

# The Political Economy of Reform: Institutional Change as a Tool for Political Credibility<sup>1</sup>

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## Abstract

This paper has two purposes. The first of these is to offer a quite comprehensive review of the political economy of economic reform literature. The second purpose is to present an argument, intuitively and through a simple model, for why early political reforms, aiming at increased political transparency and accountability, can reinforce political credibility and thereby increase political support within a democracy for the implementation of economic reforms. The argument builds on the notion that reforms may have short term costs and long term benefits, but that the benefits will not materialize if reforms get stuck at a partial state, for instance due to state capture from “winners of partial reform” (Hellman 1998). Fully rational voters may then withdraw support from the reform candidate in the elections if they are uncertain of his intentions, i.e. whether he will pursue with full reforms or if he will allow himself to be bribed into a partial reform state. This uncertainty creates a political credibility problem because even if the reform candidate’s intentions are benevolent, voters will have reasons to distrust his promises of a continuation of the reform process, since they know that a less benevolent type would claim the same thing. However, the argument I make is that far-reaching reforms of transparency and accountability decreases the gains from state capture, because bribes are likely to be verified and punished (politically or judiciary). It follows that a reformer with benevolent intentions can increase his political credibility by choosing a level of political reforms that is too costly to pursue for a dishonest candidate, and thereby separate himself from the other type in the eyes of the voters. Hence, implementation of these political reforms works as a costly signal, alleviating the political credibility problem, and help build continued support for economic reforms.

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## **Introduction**

The investment climate is a multidimensional concept. Among other things, a good investment climate requires well defined and legally protected property rights, well functioning credit and labour markets, a competent and honest bureaucracy, a business friendly legal environment and high quality infrastructure. However, many, if not most, countries fail in several of these dimensions. It thus goes without saying that an important topic for the WDR 2005 is to understand the constraints governments are facing when trying to reform their investment climate. These constraints can be of different types. In particular, they can be economic, informational or administrative in nature. The focus of this report, though, is on the political constraints facing governments, or political rulers more generally, aiming towards reform. These political constraints exist foremost because even though the reforms can be considered as improving the overall social welfare, there may be a lot of uncertainty of the identity of winners and losers. Groups that expect to lose from reform may come from all segments of the society. It may be trade unions or farmers that fear that privatization, trade reform or generally increased competition will threaten their livelihood, it may be public employees fearing that public sector reforms will threaten their jobs or their opportunities for receiving bribes, or it may be from within the political elite itself, fearing that increased transparency, accountability and more rule-based institutions will undermine their ability to use public revenues discretionally to foster clientelistic ties to their support groups. If these groups have the political power to block enactment or implementation of reform, something that depends on the collective choice mechanism at work, then political incumbents with reform on their agenda need to think about ways to overcome these constraints.

In this paper I, first of all, present a quite comprehensive overview of the political economy of economic reform literature. This literature can loosely be traced to two different important real world events, the recurring crisis in most Latin American countries in the 1970's and 1980's, and the experience of the countries in the former Eastern Bloc in their transition from command to market economies starting in the 1990's. I argue that because of the somewhat different contexts, the literatures emerging as a direct response to respective event differ in the underlying question they ask. More precisely, the literature emanating from the Latin American experience is focused on the

positive question; how can we explain the fact that what we think are socially beneficial reforms are not implemented? On the other hand, the literature emanating from the experience of the countries in transition is more focused on the normative question: how can we design the reforms process and its elements to overcome political resistance? Exceptions do of course exist, but the literature review I present is organized around these two highly related but still different questions.

Secondly, I discuss more in detail the role of elections, transparency and accountability in the reform process. As is evident from the literature review, the view of democracy has changed over time. Based on the often dismal experience of democracy and reform in Latin America, many authors came to the conclusion that decision makers needed to be shielded from the pressure for populist policies that may arise in a democracy (e.g. Nelson 1993 and Haggard and Kaufman 1992). The experience of the countries of transition is quite the contrary, though, leading to an emphasis of the importance of political accountability to check the behaviour of political elites and to decrease the risk of state capture (e.g. Hellman 1998). I argue that part of the differences in perspective is guided by different views about the underlying motivation of politicians. According to the first view, politicians are basically well meaning social welfare maximizers unless they are “forced” by electoral competition to appeal to the voting majority through populist policies in order to stay in power. In the opposite view, politicians are driven by their self interest and inherently opportunistic, so accountability at the polls is a minimum to enforce welfare improving reforms upon them. The truth is probably that there exist both types of politicians. This seems to speak in favour of democracy, since elections is an instrument for voters to oust under-performing incumbents. However, as highlighted in the political business cycle literature (e.g. Rogoff and Sibert 1988 and Rogoff 1990), voters may lack the information to be able to tell the difference between more or less competent/honest incumbents. In the context of reforms, this means that in order to get political support for the continuation of the reform process, a crucial factor may be the ability of honest and competent politicians to credibly signal their intentions.

In the third part of the paper I develop, intuitively and through a simple model, an argument for why early political reforms, aiming towards increased political transparency

and accountability, can help a truly reform minded politician in his pursuit of getting popular support for the continuation of the reform process. The argument builds on the idea that reform backlash can occur when reforms yield short term costs and only long term benefits if voters become uncertain of to what extent the long term gains are ever going to be realized. One source of uncertainty, highlighted in Hellman (1998), comes from fear that the reform process will be captured by “winners of partial reform” and therefore get stuck in a state in which the majority of voters only suffer from the short term losses and not gain from the long run benefits. The risk that this will happen will be a function of the probability that the current reform government is of a type open for accepting bribes in exchange for a stop to the reform process, what in the model is referred to as a “dishonest” reformer. The political support for a “true” reform government (one that will not be captured) will then be a function of the ability of this government to credibly communicate their intentions to the electorate. Hence, the crucial dimension of the argument is the importance of political credibility. In the setting I propose, a dishonest type will have incentives to pretend to be a true reformer, so costless signals, through attempts of communication and persuasion, will not work.

What I instead propose as a mechanism for the true reformer to gain credibility for his intentions is to institutionalize instruments of verification and penalty for corruptive and dishonest political activities, which makes the personal gain of accepting bribes lower. What I have in mind are reforms aimed at increasing political transparency and accountability such as: reforms aimed at empowering an independent media and the civil society (transparency), and electoral reforms to increase political competition and reforms aimed at strengthening an independent judiciary (accountability). Through these reforms, the personal risk of accepting bribes in exchange for a stop to the reform process becomes high. Through increased transparency, the activities are likely to be observed and broadcasted, and through increased accountability, the perpetrators are likely to be captured and penalized. Implementation of these political reforms thus effectively work as a costly signal, because they constraint the ability of the dishonest type to benefit from being captured. Hence, if the true reformer goes far enough with these reforms, the dishonest reformer will not find it worthwhile to mimic his behaviour, so the true type manages to distinguish him-self from the dishonest type in the eyes of the voters. That is,

through far-reaching political reforms the incumbent sends a (costly) signal of his type to the voters, who therefore feel secure that the long term benefits of economic reform will not be captured if the incumbent is reelected.

The main policy implication that comes out of this framework is that political institutions matter, but, not so much because they constrain the behaviour of politicians with bad intentions, but because they can help true reformers to signal their good intentions and thereby gain continued political support. As convincingly argued in Robinson (2003), politicians with bad intentions can generally find ways to circumvent institutional checks and balances on their behaviour, making institutional design aiming at “politician-proofing” a futile pursuit. However, what I argue here is that institutions may matter for political credibility, i.e. for the ability of politicians with good intentions to convince voters of their honest pursuit and thereby get the necessary political support for a continuation of economic reforms. In the model, politicians with good intentions endogenously implement these reforms as a signal of their types to the voters, that is, implementation of these reforms are unlikely to be possible through outside pressure. Hence, the policy recommendation that emanates from this argument is not so much to always *push* for far-reaching institutional reforms, but rather, to *inform* governments of the role of accountability and transparency in building political credibility. Furthermore, resistance against implementation of these reforms can also serve as a signal to the donor community that these governments are unlikely to persist in the reform process, which can be useful if selectivity ever becomes the benchmark for aid allocation.

The political economy of reform literature is huge, and often tangential to other fields, so a few words on the limits of my ambition may be warranted. First of all, the academic literature surveyed here is generally not focused on a specific type of reform, such as for instance corruption eradication. Rather, it emphasizes a general mechanism that matters for all attempts at reform in a specific environment. For instance, the paper by Fernandez and Rodrik (1991) shows how the combination of individual specific uncertainty concerning whether you will win or lose from reform, together with majority rule, may cause socially beneficial reforms to be blocked even though everybody knows that a majority will gain from reform *ex post*. The extent to which this mechanism is relevant for a specific investment climate reform must of course be judged on a case by

case basis. However, the emphasis on overcoming political resistance may be specifically important in the context of investment climate reform. As pointed out by Tommasi and Velasco (1996), when discussing judicial, regulatory, and infrastructure reforms, “..the set of interests potentially affected in the next stage reads like a *who’s who* of highly organized and vocal groups: teacher’s and judicial unions, the upper echelons of the public bureaucracy, state and local governments, owners and managers of newly-privatized utilities and Bill Clinton’s nemesis – the medical establishment.” It therefore seems likely that even this more general literature can yield some insights valuable also in the specific context of investment climate reform. Secondly, I focus more on the formalized academic literature within the fields of economics and political science (rational choice approaches) rather than on the numerous country studies and more directly policy oriented reports that exist. This should not be interpreted as a statement against the contributions from these approaches, but is rather a reflection of time and space limits and personal taste and knowledge. Finally, I do not cover (with some exception) the clearly related literatures on the political economy of growth, and governance (for surveys, see Alesina and Perotti 1994 and Keefer 2003).

The plan of the paper is as follows. In the two following sections I review (part of) the political economy of economic reforms literature. In the first section the focus is on the question of why socially beneficial reforms are not implemented, whereas the second section focuses on how to overcome political resistance against reform implementation. In the fourth section I look more closely at the role of elections, and political transparency and accountability. Finally, in the fifth section I present an argument (intuitively and through a simple model) for how political reforms can increase the political credibility of, and thereby the political support for, a government with honest intentions to undertake economic reforms.

## **Understanding reform failure**

The focus of this section is going to be on understanding political reasons why socially beneficial reforms are not implemented, while in the next section we turn to the question what can be done in order to overcome the political constraints. Important contributions

in order to understand this question emerged in the first half of the 1990's, triggered by the recurrent economic crises in Latin America in the 1980's. As pointed out in Williamson and Haggard (1994), despite a widespread consensus, among most mainstream economists at the time as well as influential international financial institutions and western governments, about what was to be considered as "good" policies, these "good" policies were often not implemented.<sup>3</sup> This literature thus emerged as a response to this puzzle, emphasizing how heterogeneous preferences, often together with uncertainty, may cause socially beneficial reforms not to be implemented, or to be delayed, when some kind of consensus is necessary to implement the reforms. The focus of this literature is thus positive rather than normative in nature, focusing on understanding what may cause the lack of implementation rather than what to do about it. The focus of the applications are mainly macroeconomic stabilization and trade reform, but most of the models describe more general abstract mechanisms that can be applied also to other potential reforms. In my discussion of these reforms I will therefore focus on the more general ideas, and set it into the specific framework only when I deem that to be necessary in order to convey the underlying intuition or if the context is of specific interest for the WDR2005.

### ***Uncertainty and Polarization***

Fernandez and Rodrik (1991) present a model of status quo bias in the presence of individual specific uncertainty. The underlying motivation for their model is the observation that groups that initially resist reforms sometimes emerge as the reforms most devoted defenders once they have been implemented. The authors offer examples of the opinions of parts of the business elites towards trade reform in a diverse set of developing countries. To explain that outcome, Fernandez and Rodrik develop a model in which individual specific uncertainty over the outcome of reform leads a majority of the voters to expect to lose from reform ex ante, even though everybody knows that a majority of the population will gain from reform ex post. It follows that the reform will

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<sup>3</sup> The so called "Washington consensus" focused mainly on trade and macroeconomic reforms but also included components of deregulation, tax reforms and legal reforms. It should be emphasized that the consensus at the time to a great extent has evaporated, and the package has rendered critic also from within the Washington institutions (e.g. Stiglitz 2002).

not gain majority support in the hypothetical case of a direct vote on whether to implement the reform or not.<sup>4</sup> The result hinges on the assumption that the winners of reform cannot in a credible way promise to compensate the losers from reform ex post, which may seem a bit dubious. However, as the authors point out, the fact that a majority of voters gain from reform once it is implemented introduces a credibility problem for any such promise. Once the reform is implemented the losers will be a minority so they do not have the political power to reverse the reform. It follows that the winners will not have to follow through on their promise. The losers will of course realize this, so any attempts of the winners to promise compensation in a situation like this will suffer from credibility problems. A potential critic of the argument above is that credibility can be gained through other mechanisms such as reputation and repeated interaction in a more general context. However, as pointed out in a recent paper by Jain and Mukund (2003), even if credible promises of redistribution can be made, it may not be sufficient to solve the problem in the Fernandez/Rodrik model. The authors even show an example of a situation in which the ability of the government to redistribute parts of the gains from reform to the losers may further decrease the support for reform. This can happen if redistribution makes those who gain only little from reform actual losers, while the size of the redistribution is too small to make the initial losers winners (even though they are better off than they are with reform but no redistribution). In Jain's and Mukund's example there is no real reason for the government to issue these transfers to the losers, but one can think of a situation in which losers from reform may cause social unrest if they lose "too much".

Another influential paper published the same year and in the same journal as that of Fernandez and Rodrik is the paper by Alesina and Drazen (1991). This paper looks explicitly at the delay of reform rather than the non-implementation of reform. The model is an example of a war-of attrition game with two players, both waiting to see if the other player is going to give in and accept to bear the blunt of the cost of fiscal stabilization. Key concepts here are political fragmentation and polarization. The underlying set-up of

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<sup>4</sup> Laban and Sturzenegger (1994) have extended the static model of Fernandez and Rodrik to a dynamic version, in which the perhaps more realistic outcome is that reform is delayed rather than never implemented at all.

the model is an initial fiscal imbalance that requires expenditure reductions or tax increases in order to avoid that the situation becomes even worse. There are two groups in society who both benefit from stabilization. However, since stabilization here is a public good, they both prefer that the other group carry most of the short term cost of stabilization, which we can think of as the allocation of a tax increase across the two groups. If both groups knew exactly the cost of respective group of waiting with initiating stabilization (the cost of inflation, high interest rates, general economic and social disruption) then the group with the higher cost of waiting would give in at once and take on the blunt of the short term cost, since the members of this group know that the members of the other group will be capable of out-waiting them. However, if these costs are unknown, then the only way to find out the other groups costs of waiting is to start a war of attrition in which both groups wait to see if the other group is giving in. Over time, members of both groups will update their beliefs about what they expect the cost of the other group to be, based on the fact that the other group has not given in yet. Eventually, the group with the higher cost 's expected benefit of waiting another unit of time falls below their cost of giving in, so the members of this group give in and stabilization takes place. Note that both groups would have been better off if the high cost group had given in immediately, but because of the uncertainty over the costs of waiting, an inefficient delay occurs in equilibrium.

The role of fragmentation here is that the government in power would not need to negotiate how to allocate the short term cost of stabilization if it had a stable majority within the parliament. The authors exemplify this case by looking at the different experiences of Britain on one hand, and France, Germany and Italy on the other hand, immediately after the end of World War I. All these countries were at the time struggling with enormous budget deficits and debt overhangs as a consequence of the war, but in the case of Britain a rapid stabilization was achieved, whereas a long political struggle leading to a sharp rise in the inflation rate, capital flight and an increased debt burden was the outcome in the other three countries. According to Alesina and Drazen (1991), the reason for these different experiences can be traced to differences in the political situation. In Britain the Conservative party had a clear majority and managed to swiftly implement tax increases on terms favourable for their constituency, whereas in the case

of the other three countries there was no single majority, and the left and the right could not agree on which group should carry most of the fiscal burden.

The role of polarization is less clear-cut, but a crude measure is included in the model as the share of the short term cost that has to be carried by the group giving in. Hence, the argument is that the group giving in will have to bear a larger share of the short term cost in a more polarized society, something that is shown in the model to lead to a longer delay before actual stabilization. Veiga (2000) offers an econometric test of the role of political fragmentation looking at 27 inflation stabilization programs in 10 (mostly Latin American) countries from the 1960's to the 1990's. Using both a Probit model and a Proportional Hazard model, he finds that increased political fragmentation decreases the probability of starting a stabilization program. Along a similar line, Dollar and Svensson (2000), looking at what explains the success rate of structural adjustment programs, find that increased ethno-linguistic fragmentation, which is often argued to be a measure of polarization, leads to a lower probability of a successful reform program. However, the effect is non-linear, indicating that the adverse effect only kicks in at rather high levels of polarization. Related to this is also the work by Easterly and Levine (1997), Alesina, Baqir and Easterly (1999) and Alesina and Rodrik (1994) who emphasize how polarization causes a bias in public expenditures toward transfers, leading to an underinvestment in public goods. Even though these latter papers are not explicitly labeled in terms of constraints against reform, the importance of public infrastructure investments for the investment climate makes this literature relevant for the purpose of the WDR2005.

Another influential political economy model focusing on polarization and (electoral) uncertainty builds on the idea that policy decisions in one period “creates facts” that will influence the optimal decision of whoever is in power in the next period. This idea was first developed in Persson and Svensson (1989) and Alesina and Tabellini (1990) in the context of strategic debt policy, but the applications in Svensson (1998) and Cukierman, Edwards and Tabellini (1992) are probably more relevant for the purpose of the current review. Svensson (1998) shows how the combination of electoral uncertainty and divergent preferences over the optimal allocation of public revenues across two public goods can make incumbents chose not to undertake reforms that increase the

protection of property rights even if this is costless. The reason is that the current incumbent wants to influence his successor to choose a low tax rate if the successor is going to spend the revenues on public goods the current incumbent doesn't prioritize. The way to achieve this is by making tax collection inefficient, in terms of the mapping between a given tax rate and total tax revenues. In the model, lower protection of property rights push economic activity into the unofficial sector, where the deadweight cost of raising taxes is assumed to be higher. The "effective" size of the tax base thus shrinks with less protection of property rights, and optimal tax levels decrease. Svensson (1998) also provide empirical support for his model showing how measures of polarization are negatively correlated with protection of property rights (as captured by the indices developed by the International Country Risk Guide), which, in turn, is positively correlated with investments in physical capital. The paper by Cukierman, Edwards and Tabellini (1992) is very similar, but instead of looking at investment and property rights reform, they study inflation and tax reform. They also provide empirical support for their argument that more polarization leads to a more inefficient tax system, which in turn yields higher inflation levels (using the inflation tax rather than income taxes to raise government revenues).

### ***Vested Interests and Natural Endowments***

The arguments outlined above emphasized how uncertainty can explain why socially beneficial reforms are not implemented even if the number of individuals that stand to gain from reform seems to be "enough" given the specific decision making mechanism. An alternative, perhaps more straightforward explanation emanates from the fact that even if the reforms are socially beneficial they may still generate losers, and these losers may be politically influential enough to block the implementation of reform. The influence may be direct, through the ability to block enactment of the reforms within the parliament or their implementation, or it may be indirect through the ability to influence politicians to choose the status quo. It should be emphasized that the vested interest groups do not necessarily come from outside, the resistance to reform may very well come from within the government or, more generally, the political elite, itself. In

particular, the interest of the special interest groups become the interest of the government if the latter relies on the support of the former.

Models of special interest group influence on political decision making (through monetary contributions or information transmission) have been used to understand the lack of reform in many different areas, such as the persistence of trade protection and farm subsidies (see Grossman and Helpman 2001 for an overview). Even if politicians care about social welfare, the campaign contributions that can be raised by running on a platform of trade protection, for instance, may cause them to put higher weight on workers and capital owners in some sectors of the economy than on others (Grossman and Helpman 1994). Another reason why politicians may put higher weight on some groups than others in their choice of policies is that these groups consist of so called swing voters (e.g. Lindbeck and Weibull 1987, Strömberg 2003). This is another claimed reason for the persistence of trade protection and farm subsidies, and it has been argued that this has been an important factor behind recent trade policies in the US (read steel tariffs). The idea here is that political candidates will compete for the votes of the undecided voters, or more precisely, the votes of the less ideologically convinced voters, since they are easy to sway through economic promises. The support of more ideologically biased voters will either be too expensive to “buy” (if they are biased against) or not necessary (if they are biased in favour).

The two sets of models just discussed can be claimed to belong to the more general idea that politicians rely on the support of some groups in society in order to stay in power, in democracies as well as in autocracies, and that reforms that go against the interest of these groups will be particularly hard to implement. This is true not necessarily because these groups can directly bloc the implementation of the reforms, but because the rulers rely critically on the support from members of these groups.

Formal models of dictatorships are far less abundant than those of democracies (see Grossman 1991, Acemoglu and Robinson 2001, Acemoglu, Robinson and Verdier 2003 and Desai, Olofsgard and Yousef 2003b for some exceptions). Nevertheless, it is clear that also dictatorships rely on the support of some key constituencies within society. To stay in power dictatorial regimes often rely on a combination of oppression and preferential treatment to buy political legitimacy from these key constituencies. The

preferential treatment often take highly distortionary forms, though, such as excessive public employment based on group belonging rather than competence, granting of monopoly profits through imposing regulations that inhibit domestic and foreign competition, and import subsidies on food that benefits the urban middle class. Attempts to reform the economy thus threaten the core of the political support groups of the ruler. Reform may thus be particularly hard to implement in autocratic regimes because the loss of political legitimacy may lead not only to a shift in power, but to a (potentially violent) transition towards a different regime type. Acemoglu and Robinson (2000) show how a political incumbent may have incentives to block the introduction of a more efficient technology (or a welfare improving reform more generally) not mainly because it will erode his economic rents, but because it will threaten his grip of power if economic profits are correlated with political power. It should also be emphasized that many reforms aim towards formalizing the rule of conduct for economic decision making, and explicitly to decrease the discretion of politicians and bureaucrats to use their power to establish clientelistic relationships. Since many autocratic rulers rely on the ability to “divide-and-rule” through discretionary perks, and use uncertainty and fear to prevent coups or revolutions, reforms that formalize decision making and expose the ruler to outside accountability are likely to be fiercely resisted from within (see Bates 1981 and Acemoglu, Robinson and Verdier 2003).

Acquiring political support may be particularly costly in autocratic states though. This is the underlying premise of the “rentier state” literature, looking at the lack of political and economic reform in natural resource rich countries, often focusing on the oil rich countries of The Middle East and North Africa (e.g. Beblawi and Luciano (1987), Chaudhry (1994) and Karl (1997)). This literature stresses that the governments in resource rich countries predominantly engage in redistribution rather than extraction (since the ability to raise taxes is not necessary), and that they build political consensus through generous public benefits. What has been labeled a “governance deficit” in many resource rich countries has been explained by the argument that “..because state leaders have no need to extract, they have no need to represent either.” Some recent papers have looked at this empirically, and established an empirical relationship between oil wealth and autocracy, and oil wealth and regime survival. Ross (2001) emphasizes that oil

wealth has made it possible for autocratic regimes to invest in a repressive state that effectively quells opposition. However, Smith (?) finds that regimes rich in oil tend to survive longer in power, even when controlling for repression, which he interprets as support for the idea that regimes rich in oil can buy the support of their constituencies through economic benefits, and thereby contain the desire for political liberalization.

Tornell and Lane (1999) formalize the idea that increased rents can lead to an increase in rent seeking activity, and a decrease in productive activity, in a common pool framework. They show that the decrease in productive activity caused by the competition over newly available rents may dominate the positive direct effect of the positive shock, what they refer to as a “voracity effect”. The potential for a politically induced “natural resource curse” (that may also be generated by a terms of trade shock, foreign aid inflows or worker remittances, see e.g. Svensson 2000 and Knack 2000) is also emphasized in Auty (2001) and Desai and Olofsgard 2003. In particular, Desai, Freinkman and Goldberg (2003) show empirically that Russian regions with more “unearned” income streams – natural resource revenues or transfers from the center – tend to use these revenues to shelter loss-making firms from competition in order to avoid unemployment, i.e. these regions have not been successful in reforming corporate incentives and soft budget constraints remain.

## **Improving the outcomes**

In the previous section I mentioned a few papers within the waste literature on the political economy of transition emphasizing the reasons why reforms are not implemented. Most of the work within this area is presented in this section, though, because the bulk of the transition literature is more normative in character. The breakdown of state socialism in the former Eastern bloc was a historical event with enormous economic, political and social consequences and ripe with uncertainty. The demand for policy advice from both economists and political scientists ran high, but the academic literature was largely lacking in the existence of models for understanding what to do in an environment where markets and the underlying judicial and regulatory institutions necessary to support markets didn't exist. In this context, it was only natural

that the literature that eventually emerged had a somewhat different focus than the literature emanating from the experiences of the Latin American countries. In particular, instead of focusing on why socially beneficial reforms are not implemented, the models within this literature generally focus on how to introduce reforms in order to overcome political constraints. From a theoretical perspective, these models can be thought of as models of agenda setting power, in which there is a reform minded government in power who is facing political resistance. The agenda setting power means that the government has some power to decide the details of the reform suggestion but in order to implement the reforms the government needs support from some other group in society. The details may concern whether to bundle reforms (“big bang”) or not (gradualism), whether to offer compensation packages to losers from reform, or how to allocate the benefits of the reform. The question then is whether the government by choosing the details of the reform package can increase the chances that he will find sufficient political support to also implement the reforms.

The argument for compensation of losers is straightforward; the resistance from groups that expect to lose from reform can be overcome by making them winners of reform. Compensation may also have an additional political appeal in the sense that it may be viewed as fair, in particular if the groups that are compensated are deemed as vulnerable, such as the poor or the elderly. However, compensation is often more motivated by political power than fairness. Compensation will only be necessary if the groups have the political clout to actually prevent reforms, which is often not the case for the most vulnerable groups (see WDR 2004 for many examples of this). Hence, actual compensation is likely to be geared more towards the already relatively well-off, and it may even trigger powerful groups to threaten to resist reform strategically in order to get compensation. Nevertheless, as a political tool for overcoming political resistance it can still be useful. Shleifer and Treisman (2000) show in detail how reform minded governments in Russia used compensation (cooptation) together with expropriation to overcome resistance against macroeconomic stabilization as well as privatization. For instance, in the case of privatization the government compensated three layers of stakeholders in the process. Workers and managers got the opportunity to use enterprise funds to buy a significant share of the privatized firms at a heavy discount. Industrial

ministries were granted veto power over privatization of some of the largest state owned enterprises, while regional governments were given the responsibility for privatization of small firms and shops.

However, the book by Shleifer and Treisman (2000) also raises a word of warning when using compensation mechanisms. To get support for macroeconomic stabilization the government offered actors in the financial sector compensation through the so called “loans-for-shares” program. This program effectively transferred a large share of the most profitable state owned firms to the owners of the financial institutions at a heavy discount, leading to the creation of a new powerful economic elite, the so called “oligarchs”. As it turned out, though, these “oligarchs” emerged as a very powerful vested interest group against some of the subsequent reforms, in particular the attempts at tax reform in the late 1990’s. Hence, compensation may empower groups that later emerge as vested interests against further reform.

Related to the idea of compensation, but not identical, is the argument that reforms can be designed directly in a way to overcome political resistance and build popular support for the continuation of reforms. The discussion below, of the political economy of bundling versus unbundling of reforms, belongs to this group of arguments, but I will first review some other tactics that have been proposed. Roland (2000), when surveying the different approaches to privatization undertaken in the countries of transition, points out how different political constraints forced governments to chose strategies that may seem economically inefficient in a first best world. The case of Russian privatization presented above is one example in which ex ante constraints from workers and managers lead to what Roland refers to as a “give-away to insiders” privatization strategy. The case of the Czech Republic, on the other hand, is a case of privatization through “give-away to outsiders” in Roland’s typology. In this case the binding constraint was the electoral support for the reform minded Klaus government. To increase political support for a reform agenda the government decided to undertake privatization through a voucher program that gave all adult Czech citizens the opportunity to buy shares at a reduced price. The idea was that by creating a class of share holders, the government also created a large group of stakeholders in support of a continuation of market reform, which was thought to have a positive effect on stock

prices in the long run. This idea is formalized in Biais and Perotti (2002), and Earle and Gehlbach (2003) show through the use of a survey that Czech citizens that participated in voucher participation program, and who held on to their shares, showed more positive attitudes towards the continuation of reforms, a market economy more generally, and political reforms. Hence, the strategy seemed to have worked.

The perhaps biggest debate in the early literature on transition concerned the relative merits of gradualism versus big bang (bundling of reforms).<sup>5</sup> Part of the discussion was purely economic in nature, but there were also political arguments made for why to choose one rather than the other. This literature is way to large to be fully surveyed here, but what comes out of reading it is that which approach is to prefer depends critically on the type of political constraint and the underlying characteristics of the transition process. For instance, if there is a number of veto players who's support is critical, then bundling of reform may be necessary in order to be able to offer everybody something. On the other hand, if support from a majority is sufficient, then unbundling can pitch current majorities against future ones, speaking in favour of a divide and rule tactic (Roland 2000). Gradualism may also have the additional political benefits that the short term cost potentially imposed by reforms is smaller, and that by first introducing relatively popular reforms, a reform minded politician can build up his support for enactment also of the more controversial reforms. For instance, in a political system with a two period term limit, incumbents may increase their chances of reelection for a second period if the short term costs are smaller and the initial reforms are popular. In the second period they cannot be reelected anyway, so their political cost of implementing also the less popular reforms is substantially lower.<sup>6</sup>

The case for a Big Bang approach often builds on the argument that it takes some time for people to realize if they are going to win or lose from reform, and to form a powerful opposition against reform if they expect to lose, so by moving quickly, the politician prevents an opposition to emerge powerful enough to actually stop or reverse reforms. Big bang may also be preferred if full reforms are necessary to reap the long

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<sup>5</sup> By gradualism I here refer to reforms implemented sequentially rather than simultaneously. Hence, I am referring to the discussion of ordering rather than that of speed.

<sup>6</sup> Note that this doesn't mean that gradualism is to prefer from an economic perspective, just that it may be preferred politically.

term benefits and there is a risk that the transition process get stuck at partial reform (see Hellman 1998, discussed more in detail below). Rational forward looking agents that would be willing to bear the short term costs if they were sure to reap the long run benefits may withdraw their support for reform if the realization of the long run benefits become uncertain because of the risk of getting stuck at a partial reform equilibrium.

Another potential argument for the Big bang approach (that I have not seen in the literature) can be derived from the recent (economic and psychology) literature on self-control problems. Experimental studies show that people often have a preference for immediate gratification. A simple example: people may sincerely claim that starting from next week they will eat carrots rather than potato chips with their lunch, since the long term benefits of eating carrots are greater than the short term gratification of eating potato chips, *as perceived today*. However, once Monday come, the urge for immediate gratification may cause a deviation, because the perceived intertemporal trade off between the costs and benefits depends on how far in the future you are making the decision.<sup>7</sup> With these types of preferences, individuals aware of their self-control problems would like to be able to commit somehow not to eat the potato chips. One way to do this is to limit your choice set, i.e. go to lunch at a salad bar where only carrots are available. In the context of reforms, a gradualism approach in which voters have to decide on whether to politically support the current reform minded incumbent's continuation of reform may be to wide a choice set. The urge for immediate gratification may make voters support the non-reformer in order to avoid the short term cost of reform continuation, even though their lifelong expected utility as calculated *in the very beginning of the reform process* is higher with continuation of reform. The big bang approach may thus serve as a commitment device in this case, because it restricts the choice set of the voters, if reform reversal is unlikely or very costly.

In the previous section I briefly discussed the “natural resources curse” literature emphasizing how these resources may either lead to increased rent seeking or at least make it financially possible to sustain the status quo if reforms are politically costly. The counterpart in this “normative” section, also focusing on external conditions, is the so

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<sup>7</sup> Formally this is captured through using a hyperbolic, or quasi-hyperbolic, rather than exponential function to capture individuals' time preferences.

called “benefit of a crisis” hypothesis. The argument in this literature is that the political, or informational, impediments to reform may be so fundamental that reform will not be possible to implement unless a real crisis has emerged. The benefit is thus, first of all, that a crisis makes the implementation of reform possible, but as shown in Drazen and Grilli 1993, a crisis may even be welfare improving if the short term cost of the crisis is dominated by greater long term benefits from having reformed early on.<sup>8</sup> The normative implication is of course not that policy makers should try to create a crisis, but this shows that just as windfalls of revenues can delay reforms, the opposite, an economic crisis, can cause them to happen.

So, why should a crisis makes the implementation of reform more likely? There are many possible answers. The crisis may undermine the economic and political power of vested interest groups resisting reform, or it may cause a big enough deterioration in the status quo to make previous adversaries now becoming in favour of reform. A crisis may also cause a certain sense of urgency, creating a “window of opportunity” for reform minded incumbents to be able to implement reforms that would otherwise be blocked. For instance, all coalitions within the parliament may agree that macroeconomic stabilization is necessary in a crisis situation, but an incumbent with agenda setting power may be able to bundle reforms aiming at structural change together with those aiming towards macroeconomic stabilization, and in that way get the less popular reforms through the process as well. Finally, as pointed out in Harberger (1993), if there is incomplete information concerning the mapping between the choice of policy and outcome, and, in particular if policy makers perceptions are somewhat biased in favour of one set of policies (such as the advantage of an import-substitution development strategy), then a crisis may be necessary for policy makers to change their view of the world and adopt the necessary reforms. Formally, the argument relies on Bayesian updating; when things turn wrong, policy makers start updating their beliefs about the

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<sup>8</sup> The argument has not been without critic. Rodrik (1996) argues that the idea is tautological, since: “A crisis is just an extreme case of policy failure. That reform should follow crisis, then, is no more surprising than smoke following fire.” The argument should probably be understood as saying that it is not enough that things turn bad (as we could think would be enough from a theoretical perspective), but things have to turn really bad. This is also confirmed by the empirical work by Drazen and Easterly (2001), where they show, among other things, that inflation levels tend to have a positive correlation over time in countries with high levels of inflation (a bad situation), but a negative correlation in countries with really high levels of inflation (a crisis).

mapping between the choice of policy and outcome. However, high inflation or moderate deficits in the internal or external balances can be rationalized by external factors, so a full blown crisis may be necessary in order to convince the policy makers that their view of what is “good” policies may be incorrect, and that reforms are necessary.

## **Elections, Transparency and Accountability**

In this section I will discuss more in detail the role of elections, and political transparency and accountability, all important aspects of democracy. One possible interpretation of much of the literature surveyed so far is that implementation of reforms, which often entails short term costs and only more long term benefits, requires that political decision makers are shielded from the influence of vested interest groups and spared from the temptations for populist policies in the presence of electoral competition. In a sense, the definition of the literature is that it shows how political constraints may hinder the implementation of a reform in a situation in which a benevolent dictator would have implemented the reform (Drazen 2000). Fueled by what some authors saw as a failure of many democracies in Latin America to break spirals of populism and recurring macroeconomic crisis, democracy as a tool for reform came somewhat in disrepute after the 1980’s. Thus, arguments were made in favour of concentrating power in a strong executive (Nelson 1993), that monetary and fiscal policy needs to be in the hands of independent, professional “technocrats” (Williamson 1994), that centralized authority is needed to overcome partisanship and division (Haggard and Kaufman 1992), and that authoritarian regimes may be more capable of resolving economic crises than pluralistic democracies (O’Donnell, Schmitter, and Whitehead 1986).

However, this reasoning builds on the explicit or implicit assumption that an uncontested political leader will chose policies in order to maximize social welfare. Examples of this do exist (at least approximately); the developmental states of East Asia are examples of that. Examples in the other direction are even more abundant, though; autocratic regimes in which the policy decisions of the ruling elites have been guided only by the desire to enrich themselves and their key constituencies and to remain in power (e.g. Klitgaard 1990, Bates 1981, Acemoglu, Robinson and Verdier 2003, and

Acemoglu and Robinson 2004). In this context, elections may be necessary to constrain the discretion of political incumbents, and to force accountability upon incumbents with a strong taste for the accumulation of private wealth.

The truth is probably that politicians come in all sizes, forms and colors. They may differ both in terms of overall competency, with respect to identifying and implementing good policies, but also regarding honesty or the underlying motivation for doing politics (in Max Weber's words: some live "off" politics, others live "for" politics (Weber 1946)). This fact seems to speak in favour of voice: through elections voters first of all have an instrument for getting rid of incompetent and dishonest politicians (the adverse selection dimension, as pioneered by the work of Rogoff and Sibert 1988, Rogoff 1990, and Persson and Tabellini 1990), and the elections may also impose a certain discipline on opportunistic politicians that enjoy political power (the moral hazard dimension, as pioneered by Barro 1973, Ferejohn 1986).<sup>9</sup>

From a pure reform perspective, these arguments do rely, though, on the idea that reform is in the interest of the majority of the population, but not necessarily for the ruler or the key constituencies on who's support he relies. The populism argument motivated by the experiences of the Latin American countries in the 1980's, seems to contradict this assumption. However, the validity of that argument has been disputed. Tommasi and Velasco (1996) mentions several examples from Latin America in which parties and politicians traditionally thought of as populist (in most cases argued to be similar to "left-wing") were the ones actually pursuing most of the reforms (Menem in Argentina, Fujimori of Peru, and Estenssoro in Bolivia are mentioned as examples). Further support for this argument is given by the experience of the countries in transition. The left wing governments that in most countries replaced the initial reformists in power in the second round of elections after the demise of communism generally continued the reform process to an equal or greater extent (Fidrmuc 2000). Hence, the argument that the electoral defeat of the initial reform governments showed the popular resentment against reforms may not be correct. On the contrary, as shown in Åslund, Boone and Johnson (1996) and Warner (2001), this may have had more to do with dissatisfaction with that only part of

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<sup>9</sup> As pointed out in Besley and Burgess (2002) and Strömberg (2004), the ability of voice to create accountability also requires a dimension of transparency though.

the reform was completed, than with dissatisfaction with the reform that had been undertaken. Polls from the Euro-barometer, cited in Warner (2001), showed that a majority of the respondents wanted faster reform in all countries surveyed, and that citizens in countries with more radical reform were more likely to say that their country was heading in the right direction.

The finding that “left-wing” or populist governments continue the reform process, and sometimes go even further in this pursuit is not necessarily as puzzling as it may first seem. An informational explanation for this phenomenon is given in Cukierman and Tommasi (1998). The argument is that politicians can only implement reforms without dire political consequences if they manage to also convince incompletely informed voters that reform is really in their interest. If reforms are deemed as an elite project, with benefits accruing to the “poor majority” only in case the economic situation really requires it, then a left-wing government may be deemed as more credible when making the case for reform. As a consequence, even if a left-wing government generally is less in favour of reforms, if a reform really is in the interest of the public, then the left-wing government has more political credibility to actually implement the reforms without the risk of being ousted out of office in the next elections. The title of the paper, “Why does it take a Nixon to go to China?”, neatly presents the implications of their model.

The countries of transition also offer ample examples of how politics become captured by elites with incentives to stall the reform process (e.g Hellman 1998, Shleifer and Treisman 2000 and Desai, Olofsgard and Yousef 2003a). Hellman (1998) argues that the most serious threat against implementation of reform does not come from the short term losers but from the risk of state capture by the winners of partial reform. These winners are the often well connected elites that manage to make profit from arbitrage opportunities that arise when reforms are only partial. For instance, with partial price liberalization groups can make great profits if they are granted the opportunity to work as middlemen between state owned enterprises selling inputs to production at regulated (low) prices and final producers working at a competitive market with deregulated prices. Along a similar line, the new owners of privatized former state owned monopolies will have incentives to prevent further reforms to open up markets and increase competition, and thus decrease their monopoly profits. In this context, it is in the interest of the broad

majority to continue the reform process, so electoral competition should not be a threat against reform continuation. Rather the opposite, without elections, or with elections but without transparency and accountability in the political process, the risk that decision making is captured by the connected elites and winners from partial reform is greater. Hence, the suggested remedy is to increase the voice of the majority of winners from the continuation of the reform process through empowerment of consumers/workers and the new entrepreneurial groups without political affiliations, and to increase transparency and enforce accountability on political leaders.

## **Transparency and Accountability as a Tool for Political Credibility**

The purpose of this section is to try to think more independently about the role of democracy, transparency and accountability. In particular, I will pick up on the idea that politicians can differ in terms of competence as well as honesty, and argue that voter uncertainty can pose obstacles for reform, if the benefits of reform to the majority depend on the incumbent's type. Fortunately, I will also offer some suggestions for what an honest and competent incumbent can do to credibly communicate his type to the voters.

As argued above, in the presence of different types of politicians, elections seem to be helpful by giving the voters an opportunity to oust dishonest and incompetent incumbents. However, as shown in political models of career concern, information of the political incumbent's qualities may not be so readily available. In particular, even if honest and competent politicians have incentives to try to communicate their qualities and intentions, less competent and honest politicians, of course, are less likely to be honest about *their* true qualities and intentions. More precisely, the less honest and competent types will have incentives to try to persuade voters of the opposite, making it difficult for the voters to discriminate between the types.

An example of how the potential existence of different types of politicians, and the lack of ability of voters to discriminate among these types, can lead to reform backlash, can be derived from the work of Hellman (1998). He describes a reform process where the social benefits of the voting majority follow a so called j-curve pattern,

with partial reform causing short term losses while long term gains are realized only if the reform process continuous. However, there is also a group who's utility peak at partial reform in his model, the so called winners of partial reform. This group will have an incentive to try to capture the state, through bribes or pressure, and lock the country into the partial reform state. If their ability to capture the state depends on the honesty of the political incumbent, then even perfectly rational and forward looking voters may withdraw their electoral support for reform because so far they have only experienced the short term losses and if they cannot tell whether the incumbent is honest or not they are uncertain to what extent the long term gains are ever going to be realized. Of course, the honest politician will have incentives to try to persuade voters of his honesty, but he may lack the instrument to distinguish himself from the dishonest type.

An application directly relevant to WDR2005 is reforms aimed at improving incentives within firms. A "second generation" reform within this context is privatization of state owned monopolies. These privatizations must be combined, though, with a set of "third generation" reforms that aim towards increased market competition in order to generate the full social benefits. However, this is not in the interest of the new private owners of the former state owned monopolies (the winners of partial reform in this example), who therefore have the incentives to "capture" political decision making to prevent the "third generation" reforms to be implemented.

It is important to note that the dilemma identified above does not mean that an autocratic system would do any better. It all depends on the type of politician that happens to be in power. Rather, what I argue is that with the existence of different types, political credibility becomes crucial. The importance of political credibility to judge whether promises of reforms will be honored is of course not a new idea, even though what it really means is often unclear. For instance, Keefer (2003) points out that credibility is often confused with predictability. The more specific definition of political credibility I have in mind is the ability of the voters (which is the group who's believes matter in this case) to separate between the promises of reform that will actually be honored, and those who will not.<sup>10</sup> Lupia and McCubbins (1998) discuss at length what they refer to as necessary and sufficient conditions for credible communication between a

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<sup>10</sup> This is highly related to the notion of credibility expressed in World Bank 1995.

“speaker” (the potentially informed agent, often referred to as the sender or the expert in the cheap talk literature) and the principal (the decision maker, in my case the voters determining whether to reappoint the incumbent) in support of economic reforms.<sup>11</sup> The authors first present a pure communication model, in which talk is cheap in the sense that the principal cannot verify whether what the speaker is saying is true or not. In this context, the authors emphasize the importance of co alignment of preferences between the speaker and the principal in order to guarantee credible communication.<sup>12</sup> This mechanism resembles that of Cukierman and Tomassi (1994) mentioned above, even though their model is not a cheap talk game. Lupia and McCubbins (1998) then go on and discuss alternative measures to guarantee credible signals when preferences do not co align, emphasizing either verification mechanisms together with penalties for lying, or costly signals, i.e. signals that reveal the speakers type (or the realization of an exogenous variable) by showing that he is willing to carry the cost of sending the signal.

In my example above with “true” and “dishonest” reformers, pure communication will not work, because the problem arises from the fact that voters do not know the identity of the current incumbent and a dishonest reformer will of course say whatever a true reformer would say in order not to reveal his type (and this will not be costly for him since “talk is cheap”). What I propose instead, and what I lay out in a formal model in the next subsection, is that a credible way for the true reformer to communicate his type to the voters is by implementing institutional reforms that imposes verification mechanisms and penalties for being captured by the winners of partial reform. The reforms I have in mind are reforms aimed at increasing political transparency and accountability. For instance, reforms aimed at empowering an independent media and the civil society, and to increase political competition can increase transparency, whereas electoral reforms and reforms aimed at strengthening an independent judiciary can increase political accountability. Through these reforms, the politicians “tie their hands to the mast” in the sense that the personal risk of engaging in corruption and criminal activities in exchange for bribes or political support from winners of partial reform becomes very high. Through

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<sup>11</sup> Their simple example is just a generic model of communication, or cheap talk, including the potential for costly signals.

<sup>12</sup> They also emphasize that the speaker must have actual knowledge about what the best option is. This is not really relevant for my case, in which the private information concerns type rather than the realization of an exogenous variable reflecting the state of the world.

increased transparency, the activities are likely to be observed and broadcasted, and through increased accountability, the perpetrators are likely to be captured. Implementation of these reforms thus effectively work as a costly signal, because they constraint the ability of the dishonest type to benefit from being captured. Hence, if the true reformer goes far enough with these reforms, the dishonest reformer will not find it worthwhile to mimic his behaviour, so the true type manages to distinguish himself from the dishonest type in the eyes of the voters.

Far reaching political reforms of this type is thus an instrument for truly reform minded governments to increase their political credibility. Furthermore, with increased political credibility, the political reforms make the continuation of economic reforms more likely, by increasing economic reforms popularity among the voters. Voters are therefore more likely to support a reform agenda at the elections, so the risk for political backlash is smaller. Transparency and accountability thus increases the ability of honest politicians to stay on to power within a democratic system. Note, though, that the implementation of these institutional reforms is an endogenous choice, not made by all types of politicians. This view is consistent with the argument that “politician proofing” of policies is a somewhat futile idea (Robinson 2003). If political incentives are in favour of derailing good policies, then politicians will come up with ways to hold on to their rents and benefit their clients even if they on the surface seem to follow the recommendations from International Financial Institutions or bilateral aid donors. Hence, the policy recommendation that emanates from this argument is thus not so much to always *push* for far-reaching institutional reforms, but rather, to *inform* governments of the role of accountability and transparency in building political credibility. Furthermore, resistance against implementation of these reforms can also serve as a signal to the donor community that these governments are unlikely to persist in the reform process, which can be useful if selectivity ever becomes the benchmark for aid allocation (e.g. World Bank 1998, Burnside and Dollar 2000, and Svensson 1999).

### *A Simple Model.*

In this section I develop a very simple voting model to illustrate the point of the mechanism I just outlined intuitively. There are three sets of players in the game, politicians, voters and the “elite”. The “elite” is a small group (who’s votes therefore doesn’t matter for the politicians choice of policy) who stand to gain from partial reform. For instance, think of these as the owners of the newly privatized former state owned monopolies who wants to prevent further reforms aiming at increasing market competition. They are therefore willing to share part of their monopoly profits with the political incumbent, through bribes, if the incumbent promises not to go further with reform.<sup>13</sup>

Politicians are of three types. The period 1 incumbent was elected on a reform platform, but he has so far only undertaken partial economic reform. To generate the long term gains from reform full implementation is necessary. However, whether this will be realized or not depends on whether the current incumbent is sufficiently ideologically motivated, or honest, to turn down the offer from the elite and go further with reforms. We call the type that cannot be bribed a “true” reformer, denoted by subscript  $tr$ , and the type that can be bribed as a “dishonest” reformer ( $dr$ ). The level of second period reform is given by the parameter  $r$ . I assume that the “true” reformer chooses full reform,  $R$ , while the “dishonest” reformer chooses reform level zero in exchange for the bribe from the “elite”. The third type of politician is the political opposition in the elections, who is a non-reformer ( $nr$ ), running on a platform of reform reversal, a strategy denoted as  $v$ . In addition to choosing different policies, all types of politicians are assumed to be office motivated. That is, incumbents are assumed to benefit from ego-rents of size  $\Omega$  if they get reelected to a second period.

Voters, finally, are all identical and vote sincerely on the incumbent or the non-reformer depending on who they expect to generate the highest pay-off. It is assumed that

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<sup>13</sup> I assume that such promises are credible. I further assume that the elite does not know if the incumbent will win the election or not when they offer the bribe, so it is a gamble from their perspective. This can be rationalized by assuming that the elite does not know at the time they offer the bribe the value of all of the parameters that determine whether there will be a separating or a pooling equilibrium.

voters are best off with full economic reform and worst off with partial economic reform. Hence, if the voters know that the current incumbent is “true” then they will reelect him, and if they know he is “dishonest” then they will oust him. We can write the condition under which a representative voter supports the incumbent as

$$E[U(r)] \geq U(v),$$

where  $E$  is the expectations operator, and  $v$  is the value of reversal. It is assumed that  $U(0)=0$  and  $U(R)=1$ .

There are two elements of uncertainty in the model. First, voters do not know the type of the incumbent. The ex ante probability that he is “true” is given by  $\mu_{tr}$  which can be any value between zero and one (the probability that he is “dishonest” is then of course given by  $1 - \mu_{tr}$ ). However, as explained more carefully below, voters can observe the choice of political reform and use that as a signal to update their beliefs of the incumbent’s type. Secondly, the incumbent has incomplete information about  $U(v)$  (that is, he is unsure about the value voters attach to reform reversal). He knows though that  $U(v)$  is drawn from a uniform distribution with support on the open set between 0 and 1. It follows that a dishonest incumbent knows that he will lose the elections with probability one if the voters know he is dishonest, while a true incumbent will win the elections with probability one if the voters know for sure that he is true. However, if the voters cannot tell the difference between a true and a dishonest type, then the perceived probability that the incumbent wins the elections is given by the probability that<sup>14</sup>

$$\mu_{tr} \geq U(v).$$

Following the distributional assumptions, this probability is given by  $\mu_{tr}$ .<sup>15</sup>

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<sup>14</sup> The full expression for the expected utility of reelecting the incumbent is given by  $\mu_{tr} U(R) + (1 - \mu_{tr}) U(0)$ . This can be reduced to  $\mu_{tr}$  though since  $U(0)=0$  and  $U(R)=1$ .

<sup>15</sup> This set-up implies that the incumbent either gets all votes or no votes at all. This could easily be changed by adding a voter specific bias towards the incumbent (a so called valence characteristic, that may have to do with charisma or perceived competence) with some known distribution. This would not change the outcome of the model in any way, though, so I stick to the simpler set-up.

So far I have not said anything about political reform aiming at improved transparency and accountability. The assumption I make is that the incumbent can choose a level of political reform,  $\lambda$ , between zero and full reform ( $\Lambda$ ), in the beginning of period 1 (before the bribe is offered and before the elections). Implementation of these reforms has benefits and costs from the perspective of the incumbent. The benefit can come from different sources, such as improved reputation and respect within and outside the country (in particular if the country is an aid recipient and aid donors favour these reforms) or it may open the door for membership in international organizations, treaties or unions, such as the European Union. There is also a personal cost of political reform though in the sense that it opens up the door for closer scrutiny of the activities of the government. The true reformer is ideologically driven to reform, but I do not presume that he is intrinsically honest or may not engage in any dubious behaviour in order to further his political or personal ambitions. Hence, I assume that all types of incumbents carry part of the personal cost of political reform. However, I also assume that the dishonest type carry the additional cost of political reform that it decreases the bribes the elite are willing to offer in exchange for a discontinuation of the reform process. With increased transparency and accountability, bribes are more likely to be observed (verification in the words of Lupia and McCubbins), and the bribers are more likely to be prosecuted (penalty, in the words of Lupia and McCubbins). The expected return from offering bribes is thus decreasing in political reform. I therefore assume that the size of the offered bribe also will be decreasing in the level of political reform. The utility function of an incumbent of type  $i$  can now be formalized as

$$U_i(\bullet) = h\lambda + I_i\gamma(\Lambda - \lambda) - C(\lambda) + \Pr(\lambda)\Omega,$$

where  $h$  stands for the marginal gain from increased political reforms,  $I_i$  is an indicator function that takes on the value of 1 for dishonest types (when  $i = dr$ ) and zero otherwise (when  $i = tr$ ),  $\gamma$  is the marginal decrease in the value of bribes as  $\lambda$  is increasing,  $C(\lambda)$  is the common cost of political reform, with  $C' > 0$  and  $C'' > 0$ , and  $\Pr(\bullet)$  is the endogenously determined probability that the incumbent wins the elections.

As a benchmark, think first of the case in which the probability of reelection is exogenous, or more specifically, not a function of the choice of political reform. The incumbent now chooses the level of political reform that maximizes his utility, as represented by the first order condition below, equating the marginal benefits with the marginal costs.

$$h = C'(\lambda^*) + I_i \gamma$$

From the simple structure it is straightforward to see that  $\lambda_{dr}^* < \lambda_{tr}^*$  since the dishonest type will set  $\lambda$  such that  $C'(\lambda)$  is smaller to compensate for the additional cost,  $\gamma$ . This is done by setting a lower  $\lambda$  since  $C(\bullet)$  is a convex function.

Things change when we take into consideration the fact that the choice of political reform is also a signal of the type of the incumbent to the voters. In particular, if both types were to choose the unconstrained  $\lambda_i^*$  as indicated above, then the true type would be reelected with probability one, while the dishonest type would be ousted with probability one, since their different choices of political reforms perfectly reveal their types. However, if the ego rents from staying in power are large enough then the dishonest type may be better off by mimicking the choice of political reform of the true type in order to stand the chance of winning the elections (with probability  $\mu_{tr}$ ). Let's define such a mimicking policy as  $\lambda_{dr}^{**} \geq \lambda_{dr}^*$ . On the other hand, this will decrease the chances of reelection of the true type, so he may have incentives to choose even more political reform in order to separate himself from the dishonest type. Let's define such a strategy as  $\lambda_{tr}^{**} \geq \lambda_{tr}^*$ . Whether there will be a pooling equilibrium (where both types of politicians chooses the same level of political reform) or a separating equilibrium (where they choose different levels of reform so the type of the incumbent is revealed to the voters) will depend on parameter values in the model.<sup>16</sup>

It is possible to specify the conditions under which a separating equilibrium exists as follows. First of all, the dishonest type must be better off by choosing  $\lambda_{dr}^*$  and winning the elections with probability zero than by choosing  $\lambda_{tr}^{**}$  and winning the elections with probability  $\mu_t$ . Secondly, there must exist a  $\lambda_{tr}^{**}$  such that the true type is better off by

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<sup>16</sup> Formally, the equilibrium concept applied is a Perfect Bayesian Equilibrium.

choosing  $\lambda_{tr}^{**}$  and winning the elections with probability one than by choosing  $\lambda_{tr}^*$  and winning the elections with probability  $\mu_{tr}$ .<sup>17</sup> This can be formalized as saying that there must exist a  $\lambda_{tr}^{**}$  such that the inequalities

$$U_{tr}(\lambda_{tr}^{**} | 1) > U_{tr}(\lambda_{tr}^* | \mu_{tr}),$$

and

$$U_{dr}(\lambda_{dr}^* | 0) > U_{dr}(\lambda_{tr}^{**} | \mu_{tr}),$$

are simultaneously satisfied. In a similar way we can specify the conditions for a pooling equilibrium. There exists a pooling equilibrium if the inequalities

$$U_{tr}(\lambda_{tr}^* | \mu_{tr}) > U_{tr}(\lambda_{tr}^{**} | 1),$$

and

$$U_{dr}(\lambda_{tr}^* | \mu_{tr}) > U_{dr}(\lambda_{dr}^* | 0),$$

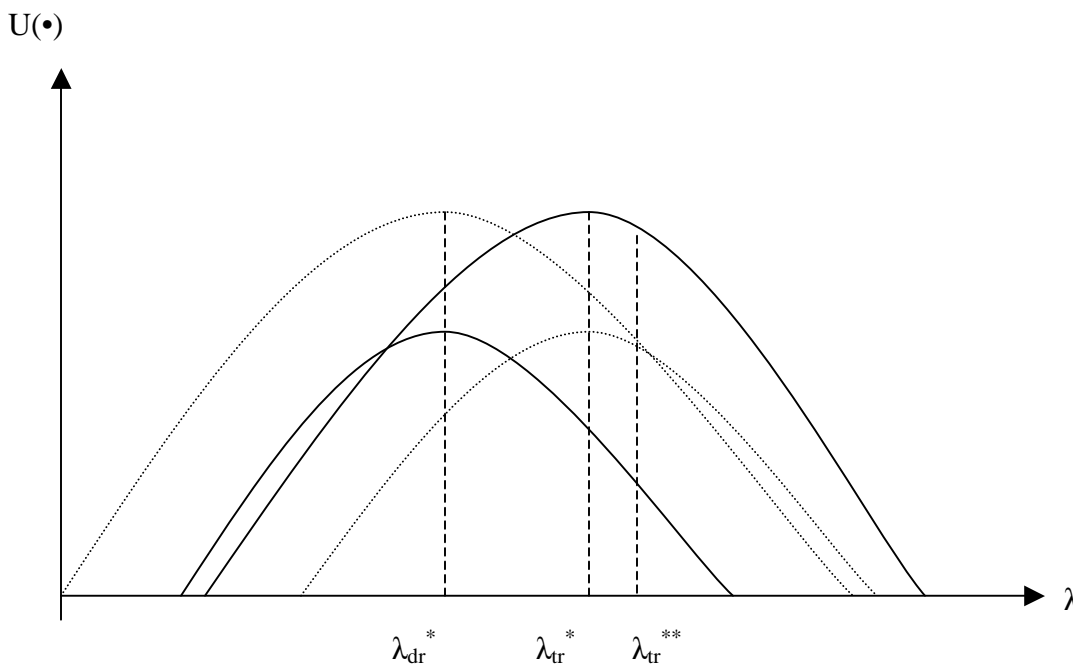
are simultaneously satisfied *for all*  $\lambda_{tr}^{**}$  such that the dishonest type is better off by not mimicking.

The most transparent way to show the intuition behind the separating equilibrium is through a figure. Figure 1 below shows utility as a function of  $\lambda$ , with the two left most functions corresponding to the dishonest type, and the two right most functions corresponding to the true type. The dashed lines represent respective types' utility in the pooling equilibrium, whereas the solid lines correspond to the utility in the separating equilibrium. Note that the dishonest type is better off in the pooling equilibrium, for any choice of  $\lambda$ , whereas the true type is better off in the separating equilibrium. Think first of the case in which both types choose their unconstrained best,  $\lambda_{tr}^*$  and  $\lambda_{dr}^*$  respectively. This corresponds to a separating equilibrium since voters can tell the type of the politician from the choice of political reforms, so utility is represented by the solid lines. There are clearly no incentives for the true type to deviate from this strategy unilaterally, but what about the dishonest type? The picture shows that in this case the utility of the

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<sup>17</sup> I disregard the trivial case in which there is a separating equilibrium even if the true type chooses his unconstrained optimal policy.

dishonest type is higher if he instead chooses to mimic the true type by choosing  $\lambda_{tr}^*$  since that means that the types now are un-separable. That doesn't necessarily mean that there exists a pooling equilibrium though. A pooling equilibrium only exists if the true type is better off by keeping to  $\lambda_{tr}^*$  when the dishonest type is mimicking him than by choosing  $\lambda_{tr}^{**}$ . As the figure is drawn, the condition for a pooling equilibrium is violated. That is, the utility of the true type is higher when choosing  $\lambda_{tr}^{**}$ , and receiving the utility represented by the solid line, than by choosing  $\lambda_{tr}^*$ , and receiving the utility represented by the dashed line.



So, what makes a separating equilibrium more likely? The conditions for a separating equilibrium have so far been expressed in very general terms, but by rewriting the expressions above using the specific utility functions we can also discuss some comparative statics results.

$$h\lambda_{tr}^{**} - C(\lambda_{tr}^{**}) + \Omega > h\lambda_{tr}^* - C(\lambda_{tr}^*) + \mu_{tr} \Omega,$$

$$h\lambda_{dr}^* + \gamma(\Lambda - \lambda_{dr}^*) - C(\lambda_{dr}^*) > h\lambda_{tr}^{**} + \gamma(\Lambda - \lambda_{tr}^{**}) - C(\lambda_{tr}^{**}) + \mu_{tr} \Omega.$$

Rearranging terms we get

$$(1 - \mu_{tr})\Omega > h(\lambda_{tr}^* - \lambda_{tr}^{**}) - C(\lambda_{tr}^* - \lambda_{tr}^{**}),$$

$$h(\lambda_{dr}^* - \lambda_{tr}^{**}) + \gamma(\lambda_{tr}^{**} - \lambda_{dr}^*) - C(\lambda_{dr}^* - \lambda_{tr}^{**}) > \mu_{tr} \Omega.$$

The most clear-cut result is that a decrease in  $\mu_{tr}$  will make both constraints looser, i.e. make a separating equilibrium more likely. The intuition behind this result is that a decrease in  $\mu_{tr}$  decreases the probability of getting reelected in the pooling equilibrium. This means that the dishonest type has less of an incentive to mimic the true reformer, whereas the true reformer will have more of an incentive to separate himself from the dishonest type. A separating equilibrium is thus more likely when voters' ex ante expectations of the overall "quality" of reformers is less favourable. The role of the political ego-rents is less obvious, though, since it will increase the gain for the dishonest type of mimicking at the same time as it will increase the gain for the honest type of separation. The marginal effect of this gain is a function of  $\mu_{tr}$ , with the gain of mimicking increasing in  $\mu_{tr}$  whereas the gain from separation is decreasing in  $\mu_{tr}$ . It follows that an increase in  $\Omega$  will make a separating equilibrium more (less) likely when  $\mu_{tr}$  is small (large). Finally, the relative cost of deviation also matters. In particular, a separating equilibrium is more likely if the relative cost of deviating from the unconstrained first best is low for the true type but high for the dishonest type. This in turn will depend on the relative decrease in bribes that comes from political reforms, and the extent to which political reforms lead to other intrinsic benefits (the true reformer may put a higher value on those intrinsic benefits).

There are in particular two interesting insights that can be derived from this simple model. First of all, the political credibility problem induces the true type of reformer to go one step further with political reform, i.e. to choose more of verifiability and penalty, in order to create a mechanism for credible communication of his intentions. The existence of the dishonest type thus leads to more political reform in (the separating) equilibrium, than what would occur in the absence of a political credibility problem. If political reform is socially desirable, the existence of a "bad" type of politician thus has

the paradoxical implication that it increases social welfare by leading the “good” type of politician to overshoot in his reform implementation. Secondly, political institutions matter, not necessarily because they constrain the behaviour of politicians with bad intentions, but because they can help true reformers to signal their intentions and thereby gain continued political support. This result thus falls somewhere in between the often over-optimistic belief in institutions as a tool to constrain bad behaviour, and the more pessimistic view of the futile pursuit of “politician-proofing”, expressed for instance in Robinson (2003). The important policy implication that comes out of the model is thus the potential merits of early and decisive political reforms in order to guarantee future support for economic reforms.

### *Empirical Implications*

So, what are the empirical implications of the simple model developed above? At the most general level the model suggests that increased democratization, in a wide interpretation of the word, will make reforms more likely. As shown in the literature review above, the experience of Latin America in the 1980’s didn’t necessarily confirm this conjecture. Opinions vary, but Chile and Mexico have been brought forward as examples of successful reforms under autocratic and dominant-party rule respectively, while there are numerous examples of failed reforms under democratically elected leaders. However, the experience of the countries of transition has been quite the contrary. The countries that pursued a simultaneous political and economic transition have generally been more successful in economic reform implementation. It is therefore probably fair to say, that the currently dominant view is in favour of voice, transparency and accountability.

For the purpose of building support for my argument, this is a very shallow approach though. This general link can be explained by many different models and arguments, so a serious empirical test must be more carefully designed. The mechanism identifies that the link from reforms of transparency and accountability to successful implementation of economic reforms goes through the impact on public support for the continuation of reforms. This support can be measured through the electoral support of

reform parties. However, there are a couple of potential caveats to that approach. First of all, political support also depends on other issues, such as policy choices in other dimensions and perceived competence and honesty. Secondly, as the experience of many transition and some Latin American countries show, parties not associated with reforms at the elections often continue the reform process anyway once elected. This has led scholars (e.g. Åslund, Boone and Johnson 1996 and Warner 2001) to question the “conventional wisdom” that reform parties were ousted because of popular dissent with the effects of reform. Rather, it is argued that the reason why these parties were voted out of office was due to dissatisfaction with the partial, or to slow, implementation of reforms. This view seems more consistent with the observation that “anti-reform” parties continued with reform once in office. Furthermore, it is also consistent with opinion poll data from the Euro-barometer (presented in Warner 2001, p. 450) that “show that a majority of respondents wanted faster reform in all countries surveyed and that people in countries with radical reform were more likely to say that their country was moving in the right direction.”

Therefore, a more precise and potentially more fruitful empirical approach would be to look at the two-step correlations between first of all early political reforms and political support for economic reforms as expressed in polls, and then between political support for economic reforms and actual implementation of economic reforms. Hence, the empirical specification would involve a system of two equations, using opinion poll data to measure public support. A recent paper by Kim and Pirttila (2003) follow an approach similar to this, looking at what determines public support for market friendly economic reforms, and how support matters for actual implementation of reforms in countries of transition.<sup>18</sup> They focus on economic variables, such as unemployment, inequality, growth and inflation, rather than political variables when determining public support for reform, so their results from this equation are not helpful for my purpose, but they also find that public support for reform has a statistically significant and positive effect on reform implementation, in line with what I expect. It would be very interesting to see, following their approach but incorporating political variables in the first regression and potentially increase the sample of countries, if the model finds support in the data.

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<sup>18</sup> They even go one step further and look at how reforms then matters for growth.

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