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Walk the line: Conflict, state capacity and the political dynamics of reform☆

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A B S T R A C T

This paper develops a dynamic framework to analyze the political sustainability of economic reforms in developing countries. First, we demonstrate that economic reforms that are proceeding successfully may run into a political impasse, with the reform's initial success having a negative impact on its political sustainability. Second, we demonstrate that greater state capacity, to make compensatory transfers to those adversely affected by reform, need not always help the political sustainability of reform, but can also hinder it. Finally, we argue that in ethnically divided societies, economic reform may be completed not despite ethnic conflict, but because of it.

1. Introduction

The past two decades have witnessed many episodes of economic reform across countries in Latin America, Eastern Europe and Asia. With considerable popular enthusiasm, reforms were initiated in various structural policies of the economy such as privatization, labor markets, trade and fiscal policy and in the overall institutional set-up. However, sustaining and completing these reform packages have turned out to be much more difficult, with policymakers having to 'walk the line' between success and failure.[1] On the one hand, in countries such as Argentina, Brazil, Mexico and India, economic reform has continued, albeit fitfully and incrementally, despite their slow progress (Bardhan, 2005; Kohli, 2006). In contrast, despite being successful, economic reform ran into a political impasse in a number of other countries such as Uruguay, Venezuela and Poland at various times over the past two decades (Weyland, 2002).[2] In this paper we develop a unified framework that allows us to analyze the dynamic interaction between the progress of economic reforms and their political sustainability, in a world with imperfect state capacity. In doing so, we throw light on the varied experience with the sustainability of reforms across the developing world, to address three issues. First, why might reforms that are proceeding successfully run into a political impasse? Second, is it easier or more difficult to politically sustain economic reforms in countries where the fiscal capacity of the state is better? Third, we examine the relationship between ethnic polarization and the political sustainability of economic reforms. In doing so we ask: does ethnic discord intensify or mitigate the politics of economic reform?

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[1] For an excellent early survey of the reform experience in developing countries see Rodrik (1996). A survey of the more recent experience is provided in Rodrik (2006).

[2] In a study of 25 transition economies over 1989–2001, Campos and Horvath. (2006) find that for an index of 'privatization' reform, 25% of year-country observations show a stoppage of reforms. The corresponding numbers for the stoppage of 'external liberalization' reforms and 'internal liberalization' reforms are 35% and 28% respectively.

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The political sustainability of reform is directly relevant to the issue of economic growth and development. Hausmann et al. (2005) conclude that the likelihood of sustained growth accelerations is significantly greater when fundamental economic reform is carried out. However, as Rodrik (2006) points out, "What is required to *sustain* growth should not be confused with what is required to *initiate* it" (emphases in original). One of the striking aspects of the growth experience of many developing countries has been that the main difficulty lies not in their inability to initiate economic growth, but rather in sustaining it, with the result that "…their growth spurts eventually fizzle out" (Rodrik, 2006). And this 'fizzling out' may be precisely because of the political difficulties of sustaining reforms under distributional conflict, imperfect state capacity or even the onset of conflict on other dimensions (e.g. ethnic). Despite the long-recognized importance of these issues, (see Hoff and Stiglitz (2001), for an overview), there has been little examination of the dynamic relationship between the unfolding of economic reforms and their political sustainability.

Accordingly, we develop a simple dynamic framework where a government may implement an economic reform that potentially generates economic benefits to the populace. Our first key assumption is that in accordance with much of the recent literature, we assume that governments are unable to pre-commit to tax rates and transfers (see Acemoglu (2003) for an overview).[3] In addition, we follow Fernandez and Rodrik (1991) in assuming that not only do reforms have distributional effects, but that there is individual specific uncertainty, so that an individual does not know whether he will be a 'winner' or a 'loser' from the reform. The distinctive feature of our framework is that the implementation of the reform is dynamic. In our framework this implies that uncertainty is resolved gradually as the identity of winners and losers is revealed over time. At each stage, based on the outcome of the reform so far, the government in power has the option to discontinue any further reform. As in Jain and Mukand (2003), governments have the ability to tax winners to compensate losers. It is worth emphasizing that our framework endogenizes both the government's decision on the continuation of reforms *and* on redistribution, through a political equilibrium involving the winners and losers at each stage. Hence political considerations, of how continuation of reforms may alter political power in the future, have important consequences for their public support (or lack thereof) in the interim, and can lead to reforms stagnating. This is because a loss of political control by the losing sector may result in lower redistributive compensation in the future and may make them more averse to continuing even with reforms that have the potential to raise average income. The actual size of redistributive compensation depends crucially not only on which group (the winners or the losers) is in political control, but also on limitations in state capacity to efficiently administer such compensation. As we show, considerations of state capacity play an important role in determining the dynamic trajectory of support for reforms, by affecting the consequences from maintaining or losing political power.

While simple, our theoretical framework throws light on the dynamic evolution of political support for economic reforms in developing and transition economies. In these countries, reform 'packages' (implementation of which lasted longer than one electoral cycle) included relaxation of wage and price controls, liberalization of trade in goods and capital as well as greater privatization. Such reforms cause major structural changes, typically resulting in unemployment, dislocation and economic hardship. However, not only economists, but most of the general public understands this and still favors their adoption (see Przeworski (1993) for evidence on this in the Polish context).

However, Stokes (2001) highlights a puzzling feature of the reform experience. Drawing on case studies on the reform experience in eastern Europe and Latin America, including Fujimori's Peru over the 1990s (Stokes, 2001), Stokes highlights that "… people sometimes reacted to economic deterioration by supporting the government and its economic program more strongly. Conversely, they sometimes reacted to economic improvement with pessimism and opposition" (Stokes, 2001, p.25). In other words, popular support for the government's economic reform frequently seemed to vary negatively with its performance. So the puzzle is why a majority of citizen-workers may change their mind about continuing with the very policies that they had supported, even though their initial impact is *favorable*. Indeed this political dynamic was strong enough to derail the reforms started under the "Balcerowicz Plan" in Poland, with the resignation of Leszek Balcerowicz in 1991. The comparative reform experiences of Argentina and Uruguay over the nineties is of direct relevance here. As Blake (1998) argues, both countries share many common traits and started out from a very similar economic point with vigorous reform efforts in 1989. However, while the reforms in Argentina continued unabated throughout the nineties, those in Uruguay ran into a political impasse in the mid-nineties, particularly on privatization. This is particularly striking since the reform's economic impact was similar with an increase in average wages (Borraz and Gonzalez, 2009).[4] Furthermore, while the gap in wages between the various skill levels remained fairly constant in Argentina, the gap between the medium and the low-skilled in Uruguay increased during this period.[5] On its own this marginal shift in the wage gap in Uruguay would perhaps not have been decisive. However, together with the fact that the National party of Luis Alberto Lasalle in Uruguay was not as committed to redistribution in a way that the populist Peronist government of Carlos Menem was in Argentina, it is not surprising that there were widespread protests against the continuation of reform in Uruguay, leading eventually to a toppling of the government in 1995. On the other hand, in Argentina, President Menem was reelected to power with a resounding majority in that same year. As our model emphasizes, the importance of the credibility of redistributive promises, over the reform process, is central for its political sustainability.

Our framework provides an explanation for why a reform, even though it may be initially successful and have positive future prospects, may still run into a political impasse. Further, we ask whether there are situations under which such an impasse is more likely to arise. In order to see why a political impasse may emerge, we begin by observing that at any stage, a citizen-worker's political backing of the reform depends on his expected benefits from its continuation. An important part of these benefits, especially for individuals who are *not* winners from the initial stages of reform, is the degree of compensation to be expected from the winners. The ability to extract this compensation, through implementing redistributive taxation, of course depends on retaining political control. We show that both the probability and the expected cost of losing political control is highest when the initial phase of reform has been successful, resulting in a relatively large number of winners. This gives rise to the result that the relative success of the initial phase of reform may actually decrease political support for continuation of the reform, even if such continuation is expected to raise overall income.

For reforms that enhance overall income to also be beneficial for all individuals, it is essential that the state have the capacity to tax winners

[3] There are a wide variety of democracies where governments face electoral pressures yet compensation through a tax-transfer system is imperfect, if not altogether absent. To name but a few: Peru and Bolivia in Latin America; India, Bangladesh and Indonesia in Asia; and Kenya, Ghana and Tanzania in Africa. All of these countries have elections, along with governments which are responsive to populist pressures, *and* have the ability to change tax rates and transfer policies from those of previous governments.

[4] Average wages in Uruguay increased by 7.7% over this period, while the corresponding increase in wages in Argentina was in fact slightly lower at 6.8%.

[5] Data from the CEDLAS (http://cedlas.econo.unlp.edu.ar/eng/index.php) show that the medium/low wage gap decreased by 7% in Argentina, while it increased by 7.2% in Uruguay.