which often sends a (symbolic) signal to interest groups that their concerns will be addressed.

Source: Edwards and Lederman (1998).

BOX 2.1

Time-Inconsistency Problems in the Political Economy of Financial-Sector Reform

Consider the relationship between five banking sector reforms: the privatization of state-owned banks, interest-rate liberalization, allowing foreign ownership and foreign direct investment in the sector, liberalization of cross-border financial services, and strengthening of prudential regulation and supervision. Suppose that a reform-oriented government decides to implement all five policies but must make a decision about their sequencing. Ideally, privatization, interest rate liberalization, allowing foreign competition and ownership in the domestic banking sector, and the strengthening of regulation and supervision should be done prior to the liberalization of cross-border financial services to avoid provoking a financial crisis. Reformers may realize that all five reforms benefit national welfare in the long run, yet they may face political and fiscal constraints in the implementation of the five policies with the optimal sequence.

In order to raise fiscal revenues at the time of privatization, governments often grant protection against foreign competition in the domestic market. Yet another problem is that interest-rate liberalization usually hurts some important interest groups that benefited from the artificially low rates of the previous system. Consequently, reformers may decide first to conduct the privatization, the interest-rate liberalization, and the liberalization of cross-border financial services (which offers the opportunity for domestic entities to tap cheaper foreign financial markets), and to postpone the implementation of the foreign-ownership reform and the regulatory reform until a later date. The time-inconsistency problem arises in this context because it is likely that the newly privatized banks will flourish in the protected environment and will grow also in political influence, thus making them capable of blocking the promised opening of the domestic banking sector to foreign ownership or the regulatory reform. In other words, the promises of opening the sector to foreign competition and improving regulation and supervision are not credible in this context.

It is not surprising, then, that many Latin American reformers have chosen to permit borrowing from foreign banks directly by opening other aspects of the capital account early in the reform process, since this policy provides access to cheaper foreign financing, without necessarily promoting foreign competition in the domestic sector. In this sense, the capital account liberalization is a form of indirect compensation mechanism: It compensates the formerly privileged domestic borrowers for the increase in interest rates (and the trade liberalization that many LAC countries have implemented at the same time). Unfortunately, this early opening of the capital account can be detrimental to the medium-term stability of reforming economies (see Edwards 1984 and McKinnon 1991). Another common decision taken by reformers in the region has been to sell public banks to financial groups that also owned real-sector firms, many of which had benefited from the subsidized credit schemes—again reflecting the use of an indirect compensation mechanism that raises the support for the reforms on the part of these affected interest groups (on Chile's experience, see Edwards and Lederman 1998).

In other venues we have suggested that a way of avoiding the time-inconsistency problem in financial reforms is to commit to the opening of the domestic sector in the context of international negotiations. For example, reformers could promise to open their domestic financial sectors in the context of international trade negotiations, which would raise the costs for future governments of not implementing the needed reforms (see Perry 1997).

use the coupons to purchase better education. The introduction of consumer choice and competition in health services will have similar positive effects. In fact, institutional reforms that enhance the ability of individuals or organizations to use "exit" or "voice" strategies to provide proper incentives to their "agents" can be politically popular. Indeed, choice (exit) and empowerment (voice) are good and popular policies. In any case, while the timing of the costs and benefits of institutional reforms may pose some political challenges, these can be overcome through a variety of reform strategies, including the use of the compensation mechanisms discussed above.

Another important consideration that has been raised by Fernández and Rodrik (1991) is that uncertainty about

the benefits from reforms may lead voters (or individuals, or even interest groups) to reject proposals for reform. Such uncertainty may arise when various reforms are introduced together (thus making it more difficult for individuals to assess the net benefits from reforms) or when there is imperfect information regarding the details and consequences of the policies. It has already been pointed out that latent interest groups may be the result of lack of information, especially regarding the technical details and distributive consequences of policy or institutional reforms. These considerations raise the need to couple reform proposals with public information campaigns. Nonetheless, reform "bundling" may be necessary to offer "something for everybody." This may be needed to raise political support or reduce opposition to specific institutional reforms (Tommasi and Velasco 1996).

The Intermediation of Societal Interests

So far the discussion has emphasized the nature and interests of societal actors, whether and how they are likely to organize collectively around their interests, whether they are potential winners or losers from the process of institutional reform, and how their support can be garnered through various compensation mechanisms and related actions. But whether pro-change or pro-reform coalitions can be built is not only a matter of the societal interests at stake.

Another important factor has to do with the intermediating role of political leaders and political organizations, such as political parties. Such intermediaries "aggregate" the interests collectively articulated by the actors in civil society. This is a crucial political function because it facilitates the harmonization of the often contradictory interests of groups in civil society and thus facilitates the adoption and implementation of public policies that command support beyond the narrow political interests of any one group. In the literature on pluralist political systems, political parties are seen as the essential "interest aggregators." Political parties also provide ideological frameworks and lenses through which their supporters can interpret and assess the numerous and complex policy issues without having to possess detailed knowledge on each and every one.

Political parties have attracted considerable attention from analysts of politics in Latin America and the Caribbean. Although broad, region-wide generalizations are obviously difficult to make, it is apparent that many political parties and party systems in the region fail to meet the criteria for effective interest aggregation.

Mainwaring and Scully (1995) suggest four criteria for "institutionalized" party systems. First, there must be some stability in the rules and nature of inter-party competition; parties should not simply appear and then just as quickly evaporate. Second, the major parties should have stable roots in society if they are to structure political preferences over time. Third, the major political parties must accord legitimacy to the electoral process, with the expectation that elections will be the primary route to governing. Fourth, party organizations matter; parties are not simply the vehicles of ambitious politicians but acquire an independent status and value of their own.

Employing these criteria, the authors note sharp differences among the party systems of countries in the region. While Chile, Costa Rica, and Uruguay, for example, appear to have party systems that are relatively well-institutionalized, Bolivia, Brazil, Ecuador, and Peru do not. Other countries in the region fall somewhere in between.

Brazil is often taken as an example of party fragmentation. One recent analysis concludes that, in Brazil, "party leaders have little control over their members, and many, perhaps most, deputies spend the bulk of their time arranging jobs and pork-barrel projects for their constituents. Parties in Brazil rarely organize around national-level questions" (Ames 1998, p. 4). Brazil, however, is certainly not the only country in the region in which political parties do not appear to perform the interest aggregation function particularly well. Why not?

The reasons given in the literature are numerous:

- Some observers place at least part of the blame on electoral systems, particularly on some kinds of proportional representation that appear to encourage a lack of discipline on the part of party politicians.
- Others focus on internal party decision-making structures and processes that they say contribute to party oligarchies. (The advent of internal party primaries in some countries has, however, partially countered this argument.)
- Others see the problem more rooted in long-standing cultural and historical persuasions, such as the alleged tendency toward "personalism" as a basis for political affiliation.
- Some political parties have been "captured" by relatively narrow class or sectoral interests, making them in effect little more than glorified interest groups.

- Some focus on the previously discussed history of clientelism in the politics of the region; patron-client relationships place a premium on personal ties and political kinship, and correspondingly downplay the role of formal party organizations.

Noting the apparent shortcomings in many political parties, some have argued that countries in the region are facing a "crisis of representation" (Domínguez 1997). This may be an exaggeration; it is difficult to argue that there is less representation in Latin America and the Caribbean today than existed in the heyday of authoritarian and military regimes. Nevertheless, it is an important question whether the formal democratization of politics in the region has been accompanied by "effective" advances in representation, particularly of the lower socioeconomic strata. The role of political parties is important in this debate; in their absence or their reduced effectiveness, it would become more difficult for the citizenry's interests and demands to be aggregated, processed, and ultimately dealt with by governmental leaders.

Governmental Institutions in the Change Process

The formal institutions of government also affect the possibilities for institutional change.[1] For example, constitutions and other formal rules can determine the nature of checks and balances between the different parts of government as well as the structure of the political system in terms of the number of political parties and the like, and they may determine which specific political actors control institutional reforms. According to G. Cox and McCubbins (1996), "political actors' incentives are significantly influenced by the rules regulating electoral competition, while their capabilities are determined jointly by their electoral success and the constitutionally stipulated powers of the various governmental posts that are at stake (either directly or indirectly) in elections."

Chapters 6 and 7 of this volume deal with two important governmental organizations—the judiciary and the bureaucracy. Here the focus is on the executive and legislative branches of government in Latin American and Caribbean countries that have presidential (not parliamentary) political systems. Such systems have two defining characteristics: (a) The chief executive is popularly elected, and (b) the terms of office of the president and the legislature are fixed. Neither the executive nor the legislature alone may shorten the other's term, except in extraordinary circumstances.

Noting that the region is characterized by presidential systems of government is not the same, however, as arguing that it is marked by "presidential dominance." In fact, there are wide variations in the powers of the president vis-à-vis the legislative branch. There are, for example, significant differences in the extent to which the presidents have veto power, can promulgate decrees without resorting to the legislature, and retain the exclusive power of introducing legislation, at least in some key policy domains. To complicate matters, such powers can differ according to the subject of proposed changes. For example, even presidents with generally strong veto powers may lack such powers when it comes to budgetary matters, and even presidents with generally broad decree powers may lack such powers with regard to particular issues. In addition, there are variations in the procedures for amending the constitution in the different countries of the region.

These differences are captured in Table 2.2, which provides a summary of presidential powers over legislation in selected countries. A "proactive" president is one who can establish—or attempt to establish—a new status quo. A "reactive" president is one who only can attempt to defend the status quo against legislative attempts to change it.

The relative power of the president, however, is not only determined by the formal allocation of authority as spelled out in the constitution. What also matters greatly is the president's partisan support in the legislature. This also varies substantially across countries, as shown in Table 2.3. The mean level of presidential support in the legislature, whether on the part of the president's own party or on the part of a coalition of parties supporting him, has been low historically in Bolivia, Brazil, Chile, and Ecuador. Presidents have been far from commanding majority support in the legislature in these countries. Moreover, even where support for the president in the legislature hovers near a majority, such support is frequently vitiated by a lack of discipline in the president's own party or the coalition of parties supporting him. While the nature of social cleavages and other historical factors undoubtedly plays an important role in determining the extent of party proliferation within the legislature, research has also demonstrated the importance of such factors as concurrent elections for the presidency and the legislature, various kinds of proportional representation, and characteristics of the institutions

TABLE 2.2

Summary of Constellations of Presidential Powers over Legislation in Latin American Constitutions

PRESIDENT'S CONSTITUTIONAL LEGISLATIVE AUTHORITY	CONFIGURATION OF POWERS	EXAMPLES
Potentially dominant	Decree, strong veto, exclusive introduction	Chile 1980-89[a] Colombia 1968–91
	Decree, strong veto	Argentina[b] Ecuador[b, c]
Proactive	Decree, weak veto, exclusive introduction	Brazil 1988[b] Colombia 1991[b] Peru 1993[a]
	Decree, weak veto	Peru 1979[a]
Reactive	Strong veto, exclusive introduction	Brazil 1946 Chile pre-1973 Uruguay
	Strong veto	Bolivia Dominican Republic El Salvador Panama
Potentially marginal	No veto (on annual appropriation bills)	Costa Rica[b] Honduras[b] Mexico[b] Nicaragua Paraguay Venezuela

Notes: Decree—the president may establish new law without prior congressional authorization (therefore not including decrees of a regulatory nature). *Strong veto*—override requires more than a majority of all members. *Exclusive introduction*—certain important bills in addition to the budget must be initiated by the president, or congress may not increase items of expenditure in budget proposed by the president.

a. Decree restricted primarily to fiscal matters.

b. Different veto provisions apply on different types of bills. The Colombian president has strong veto powers over the budget but weak power over other forms of legislation. No other presidents have veto power over budgets. Veto powers over other forms of legislation are strong in Costa Rica, Honduras, and Mexico, and almost absolute in Ecuador.

c. The Ecuadorian president's veto may not be overridden if he or she vetoes the entire text, although Congress may request a referendum on the bill; if the president objects only to specified parts of a bill, the veto (of the whole bill) may be overridden by a two-thirds veto.

Source: Mainwaring and Shugart (1997, Chapter 1).

(rules) of the legislative branch (Mainwaring and Scully 1995; Mainwaring and Shugart 1997).

A recognition of both the formal constitutional and partisan powers of the president leads to a more complete understanding of the president's ability to effect change, including institutional change. Table 2.4 combines a consideration of each kind of power and produces some instructive results. For example, the only country in which the president has strong constitutional powers accompanied by at least moderately strong support in the legislature is Argentina. In several other cases, presidents with strong constitutional powers have had relatively low support in the legislature, rendering decisive governmental action difficult. Interestingly, many countries' presidents actually have relatively low levels of formal constitutional powers and their strength derives principally from the partisan support they enjoy in the legislature. This is the case, for example, with the president of Mexico, traditionally considered perhaps the strongest chief executive in the region. From a comparative perspective, the Mexican president has relatively limited formal powers but has been immensely fortified by his leadership of the Partido Revolucionario Institucional (PRI), the formerly hegemonic political party in the Mexican system. If future political developments in Mexico lead to more power-sharing with other political parties, then it is likely that Mexican presidential power will diminish due to the formal constitutional provisions. More broadly, Table 2.4 demonstrates that in many countries of the region the vaunted power of the president is closely tied to electoral outcomes and partisan configurations in the legislature.

Attention to executive-legislative relations is arguably even more important in the current institutional context in the region. The democratization of regional political systems has, in theory at least, increased the importance of the legislative function. Thus, issues that have long been prominent in the study of executive-legislative relations in the advanced industrial democracies—such as the internal decision-making structures and processes of the legislature, the adequacy of legislative staffs and of legislative access to independent information sources, and the nature of legislative oversight of executive decision-making—may take on added significance in Latin America and the Caribbean as well.

Chapter 7 suggests that the nature of executive-legislative relations may be an important element of achieving viable bureaucratic reform. Other studies have demonstrated their importance for a considerable array of policy domains. A fruitful line of inquiry has been one that emphasizes the alignment of incentive structures in such a way that politicians' interests in short-term political survival can be harmonized with their desire to promote more encompassing social or political objectives (such as institutional reform). Geddes (1994), for example, has demonstrated that the adoption of more meritocratic presidential

TABLE 2.3

Presidents' Parties' Mean Share of Congressional Seats in Latin America
(percentages)

COUNTRY AND PERIOD	YEARS	NO. OF ELECTIONS	PRESIDENT'S PARTY		PRESIDENT'S COALITION	
			LOWER CHAMBER	UPPER CHAMBER	LOWER CHAMBER	UPPER CHAMBER
Argentina	1983–93	6	48.3	52	49.1	52
Bolivia	1980–93	4	33.9	47.2		
Brazil						
Ia	1945–50	3	34.8	44	52.2	48.6
Ib	1954–62	4	26	26	44.8	52
IIa	1985–90	4[a]	26.9	25.6	37	31.8
IIb	1994	1	12.1	13.6	35.4	42
Chile						
I	1932–73	18	23.3	20.8	41.6	41.2
II	1989–93	2	31.7	28.3[b]	58.3	46.3[b]
Colombia	1945–49, 1974–94	11	55.2	56.3	55.2	56.3
Costa Rica	1953–94	11	49.6	—	51.8	—
Dominican				69.1		
Republic	1962, 1966–90	8	55.6	—		—
Ecuador	1978–94	7	22			
El Salvador						
I	1985–91	4	47.5	—		—
II	1994	1	46.4	—		—
Honduras	1981–93	4	54.2	—	54.2	—
Mexico	1982–91	4	65.8	95.8	65.8	95.8
Nicaragua	1984–90	2	65.4	—		
Paraguay	1993	1	47.5	44.4	—	—
Peru						42.2[c]
	1980	1	54.4	43.3	54.4	43.3
	1984–90, 1995	3	47.1	40[c]	47.1	41.7[c]
Uruguay	1942–71, 1984–94	11	45.6	43.8		
Venezuela	1958–93	8	41.1	47.4	43.2	47.7

Notes: a. Includes the indirect presidential election of 1985.

b. For Chile II, appointed senators were included in calculating the president's share of Senate seats. If one takes only elected seats, the percentage increases to 34.2% for the president's party and 56.6% for the coalition.

c. Does not apply to 1995; Peru moved to a unicameral legislature with the constitution of 1993.

Source: Mainwaring and Shugart (1997, Chapter 11).

appointment strategies to bureaucratic posts in many countries of the region has been crucially affected by some fundamental features of the political landscape, including the size of the president's party, the discipline of party members, and whether the president is attempting to build a political machine while in office. Such studies emphasize that the harmonization of short-term political survival goals with the broader "public interest" in institutional reform is likely to be at the heart of reforming institutions through the mechanisms of the political process.

Some Guidelines for Reform

The discussion in this chapter indicates that a full-blown theory of the political economy of institutional change still remains elusive, despite the contributions of economists and other social scientists. In focusing upon institutional change as the factor to be explained (i.e., the "dependent variable" in social science terminology), it is clear that there are various explanatory levels—broadly speaking, societal, intermediary, and formal/governmental—that facilitate understanding of why and how such change occurs. But a systematic appreciation of the precise relationships among these levels, or of their analytically independent contributions to the explanation of varying outcomes, remains a daunting task.

Nevertheless, this survey of some of the key emphases in the study of the political economy of institutional change has highlighted a range of relevant factors that need to be taken into account by those—be they societal actors, governments, or international agencies—who may be interested in promoting reforms aimed at improving the quality of domestic institutions. Taken together, they

TABLE 2.4
Relationship Between Presidents' Constitutional and Partisan Powers in Latin America

CONSTITUTIONAL POWERS OVER LEGISLATION	PRESIDENT'S PARTISAN POWERS			
	VERY LOW	MEDIUM LOW	MEDIUM HIGH	VERY HIGH
Potentially dominant	Chile, 1989 Ecuador	Colombia, 1968	Argentina	
Proactive	Brazil, 1988	Colombia, 1991 Peru		
Reactive	Brazil, 1946 Chile, 1925	Bolivia	El Salvador Uruguay	Dominican Republic
Potentially marginal			Costa Rica Paraguay, 1991 Venezuela	Honduras Mexico Nicaragua

Source: Mainwaring and Shugart (1997, Chapter 11).

constitute a few basic guidelines for institutional reformers. Borrowing from central concepts in institutional economics and political economy, the guidelines are as follows:

- *Pay systematic attention to the nature of prospective winners and losers from institutional reform* (e.g., trade unions in the formal sector with respect to labor market reform, diverse rural interests regarding "market-based" land reform, teachers' unions regarding education reform, various subcategories of the financial sector regarding financial reforms, etc.). Be aware of the main cleavages that appear to separate such winners and losers—sometimes, for example, these may have a regional dimension, sometimes a sectoral base, sometimes a base in social classes linked directly to their position in the productive structure. In any event, monitor closely the nature and intensity of support or opposition as manifested by public opinion polls, proclamations of interest groups, public demonstrations, and the like.
- Based on well-informed assessments, *attempt to craft compensation schemes that are politically viable and thus credible.* In addition, it may be necessary to make promises about future compensation schemes, which may be key ingredients for both the effectiveness of the reforms and for their political sustainability. One way to enhance the credibility of compensation schemes is to raise the costs of "exit" from commitments by future governments through adherence to international treaties or similar commitments, such as the signing of summit declarations.
- *Empowering the beneficiaries is good policy and smart politics.* Graham and Naím (1998) have suggested that institutional reforms are more likely to be supported if the potential beneficiaries participate in the design of the new institutions. One way to do this is through "voice," in Hirschman's (1970) terminology, which is a feedback device by which principals exert control on the decision-making process of their agents and organizations. As is discussed in greater detail in Chapter 5, one way of improving the performance of schools in the region is to provide greater participation to parents in the schools' management. Empowerment (or voice) then becomes a means to ensuring that the school acts according to the interests of the households, which is particularly important when the "exit" or choice strategy is not available. It is also safe to argue that the beneficiaries will welcome such policies. In the context of financial reforms, protecting minority shareholders' rights is also a voice strategy for reform, which should not face severe political obstacles on the part of public opinion. The decentralization of state functions to local governments is another example where local communities can potentially gain voice over public bureaucracies in the context of democratic (choice) politics.

- *Providing choice to beneficiaries is also good policy and smart politics.* Some of the assertions stated above about empowerment also apply to the provision of "choice" or "exit" strategies for beneficiaries. If principals are not satisfied with the quality of services provided by their agents or organizations, they can desert and look for the services elsewhere. The threat of exit is a complement to the provision of voice or empowerment strategies for institutional reforms, since the threat of exit strengthens the voice strategy. In the case of education, for example, the use of education vouchers may be a good (and politically popular) complement to empowerment strategies, where the schools have to respond to the demands of parents, especially if public-education subsidies for schools are linked to children's enrollment (as in the case of Chile, for example).
- *Public-information campaigns should be part and parcel of reform efforts.* A frequent issue that emerges out of the political-economy perspective is that latent interest groups are politically inactive as a consequence, in part, of the costs of collecting information about the potential costs and benefits of particular reforms. If reforms are viewed as a collective good, however, there is clear justification for reformers to spend resources explaining the details and likely consequences of proposed policy initiatives. This role is particularly important in the context of democratic regimes, where voters have political voice and exit strategies available but may not use them to defend their interests effectively.
- *Pay careful attention to the political support for prospective reforms at the intermediate level, particularly among key political leaders and political party organizations.* Assess the possibilities for "deals" and tradeoffs among them. Be particularly aware of the "political cycle"—i.e., how windows of opportunity for institutional change might open (or close), depending upon impending elections.
- *Have a clear understanding of the constitutional—i.e., formal/governmental—facilitators and obstacles to institutional change and reform* (e.g., the possibilities of introducing reforms via presidential decree, the realistic scope for reform in situations in which a strong legislative branch shares important powers with the president, the potential for creating autonomous or semi-autonomous agencies as relatively non-political enclaves within the formal structure of government, etc.). Such an understanding, simple as it seems but important as it is, could facilitate ex ante calculations of the feasibility of institutional reform—of labor market reform in Argentina, to take but one example, or of administrative and social security reform in Brazil, to take another. With a clear understanding of the constitutional forces in play, and of their close relationship to partisan forces particularly in the legislature, think creatively about how to exploit the opportunities and overcome the constraints.
- *Focusing on reforming incentive structures is good policy and smart politics.* Perhaps the most difficult reforms to undertake from a political standpoint are those that aim to change or reduce the size of public employment. This is the case for two reasons: First, the losers have human faces that become the symbols of the costs of such reforms, and second, the public jobs are often part of the political game by which supporters of certain leaders get rewarded. Consequently, reforms of the civil service and societal organizations (e.g., schools) should focus on the incentive structures rather than on changing personnel or installing the latest technology. This approach may not only be more politically viable than wholesale changes in personnel, but may also be the most appropriate approach from a technical standpoint, based on the emphasis placed on incentives by the new institutional economics.

* * *

In sum, the analysis in this chapter indicates that reforming institutions in the countries of Latin America and the Caribbean is far from an impossibility. To the contrary: The increased demand for more effective institutions in the region can be matched by commensurate supply. What is required from would-be institutional reformers is sustained political commitment and carefully tailored strategies for putting such commitment into operation in specific sectors. Policy analysts, using some of the tools of the trade discussed in this chapter, have an important role to play in helping reformers craft such strategies. The combination of historical trends that have raised the demand for institutional reforms, and the fashioning of astute reform strategies that are sound from both technical and political points of view, present Latin American and Caribbean countries with a historic opportunity to close

the "institution gap" that currently afflicts the region—a gap that both threatens the consolidation of the vital reforms already undertaken and impedes the implementation of the "second generation" reforms that are crucial.

Note

1. The discussion in this section draws extensively from Mainwaring and Shugart (1997), especially Chapters l and 11.