SOME REFLECTIONS ON THE INSTITUTIONAL REFORMS REQUIRED FOR LATIN AMERICA

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INTRODUCTION

The development debate during the 1980's rendered a clear cut, well-trimmed and compact blueprint, the so-called Washington Consensus (Williamson, 1990). This decalogue was -more or less dutifully- adopted by most Latin American countries during the last decade.

The 1990's have provided for a renewal in the mainstream development discourse. The experiences of Latin American countries with market oriented reforms, the unprecedented success and unexpected crash of East Asian economies, the recurrent world financial crisis associated to the ebb and flow of international portfolios, among other experiences,[1] have paved the way for the forging of a consensus around a new paradigm. A new paradigm that stands in contrast with the narrow economicist discourse that dominated throughout the 80's.

The "new paradigm" is in part a complement of the previous reform efforts, and in part a theoretical break.[2] It is complementary in that it does not attempt to dismantle what has been achieved in the previous decade, but rather to strengthen those achievements. It is a break in that new theoretical approaches have a predominant voice in the new discourse.

The development discourse of a few years ago was broadly dominated by the tune of vainilla neoclassical economics: let the markets free, and they will take care of most of the societies' problems. The new discourse is not a uniform tune, but a poliphony; the most vibrant new voices are different streams in the social sciences such as the new institutional economics, the new institutionalism, and the new political economy.[3] In a nutshell, this renewed conventional wisdom is grounded on the fundamental premise that *institutions are crucial for development*. And it is from this standpoint that the need for "consolidating" the reforms "initiated" under the blueprint of the Washington Consensus has become the imperative guiding Latin American reformers (Haggard and Kaufman, 1995).

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[1] [experience of the multilaterals in Africa; learning from the post-communism processes, etc]
[2] One might add that it is also in part a change in the emphasis given to different policy areas – although that change might be folded back into complementarities and theoretical break.
[3] See Saiegh and Tommasi (1998b) for an introduction to the intelectual dynamics of these approaches.

It is under this light that a new program of reforms for Latin American countries is being crafted. This program intends to deal with the challenges that come about in a post-structural adjustment and market-oriented reforms scenario. Furthermore, the requisite to seize the ‘benefits’ that the market delivers is a redefinition in the areas and capacity of intervention of the State, in all of its dimensions and with emphasis in the provision of safety nets for the vulnerable population. More specifically the efforts seem to be geared towards attaining a more efficient and legitimate public sector.

The crux that this new vision puts forward is that Latin America’s institutional feebleness constitutes a major bottleneck for the needed fundamental transformations. And this is why the required reforms are said to be institutional in essence.

The developing consensus is rather lax –especially if compared to the tight set of policy prescriptions with which the orthodox paradigm had come about-. In point of fact, there is no one policy manifesto summing up the reforms that Latin America ought to be implementing in the next decade. Yet, many have attempted to draw together this growing consensus in a reform program for the region.

The second generation reform agenda contains prescriptions regarding different aspects of public policy. In particular, it puts forward the policy areas which governments should address; it contains specific policy recommendations for each particular area, and outlines some principles, which should permeate governmental decisions in order to come to successful institutional reforms.

The agenda claiming, recommending and defining the character of the ‘required’ institutional reforms is broad and it comprises a wide variety of themes. While it makes clear reference to the issues to address and the means by which to do so, the design and sequencing of the policies to implement remains unresolved. Moreover, as Joseph Stiglitz has asserted, one of the peculiarities of this “post-Washington Consensus” is that it will not be based in Washington anymore (Stiglitz, 1998). Being country specific, the maximum aspiration that such a reform program may have is to propose the ‘tools’ and general path, which will help each country to undertake this endeavour.

There have been many attempts to crystallise this new agenda in a simple and clear-cut decalogue, such as the one portrayed in the Washington Consensus. Yet, scholars, politicians and policy makers still present a variety of interpretations on the issue.

Section I below provides a brief presentation of some of the fundamental aspects of this new agenda, organized around new policy areas, new policies, and new organizing principles. Section II attempts to clarify the notion of institutions implicit in the discussions and suggests a change of focus. Section III illustrates the approach suggested in Section II through an exploration of fiscal federalism in Argentina.[4]

I. THE SECOND GENERATION REFORMS AGENDA

I.1. The 'New' Policy Areas

Underlying the diversity of policy issues that the proponents of this new agenda bring forth is the realisation that what lies at the core of this renewed debate is a redefinition in the way in which the state provides public goods and services. From this standpoint, different authors underscore or give priority to different policy areas for which the intervention of public powers should be redefined.

Moises Naim has been among the first scholars to gather the ideas around which a consensus had been evolving. In "The Second Generation of Reforms" (1994) and "Latin American Post-Adjustment Blues" (1993) the author attempts to give shape and meaning to what is now known as the second generation reforms. The author concentrates on different aspects of this new agenda, or 'second stage of economic liberalisation'. Naim defines these reforms by opposition to the stage I: pure market oriented reforms, yet, the characterisation –as we can see in Table 1- is very broad.

[4] This is a good point to remind the reader about the preliminarity of the paper and about the tentativeness of the ideas we run the risk of sharing here. The reader will notice that Section III is longer than the previous ones, and might wonder why he/she has to suffer through some gory details of fiscal arrangements in a particular country when reading a paper on "required institutional reforms for Latin America." This is in part due to the incomplete nature of the paper, but as we will argue in Section II, it is also due to our view that it is

Table 1: Two Stages of Economic Liberalisation		
	Stage I	**Stage II**
Priorities	• Reduce inflation • Restore growth	• Improve social conditions • Increase international competitiveness • Maintain macroeconomic stability
Reform Strategy	• Change macroeconomic rules • Reduce size and scope of the state • Dismantle institutions of protectionism and statism	• Create and rehabilitate institutions • Boost competitiveness of the private sector • Reform production, financing, and delivery of health care, education, and other public services • Create “economic institutions of capitalism” • Build new “international economic insertion”
Typical Instruments	• Drastic budget cuts and tax reform • Price liberalisation • Trade and foreign investment liberalisation • Private sector deregulation • Creation of social “emergency funds” bypassing social ministries • “Easier” privatisations	• Reform of labour legislation and practices • Civil service reform • Restructuring of government, especially social ministries • Overhaul of administration of justice • Upgrade of regulatory capacities • Improvement of tax collection capabilities • Sectoral conversion and restructuring • “Complex” privatisations • Building of export promotion capacities • Restructuring relations between states and federal government
Principal Actors	• Presidency • Economic cabinet • Central Banks • World Bank and IMF • Private financial groups and foreign portfolio investment	• Presidency and cabinet • Congress • Public bureaucracy • Judiciary • Unions • Political parties • Media • State and local governments • Private sector
Public Impact of Reforms	• Immediate • High visibility	• Medium and long term • Low public visibility
Administrative Complexity of Reforms	• Moderate to low	• Very high
Nature of Political Costs	• “Temporary corrections” widely distributed among population	• Permanent elimination of special advantages for specific groups
Main Governmental Challenge	• Macroeconomic management by insulated technocratic elites	• Institutional development highly dependent on midlevel public sector management
Source: Naim (1994)		

neccessary to dwelve into details of political history in order to make more useful suggestions for institutional reform.

Many others have taken stance on this debate. The World Bank's position regarding the reform priorities for Latin America are summed up in two documents: "The Long March" (1997) and "Beyond the Washington Consensus: Institutions Matter" (1998). In "The Long March", the task is conceived as one of institutional reforms in five broad policy areas (Burki and Perry, 1997). Namely, the development of human capital, improving financial markets, enhancing of the legal and regulatory environment, increasing the quality of public sector governance and fiscal strengthening. In particular, there is an explicit reference regarding public sector governance and fiscal strengthening as preconditions for the reform program.

"Beyond the Washington Consensus" concentrates only on some of the many aspects contained in the five original policy areas. In particular, the 1998 report concentrates on institutional reforms regarding banking and capital markets, education, justice and public administration. The report uses the new institutional economics to justify both the need to develop institutions in these markets or hierarchies, and the prescriptions for each policy area.[5]

The new agenda proposed by the IDB (IDB, 1997) enshrines four objectives: deepen market reforms, reduce the sources of volatility, accelerate the accumulation of human capital and broaden the tools for pursuing equity. In point of fact, the policy areas that it depicts are the following: trade policy, financial policy, tax policy, privatisation, labour legislation, monetary policy and savings, fiscal policy, education levels, factor markets and government institutions. Notice the broadness of the list, not only in terms of how many areas of policy are covered, but also how many different institutional levels are involved, a point which will be the center of our later discussion.

In essence, the two major multilateral development banks propose a similar array of issues for the region to address in the near future, major differences stem from the prioritisation

[5] The only reference to the policy reforms proposed in the first report for other policy areas is through the synergies that are generated between the aforementioned policy areas and public sector and legal/regulatory

and emphasis on each issue. IDB's agenda seems to prioritize the macroeconomic components of this agenda.

I.2. The 'New' Policies

Unsurprisingly, the sweeping transformation this new agenda propounds renders numerous and diverse policy recommendations. It has been mainly the multilateral development banks the ones that attempted to underpin the policy prescriptions comprised in each policy area. At this point it is important to note that the consensus around the policy prescriptions is less clear, and therefore brings forward the need to develop more accurate and pertinent tools with which to address the new priorities –what entails further research-. Yet, in essence, the recommendations between the reform programs of the WB and IDB are quite similar.

The recommended institutional reforms intend to improve information and enforcement problems likely to arise in the provision of public goods and services (public goods and services understood as ranging from the provision of a good quality health care system to regulating the private provision of public services or providing an appropriate legal environment). The Tables 2 and 3 show some of the main policy prescriptions.

TABLE 2
The World Bank's Reform Program for Latin America in the Next Decade

Policy Area	Premises	Reform Program
I. Quality Investment in Human Capital	The degree of human capital development (i.e. the health and skills of the labour force) determines competitiveness and productivity levels in the medium and long terms. Improving the efficiency and quality of education and health services will improve that quality of the investment in human development, and will enhance the poverty reducing effects of economic growth (especially in the case of education services).	The program comprises institutional reforms regarding the incentives of the educational and health system, it includes: - Fostering school autonomy under parental and community control - Extending the time of attendance to school (through an extension of both the school-day and school-year) - Remunerating teachers on performance basis - Reforming teacher training institutions - Increasing the provision and educational content of public and private day-care services (especially for the poor) - Promoting competition among public and private providers - Separating financing from delivery institutions in the health services - Improve health institutions capacity and performance (making them more autonomous and responsible for performance) - Regulating the private provision of

reforms.

		health services - Controlling for the number and quality of medical school graduates
II. Sound and Efficient Financial Markets	A weak financial system is a threat on macroeconomic stability. The development of banking and capital markets increases investment at the same time that it makes for a more efficient resource allocation. The concentration of the access to financial markets obstructs the job-creation and poverty-reduction effects of economic growth.	Modern norms and supervision strengthen financial institutions, they include: - Privatising inefficient state- owned banks - Allowing foreign competition in banking services - Stimulating the participation of non financial institutions in the reception and placing of funds - Improving regulations and supervisions of financial markets - Fostering domestic and foreign competition - Intervening to develop deep and liquid bond and equity markets - Integrating segmented markets for microenterprises in the rural and housing sectors
III. Improvement of the Legal and Regulatory Framework	Property rights and adequate juridical and regulation systems are crucial to growth since they foster greater and more efficient investment. Moreover, they are a necessary condition to incentivate private sector investment in infrastructure, public and social services. The precarious nature of property rights is an important obstacle to move out of poverty. Excess regulation, especially in the labour market, fosters activities in the informal sector and stimulates patterns of growth that economise in labour costs, and so limit the poverty-reducing effects of growth.	In order to reduce uncertainties and operation costs, the program comprises: - Raising the protection provided by property rights and contracts - Widening the programs for granting property titles - Formulating efficient competition laws - Eliminating unnecessary or inefficient regulation of the economic activity, through reforms in the labour market (which comprise: increasing flexibility for hiring and collective bargaining; reforming the system of severance payments; and reducing –if fiscal conditions allow- the tax on the use of labour), and in the normative frameworks for private investment in infrastructure and social services (including: better normative frameworks; establishing autonomous regulatory agencies with highly competitive officials; and improving the distribution and management of risks related to private investment in infrastructure)
IV. Public Sector Quality and Governance	The efficiency, responsibility and trust that governments have are a precondition for the proper design and execution of these reforms. The quality of government is critical for development, since it affects investment and economic growth. Governments should be capable of confronting crime and violence, since they are a challenge to economic growth. The objective is to increase public sector governance, orienting governments towards results, making them responsible and transparent, and strengthening the rule of law.	These objectives can be achieved through an: - Efficient decentralisation of the public administration and the responsibilities of public expenditure (for which an efficient local taxation and revenue sharing systems are fundamental) - Public administration reforms (improving the incentive structures operating in the organisations: improve remuneration and compensation systems for public employees, adopting ‘performance contracts’, and articulating new institutions in this framework: such as regulatory agencies, etc.) - Judicial power and criminal justice reforms (promoting law studies, improving the administration of courts, promoting judicial capacitation, developing alternative mechanisms for conflict resolution and improving

		general access to the system) - Improving the quality of government
V. Fiscal Strengthening	Fiscal strengthening is the other precondition for the success of the whole program. In a world where financial integration and instability in capital flows are the rule, fiscal prudence and flexibility are the cornerstones of macroeconomic stability -the fundamental condition of growth-, helping to increase domestic savings rates, allowing adequate levels of investment in human and infrastructure development. Furthermore, fiscal strengthening increases efficiency and promotes equality.	The program to improve resource allocation and promote efficiency in tax collection comprises: - Social security reforms: to assure the financial viability of the social security systems and to cover the obligations for which financing had not been anticipated - Fiscal reform at subnational levels: in order to prevent the undermining of adjustment policies at the national level by inadequate fiscal policies at subnational levels or deficient formulation in the revenue sharing mechanisms - Adequate budgeting and financing of other types of eventual passives (cuasifiscal operations of central and state owned banks, and the guarantees to exporters and private investors in infrastructure).
Source: based on Burki and Perry (1997) "The Long March", World Bank, Washington D.C.		

TABLE 3
The Inter American Development Bank's Agenda of Economic and Social Policies

Objective	**Recommended Policies**
Deepen Market Reforms	• *Trade Policy:* further unilateral trade opening and efforts to bring convergence of regional agreements (adoption and harmonisation of rules regarding non-tariff restrictions and resolution of trade conflicts, and adjusting to the commitments of WTO) • *Financial Policy:* deepen financial reforms in the areas of regulation and supervision - Adoption of adequate accounting systems so as to facilitate proper classification of assets by risk considerations, register in a timely way changes in valuation of assets, and make it possible to follow changes in portfolio quality quickly and accurately - capitalisation requirements linked to risk of all assets, in no case less than those established in the Basel Accords and ideally greater, in view of the more volatile economic atmosphere in LA countries - Standards to limit the concentration of loans or granting of credit to companies or individuals with ties to the owners or management of a financing agency - Legal standards setting strict and transparent conditions for creating new financial entities, which take into account the procedures to be followed and actions to be taken by authorities in the event of a crisis - Supplementing government supervision through the use of outside auditors and private risk assessment agencies - Complementary domestic oversight of banks that have foreign capital with overseas supervision - Requirements that accounting information on financial entities be released publicly, with a view to making it easier to monitor by the market • *Tax Policy:* complete the reforms (neutral and rational tax structure) already in progress and: - increase collection through direct taxation, mainly the income tax - rationalise selective consumer taxes - improve management of the VAT, extending bases and in some cases lowering the rates - revise tax powers between levels of government and shared tax systems, stimulating the development of taxation at subnational levels of government - modernise models of tax management and strengthen the functions of assigning taxes, collecting and court procedures

	- bring procedures for tax administration into line with the process of international economic integration • *Privatisation:* the sequence in this area is as follows: - Sell state owned companies in areas of industry, finances and others that are now operating in a free competition framework to the private sectors - Establish regulatory frameworks - The primary objective pursued by privatisation is economic efficiency - Avoid capital investments before companies are privatised, focus on administrative reorganisation, clean finances and cutting back on personnel - Pay attention to the social costs of the unemployment that may ensue - Allow the market to set transaction prices, with payments preferably made in cash - Assure that the entire process is legally, administratively and operationally transparent • *Labour Legislation:* must strive to facilitate job creation, but must keep in mind the need to stabilise worker incomes and avoid segmenting the market according to the social protection regulations enjoyed by the workers. The goals are: - reduce the tax character of payroll contributions and charges intended for social security programs, and instead tie them to the individual benefits that workers derive from such programs, so that they may be perceived as part of their pay (e.g. from the traditional pension system to the individual capitalisation systems) - eliminate factors of uncertainty of labour costs, especially those derived from dismissal costs connected to worker seniority - seek to stabilise incomes rather than worker's jobs - grant the same social security and other benefits to temporary workers and workers in different occupations. Allow flexibility in a wider range of job categories - reduce wage rigidities imposed externally on the parties contracting a labour arrangement - nevertheless, a policy of stable real minimum wages compatible with high levels of unemployment should be maintained - improve the management of government employment services - reduce state monopoly over labour training
Reduce the Sources of Volatility	• *Monetary Policy and Saving* • *Fiscal Policy:* - set a maximum limit on the fiscal deficit through legal norms or requiring governments to adhere to macroeconomic programs that will assure the consistency of macroeconomic variables and will anticipate the policy action that will be necessary in order to prevent unwanted fiscal imbalances from occurring - dismantle systems for transferring fiscal resources
Accelerate the Accumulation of Human Capital	• *Raise education levels of the work force:* the main challenge is one of organising, it should follow this criteria: - budget allocation on the basis of the quantity and quality of service provision - transfer to schools the decision making responsibilities in hiring staff and financial and management administration - setting standards of quality and proof of performance that are universally applicable - providing information and technical, management and academic help to schools and to their management bodies and services - encouraging the participation of communities and parents in oversight over school administration - granting parents a chance to choose between schools - the centre of attention should turn increasingly towards secondary education - stimulate demand for education through demand subsidising
Broaden the Range of Tools Pursuing Equity	• *Restructuring Factor Markets:* broadening and democratising access to the productive resources: - reform labour codes - design and implement mechanisms for evaluating and monitoring credit risks of small borrowers - strengthening mortgage financing systems • *Restructuring of Government Institutions:* inequitable access to government

	services and to decision making bodies in government and other public institutions have an influence on the characteristics and persistence of inequality - development of social insurance institutions - develop institutions for handling conflict
Source: based on IDB "Latin America After a Decade of Reforms" (1997:77-82)	

I.3. The 'New' Universal Principles

The broadness and diversity contained in this agenda is tempered by some general/universal principles, which permeate it throughout. These principles have become the banners raised –especially by the multilateral development banks- for the sake of the consolidation of the macroeconomic goals attained through the market oriented reforms in course. As Casaburi and Tussie have noted: "these reforms can only be politically feasible, sustainable in the long term and achieve their expected results, if they are carried out under specific conditions: legitimate governments, adequate economic regulations, active participation by those most directly affected, a capable and honest civil service, and a decentralised system of policy implementation that generates accountability at all levels. Put together, these new conditions become increasingly packaged under the catch-all word *governance*." (Casaburi and Tussie, 1997).

The principle guiding the second generation reforms recommendation is *governance*. Governance is a broad and ample concept, which –according to a definition proposed by the UNDP- refers to "the exercise of economic, political and administrative authority to manage a country's affairs at all levels. It comprises the mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their interests" (UNDP, 1997:2). That is, governance rests on three legs: the decision making processes affecting a country's economy, policy and system of policy implementation. The amplitude comprised by this concept provides the specific countries of broad margins to adapt the wide, general prescriptions to certain –unrevealed- specific characteristics of each particular country.

More specifically, it is *good governance* –as a necessary condition for sustainable human development- what the second generation reforms agenda seeks. Good Governance "addresses the allocation and management of resources to respond to collective problems;

it is characterised by participation, transparency, accountability, rule of law, effectiveness and equity". Furthermore, Good Governance encompasses and comprises the state at the time that it transcends it, by including civil society and the private sector. The underlying theme is not far from the topic that has dominated social and political thought throughout history: the characteristics of government and its relationship with the governed.

In the light of this principle, the UNDP proposes reforms in the following fields: governing institutions, public and private sector management, decentralisation and support of local governance, civil society organisations and governance in special circumstances (crisis and transition).

At this point, one can identify a set of all encompassing strategies, which are proposed as the means by which to attain good governance; one of which is *decentralisation*. In particular, decentralisation is seen as conductive to good governance in that it enables more direct participation, at the time that it enhances empowerment –especially of disadvantaged groups-, more accountability, transparency, responsiveness and social efficiency –in that the provision of public goods and services is tailored to local needs. In particular, decentralisation is advocated more strongly in what regards the provision of social services, at the time that is conceived as an institutional reform strategy leading to good governance.

Both participation and decentralisation are conceived as general principles/strategies by which countries can attain their development goals. These prescriptions have been spread, not only in Latin America, but throughout the world, and transpire from most of the projects assisted financially and technically by international development organisations.

II. INSTITUTIONS AND REFORMS

The process from the first wave of reforms (and the economic reductionism that sustained it) to the second generation reforms (and the recognition of the importance of politico-institutional and social factors in macroeconomic change), still today maintains a blurry boundary between politics and economics. The synthesis contained in the previous section, shows novelties in policy areas, policies and universal principles, and nevertheless also shows problems in its approach towards institutional change and policy making. This section addresses some of these problems from a conceptual point of view.

II.1. Revisiting the meaning of *institutions* and *institutional reforms*

Stemming from North (1990) and Knight (1992), we consider institutions as sets of rules that structure interactions in particular ways. For a set of rules to be an institution, knowledge of these rules must be shared by the members of the relevant community or society. Institutions imply the notion of equilibria. Up to this point there seems to be little disagreement with fairly standard approaches to the issue.

Knight (1992, chapters 1 & 7) has pointed out that both, classical and contemporary theories tend to stress two alternative understandings of institutions, their emergence and change. On the one hand, those that stress the collective benefits that institutions offer to the community as a whole, highlight the role of institutions as rules that solve coordination problems. In this setting, institutions offer incentives aimed at solving collective action problems. Beyond their differences, classical authors as Hobbes, Hume, and Smith and contemporary ones as Arrow, Olson, Bates and North, share the basic understanding of institutions as solving coordination problems.

The second trend in the explanation of institutions stresses the differential benefits that institutional arrangements allocate among diverse social groups. In this sense, the focus of attention is on the impact of institutions on the competition among different and conflicting interests. The emphasis is therefore on the distributional effects of institutions and the conflict inherent in those effects. The marxist and weberian traditions, as well as the work of contemporary authors as Przeworski and Knight reflect this understanding of institutions.

Our work attempts to break away from the dichotomy coordination versus conflict, by considering institutions as rules that aim at solving coordination problems <u>and</u> distributional conflicts. Institutions tend to solve coordination problems by stabilizing social expectations through the provision of information and sanctions, thus structuring behavior in the direction of equilibrium outcomes. On the other hand, these outcomes are not neutral with respect to conflicts of interests, implying that the equilibria achieved necessarily entail resolutions of distributional conflicts.

In other words, for institutional reforms to be socially desirable they have to be changes or introduction of rules that transform the strategies of the actors from defection to cooperation in a way that the outcome constitutes an equilibrium collectivelly benefitial. We know that the improvement of the collective situation can, nevertheless, show situations where one equilibrium is Pareto optimal (neither actor can be better off without the others being worse off) and Pareto superior (a change from any other alternative towards the outcome makes at least one actor better off without making the others worse off) to other alternatives, and the problem is strictly of coordination.[6] On the other hand, institutional reforms might face situations where there are multiple potential equilibria that are Pareto optimal and superior to the initial conditions, but, nevertheless, are not Pareto improving vis-a-vis each other. In this last case, different actors will prefer different future equilibria, i.e., different institutional reforms, and therefore, face a conflict of interests instead of a coordination problem. (Przeworski, 1997).[7]

The issue becomes a bit more complex when we move beyond the recognition that institutional reforms can deal in some cases with coordination problems and in others with conflicts. That they might also deal with coordination problems <u>and</u> conflict of interests simultaneously, that is, within the same case. Institutional reforms are not extended games played by two homogeneous actors that face symmetric choices and payoffs. The complexity of processes of institutional reforms usually stems from the fact that, a) the participant actors are numerous with diverse interests and capacity to act (power); b) these actors act in a number of interrelated settings with different rules, choices and asymmetric payoff matrixes; c) these processes of reform, by definition, entail changes that take place in a series of steps that modify or affect all of the above: in a process of change the distribution of resources varies, the participant actors themselves might vary (at a given time of the process of change old actors are displaced by new ones) and the rules are

[6] We are using "coordination" in a broad sense, to include many aspects of "intertemporal exchanges", to be explained in section III.
[7] Although Przeworski´s arguments refer to "pacts," we consider the way in which he analyzes the dynamics

redefined. In this sense, institutional reforms should not be understood as the same game that is repeated (an extended game) from one equilibrium to another.[8] The relationship between the initial and new equilibria resulting from the reform, hides a series of different games, some of which are nested in the sense that the dynamics of one affect those of the others (Tsebelis, 1990), and others are concatenated in a way that the resolution of a game sets the initial conditions for the following one. In this series of, some simultaneous and some concatenated, different games that constitute the process of a given reform, some of the games may embody problems of coordination, and therefore admit a Pareto improving solution, and some others may be of conflict of interests. Institutional reforms can, and very often are, complex processes that entail problems of coordination <u>and</u> of conflict of interests.

Therefore, the understanding of institutions and institutional reforms implies considering both, the Pareto improving aspects of institutions and those institutional features that result from or have an impact in asymmetries of power and conflict of interests. If, on the one hand, power is understood as the capacity to achieve objectives and realize interests and, on the other, institutional arrangements assign differential probabilities of success to the diverse social interests and actors, institutions are nothing less than the social organization of power (Przeworski, 1986), and therefore their reform seldomly is isolated or neutral vis-a-vis conflicting interests and objectives. Politics can not but be at the core of institutional reforms. (Shepsle, 1998).

II.2. Institutional architecture (R1, R2 and R3)

Interests are affected by rules/institutions that operate at different levels. The way in which these different rules interact structures the set of options and differential probabilities of success that actors face when they plan and implement strategies. This institutional realm structures the problem related to institutional reforms.

Rules can be formal (defined by positive law or regulation) or informal (shared understanding about how something works either when is not covered by formal rules or

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of pacts applicable to institutional reforms.

[8] This also coincides with Przeworski, although when he argues that transitions are not extended games he is refering to transitions to democracy (Przeworski, 1992, p. 106...).

when it contradicts them). Non credible formal rules are usually acompanied by effective informal ones. When they are not, chaos or anomy reigns (Nino, 1992). Nevertheless, real life behavior seldomly results from one or the other type of rule: it tends to reflect varying causal mixes of institutional formality and informality.

Rules or institutions, formal and informal, can be classified as a function of the level of their domain.

First level rules, R1, deal with specific outcomes or contents as, for example, increasing fiscal revenue 10%. A law or regulation establishing who pays and how much is paid as income tax is an example of this type of rule. Another example is a law or regulation that establishes sanctions for those that do not comply with fiscal obligations. An example of R1 informal rules would be a shared social undestanding that if you bribe the tax collector or are the President´s lover, you don´t pay and don´t suffer the consequences established by the R1 formal rules. In equilibrium the rule is taken as a given: actors will maximize their interests implementing strategies as a function of their resources and the structure of options defined by the more credible rule. Therefore, they might vary their level of investment, consumption, savings or, simply, hide income. Different dominant strategies will result in the achievement or frustration of the objective (10% fiscal revenue increase) and in socially optimal or suboptimal outcomes. R1 rules structure the options for the actors´strategies and determine specific outcomes related to given issues.

Second level rules, R2, determine the rules that determine specific outcomes. A law that identifies the decision making actors and defines the way they decide, for example, who pays and how much is paid as income tax, falls within the R2 formal category. What can and must be decided in terms of the specific issue (taxing in our example) by the national government versus the provincial or municipal ones, or by the Executive or a branch of the Executive (a Ministry) versus Congress, would be the typical content of a formal R2 rule. In case the formal R2 were not credible, a hypothetical informal counterpart could be telling us that the board of the big corporation that has the President and an important number of representatives in its payroll is the locus of decision. Informal rules do not have to refer to corruption, sometimes they can be linked to political dynamics and distribution of power within the law: an alternative informal counterpart to the above mentioned, could be telling us that, given its influence over an important portion of the voters, the executive secretariat of the Workers´Central is the effective locus of decisions related to the labor market.

Third level rules, R3, are those that govern the lower level rules (R2) that determine the even lower level ones (R1) that induce specific outcomes. R3 laws define who makes and how laws are made in general terms (that is, beyond specific issues). In this sense, R3 institutions define political participation and decision making processes at the social level. They define the nature of the political regime. Examples of formal R3 institutions are, obviuosly, constitutions. Examples of informal R3 institutions could, for example, take the form of rules that state the predominance of the Executive over the Judiciary in any matter that affects the former.

Again, as in the case of the way formality and informality of rules determine behavior, this classification can not be clear cut. On the one hand, we could disaggregate rules and institutions in more than three levels. We could define R1 rules as institutions that aim at enforcing the rules that affect specific outcomes. In this case, the rules and regulations that define the organization and actions of an Internal Revenue Service would be R1 and, therefore, the law or regulation establishing who pays and how much is paid as income tax woud turn R2; the law that identifies the decision making actors and defines the way they decide who pays and how much is paid as income tax, falls now within the R3 formal category and, finally, those rules like the constitution, that govern the lower level rules (R3) that determine the even lower level ones (R2) that induce specific outcomes and generate the need to define the way in which the R2 rules will be enforced (R1), are pushed to the R4 level. At this point, so many levels can turn the issue more obscure than it is, so let´s leave it at three levels.

On the other hand, real life rules and their content are politically contingent to historically anchored processes and do not necesarilly respect logical classifications. In other words, while some societies show R3 rules that include strong R2 and even R1 components,[9] other

[9] For instance, the Brazilian constitution of 1988 pretends to regulate even the interest rate.

cases show R2 laws that incorporate the constitution/organization of enforcement agencies for whatever future lower level specific decision that might result from it. Our suggestion is not that institutions follow an organization by levels or interconnected layers as the ones described and that concrete institutions do not mix levels. Our claim is that institutional functioning demands a hierarchical division of functions. Moreover, and more relevant to our discussion, we also claim that recognizing this hierarchical division of functions not only helps to understand the way institutions work, but also affects the behavior and strategies of actors, a central issue to analyze the feasibility and probability of success of institutional reforms. Let´s turn to this.

II.3. The uneasy road of required institutional reforms

In section II.1. we argued that a process of institutional reform should be understood as a series of nested and concatenated games that embody problems of coordination as well as of conflict of interests. If institutions are in equilibrium, actors will act strategically within the given rules. Nevertheless, if actors find that within the given R1 rules their interests are not realized, their strategy might “shift” towards a higher level of action with the objective of modifying the rules.

The strategies of the actors might move from taking the rules as a given to lobbying over those that decided the contents of R1 in order to obtain its reform in a direction more functional to their interests. To follow our example, actors would in this case pressure the decision makers to, for example, lower the income tax. In this case, actors face incentives to depart from institutional equilibrium. If they are not succesfull in modifying R1, they might resort to political alliances in order to change the higher level rules (R2) that determine the decision making process that affects their interests. To vary the income tax they now attempt to change the rules that determine the way it is decided. If, finally, they become convinced that no possible rule related to the specific issue of their interest can be modifyed to their advantage, they might aim at changing the political system as such. They might attempt to exclude all together from the decision making process those actors or voters that cause a non favorable distribution of power for their interests, for example promoting and supporting a coup d´etat.

When actors "move" or "extend" their strategy from one level to the other, they not only take further distance from the original equilibrium point. They also face different settings where the rules of conflict resolution, decision making and also actors change, as well as the potential impact of their organizational and political resources change. This means that when actors plan their strategies, their options include taking the rules as a given or trying to change the rules. And if the choice is the latter, institutional reform implies choosing (and sometimes shifting back and forth) among different strategic settings. In other words, choosing among the different games entailed in the different levels that characterize the institutional structure.

Institutional reformers can not but be strategic actors. As such, not recognizing the different games they face, the ways these games interact or the implications of aiming the strategies at one level and not the other, might prove fatal to the success of the reform (and as the Latin American history shows, might sometimes prove fatal to the reformer himself).

From our arguments about the notion of institutions and institutional reforms, as well as about the structure of the problem of institutional reform, we draw some conclusions that depart from the mainstream understanding on the issue.

When we see institutional reforms through the eyes of the multilateral banks documents and most of the current literature, politics is still very much divorced from economics, or macroeconomics from institutions.

The first and second generation reforms tend to be characterized as the difference between macroeconomic and institutional reforms. "Macroeconomic reforms are considered those that center on changing the rules guiding macroeconomic behavior; that were adopted by the executive branch in relative isolation from the rest of the political system; and new policies imply the dismantling of many existing agencies, rather than the building of new organizations. Institutional reforms are considered quite different because thay are supposed to entail changing organizations and establishing whole new sets of rules: the creation and development of the institutions needed to support the new economic policies as well as the upgrading of existing agencies devastated by decades of neglect, underinvestment, and capture by special interests" (Graham & Naim 1997).

We feel uneasy with this generalized understanding. It leaves aside the recognition that all the reforms that took place were institutional, and therefore political. From the very first macroeconomic reform of the "first generation," rules were redefined and distributional effects took place. Furthermore, an economic reform (which attempts to modify the behavior of economic agents) cannot be successful unless it is credible (Rodrik, 199x). Credibility refers not to the current policy vector, but to the expected future policy vector. In forming expectations about future policies, economic agents are very concious about the rules for changing policies (i.e., institutions).[10]

We will also argue that the strategies of reform have relied on universal blueprints that focused on the redefinition of R1 rules with some impact at the level of R2. Two are the problems of this approach towards reform. First, the universal blueprints that guide the reforms tend to assume that specific contents and outcomes of the reforms have general validity. Second, **the priority on the achievement of specific outcomes has undermined the possibility of assigning central importance to political rules and decision making processes.**

In this sense, our main argument is that the required institutional reforms should not adopt the form of a new blueprint that confronts with old ones. To do this would be to assume that the reformers know what to do in every contingent state of the world, something that although not feasible is, nevertheless, an assumption behind every list of universal recommendations that constitute each blueprint.[11] The uneasy road of the required institutional reforms has to go beyond the blueprint and aim at the generation of certainty about rules while bearing uncertainty about outcomes. Bringing politics back in implies to stress the need to build more efficient R2 and R3 rules, leaving specific outcomes open-

[10] Even though nothing about this was spelled out in the Williamson decalogue, successful reformers understood it all too well (think of the Convertibility Law in Argentina, for instance).

[11] The attempt to provide a detailed menu (even though all the offered dishes are seasoned with references to *participation*) is similar to an attempt to suggest writing "complete contracts," something that has been long discarded in the contract literature in economics even for much simpler exchanges than the process of Latin American reforms (see for instance Hart and Holmstrom 1987 and Milgrom and Roberts 1992).

ended.[12] **The institutional reforms that are strategic in the long run are those that assure better and more stable rules and not contents. The contents should be the object of good decision making in each society. Good contents without good rules call for disaster once tutelary powers loose the upper hand.**

III. EXPLORING A NEW APPROACH THROUGH AN EXAMPLE

The Case of Argentine Federal Fiscal Institutions

In this section we illustrate our suggestion of "focusing on R2 and R3" using the case of fiscal federalism in Argentina. After an introductory description of the system, we summarize the evidence about its many defficiencies. We then summarize the changes suggested by most analysts. We argue that those suggestions, by ignoring the political logic that lead to the current situation, are not going to be succesfull unless there are complementary changes in the political decision making process. In order to find out what type of R3 changes are necessary, we explore the evolution of the system through the lenses of the "transaction-cost politics" approach; and suggest an agenda of institutional reform on the basis of that.

Argentina, a federal country consisting of 23 provinces plus the (recently) autonomous city of Buenos Aries, is the most decentralized country in Latin America, with approximately 50 % of total public spending occurring at the subnational level (IDB, 1997). At the same time, it has a high degree of vertical fiscal imbalance. From 1985 to 1995, an average of only 35% of provincial expenditures were financed by taxes collected directly by the authorities of each province, while the remaining 65% were financed from taxes collected by national (federal) authorities. The process by which these taxes, once collected nationally, are then allocated between the national government and across the provinces, is generically referred to as "*Coparticipación Federal de Impuestos*" (federal tax-sharing agreement). The first such regime dates from 1934 and the current law dates from 1988.

Throughout the years, the underlying legal framework of the tax sharing system was repeatedly altered and it has been the source of numerous conflicts. These periodic

[12] This is consistent with Przeworski's arguments about democracy (1986) and political pacts (1997) in the

modifications led to a current situation where the whole system has reached a high level of complexity. As many observers have shown, this intricate scheme (christened "fiscal labyrinth") does not correspond with any economic criteria, and provides all sorts of perverse incentives for the provincial leaders to overexploit the common pool of national taxation.[13] We provide below an abridged listing of its main shortcomings (for more details, see Saiegh and Tommasi 1998 and references there.)

III. 1. The shortcomings of fiscal federalism in Argentina

- Lack of "Fiscal Correspondence": The high degree of vertical fiscal imbalance in Argentina, coupled with the relatively large fraction of government services provided at the sub-national level, contributes to create a common pool problem across provinces. This induces provincial governments to behave as if they did not face a hard budget constraint, increasing spending and reducing local tax effort

- The Bailout Problem: (a dynamic version of the common-pool problem). It refers to the fact that higher levels of government are likely to bail-out lower levels of government in financial distress, generating a moral hazard problem that undermines the incentives of lower units to behave in fiscally responsible ways.

- Perverse Intertemporal Fiscal Behavior: Both Keynesian and neoclassical macoreconomic models recommend countercyclical fiscal policy, to help to smooth out business-cycle fluctuations. Empirical evidence for OECD countries has found a behavior roughly consistent with these recommendations. Argentina, on the contrary, as most of Latin America seems to "suffer" from procyclical fiscal policy, magnifying aggregate economic fluctuations. Several authors have argued that this behavior in Latin America is related to the behavior of multiple fiscal authorities in decentralized settings. In the case of Argentina, we have found preliminary evidence that fiscal behavior at the provincial level is highly procyclical and that this is, in part, caused by the tax-sharing system.[14] As an illustration, Figure 1 shows the rates of growth of GDP

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sense that they create certainty about rules but uncertainty about outcomes.

[13] See, for instance, Aizenman (1998), Bird (1993), Fundación de Investigaciones Económicas Latinoamericanas (1992), Porto (1990), Piffano (1998), Interamerican Development Bank (1997), and World Bank (1992) and (1996).

[14] In relation to that, many authors have argued that the tax-sharing system makes fiscal adjustment much harder to attain. Recent evidence is provided by stabilization efforts during the Alfonsín administration

and of aggregate provincial spending for the last ten years. The two are highly correlated, with provincial spending over-responding to the fluctuations in output. Also, the instability of coparticipation funds seems to have induced fluctuations in government consumption and a lack of predictability, which, in any sensible intertemporal model of the economy, produces welfare losses.

- Inducing Inefficiencies in the Aggregate Fiscal Mix: The fact that some taxes are shared and others are not has induced the federal government to make some inefficient decisions. As Tanzi (1996) has suggested, this leads to situations where non-shared taxes acquire greater weight in the tax system, even when they are less efficient. - Also, when fiscal adjustment is necessary, the "optimal response" tends to include a mix of increased taxation and spending cuts. Given that the increase in taxes is partially dampened by transferring 50 % of them to the provinces, this biases the federal government towards "excessive spending cuts." Similarly, at times this has prompted the federal government to raise import-related revenues.[15][16]

- Lack of Achievement of Fair Redistributive Outcomes: The development of the tax-sharing regime over the years has been intimately related to redistributive efforts. Many analysts argue that "genuine" redistribution towards the poorer regions has been mixed with other redistributive ventures, favoring politically powerful (needy or not) actors. - For instance, Porto and Sanguinetti (1996) show that, even though on average the regime has redistributed towards poorer regions, more detailed analysis indicates that some richer provinces have benefited more than some poorer ones and that, even among poor provinces, the redistributions do not follow any reasonable indicator of fiscal need. - There is also the suspicion among observers and political

(Aizenman, 1998), and during the Convertibility plan (Schwartz and Liuksila, 1997). In both instances, faced with the need to correct large macroeconomic imbalances, the federal government introduced major tax, spending and administrative reforms that succeeded in raising the ratio of taxes to GDP. Through these efforts at the federal level, provinces received an automatic revenue windfall via the various revenue transfer mechanisms. The financial problems the provinces experienced during the 1995 recession (after the Mexican crisis) reflected difficulties in cutting back expenditures in line with reduced transfers, particularly from coparticipation.

[15] Also, there has been a tendency to implement different "*precoparticipaciones*" to "compensate" for changes in taxes or national spending needs.

[16] A similar problem occurs in the relation of each provinces to its municipalities. Provinces have to transfer a fraction of the coparticipated taxes to municipalities. Depending on the intra-provincial political relations, oftentimes the provincial government has incentives to trade coparticipation funds for other monies which give "him" more discretion (we thank Federico Weischelbaum for bringing this point to our attention).

actors that the true impact on the personal distribution of income does not follow the regional distributive pattern. Many regimes are thought to redistribute towards the richer citizens of the poorer provinces. An often cited example is the "industrial promotion" (i.e. tax breaks for businesses in some poor provinces) regime. Another suspect is the "national housing fund" (FONAVI) which does not reach the very poor and has evolved into a mechanism for subsidizing middle-class housing (Schwartz and Liuksila 1997).

- Irregular Provision of Public Goods: Part of the proceeds of several specific taxes are earmarked to finance several specific services. In practice, the provision of those services fluctuates along with those taxes, instead of following "demand side" needs.

- Distorting Taxes: Some of the taxes that amount to a large fraction of provinces' own revenues are highly distorting and harmful for competitiveness (gross-income tax; "stamp" tax).

- Poor Tax Compliance: Tax compliance in Argentina is very deficient. For instance, compliance of the nationally collected VAT was estimated to be 34% in 1989 and 55% in 1994, while neighboring countries like Chile (80%) and Uruguay (70%) have much better compliance rates. This is not strictly a consequence of the tax-sharing system but there are reasons to believe that the current regime provides no incentive for provincial authorities to collaborate in the enforcement of the collection of the most important (shared) national taxes. This is the common pool problem again: why pay the political cost of using local police to close down businesses that fail to pay taxes if there is no connection whatsoever between how much is collected and how much is received by each province out of national taxes?

- Lack of Information and Lack of Incentives to Produce Information: The current discussions around the possible reform of the tax-sharing regime make clear that most actors believe that there are better, more rational, ways of designing intergovernmental transfers. In a recent meeting, there were several statements by provincial governors complaining about the lack of information on the way coparticipation money is spent in other provinces (Palanza and Sin-Silva 1998). There is a clear sense that the current regime rewards inefficiency, through some sort of "ratchet effect," by which provinces that beahve with austerity today, are penalized with reduced funds next round. Hence, there is little incentive, at the level of one individual provincial government to spend the effort and the resources necessary to provide better information about the costs and technologies for satisfying the different public needs in that province.

- Misallocation of Time and Managerial Effort of the Authorities: It is evident that the "Federal Fiscal Game" provides incentives to political participants to spend most of their effort and ingenuity trying to alter the redistributive mechanism in their favor. It is commonplace in Argentina that governors and other local officials spend more time in Buenos Aires lobbying for redistribution, than in the province generating, implementing and monitoring adequate public policies. (This is related to the poor information incentives described above.)

- Complexity: In the appendix we provide a description of the Argentine tax-sharing regime, taken from the International Monetary Fund volume on federal fiscal arrangements (Ter-Minassian, 1997). What the description, summarized in Figure 2,[17] suggests is that the ever-increasing complexity of an interdependent network of different shared taxes and of expenditure functions and decision-making bodies renders it impossible for voters and taxpayers to identify which government spends or taxes and for what purposes. This breaks the benefit-tax link that is essential for enhancing efficiency in the provision of public goods, at the same time that magnifies the problem of exploitation of the common pool.

III. 2. Recommendations for the modification of the tax-sharing regime agreed upon by most economists

In light of these patent defects, there are multiple efforts to modify the system. The 1994 Constitution required the promulgation of a new regime by 1996, a requirement yet unfullfilled. The last few years have witnessed a number of discussions towards a new

[17] Figure 2 is a representation of what many observers have dubbed the "**Coparticipation Labyrinth**." Our own construction (based on Ministry of the Interior, 1996; Schwartz and Liuksila, 1997; and Llach, 1997) may well be inaccurate at the time of writing, and will most likely be inaccurate at the time of reading.

regime (summarized in Saiegh and Tommasi 1998 and Palanza and Sin Silva 1998). From the "technical" standpoint, we find several common recommendations, including:[18]

- increase fiscal correspondence and tax compliance by decentralizing several taxes
- impose credit ceilings and/or other control-mechanisms to the indebtness of provincial governments (and, in some versions, also of the federal government)
- move from "magical" and "inflexible" coparticipation coefficients to mechanisms that match the normative principles of covering the imbalances between the fiscal capacities and fiscal needs of the different jurisdictions).[19] -- Capacities and needs, we may add, that are dynamic and endogenous to a series of decisions, including the decentralization, or centralization for the matter, of different spending responsibilities.
- move from regionally-oriented redistribution to personal redistribution of income
- Some authors suggest that the distribution of funds be based on estimates of the cost of providing a certain basket of public goods in each province
- Many people are also emphasizing the need to have a more inclusive tax-sharing regime, which could prevent the emergence of the ubiquitous special funds and other special allocations.

III.3. Bringing politics back in to understand Argentina´s fiscal federalism

Although we sympathize with the recommendations summarized above, we disagree with the emphasis and institutional strategy implicit in most of the analyses supporting those recommendations.

Several of the recommendations have what we might call a "first-best / pure economics" approach, reminiscent of the social-planner metaphor of (old?) microeconomics and welfare economics textbooks. We agree with the spirit, but the statements beg the question of why it is that we do not have those better policies in place yet.

Other recommendations (for instance "credit ceilings") are of a "second-best / avoid politics" nature, i.e., they try to correct for biases implicit in the political decisionmaking process ("if we do not impose such constraints, provincial governments will continue to

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[18] FIEL (1993), Piffano (1998), World Bank (1996), Porto (1990), etc.
[19] Several authors (and actors!) specifically ask for "rationality" of the distribution criteria.

ignore the negative externalities they impose on the public good of 'good credit standing'").

We think that the emphasis of these recommendations may be misplaced: more effort should be spent in trying to understand the political logic by which the current regime, with all its inefficiencies has evolved. From that analysis, suggestions to improve the R3 decision making process might emerge. If we were able to make progress in this direction, "trully first-best" recommendations might become politically more feasible, while "second-best" recommendations might become unnecessary burdens. [20]

This brings us back to one of the main points of this paper. The list of a recommendations that the typical economist would give, looks very much like a blueprint (which in practice might imply a very detailed and long coparticipation law),[21] with very little or no attention to the need to create better governance structures that might support the movement towards a regime which is collectivelly more rational.

In our view, then, it is necessary to study the history of the politics that lead to the building of the current regime, in order to be able to suggest "R2 & R3" changes. In Saiegh and Tommasi (1998) and (1999) and Iaryczower, Saiegh and Tommasi (1999) we have attempted to travel such path, by studying the historical evolution of the federal fiscal regime in Argentina. Of the certainly many ways of approaching such a study, we have chosen to look into that history with the lenses of "transaction-cost politics".

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[20] How is it possible that we might come up with some feasible improvement that the actors haven´t found themselves? [the criterion of "remediableness" proposed by Williamson 1996 is applicable also to the R3 level], [North "vs" Williamson (TCE? and TCP?)]. Possible justifications: (1) In the modern theory of growth, economists have permitted themselves to consider the possibility that agents will come up with technological innovations; it is time to allow for institutional innovations. (2) We have to take history and politics very seriously, but not to the point of inaction. We have to think about possible institutional innovations, and once we have a clear idea we should go and explain them to political actors. Part of that will be an exercise in persuasion (as emphasized by minister Aninat in the epilogue to Burki and Perry 1998), and part of that will be an excercise in humility, finding elements which we have ignored in our analysis of the "underlying logic". With this new information we should get back to the drawing board and try again. It is conceivable, that in some cases we will end up concluding that we cannot come up with politically feasible institutional improvements, but we shouldn´t give up before starting.

[21] It is worth noting that some "fundamentalist" economists (some of which are in the current administration) stand precisely at the other extreme, calling for a few-lines law, in the spirit of what we would call very simplistic (and inflexible) "rules".

TCP is an idea spearheaded by North (1990) and explored in a recent book by Dixit (1996), which purports to translate into the political domain, the ideas in the field of Transaction Cost Economics.[22] In transaction cost politics, the basic relation is a political transaction, trading votes (or contributions) for policies, or votes for votes.

It has been argued that transaction costs – problems of information, specification or enforcement of a political transaction – are even higher in politics than in economics. Both North and Dixit stress the time dimension of political transactions, so that the problem of dynamic inconsistency is particularly acute. Given the nature of political transactions, the notion of a contract plays a central role in TCP. As in TCE, and probably more so, contracts are necessarily imperfect. Complexity and uncertainty are very pronounced in politics; contracts are less explicit and more difficult to enforce than in economics. Transaction costs are higher and the contractual safeguards against expost opportunism that are put forward in TCE are less effective. Forms of governance other than standard contractual remedies become more important. Governance structures in TCP are political institutions broadly defined. The intertemporal nature of political exchanges makes it necessary to devise a set of institutional arrangements to allow for exchange "over space and time" (North).[23]

III.4. Looking at the case of Fiscal Federalism in Argentina through the lenses of Transaction- Cost Politics[24]

The evolution of federal fiscal arrangements in Argentina presents several characteristics which could be interpreted in the TCP framework summarized above. Most analysts would agree with us in that the extant set of federal fiscal institutions is very inefficient (because it generates all the perverse incentives enumerated in point 1 above).

The inefficiency of these institutions can be explained because of an inability to move to Pareto improving institutional arrangements <u>and</u> (not "<u>or</u>") because powerful political

[22] Transaction Cost Economics is one branch of a larger approach, the New Institutional Economics, which we are loosely using throughout this paper.
[23]Weingast and Marshall (1988) argue that the complicated committee system of the U.S. legislature are examples of such arrangements.

actors or coalitions at some point in the past were able to instrument institutional changes favorable to them in the shor run, but deleterious to society in the long run.[25] We believe both sets of reasons wer present in the federal fiscal history of Argentina, and that they interacted to create the current situation. The coparticipation labyrinth can be explained as an outcome of deliberate political activities by the main political actors over time.

In an environment which has been quite unstable politically (recall the numerous military "interruptions") and economically (inflation being its most salient expression), political actors tended to adopt a particularly myopic perspective, did not invest in building more efficient institutions, and attempted to protect their (quite vulnerable) property rights.[26][27]

Hence, many of the features of the coparticipation system derived from this particular process of institutional change: sudden changes that improved the bargaining power of a group of agents lead in some cases not just to minor adjustments at the margin, but to steep radical changes (sometimes, the alteration of the rules of the game altogether).

Rules that were put in place by civilian governments were subsequently reversed by military regimes and vice-versa. The changes usually involved alterations to the criteria for revenue sharing between the federal government and the provinces as well as among the provinces. When the power was more concentrated in the national government (mostly

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[24] In Saiegh and Tommasi (1998) we provide a more detailed historical narrative of the evolution of the federal fiscal regime in Argentina, through the lenses of TCP. In this brief subsection, we extract the main points in light of the type of institutional reform we are suggesting.

[25] This builds in part on the distinction in Tsebelis (1990: 104-115) between efficient and redistributive institutions.

[26] As Moe suggests, the authority of decision making can be viewed as a property right (a political property right), and the instability of these property rights has profound consequences in the political actors choices once they are in power: policies and institutional structure are designed to protect these property rights.

[27] One of the first issues that a federal country has to define is the division of areas of decision making across different levels of government. In principle, we can have areas of exclusive authority for each province, areas of exclusive authority for the national government, and areas of joint decision making. These things are, usually, decided at the constitutional stage. Constitutions, as we know, are very incomplete contracts. Many grey areas do, in fact, arise, and those could be the source of problems. These potential problems include the instability of social choice (which, in a "property rights" interpretation, is an important part of our point) and collective action problems. -- While property rights are taken as given in the Coase Theorem, this is essentially different in a democracy (and even more so in a polity with the characteristics that Argentina had during most of this century), where those rights are defined by the same actors which operate under them. The US-centered literature has tended to emphasize democracy´s sources of uncertainty (majority rule, politicians´short horizons – see for instance Besley and Coate 1998); in the Argentine case one has to add the uncertainty introduced by the frequent coups d'etat and the ever lasting need to adjust to a chaotic economic situation.

during military regimes), the changes were intended to shift the distribution of shared taxes in its favor. This was achieved by different means, such as explicitly changing the proportion of tax revenues the national government had to share with the provinces, or in more subtle ways, by introducing new taxes (not to be shared), or increasing the rates of existing but unshared ones.

Conversely, with democratic opening, the once again elected provincial governors and legislators engaged in new debates over the distribution of tax revenues in order to reverse the changes that were produced during the previous regime. This usually resulted in modifications to the distribution of shared taxes in the provinces' favor.

In our view, these attempts of political actors to protect and to appropiate property rights in an uncertain environment account for the inefficiente evolution of policies and institutional structure. Indeed, over time, the succesive changes eventually lead to: a) rigidity of the coparticipation mechanism (in terms of incapacity to properly adjust to economic shocks); b) poor incentives for healthy fiscal performance, and c) the unclear rationality of redistribution.

Many of these offensive "violations" consisted in the discretionary use of instruments, other than the "vertebral" tax-sharing agreement to favor specific provincial coalitions which were politically important at that node. Other violations consisted in not delivering a fair compensation to each provincial government after changes in the federal fiscal system such as the decentralization of certain services, or changes in tax policies.

Whereas the institutional rigidites that were introduced in an attempt to limit these violations included:

(1) making the tax-sharing regime (which has the nature of a veto game, since the coparticipation law has become a "*Ley Convenio*")[28] more inclusive, to minimize the

[28] *Ley convenio* is a law that requires ratification by provincial legislatures. In practice, the approval of these laws has been negotiated by the provincial governors with the national executive, at the same time that in the national Congress. It is worth noting that the institutional set-up has also evolved from a relatively "majoritarian" decision making procedure towards the current situation in which the 1994 requires a Ley Convenio. This could be interpreted as a reaction of the political actors to the uncertainty induced by instability.

range of decisions regarding federal fiscal allocations which are taken by unstable majorities in Congress or, even worst, by discretionary bargains between the national executive and particular provincial governments,

(2) establishing minimum revenue guarantees for the provinces, and

(3) establishing floors in terms of the share of coparticipated revenues to each province.

It is worth noting that the extant law (which was sanctioned as a temporary law in 1988) has all the appearance of being a non-discretionary rule , which specifies exactly the pool of shared taxes and the fraction of tax revenues going to each jurisdiction. In fact, as the labyrinth in Figure 2 (partially!) indicates, there have been many alterations (precoparticipations, "Pactos Fiscales"),[29] which in turn have generated further moves attempting to increase the "rigidity" of the system as those embeded in the 1994 Constitution. (The very fact that several features of the tax-sharing regime are written in the constitution is, in part, the ultimate example of institutional rigidity).

While the institutional structure of federal fiscal relations in Argentina initially developed to protect property rights introducing more veto power, the existence of loopholes in the original agreements[30] and the possibility of altering payoffs with substitutes to coparticipation funds which can be decided with "lighter" majorities[31] gave place to the opportunism of different coalitions which violated previous agreements (the coparticipation laws) and in this way introduced instability to property rights.

This has three basic effects. First, it modifies directly the vertical and horizontal allocation of funds, driving it away from "technical" considerations (equity, efficiency, explicitation of stable criteria). Second, it destroys possible commitment technologies for the national government, leading to dynamic inconsistencies, which relate to the common-pool (bad

[29] [Pactos Fiscales were ...]

[30] Reflected in practices like pre-coparticipations, altering the mix of taxes, creation of new taxes, the inflation tax, debt, etc.

[31] (ATNs, national spending in the provinces, special funds, other laws favoring specific regional constituencies, etc)

timing) and bail-out problems previously described.[32] Finally, it affects the "structural" decisions, inducing the imposition of rigid limits to prevent this opportunism.[33]

To conclude this tour, we want to mention two contemporary anecdotes that highlight the "transaction cost" nature of the problem. The first one, we interpret as an example of R3 difficulting the move towards better R1s; the second one as R3 impeding the movement towards better R2.

In 1998 the National Executive attempted to introduce a tax reform to lower the (non-shared) inefficient labor taxes at a time of high unemployment, and to raise shared taxes.[34] To compensate, it requested some amount to be pre-coparticipated to the national government. The provinces resisted this complementary clause (in part because of disagreements about the estimates of the revenue potential of the increase in the rates of shared taxes that it would produce). This reflects the incapacity to come up with more complete contracts, contingent on the actual produce of the tax changes, at the same time that highligts the type of rigidities we are emphasizing.

All fiscal experts agree on the need to decentralize some taxes from the national government to the provinces.[35] The timid attempts at implementing such decentralization face fierce opposition from most provincial governments -- the opposite situation from what happened in Australia (see Painter, 1998). This attitude (perfectly understandable in light of prior experiences) reflects the inexistence of adequate mechanisms to calculate compensations and enforce these deals. Every actor fears loosing what it now has in passing to a new system with uncertain payoffs (and there is also an element of "hold-up"

[32] A salient feature has been the inability of the different political actors to undertake (efficient) intertemporal commitments. There have been several instances in which the federal government (or coalitions of provincial governments) has (have) acted in ways that , although rational in a short-term perspective, implied violations of explicit or implicit previous agreements. (See Palanza and Sin-Silva 1998).

[33] These limits are both "implicit" and "explicit". The implicit ones relate to the absent qualities of the regime in terms of the flexibility, efficiency and insurance that could be expected from an efficient contract. The explicit ones are the list provided above, whith its ultimate manifestation in the 1994 Constitution. All of these rigidities, in turn, increase the payoff from breaking the rules. These highlights the fact that, on top of the usual costs of rigidities identified in the "Rules vs discretion" debate, we identify here the fact that rigid rules are more likely to be violated.

[34] After sustantial negotiations and modifications the law has been passed, although there are still several attempts at changing and partially reversing it.

[35] There is more desagreement about the details of such decentralization.

in each province refusing to approve a beneficial social change in the hope of receiving an extra payment for its vote).

III.5. Towards better (R2 & R3) political decisions[36]

In this subsection we convey (in a succint way) the spirit of the solution we are proposing for the reformulation of the federal fiscal regime in Argentina. (Some more details are available in Iaryczower, Saiegh and Tommasi 1998 and 1999).

The 1994 Constitution calls for a new Tax-Sharing regime to be promulgated. It requires that it be approved as a "Ley Convenio" (a mechanism that, in practice, approximates the need for a unanimous consent by all the provinces); it stipulates some guiding principles that the regime should follow; and it mandates the creation of a "Federal Fiscal Institution" which should be in charge of controlling the regime.[37]

The positions of economists with respect to this new regime tend to lean on what we might call a "rules" approach (drawing from the well-know discussion on "rules versus discretion"). They call for a new law that would stipulate a series of "rules" of the sort enumerated in point 4 above. As it is well known, (adecuate) rules have the advantage of correcting underlying biases – in the paradigmatic application, time-inconsistency biases; in this case, an interaction of time inconsistency with other collective choice problems. The problem, of course, is their rigidity to accomodate a reality which is in a continous state of flux. (As reflected by the numerous modifications, many of them by "outside channels" to the extant 1988 law.)

Our own proposal, taking advantage of the window of opportunity provided by the constitutional mandate, is one of reform of the structure and process of federal decision making, of the institutions that allocate authority for the making of collective choices. (This comes closer to inducing first-best choices whenever possible).[38] The problems

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[36] [section under construction]

[37] Note that the constitutional mandate was not fulfilled in time, what reflects the difficulties of reaching an agreement on this matter.

[38] One dimension of the discussion is whether to promulgate a Ley Convenio of a fixed duration, or an open-ended one (i.e., one that will be in place until modified by another Ley Convenio). We argue in favor of the latter, but with a law that includes the rules for changes whithin the regime. Our preference derives from

identified in III.1 are the result of the rules of the politico-institutional game. Any feasible and sustainable improvement requires some change of those rules, otherwise the “monsters lurking behind” will keep reappearing.

The main advantages that a properly designed change in the structure and process of decisionmaking can bring about are:

- evolutionary capabilities of the system, allowing
- adaptation to changes in the constantly flowing economic and political realities of a complex federal country
- learning
- a gradual implementation of superior incentives through gradual politics
- Commitment: credibility and enforcement of long term agreements
- Coordination and better incentives to generate information, increasing transparency

We think that the new “design” has to:

- Strengthen federalism by bringing many decisions that today are at the discretion of the national government, into an explicitly federal decision mechanism
- More generally, the spirit of the proposal is to bring inside the collective decision process a number of choices that in the past have been dealt by “lateral” channels.[39][40]
- Attempt to solve some of the collective action problems by delegation (in the spirit of the delegation of monetary authority to the Central Bank and of regulatory authority to independent regulatory agencies).

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social-choice theoretic reasoning, plus the reading of past experiences with “temporary” rules-oriented laws. It is inspired by the “incomplete contracts” literature in economics, which argues for optimization of ex-post governance structures (see, for instance, Hart and Holmstrom 1987 and Milgrom and Roberts 1992).

[39] We suggest a more encompassing political decision mechanism, formalizing the arena of federal fiscal choices, regulating procedures, making them more transparent, in order to move to a set-up closer to the “Weingast-Marshall” world -- which for reasons that we speculate about in Spiller et al (1999), has not evolved in Argentina.

[40] In describing the political uncertainties reflected in the history of federal fiscal arrangements in Argentina, we pictured the actors asking themselves (regarding the federal fiscal negotiations): “When will be the next meeting? Where will it take place? Will I be invited?” (Saiegh and Tommasi, 1998).

More specifically (and hence more preliminary and subject to discussion and iteration):

- We suggest a "Federal Fiscal Institution" (FFI) organized in a manner somewhat similar to the Austrialian Commonwealth Grants Commision. It will be composed of a highly qualified and well equiped Technical Commission (TC) with technical capabilities comparable to those of the Central Bank and of the Ministry of Finance; and a Council of Ministers (Federal Fiscal Assembly – FFA) with political representation from the National government and each of the provincial governments.
- The TC will be in charge of generating the studies and information, on the basis of which, decisions will be made by the FFA. These studies will include from the data necessary to adjust the distribution as a function of sharing-formulas previously decided, to suggestions for changing those formulas in light of changes in other parts of the system (say a new Tax Law by Congress), in order to maintain the spirit of the original agreement
- The <u>political property rights</u> of the different jurisdictions will be respected by appropiate voting mechanisms in the FFA. In an extreme, pessimistic, scenario one can imagine a unanimity rule for every single issue. In that case most proposals will be defeated (what is equivalent to the "rules forever" solution) and a few Pareto-improving ones will be approved. Hopefully the CT would be able to present bundles of proposed reforms which might generate Pareto improvements. Less pessimistically, one can imagine softer majority requirements such that each jurisdiction, even though at some particular point may lose from a decision, expects to gain from the mechanism on average.
- (Institutional general equilibrium) The hope is that the new equilibrium after introducing this "FFI" onto the extant system will generate virtuous dynamics.[41]

[41] [Formal/informal institutions (how will actors react to this new setup, will violations still exist, but now in different ways?; are we creating a "new federal government" or we are just "federalizing" a set of "particularistic" transactions (often having the National government as the main culprit – not surprisingly given its faster maniobrability, typical political version of the time consistency – asset specificity problem).]

IV. CONCLUSION

The approach of the New Institutional Economics does not believe in definitive solutions, but in processes that go in the right direction. There is no solution which is optimal or perfect; there are solutions that are better than others. In going about the formulation of economic and social policies, it pays to follow the advice of one of the founding fathers of the NIE, H. Simon (1957), in that optimal is ideal, but satisfactory is realistic. (Wiesner, 1997).

As we said a few times already, a detailed historical analysis of politics and institutions is necessary before “requiring” “institutional reforms”. The tentative recommendations for federal fiscal arrangements in Argentina (if correct) are very specific, we would not dare suggest a similar structure to improve the fiscal system in, say, a unitarian nation.[42]

RECOMMENDATIONS:

1) concentrate on R2 & R3
2) study history and politics (because Ri*s are a function of country/sector characteristics)[43]
3) beware of blueprints: there are no universal required reforms
4) don´t forget about informal institutions

It is good to end quoting some reflections by T. Eggertson, that, although formulated with respect to economic policy, seem to apply even better to institutional reforms:

> Usually, economic policy involves modifying formal institutions, since it is not obvious that informal institutions are available policy instruments (nor would that be very desirable). However, a better understanding of informal institutions as an exogenous phenomenon is of vital importance for policy. Formal and informal institutions are

[42] Perhaps, in such case, R2 recommendations are enough. Still it is not clear which is the nature of the political game in a unitarian country with elected local authorities. That is an important point, that requires a detailed historical analysis of politics and institutions.
[43] Where Ri* is the “optimized” value of Ri, for i=1,2,3.

complementary in creating specific economic outcomes, and the design of efficient formal rules must take into consideration the interaction between new formal rules and existing informal ones. The game-theoretic framework can obviously be of considerable use here. A better understanding of informal rules could help us understand when the introdcution of particular formal rules is futile – when they do not match the system of informal rules and therefore will not be enforced. Some of the serious mistakes made by the industrial countries in their programs of aid for developing countries may be due to a limited understanding of the relation between formal and informal institutions. Conversely, a better understanding of the role of informal institutions could be of help in designing formal rules that take advantage of existing informal rules to rely extensively on self-enforcement, leaving only pathological cases for the formal enforcement mechanism, the police and the courts. (1996: p 21-22)

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FIGURE 1: Procyclical Behavior of Provincial Public Finances: Annual Growth Rates of GDP and Provincial Spending

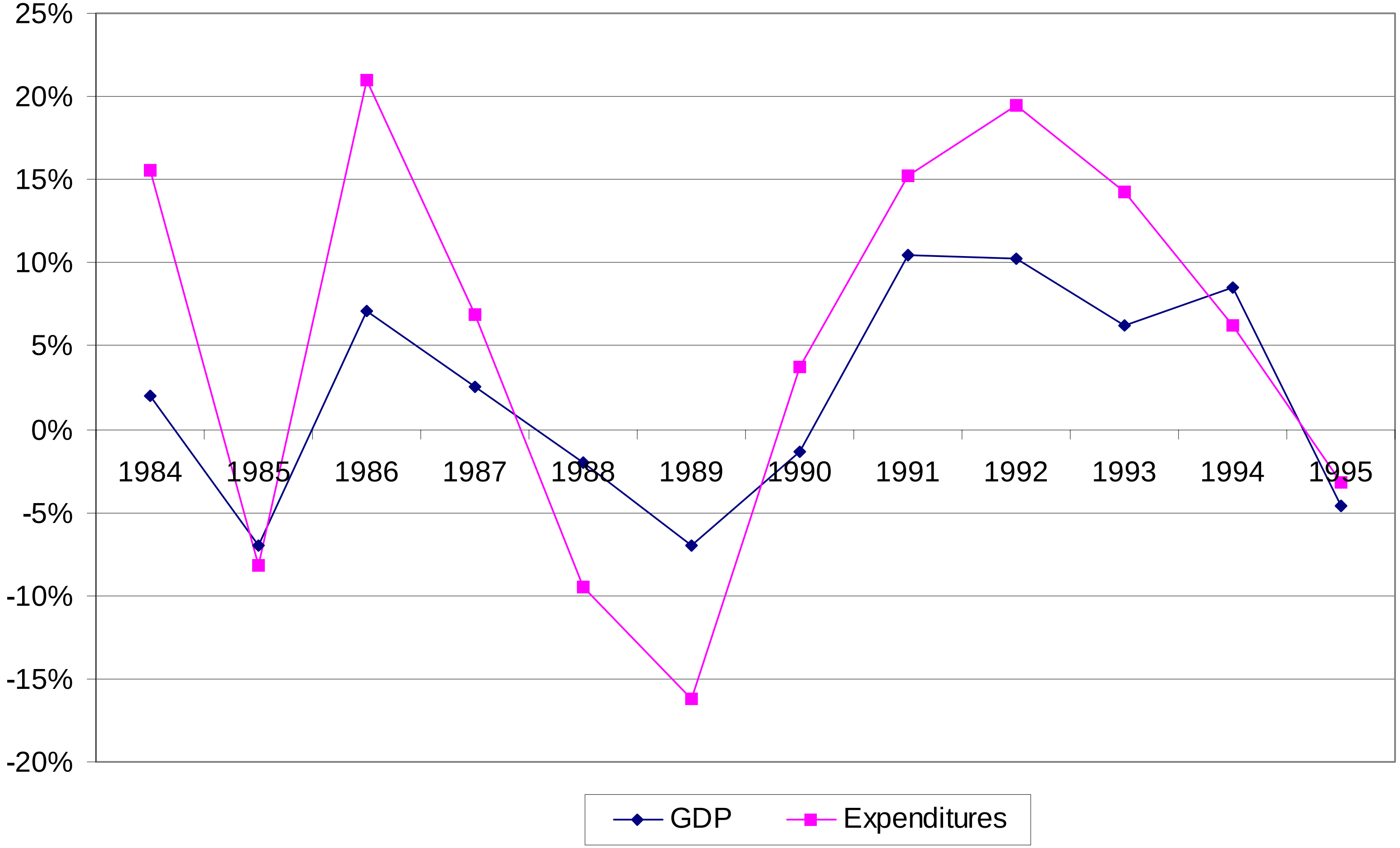

Figure 2. The Labyrinth