

**Political Institutions, Policymaking Processes, and Policy Outcomes**  
**AN INTERTEMPORAL TRANSACTIONS FRAMEWORK \***

Pablo T. Spiller, Ernesto Stein and Mariano Tommasi \*\*

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\*\* Spiller: Haas School of Business, UC-Berkeley; Stein: Research Department, Inter-American Development Bank; Tommasi: Universidad de San Andres and CEDI. We thank Mark Jones, Marcelo Leiras, Eduardo Lora, Frances Rosenbluth, Carlos Scartascini., Jessica Seddon Wallack, Olga Shvetsova, and participants at the Yale Political Economy Lunch, and at the Princeton Conference on Comparative Analysis of Political Institutions for valuable comments. This paper has benefited indirectly from comments, criticism, and suggestions to Spiller and Tommasi (2003b), especially by Margaret Levi. This paper was written while Tommasi was visiting professor in Economics and Political Science at Yale University. The hospitality of the Leitner Program in International and Comparative Political Economy at the Yale Center for International and Area Studies is gratefully acknowledged.

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## **I. MOTIVATION**

Policy economists' natural inclination is to emphasize policy recipes as ways to improve people's well-being, in developed and developing countries alike. The outcome of this effort in developing countries, however, has often been disappointing. After thirty or more years of major reforms throughout the developing world, only a handful of the then developing countries have moved into, or are in the course to, join the first league. This project is based on the belief that the potential of policy recipes depends on the quality of the policy-making process onto which those recipes will be applied. Thus, only through improvements in policy-making processes (or through a better understanding of these processes when policies are designed) can we expect sustainable improvements in public policies and in their impact on development objectives.

What determines a society's capacity to adjust its policies in the face of changed circumstances or in the face of the failure of previous policies? What determines the ability to sustain policies long enough to create an environment of credibility and hence to elicit the adequate responses from economic agents? More generally, what determines the capacity to decide and instrument effective policies? These are the types of questions that this project will try to address.

The purpose of this paper is to develop a framework to analyze the way in which political institutions affect policy outcomes. Within the framework proposed here, the policymaking process plays a central role in the link between political institutions and policy outcomes. Institutions do not affect outcomes directly, but rather through their impact on the process by which policies are designed, approved and implemented. We place particular emphasis on the way in which some features of the process of making policy in each country affect some characteristics of the resulting policies. Those features of the policymaking process are, in turn, traced back to their institutional determinants.

There is in Latin America a sense of disenchantment with the economic and social impact of the so-called "market-oriented reforms" or "neo-liberal economic reforms" (by their supporters and critics respectively).<sup>1</sup> "The reforms" are, at some level, generic titles given to certain broad definitions of policy, for instance "privatization of utilities." Many different practices and actual experiments can fall under one such title (Murillo, 2002). As indicated by the example of "pension reform" in Argentina, developed in Section VI below, what matters the most for policy performance and for people's welfare, is not whether a country has a "public pay-as-you-go system" or a "system of individual accounts administered by private pension funds regulated by the State," but whether the State has the capacity to sustain some intertemporal commitments, such as that of not expropriating people's savings.

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<sup>1</sup> That disenchantment, coupled with the excessively bullish claims made by reform advocates at the time, might be leading in some cases to a pendulum swing to over-simplified negative interpretations (Tommasi, 2002b). For example, Ruben Lo Vuolo, economic advisor to one of the top presidential candidates in Argentina, says "Argentina was the best pupil of the Washington Consensus, and see where we ended up. We have to change the model." (Lo Vuolo, 2002). The current state of the reforms, both in terms of substantive outcomes, as well as in terms of public opinion, is thoroughly reviewed in Lora and Panizza (2003).

The capacity to sustain intertemporal commitments, the quality of implementation, the stability and credibility of policies, are all profoundly influenced by the characteristics of the policymaking process (PMP) and hence, of the political process in each country. Thus, to make sustainable improvements in policy and welfare, and to adapt policies to policymaking capabilities, we need a good understanding of each country's policymaking and political processes.<sup>2</sup>

A focus on PMPs (at least as a complement to economists' usual focus on policies themselves) is also desirable because there are no universally valid policy recipes. Best policies are contingent responses to country-specific and state-of-the-world factors.<sup>3</sup> For that reason, it is more important that countries develop the capacity to figure out and to instrument good policies by themselves, than to push the "universally valid" prescription that the "development consensus" favors at any given point in time.<sup>4</sup>

Policymaking processes (and so-called State capabilities) are grounded, in the end, in each country's political process. The political process, in turn, is conditioned by the incentives and constraints faced by the key political actors. These, in turn, are shaped by the country's

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<sup>2</sup> We are making a rather idiosyncratic use of the terms *political process* and *policymaking process* (PMP). We think of the political process, as the process by which political actors interact trying to achieve their goals. In our approach we assign special importance to the role of "professional" full-time political actors, such as politicians. It is well known that the goals of politicians relate to policy outcomes, but also to other things. The policymaking process is the connected process by which policies are discussed, decided and implemented. We can think of those two processes as connected games.

<sup>3</sup> Furthermore, our knowledge about those states of the world and about best responses to them, is always imperfect and in a state of flow, so that "the flavor of the month" keeps changing.

<sup>4</sup> These points, developed in more detail in Acuña and Tommasi (1999), are consistent with recent views expressed by several authors emphasizing the importance of home-grown development strategies. As suggested by Mukand and Rodrik (2002), there is a tendency for countries to "imitate too quickly" formulas that have been successful elsewhere. (See also North 1994, Evans 2001, Pistor 2000, Hausmann and Rodrik 2002, Lindauer and Pritchett 2002). Best policies might be country-specific not only because of the diverse nature of underlying problems and societies, but also because of the "fit" or complementarity with the broader institutional environment. There are countless examples of "good policies" (i.e. policies that might work reasonably well under certain circumstances) that failed because of their mismatch with the workings of the country's political institutions and policymaking process. Repetto (2002) describes the failure of "Plan Solidaridad" an ambitious anti-poverty program in Argentina, which was designed following the blueprint of the supposedly successful experience of Progresá in Mexico. Similarly, social programs which (from a technical point of view) are well designed to focalize assistance, may end up trapped in clientelistic networks under some institutional contexts, creating more harm than good (see Ronconi 2002 for Argentina's Plan Trabajar). Another common mistake in Latin America has been an excessively formalistic/technocratic approach to some reforms such as civil service reform, tending to ignore the politics of civil service (Heredia, 2002). See Repetto (2002b) for an account of the limited success of the attempts to "modernize the State" in Argentina. Similarly, it has been a common belief that by enacting laws such as a Fiscal Responsibility Law one can "control" the misbehavior of the polity that is producing inefficient fiscal outcomes. Indeed, absent external enforcement, the same equilibrium forces that generate fiscal problems in the first place might still be at play, rendering such laws ineffective. Braun and Tommasi (2002) provide several examples of failure of such laws in Latin America. Even the World Bank has recognized such failures: "Technical administrative fixes have been applied to fundamental problems of political economy. And even on the technical side the focus has been narrow, ignoring crucial links with other parts of the larger system." (World Bank, 1999).

political institutions, that is, by the rules of its political game. This is the reason for this project's emphasis on understanding the way political institutions shape political incentives and behavior, how political behavior influences policymaking processes (and State capabilities), and how policymaking processes determine the properties of public policies.

At the same time that economic reforms have come into question, several countries are engaged in the discussion and, in some cases, implementation of political reforms. As an example, around the year 2000 there were in Argentina four sets of parallel reform "efforts" or conversations: on changing some electoral rules and campaign financing laws, on reforming the Civil Service system, on "modernizing parliament," and on reforming the intergovernmental fiscal system. Lawyers and politicians were dominating the first topic, public administration experts the second, computer wizzes and architects the third, and public-finance economists the latter. The quality of the debates and of the analyses underlying those discussions was affected by the disciplinary limitations with which the various analysts approach such complex subjects, and by the fact that those conversations were taking place in separate quarters, without any cross-fertilization, and without any global diagnostic on how those four spheres might be related.

This project has the objective of helping to enhance the quality of debate about "political reform," by bringing together scholars from different disciplines, and by providing some common metrics and tools to facilitate the discussion. We believe that some of the features of the approach suggested here will be particularly useful for that purpose. Among other things, we suggest a *consequential* approach, in which the rules of the political game are analyzed in terms of their consequences for the PMP and for the qualities of policies. Also, we emphasize a *systemic*, or "general equilibrium" approach to the analysis of political institutions. There is abundant and valuable literature in political science and in political economy studying the "partial" effects that some political institutions (say, electoral rules) have on political and policy outcomes. That literature is quite helpful as background material, but in order to seriously discuss political reforms in specific country contexts, a more systemic, detailed, and country-specific approach is necessary.

The purpose of the agenda promoted here is to provide a methodology to generate diagnostics of the workings of the policymaking processes in Latin American countries to help the countries and the IADB:

- (1) to promote and instrument policy reforms that are more likely to achieve the desired development objectives, given political institutions and practices of each country;
- (2) to inform the debate on political reforms so as to improve the PMP's qualities in each particular country;<sup>5</sup>

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<sup>5</sup> There are several reasons for caution in this second objective. Among them is the combination of institutional general equilibrium and slow dynamics of institutional impact. One can envision several examples in which well intentioned reforms worsen things in the short term. For instance, in the case of Argentina, we believe that limiting discretionary powers of the executive would be desirable (to foster more stable policies), yet that reform in isolation would give, in the short run, power to a Congress populated by amateur legislators with little incentives to develop high quality national policies.

(3) to find a more effective role for international organizations.<sup>6</sup>

## **II. A PRELIMINARY SKETCH OF THE FRAMEWORK**<sup>7</sup>

The main objective of this framework is to contribute to the understanding of the determinants of public policies. For example, we want to understand why some countries are able to implement policies that are stable over time, yet are flexible enough to adapt to changing economic conditions, while other countries tend to change policies whenever the political landscape changes, or must resort to highly inflexible and inefficient rules. In order to understand these policy outcomes, we focus on the machinery that produces public policies: the PMP and its institutional determinants.

There are many different ways to approach the PMP. Here we offer a particular lens with which the authors of the country studies can focus the analysis of the PMP.<sup>8</sup> At the core of our approach is the idea that several important features of public policies will depend crucially on the ability of political actors to achieve cooperative outcomes, that is, their ability to strike and enforce intertemporal political agreements. In environments that facilitate the striking of such intertemporal political deals, the policymaking game will result in cooperative outcomes, leading to public policies that are more effective, more sustainable, and more flexible to respond to changing economic or social conditions. In contrast, in settings where cooperative behavior is harder to develop and sustain, policies will be either too unstable (subject to political swings) or too inflexible,<sup>9</sup> policies will be poorly coordinated across policymaking actors, and the overall process will be characterized by weak State capacities.

Within this framework, the ability to achieve cooperative outcomes affects not so much the content of specific policies (whether protection is high or low, which sectors benefit from fiscal transfers, etc.) but rather certain common features of public policies, whether they are stable and predictable, whether they can adjust to changing economic conditions, whether they tend to generate broad or concentrated benefits, and so on and so forth. Following Spiller and Tommasi, we refer to these features as the “*outer*” features of policies.

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<sup>6</sup> For example, from a diagnostic that interprets policymaking deficiencies as the outcome of the inability of political actors to agree and enforce the political commitments necessary to instrument better policies, one might find a role for international organizations to act as “commitment technologies” for such agreements.

<sup>7</sup> The methodology and its application to Argentina are formulated in detail in Spiller and Tommasi (2003b). A summary is provided in Spiller and Tommasi (2003), a paper that is distributed as one of the background materials for the project. Their study of Argentina should be taken as a “pilot” case for the overall comparative project. The sketch presented in this subsection provides a simplified introduction to the framework in a relatively non-technical language, and avoids citing the previous literature from where this framework builds upon; references are provided in Section V and in the underlying papers.

<sup>8</sup> Researchers are welcomed to combine this suggested lens with others that they believe relevant for the understanding of key features of their respective countries’ PMP.

<sup>9</sup> Rigidity arises when political actors do not trust their opponents, and prefer to tie their opponents’ (and perhaps their own) hands, rather than allow for political discretion.

The central question within this framework is whether the workings of the PMP tend to facilitate or hinder cooperative outcomes in the political transactions game. Researchers should study the PMP with this question in mind. The literature on repeated oligopoly games provides useful insights for this purpose. According to the theory, cooperative equilibria are more likely to exist if i) the immediate benefits from deviating are relatively small; ii) the number of actors is small; iii) these actors interact repeatedly; iv) the deviations from cooperative behavior are easily observed; and v) there are enforcement mechanisms to credibly penalize those that deviate from cooperation.<sup>10</sup>

The mapping from those abstract variables identified by the theory of repeated games into aspects of the actual policymaking game in specific countries is not trivial, especially due to the configural / general equilibrium interactions at play. In the end, such a mapping is as much an art as a science.<sup>11</sup> Nonetheless, there are some possibly useful hints towards empirical implementation. For example, while in oligopoly games the number of actors would be associated to the number of firms in the market, here it would be associated to the number of political actors with substantial influence on the PMP. Likewise, the discount rate may in turn depend on the expected tenure of the political actors involved in the PMP, or on the degree of party institutionalization (if the relevant actors are political parties). The availability of credible enforcement technologies may be related to the existence of an independent judiciary, or to the existence of some informal bureaucratic norms (Spiller and Vogelsang, 1997).

So far we have focused on the PMP and on its role in determining features of public policies. The key elements of the PMP are determined, in turn, by the political institutions in place in each country (such as the presidential/parliamentary nature of the government, the electoral rules in place, the rules governing the interactions of the executive and the legislature, the federal structure of the country, the existence of an independent judiciary, etc).<sup>12</sup> The link between political institutions and the PMP is another important component of this framework.

In studying the connection from institutional variables to the workings of the PMP, we suggest a systemic / general equilibrium approach again (as we do for the other *stage* from the PMP to the features of policies). As we explain in more detail in Section IV, the existence of a PMP that leads to cooperative outcomes, will not depend on a single institutional factor (such as whether the system is presidential or parliamentary), but rather on the interaction among a number of factors. This approach is very demanding in terms of knowledge of institutional detail, and thus requires a country focus, to be carried out by researchers with considerable country expertise. At the same time, there are important

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<sup>10</sup> This list is not intended to be complete. The theory has broader implications than those explicitly mentioned in this paper, and country authors might find other elements particularly important in specific cases.

<sup>11</sup> We believe that the same applies to almost any effort relating mathematical models to real world variables.

<sup>12</sup> At this point, questions of endogeneity arise naturally. What do we take as given, and what do we explain? These questions, which are difficult to answer in cross-country econometric work, are easier to answer in historically grounded, country-specific, research of the type we are peddling here. More details later.

benefits of having different country teams working simultaneously and interactively in their respective reports. First, complementary approaches suggested by a team in one country may be useful for other countries as well. Second, a project involving several country studies imposes more discipline on the researchers, and limits the possibility of engaging in “ex post rationalizations.” Most importantly, the approach proposed here should be seen as “work in progress,” a framework that will evolve as we learn more about the issues, as we get feedback from the country teams, and as we contrast the results obtained in the studies.

### **III. THE DEPENDENT VARIABLE: CHARACTERISTICS OF PUBLIC POLICIES**

Normally, the political economy literature concerns itself with the “content” of public policies – i.e., will agriculture be subsidized or taxed, will exports be subsidized or taxed, which sectors get more or less protection, who benefits and who pays from income redistribution, and so on and so forth.<sup>13</sup> Here we will be focusing on some “outer” characteristics of policies, such as their predictability, their adaptability to changing economic circumstances, and other related qualities. These outer features fit more naturally with our theoretical framework, and have the advantage of allowing it usage across varied policy domains.

This has the advantage of providing a possible source of cross-sectional variation even within country. While the features of most policies within a country will be affected by some general characteristics of the PMP, it is also expected that public policies in some areas will have different features. This may be the result of different policy areas being less dependent on the aspects of the political game emphasized here, and having different transaction-cost characteristics. For example, some issues (such as pensions) will be highly demanding in terms of intertemporal transactions, while others may only require spot political transactions. In addition, the relevant PMP may differ in important ways for some specific policy issues. Some policy areas have important additional institutional actors (such as unions in the education sector) that may imprint particular characteristics to the PMP game. Some policy issues may be more easily subjected to some enforcement mechanisms (e.g., delegation to the bureaucracy or to supra-national institutions like the role played by the International Center For Settlement of Investment Disputes in regulatory issues); or they may be determined in particular arenas (for instance some trade policy issues in cases in which international agreements impose additional institutional structure or constraints). These differences should result in different qualities of policies across policy areas. The country teams are encouraged to pay special attention to such differences, since they may provide additional “degrees of freedom,” which are precious in the context of country studies.

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<sup>13</sup> For an interesting exception, close in spirit with our emphasis here, see Rodrik (1995). He analyzes six countries that implemented “the same policy,” export subsidization, but with varying degrees of success. Rodrik relates success to features such as the consistency with which the policy was implemented, which office was in charge, how was this policy bundled or not with other policy objectives, and how predictable was the future of the policy.



We list below some characteristics we suggest focusing on. The list is, of course, not taxonomy, and researchers are encouraged to highlight additional policy characteristics that may be particularly relevant in their own countries, which might complement these ones.<sup>14</sup>

### *Stability vs. volatility*

Some countries seem capable of sustaining (some) policies over time, allowing economic and social agents to incorporate those stable rules in their behavior, in ways that make the objectives of the policies more likely to be fulfilled. In other cases, we observe frequent policy reversals, often at each minor change of political winds (for instance whenever a cabinet member, or senior bureaucrat changes).<sup>15</sup> In the framework of Section V we associate stability with intertemporal agreements that allow the preservation of certain policies beyond the tenure of particular office holders or coalitions.<sup>16</sup> (Some countries in Latin America, aware of the need to find ways to commit to certain policy courses beyond the vagaries of electoral and partisan politics, are calling nowadays for “*Políticas de Estado*.”) Weaver and Rockman (1993) include “ensuring policy stability so that policies have time to work” as one of the key “government capabilities.” Also, our notion of “stability” is quite close to the notion of “resoluteness” in Cox and McCubbins (2001).

### *Adaptability or flexibility vs. rigidity*

Policies might be more or less responsive to changes in the environment or in the information available. The inability to adjust to new circumstances reflects difficulties in developing patterns of political cooperation that facilitate the implementation of welfare improving policies. In environments with high political transaction costs, political actors may embed rigidities into some policies as protection against future reversals, even if those reversals could be welfare improving. Given the inability to write complete contracts, preventing *political* opportunism might lead to incapacity to adjust to changing underlying circumstances. A dramatic illustration was provided recently in Argentina, where the rigidities of the Convertibility regime, combined with the rigidities of the federal fiscal agreement lead the country in a spiral of crisis and despair, while key political actors were unable to agree on adequate policy responses.<sup>17</sup>

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<sup>14</sup> The companion paper by Scartascini and Olivera (2003) suggests some possible empirical proxies for these policy characteristics.

<sup>15</sup> CEDI (2001) shows that to be the case for many social programs in Argentina.

<sup>16</sup> This in practice is complicated by the fact that often political changes are induced by changes in the policy preferences of the electorate, that elect certain politicians *precisely* because they want some policy change. Broad cross-sectional empirics will be complicated by the difficulty in distinguishing this from the case in the text; but at a conceptual level these differences could be identified. It is very different a case in which the population becomes more favorable to welfare spending, than a case in which a new minister starts funneling a lot more resources to his region of origin.

<sup>17</sup> The changing underlying circumstances might include the stock of knowledge, for example learning about the effects of policies. Hence, what Weaver and Rockman call the ability “to innovate when old policies have failed,” could be subsumed under our notion of adaptability.

### *Coordination / Coherence*

Policies are the combined result of actions taken by multiple actors operating through different stages of the policy process. Lack of coordination among those actors may lead to inconsistent or incoherent policies. This may reflect the non cooperative nature of political interactions. In their application to Argentina, Spiller and Tommasi find several examples in which the actions of different ministries, or of different levels of government (national, provincial, municipal) operating over the same policy issue (e.g. fighting poverty) are poorly coordinated. [This relates to the notion of “balkanization” in Cox and McCubbins (2001).]

### *Investment-related qualities / capacities*

Many actions by political players have investment-like properties, showing up-front costs and long-term benefits. If the environment does not protect political property rights, those investments might not be undertaken. Whether such investments have been undertaken or not will be reflected in the answers to questions like: Are the implementing agents well qualified? Do they have experience in running such programs? Do legislators have policy expertise? Do sub-national governments invest in improving their policy capabilities? This feature is somewhere in between properties of the policymaking process and properties of policy outcomes. Given the potential difficulties in finding adequate empirical proxies for some of these categories, we take an eclectic approach to empirical work, and we are willing to utilize whatever is available at reasonable cost. Sometimes it would be easier to find measures of the quality of outcomes (such as degree of tax compliance), while in other cases (perhaps through secondary sources) we might be able to get information on the “investments” behind those policies (such as the quality of the tax-collection agency).<sup>18</sup>

### *Public vs. private-regardedness*

Cox and McCubbins (2001) refers to this feature as the extent to which the policies produced by a given system resemble public goods, improve allocative efficiency, and promote the general welfare versus funneling private benefits to individuals, factions or regions, in the form of projects, subsidies, and tax loopholes.<sup>19</sup>

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<sup>18</sup> This notion is also related to another characteristic that is hard to handle empirically, the quality of the public policymaking arena (Nelson and Tommasi, 2001). Some countries develop arenas, be them within the Government, in political parties, or in somewhat institutionalized exchanges through think tanks, research institutes, universities, or NGO’s, that provide some “intertemporal technical glue” to the policymaking process. Whether such spaces develop, and whether the available scientific knowledge is incorporated into the policymaking process, depends on several things. Some reasons are historical, other more microeconomic relating to the “industrial organization” of research in the country. But it also depends on the incentives of the key political actors. Our knowledge of the Argentine case indicates that such “public space” functions very poorly. Superficial observation in our trotting around the world suggests that such spaces might be a little better in other countries (Chile? Colombia? In part Brazil?).

<sup>19</sup> To finish this brief tour, it might be helpful to reproduce the ten capabilities “that all governments need” according to Weaver and Rockman (1993): to *set and maintain priorities* among the many conflicting demands made upon them so that they are not overwhelmed and bankrupted; to *target resources* where they are most effective; to *innovate* when old policies have failed; to *coordinate conflicting objectives* into a coherent whole; to be able to *impose losses* on powerful groups; to *represent diffuse, unorganized interests* in addition to concentrated, well-organized ones; to *ensure effective implementation* of government policies once they have been decided upon; to *ensure policy stability so that policies have time*

#### **IV. SOME METHODOLOGICAL CONSIDERATIONS**<sup>20</sup>

Much work in Political Economy linking political institutions with political and economic outcomes is designed to search for the *effects* of a particular explanatory variable (forward-looking hypotheses), rather than for the *causes* of a particular empirical outcome (backward-looking hypotheses). When one is looking forward from a particular independent variable to its potential effects, hypotheses can be formulated so as to control the length of the chain of causation that is to be covered before a particular effect is selected as the “dependent variable” (Scharpf, 1997). If the chain is short enough (e.g. from X to E1 in Figure 1) interaction effects from other variables are less of a problem than they are for hypotheses trying to cover long distances (e.g., from X to E3). An example of this “longer” reasoning can be found in many works relating electoral rules (*structure*) to political behavior (*politics*), and political behavior to *policy* outcomes. The first link is the bread and butter of a large literature in political science, while economists doing political economy tend to be more interested in the longer chain going all the way to policy.<sup>21</sup>

<Figure 1>

As in the “policy episodes” that are the object of the methodological discussion in Scharpf (1997), in the research we are proposing here, the questions to be answered are typically backward looking, starting from an *explanandum* or dependent variable at the end of the hypothetical chain of causation. In such cases, the expected end product is not the empirical confirmation or disconfirmation of single-factor hypotheses, but rather explanation of particular policy choices, or (as in this work) of particular features of public policies in a given country. As a consequence the chain of causation considered cannot be arbitrarily shortened but rather must be long enough to reach from the dependent variable to pragmatically useful independent variables. As illustrated by comparing Figures 1 and 2 (from Scharpf), this takes us to a more complex methodological domain, where it is much

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to work; to *make and maintain international commitments* in the realms of trade and national defense to ensure their long-term well-being; and, above all, to *manage political cleavages* to ensure that the society does not degenerate into civil war. These capabilities are the dependent variables for their collective study. Individual chapters in their volume examine specific policy problems that “require the use of one or more of these capabilities.”

<sup>20</sup> This section draws extensively from a literature in policy analysis, especially Scharpf (1997). See also the Analytic Narratives project summarized in Bates et al (1998), as well as Ostrom (1999), Thelen (1999), Elster (1989), Tsebelis (1990), Putnam (1988), and Levi (2000). Sabatier (1999) presents a good set of theoretical “lenses” for the study of public policies, as well as some valuable general considerations about conditions such approaches must satisfy. We believe that the approach we develop here is on its way to satisfy those conditions.

<sup>21</sup> Cox (1997) is a masterpiece linking electoral systems to political behavior. Haggard and McCubbins (2001, p. 1) provide broader references. Rogowski and Kaiser (2002), Milesi-Ferreti et al (2002) and Persson and Tabellini (2002) are recent examples of work linking political institutions to policy outcomes. Cowhey and McCubbins (1995) is a collection emphasizing quite clearly these two steps, that they dub “structure-politics-policy.” See Scartascini and Olivera (2003) and Persson and Tabellini (2003) for richer surveys.

harder to isolate the interactions of several variables, and hence we have to deal with *configural* rather than *additive* relationships (Scharpf, 1997, p3x).<sup>22</sup>

<Figure 2>

In particular, if one wants to understand the policymaking process in a given country, which leads to policies with certain features, one cannot be content with a theory (and cross-national empirical work) linking one particular institutional characteristic to one particular policy characteristic. In general, we will be in an analytical domain such as that of Figure 2, in which there is a combination of factors leading to the policy properties in question in the given country.<sup>23</sup> As stated before, in order to think about reforms of political institutions that might improve policymaking processes, one needs a country-based approach conveying detailed knowledge of institutional context and historical background, allowing an understanding of the interactions among factors that affect the incentives of the makers of policy. Furthermore, the country-focused approach can easily handle some problems of endogeneity, by recourse to the temporality of occurrence of different events (Buthe 2002). We illustrate this point in our application to Argentina.

This country focus, and the study of interactions among political institutions, requires a *modular* approach. We agree with Scharpf (1997) in that complete explanations of complex phenomena can only be modular constructs, combining and linking several theoretical and empirical “modules” to account for potentially unique observed phenomena.<sup>24</sup> “The composite explanation of particular processes is likely to be unique for each country but ... the modules employed in constructing it may reappear more frequently in other cases as well and thus are more likely to achieve the status of empirically tested theoretical statements. ... Thus we will often depend on narrative, rather than analytical, connections between partial theories that have analytical as well as empirical support.” (Scharpf, 1997: 31).

In order to enter the search for the relevant variables and their interactions, one needs a “lens,” a conceptual framework, to abstract away the noise and focus on the essential issues

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<sup>22</sup> Spiller and Tommasi (2003) use the term “institutional general equilibrium” to refer to those interactions. Although rather pompous, the term reflects their sense that much empirical work in Political Economy seems to take a partial equilibrium approach to explain the effects of specific political variables. There is, though, some important work that is quite explicit and sophisticated about the interactions among some particular institutional (or even more structural) variables. See, for instance Cox (1997, Chapters 10 and 11), and Amorim Neto, and Cox (1997). See also Jones (2001).

<sup>23</sup> The types of factors behind the performance of a country policymaking process are likely to be varied, including socioeconomic and cultural factors. In our discussion we will emphasize institutional factors, although in each specific country case it might be necessary to bring other crucial determinants into the picture.

<sup>24</sup> Scharpf (1997: 31) argues that “[a] framework should provide an ordering system that describes the location of, and the potential relationships among, the many partial theories or more limited “causal mechanisms” that one can draw upon for the theoretically disciplined reconstruction of complex and unique cases...” and that “even when we can rely on models with high predictive power, they are likely to be of limited scope and will only represent certain subsets of the complex, multiarena and multilevel interactions that are characteristic of real-world processes.” Thus “it is usually necessary to combine several such modules into more complete explanations.”

of those complex realities.<sup>25</sup> This lens, in turn, will be a mix of some “theoretical modules” combined with suggestions on the empirical implementation of such modules, in terms of observable variables that capture key aspects of the institutions, the policymaking process and the policy outcomes.

We devote most of the rest of the paper to suggest a framework, a collection of modules, derived from Spiller and Tommasi (2003b), emphasizing the degree to which political institutions induce policymaking games leading to more or less cooperative intertemporal political transactions. Yet, other authors have suggested some other valuable theoretical lenses. Before getting into the specifics of our own framework, we devote the rest of this section to summarize the recent work of Tsebelis (2002) and Cox and McCubbins (2001) which we see as providing approaches (mostly) complementary with the one suggested here.<sup>26</sup>

Tsebelis (2002) brings together a vast amount of that author’s work around the notion of “veto players” as the overarching concept that best summarizes the characteristics of political systems and their impact on policies. His argument is that to change policies, a certain number of (individual or collective) actors have to agree to the proposed change; these actors are called veto players. Every political system has a configuration of veto players, with varying numbers, ideological differences and internal levels of cohesion. These characteristics affect the set of outcomes that can replace the status quo (the “winset” of the status quo). The size of that winset has specific consequences for policymaking: when it is very small, “policy stability” obtains. From there, Tsebelis derives rich empirical implications, which are tested in different contexts in the book.

Cox and McCubbins (2001) present a related approach to public policy.<sup>27</sup> They suggest that one of the most important trade-offs in policymaking is that between the ability to change policy (“decisiveness”), and the ability to commit to a given policy once it is enacted (“resoluteness”). Different institutions (electoral rules, the number of chambers, legislative procedures, etc) would map, through “separation of powers” and “separation of purpose,” into effective number of veto players (*à la* Tsebelis). Countries with more veto players will be located closer to the resoluteness end along a decisiveness-resoluteness continuum. The dual notion of separation of power and separation of purpose is one explicit “microfoundation,” or intermediate module, towards empirical implementation of the counting and characterization of veto actors. The effective number of vetoes increases when a polity has both many institutional veto points (separation of power) and political actors with diverse interests controlling those veto points (separation of purpose.) Shugart and Haggard (2001) go further and link “key institutional variables” (powers of the president, legislative institutions, federalism, electoral rules) to separation of power and of purpose.

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<sup>25</sup> “Given the staggering complexity of the policy process, the analyst must find some way of simplifying the situation in order to have any chance of understanding it.” (Sabatier, 1999, p. 4).

<sup>26</sup> Additional sources can be found in the “policy theory” literature, such as the useful collection in Sabatier (1991). See specially chapter 3 by Ostrom.

<sup>27</sup> For brevity, sometimes we use the shorthand “Cox-McCubbins” to refer to the broader collaborative effort in Haggard and McCubbins (2001), especially the introductory chapter 1 by Haggard and McCubbins, chapter 2 which is the theoretical paper by Cox and McCubbins, and chapter 3 by Shugart and Haggard which maps the theory into political variables.

Several features of the approaches of Tsebelis and of Cox-McCubbins are consistent with the approach we propose here, especially the fact that they are “consequential” approaches, and that they emphasize interactions (and political detail). Regarding the emphasis on interactions, Tsebelis (2002, p. 11) argues that “most of the literature on political institutions uses a single criterion to identify the main characteristics of a polity. For example, political regimes are divided into presidential and parliamentary, legislatures into unicameral and bicameral, electoral systems into plurality and proportional, parties into strong and weak, party systems into two-party and multiparty. The relationships among all these categories are underdeveloped. For example, how are we to compare the United States, a presidential bicameral regime with two weak parties, to Denmark, a parliamentary unicameral regime with many strong parties? What kinds of interactions do the combinations of different regimes, legislatures, parties and party system produce?” Similarly, Haggard, McCubbins and Shugart (2001, p. 319) argue that “what is required is a more nuanced analysis that looks to variations within these large categories and to interactions among different institutions.”

After presenting our approach in the next section, we will provide a more detailed comparison highlighting the common and the differentiating factors between our approach and those of Cox-McCubbins and of Tsebelis.

## **V. AN INTERTEMPORAL TRANSACTIONS APPROACH**

Understanding policymaking process in a given country requires reconstructing complex and unique “cases.” We suggest here a set of modules and connections, which are useful as an entry point for such studies. The framework can be explained by referring to Figure 3. We are ultimately concerned with the features of public policies, which thus constitute our dependent variable (*Y* in the figure). Our unifying theme is that public policies are the outcome of intertemporal political transactions among political actors. These transactions, in turn, are conditioned by the rules of the policymaking game, resulting from the workings of political institutions (*X*), which in turn depend on some more basic institutional features of a constitutional and historical nature. The features of the resulting policies are also affected by the nature of the “objects” being exchanged, i.e., by the features of the underlying policy issues (*Z*).

<Figure 3>

We devote the following subsections to develop in more detail each of the “modules” involved.

### **V.1. Transaction Cost Analysis: Links (1) and (2) in Figure 3**

The framework suggested here is an elaboration of previous work on transaction cost economics and its application to politics.<sup>28</sup> Transaction cost economics attempts to

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<sup>28</sup> North (1990) and Dixit (1996) have labeled *transaction-cost politics* the use of transaction-cost reasoning to think about politics. While North and Dixit emphasize transactions among citizens and politicians, we

understand economic organization, taking economic transactions as the units of analysis. Economic transactions are characterized by a number of dimensions, or attributes, such as the specificity of the investments required to conduct the transaction, the frequency with which similar transactions occur and the duration or period of time over which they are repeated, the complexity of the transaction and the uncertainty about what performance will be required, the difficulty in measuring performance, etc. Transactions with different characteristics call for different ways of organization. Most of the initial work in transaction cost economics (Williamson 1979 and 1985) takes as given the institutional environment (such as the workings of the judiciary), and conducts a detailed analysis of the characteristics of different economic transactions. This microanalytical approach endogenizes and explains the governance structures (distribution of ownership, contracts, etc.), chosen to support the different transactions.

As in transaction cost economics, different political issues can be characterized by a number of properties. These properties, which we characterize as **Zs** in the framework, are important in determining their implementation difficulties. They include the number and cohesiveness of the relevant political actors involved, the degree of irreversibility of the assets involved in the policy, the intertemporal pattern of payoffs to the different actors, the duration of the policy “exchanges” involved, the easiness with which performance can be measured, the observability of the shocks, and the degree to which the policy benefits broad or narrow interests.<sup>29</sup>

For example, pension policy has intertemporal characteristics that make it an area very prone to opportunistic behavior. It is a mechanism that forces people to give away part of their current income, in exchange for money after retirement. It is complicated in practice by several political hazards, such as the tendency of ex-post political coalitions to renege on previous policies (Iversen and Soskice, 2002), or the political temptation to expand coverage even to those who did not contribute throughout their careers. For all these reasons, pension systems have been politically and economically problematic in several Latin American countries, both in the old times of public pensions and in the new wave of private pensions (as illustrated in the Argentine example in Section VI). In principle, those problems might be alleviated in countries where political institutions deliver a stronger capacity for intertemporal commitment. The case of pensions could be contrasted with simpler policy issues with fewer transaction hazards, such as the building of a monument to a local hero.

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emphasize, primarily, transactions among politicians. In that sense our work is closer to the pioneering papers by Weingast and Marshall (1988), Moe (1990 a and b), and Moe and Caldwell (1994), and to the recent book by Epstein and O’Halloran (1999). (Huber and Shipan (2002) belongs to this class, even though they do not couch their analysis in explicit transaction-cost language.) Some of the formalization in Spiller and Tommasi (2003) and (2003b) follows the lead of Dixit (2001). Spiller and Tommasi also show that the cooperativeness of the interactions among formal political actors is one natural microfoundation for the cooperativeness of interactions between “the State” and economic agents, for instance in time-consistency policy games. (See also chapter 12 of Persson and Tabellini, 2000, and references there.)

<sup>29</sup> Those characteristics include: the number and cohesiveness of the relevant political actors involved, the degree of irreversibility of the assets involved in the policy, the intertemporal pattern of payoffs to the different actors, the duration of the policy “exchanges” involved, the easiness with which performance can be measured, the degree to which the policy benefits broad or narrow interests, etc. [This is related to what Ostrom (1999) calls “attributes of the world” (see details there, p. 37 on).]

Levy and Spiller (1996) is a classic piece looking into the political complexity of the transactions involved in the telecommunications sector/policy issue. From our “comparative (transaction cost) politics” perspective, they take the important step of -- holding constant the properties of the (now political) transaction, the regulation of utilities -- varying the institutional environments across countries. From there, they endogenize the governance structure (detailed regulation, simple regulation, public ownership, etc.) of that particular transaction between “the government” and “the firm” to the features of each institutional environment.<sup>30</sup> In terms of the mapping  $X \times Z \rightarrow Y$  described above, Levy and Spiller hold constant the issue (regulation of telecoms) with its vector of transaction characteristics (its  $Z$ ), and vary the “institutional endowments”  $X$  of different countries.<sup>31</sup>

Here we attempt a generalization and especially a deepening of Levy and Spiller (1996). It is a generalization in the sense that we purport to study a broader set of policy issues (not just telecommunications regulation); it is a deepening in that we purport to study in more detail the political-institutional environment of each country. Rather than using a small set of characteristics of the political system, we suggest a way of articulating several (partly pre-existing) modules into a more complete picture of the policymaking process.

As a “lens” to capture the complexity of the institutional (political) environment, we characterize the policymaking process in terms of a game of (intertemporal) cooperation. More specifically, we view public policies as the result of agreements among political actors, in what we call “contracting moments,” and of the actual play of the policy game given those agreements, as we describe in the next section.

## **V.2. Games of Political Cooperation: Game (3) in Figure 3**

One crucial aspect of public policymaking is that it attempts to solve collective problems, in contexts where there is conflict of interest. In order to capture those elements, we depict policymaking as the outcome of an intertemporal game (which is formalized in the Appendix). Imagine a number of political actors who have to make collective decisions (under certain rules to be specified), and who may also take “individual” policy actions.<sup>32</sup> The environment is characterized by conflict and commonality. Players have a common interest in having the policy respond to a common economic or technological shock. The

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<sup>30</sup> Levy and Spiller examine the interaction of political institutions with regulatory processes and economic conditions in determining the potential for administrative expropriation or manipulation in the telecommunications sector of five countries. In this way they link institutions and regulatory processes to sector performance. Their results are consistent with our view that decision-making processes are fundamental determinants of private incentives. Indeed, they find that performance can be satisfactory with a wide range of regulatory procedures, as long as regulatory credibility can be developed. Without that commitment, they conclude, long-term investment will not take place.

<sup>31</sup> Huber and Shipan (2002) is an interesting recent effort that measures the degree of delegation to the bureaucracy in some particular issues, as a function of several factors, including the “institutional environment.” Epstein and O’Halloran (1999) keep constant the institutional environment (the U.S.) and study delegation across a range of issues, in what we might consider as one *political* version of the Williamsonian exercise.

<sup>32</sup> Think of a confederation, in which certain policies are decided collectively, while other policies are chosen “individually” by each constituent unit.



heterogeneity of preferences and/or the distributive nature of politics generate conflict.<sup>33</sup> Politics is also subject to random shocks, which shift the relative political power of the players.<sup>34</sup>

Assume that the political game starts with a period in which players (by a strong majority or by unanimity) can make some agreements. This period captures the notion of a “contracting moment,” a time when the parties reach an understanding about how they will restrict their actions in the future. The set of feasible agreements constitutes an exogenous feature of the institutional environment, which affects the type of policies that emerge in equilibrium. The set of feasible contracts will depend on the availability of enforcement technologies – for instance, whether there is an independent and technically competent judiciary. It will also depend on the nature of the issues in question through the observability and verifiability of the various actions and payoffs.

Define first-best policies as those that would be agreed upon in a complete contract before the world starts running – or, equivalently, those that a benevolent social planner would choose. It is easy to show that these optimal policies will be “moderate” and invariant to the realization of political shocks,<sup>35</sup> but flexible enough to adjust to economic shocks. It is also easy to show that if political actors are infinitely lived and patient enough, they can sustain first-best policies as a Nash equilibrium in the infinitely repeated game.<sup>36</sup> If their discount rate is high enough, though, (full) cooperation will not be sustainable in equilibrium. In such a case, policies will depend on the realization of political uncertainty, and welfare will be lower than in the cooperative case.

Looking into the prior contracting stage in which players can make some agreements, restrictions on the set of feasible (i.e., enforceable) contracts will depend on the issues in question and available enforcement mechanisms. Suppose for instance that agreements can be enforced by third parties, but that the realization of economic shocks is not verifiable. In that case, it will not be possible to enforce agreements that prescribe (economic) state-contingent rules. Simple rules, however, can be agreed upon. These rules would imply relatively inflexible policies. Since *ex-ante* parties prefer policies that are independent of political shocks, these simple rules will not be sensitive to those shocks. On the other hand, since economic shocks are not verifiable, policies will not be able to adjust to the changing economic environment either. The best *ex-ante* policies, then, may be rigid policies. They

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<sup>33</sup> The Appendix provides a formal model that captures the heuristics presented in this section. As an example of the reduced-form policy preferences used there, imagine a policy of “proportional income tax spent on a public good.” Given identical preferences, richer (poorer) players will want lower (higher) taxes, but everybody would increase (decrease) his desired level of public goods in periods in which those goods are cheaper (more expensive). See Cukierman and Tommasi (1998) and Persson and Tabellini (2000) for other examples that could deliver this type of reduced form policy preferences.

<sup>34</sup> This type of political uncertainty can be modeled by some variation of a “random recognition rule” used in legislative bargaining models pioneered by Baron and Ferejohn (1989).

<sup>35</sup> That is, first best policies will not depend on the identity of each period’s agenda setter in Baron-Ferejohn (1989), or of the party in power in Alesina (1988).

<sup>36</sup> More generally, the possibility of sustaining cooperation will depend on a number of factors beyond the discount rate, including the number of players, and the parameters that characterize the details of the intra-period decision procedure.

deliver, as a consequence, lower welfare levels than could be obtained in a fully cooperative equilibrium or in an environment of full enforcement.

Indeed, whenever the repeated game delivers full cooperation, these simple rigid rules will not be utilized –players will prefer adaptation to economic shocks to a set of rigid *ex ante* rules. When the repeated game does not develop cooperation, though, there are conditions under which an inflexible policy rule will be chosen over the discretionary policy of the Nash equilibrium. That choice depends on the relative cost of not being able to adjust policies to economic shocks (related to the variance of the economic shocks), compared to the cost of “partisan” policymaking (related to the heterogeneity of preferences).<sup>37</sup> Thus, when enforcement of intertemporal political exchanges is relatively weak, we may observe highly volatile political agreements or highly inflexible policies.<sup>38</sup>

This discussion can be interpreted in standard transaction costs arguments. If the institutional environment facilitates political cooperation, then relatively efficient and adaptable policies can be implemented without many (and costly) safeguards. When the environment does not facilitate cooperation, but the costs of implementing safeguards are relatively low, then the policy will be implemented with the associated safeguards (*ex-ante* rigid rules). When the costs of implementing safeguards are very high, policies will respond to political shocks.

The connection to transaction cost analysis goes even further in extensions of the basic model just sketched, in which the “policy issue” was a fairly simple one-shot policy chosen anew every period, in a collective manner. Two natural extensions consist of (i) adding intertemporal policy linkages, as well as (ii) introducing individual policy actions (by different layers of government in a federal hierarchy, by different horizontal units such as ministries in a given level, by multiple actors throughout the policy process, etc.).

(i) Many policies are linked over time. Those linkages could arise because of technical reasons (i.e., policies that have intertemporal effects), legal reasons (a law is in place until it is changed), or economic reasons (present fiscal actions have future effects through intertemporal budget constraints). Introducing such linkages, Spiller and Tommasi (2003b) show that in bad transactions environments, some welfare improving policies (or policy reforms) are not undertaken, and that there is under-investment in policymaking capacities.<sup>39</sup> The former result obtains due to the incapacity to instrument the intertemporal compensations necessary to improve the welfare of all veto players. The latter is just the “policy” analogue of the well-know result in transaction cost economics that *ex-post* opportunism reduces *ex-ante* investment.

(ii) Another easy extension of the model introduces individual policy actions other than the “collective” choice analyzed above and modeled in the Appendix. Those actions could be

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<sup>37</sup> Notice that this result is similar to the standard rules vs. discretion result in monetary policy. See for instance Persson and Tabellini (2000), Chapter 17.

<sup>38</sup> In an extension to the model in which recontracting is allowed, we obtain the more realistic prediction that some policies might shift back and forth from a volatility regime to a rigid rule, depending on the evolution of economic shocks.

<sup>39</sup> By investment in policy-making capacities we refer to things such as provincial governments investing in improving tax-raising capacities, legislators investing in acquiring policy expertise, etc.

more or less cooperative. In bad transaction environments, those individual policy actions will be less cooperative (a basic result from non-cooperative game theory), leading to poorly coordinated policies.

The discussion so far has direct implications for the relationship between the extent of political cooperation and the features of the resulting public policies [(1), (2) and (3) in Figure 3]. For instance, we have argued that in non-cooperative political environments policy might be too volatile and/or too rigid, poorly coordinated, and in general of low quality due to insufficient investment. We have not yet discussed the effects of different political institutions on the extent of cooperation in policymaking. We do so in the remainder of the paper.

### **V.3. The Determinants of Political Cooperation: Link (4) in Figure 3**

We have suggested that several features of public policies will depend on the cooperativeness of political interactions. We still need to identify what aspects of political institutions are conducive to more or less political cooperation. We do that in two steps. The first one [link (4), in this subsection] is a listing of the abstract elements pertaining to the description of the policymaking game that facilitate the enforcement of cooperative play. The second one [links (5) and (6), below] is a mapping of those abstract elements into observable characteristics of a political system.

So far our discussion of the qualities of transaction environments (i.e., of the likelihood of political cooperation) has focused mainly on the discount factor (intertemporal patience). The game theoretic approach sketched above and developed in the Appendix could be extended to incorporate several elements of the description of the game that facilitate the enforcement of cooperative play. We list here factors that affect the degree of cooperation in equilibrium outcomes, drawing insights from the analysis of repeated oligopoly games – for instance, Green and Porter (1984) and Rotemberg and Saloner (1986).

#### *Intra-period payoff structure*

The elasticity of per-period payoff to alternative spot actions will be an important determinant of whether cooperation is sustainable in equilibrium or not. In repeated games, if the spot payoff from deviating to non-cooperation is very high, cooperation is less likely. In repeated oligopoly games, this is the case with elasticity to price discounts: if a firm stands to gain very large short-term profits by lowering its price (for instance because there are a large number of competitors from which to steal customers), collusive oligopoly is harder to sustain. In the context of the Argentine federal fiscal system, a province's individual payoff to deviate from a cooperative agreement (for instance by attempting to get special benefits from the national government) is quite high, and hence the federal fiscal game has non-cooperation as its equilibrium outcome.

### *Number of political players*

The theory predicts that the larger the number of players, the smaller the set of other parameters for which cooperation obtains. [Fudenberg and Tirole (1991, section 5.1.2) and Fudenberg and Maskin (1986) show that, holding constant the set of feasible payoffs, increasing the number of players reduces the set of equilibria towards less cooperative ones.] This goes in line with traditional assumptions (such as those in Buchanan and Tullock, 1962) that depict the costs of making a decision as increasing in the number of players. It also relates naturally to the previous point, in that in many common pool situations the intra-period payoff structure is related to the number of players. It is important to notice, that in the empirical implementation our notion of the number of players is different from the number of veto players in Tsebelis. In Tsebelis, the number of veto players relates (roughly) to the number of actors holding institutional veto positions at a particular point in time, while we refer to the number of “permanent” players, even if they do not happen to be holding specific veto positions at a particular point in time.<sup>4041</sup>

### *Intertemporal linkages among key political actors*

The intertemporal pattern of interactions among specific individuals in formal political positions (such as legislators, governors, and bureaucrats) matters for developing cooperative outcomes. It is not the same to have a legislature in which the same individuals interact over extended periods of time, as to have a legislature where individuals are drawn at random from given populations (parties, provinces, etc) with frequent replacement. Cooperation is less likely in the latter. Also, historical events, such as past democratic history can leave a legacy of short-termism.<sup>42</sup>

### *Timing and observability of moves*

Cooperation is harder to sustain if unilateral moves are hard to observe or hard to verify (Green and Porter 1984, Lehrer 1989, Bednar 2003).

### *Delegation*

Other than self-enforcement through repeated play, certain forms of cooperation could be achieved by alternative institutional means. One alternative consists on fixing policy rules of the type analyzed above, which prevent future opportunistic behavior. Delegating policy to

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<sup>40</sup> For instance, in a country with a stable party system dominated by two major parties that alternate in power, even if one party is out of power at a particular point in time, it is still a player in the intertemporal game.

<sup>41</sup> The theory has interesting predictions also in terms of the stochastic process generating the exact institutional position of the different players over time. Dixit et al (2000), and de Figueiredo (2002) present interesting insights in that direction.

<sup>42</sup> Countries that have had military frequent and/or long-lived military governments, might endure non-cooperative legacies even several years after the return to democracy. Another dimension might relate to the history of the franchise and the type of interaction citizen-politician it tends to induce. It might be the case that in countries where large groups of citizens do not have a long tradition of voting, clientelistic practices might be more common, and such practices might induce more myopic behavior from both voters and politicians. According to World Bank (2001), that might be the case in Peru.

an independent bureaucracy is another alternative.<sup>43</sup> In the example of the Appendix, it can be shown that delegating policy forever to an individual with preferences intermediate between those of the two parties, leads to the first best. More generally, delegation has its problems, but there will be cases in which the cost of those problems is smaller than the cost of “partisan” policymaking.

#### *Availability of enforcement technologies*

As in transaction cost economics, intertemporal cooperation is easier to achieve, if there is good third-party enforcement. The presence and characteristics of a potentially impartial umpire and enforcer of political agreements, such as an independent Judiciary, will vary from country to country, providing variance in the degree of enforcement of intertemporal political cooperation.

#### *Characteristics of the arenas where key political actors undertake their exchanges*

The complex intertemporal exchanges required for the implementation of effective public policies could be facilitated by the existence of exchange arenas that are organized in ways that make cooperation easier to enforce. Seminal work on the U.S. Congress debates the role that different institutional arrangements have in facilitating legislative bargaining, but it is agreed that *somehow* things are arranged in a way that facilitates some intertemporal cooperation in political exchanges -- see for instance Weingast and Marshall, 1988, Shepsle and Bonchek, 1997, and the collection in Shepsle and Weingast, 1995. Whether the legislature as the arena where these transactions take place is adequately institutionalized or not, depends on several factors including legislators’ incentives and capabilities. There are some environments, and we argue that Argentina is one of those, in which legislatures are much weaker than the benchmark U.S. case. If political exchanges are actually undertaken, they take place in settings that are more informal, more uncertain, and harder to monitor, observe and enforce.<sup>44</sup>

To sum up, political cooperation leading to effective public policies is more likely if: (1) the short-run payoffs from non-cooperation are lower, (2) the number of political actors is small, (3) those actors have strong intertemporal linkages, (4) policy and political moves are widely observable, (5) good delegation technologies are available, (6) good enforcement technologies (such as a strong Court to arbitrate) are available, and (7) the key political exchanges take place in arenas where properties (2)-(6) tend to be satisfied.<sup>45</sup>

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<sup>43</sup> Although bureaucratic delegation is endogenous to each agreement (Moe 1990, Epstein and O’Halloran 1999, Huber and Shipan, 2002), it is constrained by some general properties of civil service in the country, like its professionalism. (Huber and McCarty, 2001).

<sup>44</sup> Somewhat similar conclusions are reached by Hicken (200x) with respect to Thailand and the Philippines.

<sup>45</sup> This listing of elements plays the same function that the notion of “number of veto players and their characteristics” in Tsebelis (2002) and of “separation of powers and separation of purpose” in Cox and McCubbins (2001).

#### **V.4. Mapping those Abstract Variables into Political Variables and Institutions: Links (5), (6) and (7) in Figure 3**

The elements listed in the last paragraph of the previous section provide some guidance with which to enter into the observation of actual polities. A couple of comments are in order at this point. First, the listing we provide is meant to be suggestive, and not taxonomic. There are other factors that may be relevant when characterizing the incentives for or against cooperation in the policymaking system in any given country. For instance, we might want to know whether there are historical factors (beyond a specific configuration of political institutions at any point in time) that foster or hinder cooperative political behavior. Or whether cultural, social or economic configurations facilitate the enforcement of cooperation. Or, in a more game-theoretic vein, whether punishment for non-cooperation is easy to inflict, and costly enough to those who deviate from cooperation.

Also, mapping such abstract variables into real world political “observables” is not a simple task in general, and it is still open to substantial interaction between empirical (inductive) and theoretical (deductive) exploration in this framework.<sup>46</sup> Our emphasis on interaction among political variables makes that mapping difficult and requires it to be grounded on a deep institutional knowledge of the countries in question.

Having stated those caveats, we now suggest some of the steps involved in moving to the empirical implementation of linking the model developed so far with actual political institutions. Roughly, one has to start by asking questions such as: Who are the key actors? What are the payoffs for political cooperation and for deviating from cooperation in the specific games in which they tend to be involved? Where and how frequently do they undertake their exchanges? What are the properties of the arena/s in which they exchange?

Some of the observable proxies for such questions relate to things such as institutional veto points, variables determining who holds those institutional veto points at each point in time (related to the parameters of the stochastic political shock), number of “permanent” intertemporal players, the determinants of the short-term incentives of those players, length of horizons and its determinants, institutional features (constitution, budget procedures, informal practices, etc) that permit unchecked moves by some actors, independence and “strength” of Supreme Court or equivalent, administrative capabilities, history of political instability, etc.

The answer to those questions and the “filling in the blanks” of the incomplete list suggested above in each specific country, will need to be supported by “modules” justifying theoretically or empirically those answers [related to (5), (6) and (7) in Figure 3].<sup>47</sup> For instance, in attempting to answer the question about the existence of enforcement

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<sup>46</sup> Bates et al (1998) view the construction of *analytic narratives* as an iterative process, moving back and forth between interpretation and case materials, modifying the explanations in light of the data, which itself is viewed in new ways, given the evolving understanding. (See also Buthe, 2002).

<sup>47</sup> All of that needs to be done taking into account the “general-equilibrium” “country-specific” interactions emphasized in this approach. A tentative list of potential variables to be considered, as well as references to some pre-existing theoretical linkages is provided in the companion paper Scartascini and Olivera (2003).

technologies, it is important to look into the workings of the judiciary (especially the Supreme Court or equivalent), and the workings of the public administration (characteristics of the Civil Service, etc). In order to answer whether the Supreme Court tends to be independent of the other branches of government, it is necessary to provide theoretical connections between the (political or other) determinants of judicial independence and /or empirical evidence (or “local” secondary sources) showing (or arguing) that, for instance, “the Supreme Court of this country tends to be politically aligned with the Executive.” Similarly, in order to ascertain whether the bureaucracy of a given country has some generic characteristics leaving a particular imprint on policymaking, it is crucial to have theoretical and/or empirical building blocks explaining and/or documenting such characteristics. In describing the incentives, horizons and characteristics of some key institutional players such as legislators, it is imperative to justify such description on extant work relating legislator behavior and incentives to electoral systems (for instance, Carey and Shugart 1995), and/or on empirical work describing legislator behavior in the country.<sup>48</sup>

It is useful to use the analogy to a website, in which there is a “main page” describing the workings of the policymaking process in a country (characterized by its degree of cooperativeness and some related features) and “links” to pages providing the background information (theoretical, empirical, and or based on secondary sources) for the assertions in the main page. The work of Spiller, Tommasi and co-authors on Argentina, which could be considered a “pilot-project” for our purposes, provides an example of how this may be done. In the next section, we provide a brief summary of their work. Before that, it is useful to relate the approach suggested here to other existing approaches, such as those of Tsebelis (2002) and of Cox and McCubbins (2001).

The list of determinants of cooperativeness in policymaking games provided above plays the same function as concepts such as “the number of veto players and the distance in their preferences” in Tsebelis (2002) and as “separation of powers and separation of purpose” in Cox and McCubbins (2001). In all cases these concepts constitute abstract constructs, steps from game theoretic variables, to the empirical application to actual polities.<sup>49</sup> For instance, Cox and McCubbins have some valuable suggestions on the possible determinants of the public vs. private – regardedness of policies, which do not come out so naturally from the framework we have suggested so far. Also, some of the variables that we have listed above (for instance institutional veto points, variables determining who holds those institutional veto points at each point in time) are equivalent to the variables emphasized by Tsebelis and by Cox and McCubbins, and the empirical implementation can follow (in a modular sense) their work. Yet, the framework presented here provides additional angles and some additional focus for the purpose at hand. In particular, we want to highlight two differentiating aspects.

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<sup>48</sup> Similarly the output of the legislative interaction between the Executive and Congress will depend on several institutional details conditioning that interaction. See for instance Payne et al (2002 ch. 8), Mainwaring and Shugart (1997), and Aleman and Tsebelis (2002).

<sup>49</sup> That is a crucial step even in more “forward-looking” type of explanations that attempt to explore the policy implications of some particular institutional characteristics. For instance the way in which Persson, Roland, and Tabellini (1997 and 2000) map “presidentialism” to some particular structure of a budget game, has been criticized by Cheibub, Przeworski and Saiegh (2003).

On the one hand, our approach pays special attention to the intertemporal nature of political exchanges. For instance, we believe that the rather stark trade-off between decisiveness and resoluteness presented by Cox and McCubbins can be relaxed by some institutional characteristics that facilitate intertemporal political exchange, in a sense increasing *both* decisiveness and resoluteness vis a vis a polity that does not have institutional characteristics that facilitate intertemporal political cooperation.

Relatedly, our approach provides a stronger conceptual basis for normative analysis and for thinking about institutional evaluation and (perhaps) institutional reform. In particular, Tsebelis is very upfront about the fact that his approach cannot tell whether policy “stability” is socially desirable or not.<sup>50</sup> Our approach (substantiated in the model in the Appendix) allows us to distinguish those policy changes that might in principle be more generally desirable (responses to economic or technological shocks, or to learning) from those that are in general less desirable (in response to the realization of the “political lottery”).

As an example that somewhat encapsulates these two distinctions, let us consider the role of the Judiciary. The Haggard-McCubbins team seem to count an independent Court as an additional veto player that moves a polity towards less decisiveness and more resoluteness. (That is indeed followed in some applications, for instance Hicken, 200x). In our intertemporal view, the fact that there is an independent Court (and that quite likely will be one in the future) might induce some other “veto players” to allow some socially desirable policy changes today, if they believe that the presence of an independent Court will improve the intertemporal enforcement of the political agreement undertaken today to implement that policy change. If that is the case, an independent Court might increase both resoluteness (avoiding unnecessary/opportunistic policy change) *and* decisiveness (allowing the implementation of some efficiency enhancing policy changes today, that might otherwise be obstructed by other players for fear of future opportunism).<sup>51</sup>

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<sup>50</sup> “I take a more agnostic position with respect to policy stability. It is reasonable to assume that those who dislike the status quo will prefer a political system with the capacity to make changes quickly, while advocates of the status quo will prefer a system that produces policy stability. It is not clear that a consensus exists (or is even possible) over whether a faster or slower pace of institutional response is desirable. Decisiveness to bring about policy change is good when the status quo is undesirable (whether it is because a small minority controls the government as with the French *ancien regime* or recent South Africa), or when an exogenous shock disturbs a desirable process (oil shock and growth in the seventies). Commitment to non-interference may be preferable when the status quo is desirable (such as when civil rights are established), or if an exogenous shock is beneficial (such as an increase of the price of oil in an oil producing economy). But regardless of whether policy stability is desirable or undesirable, the above literature indicates that it is important to study under what conditions it is obtained, which is a goal of this book.” (Tsebelis, 2002, pp. 7-8).

<sup>51</sup> That is, in their approach “adding” an independent judiciary moves a country along the decisiveness-resoluteness frontier towards more resoluteness and less decisiveness. In our approach, it might shift that frontier outwards, leading to an increase in both decisiveness and resoluteness.



## VI. APPLICATION TO ARGENTINA<sup>52</sup>

### VI.1. Public Policies in Argentina

#### *Generalities*

ST2003b explores the characteristics of Argentine public policies, combining the use of some cross-national data sets, with case studies of practices in specific policy areas and specific policy episodes. We present here a brief sample of the cross-national comparisons, and one of the policy cases, that of pension reform in the 1990's. (The other cases analyzed in that book are privatization and regulation of public utilities, other social welfare policies, fiscal federalism, and monetary/exchange rate policy.)

<Figure 4>

Figure 4 summarizes some cross-country evidence.<sup>53</sup> Panel (a) provides a quick “control” indicating that Argentina is an upper middle-income country. Panel (b) shows that Argentina’s overall economic stance has been the 7<sup>th</sup> more volatile in a sample of 106 countries. Panel (c) indicates that, in the opinion of international businessmen, those frequent policy changes are indeed quite costly for the operation of the private sector. Panel (d) presents the one reply by businessmen where Argentina seemed to rank quite well, presenting very low “expected exchange rate volatility.”<sup>54</sup> Unfortunately, that survey was taken in April of 2001, and 8 months later the exchange rate blew off the ceiling, after the breakup of the (10 years long) convertibility regime. This suggests that in Argentina, policy credibility, stability and predictability, can only be built on the basis of very rigid mechanisms, which eventually explode into pieces or become very costly under certain states of the economy.<sup>55</sup> Panels (e) and (f) indicate that the Argentine State is a weak enforcer of its policies (be that minimum wages, or taxes). Panel (g) shows that Argentine public spending is not viewed as very useful by the private sector. Argentina does not appear too bad in panel (h), quality of infrastructure, where it is only slightly below the sample median. Unfortunately, if one were to review this indicator in a few years, Argentina would have moved to the right, to a much lower ranking. That is because the 2001 observation is “inflated” by the large investment during the 1990’s after privatization, in what was (from a 2003 perspective), just another cycle in the Argentine pendulum. Panel (i) shows that Argentine public schools rank relatively low in international comparison, in spite of the fact that Argentina ranks well in indicators of literacy and school achievement, (mostly through the effect of the better private schools to which almost everybody who can afford it, tries to send their children.) Panel (j)

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<sup>52</sup> This brief anatomy of the PMP in Argentina is a summary of Spiller and Tommasi (2003: ST2003), which is being distributed as background paper for this project.

<sup>53</sup> Years 2000/2001. Sources: Fraser Institute, and Global Competitiveness Report.

<sup>54</sup> In Figures 4c to 4j, higher bars indicate “better” policy characteristics. In this particular case a higher bar implies the expectation of low exchange rate volatility.

<sup>55</sup> See Galiani, Heymann, and Tommasi (2003) for further analysis of the origin and dynamics of the Argentine convertibility regime.

shows that public officials are not perceived as being too competent, in international comparison. (Again, this in a country where overall levels of human capital are reasonably high by international standards).

### *Pension Policy*

Pension policy is an issue with transaction characteristics that make it particularly prone for “trouble.”<sup>56</sup> The underlying “economic” transaction consists on taking money from people currently working (in the formal sector), in exchange for returning that money 30 years from now, when the worker reaches retirement age. (Clearly pension systems serve other purposes, such as redistribution, and insurance “against” long life). There are so many things that could go wrong along those 30 years, that it is no wonder that pension systems are such hot political problems in almost any country.

Argentina has had its fair share of problems with the pension system. It was created by President Peron as a Pay -As-You-Go-System. At that time, most of the population was uninsured against impoverishment in old age or late death, so the program was very popular. Regrettably, the system was running deficits only thirty years after its creation. There are two main reasons behind that outcome. On the one hand, the pension fund was managed discretionally by the executive. Resources were used clientelistically to finance a wide range of social programs. On the other hand, the underlying demographic and economic assumptions of the system were totally unrealistic, particularly for those groups that received special treatment (public employees, congressmen, etc.)

Minor reforms were implemented during the seventies and eighties, but none of them resolved the problem. The large deficit of the social security system was one of the causes of the late eighties hyperinflation crisis. Among the many problems of the system, it was salient the low rate of contribution, with a large fraction of people avoiding contributing to the system. In a nutshell, the main problems of the public system were low compliance of individuals, and opportunistic political manipulation by the government which often translated into “stealing people’s pensions.”

In 1993, after several years of debate (including the accommodation of union demands by letting them run their own pension companies), the “public” PAYG system was replaced by a multi-pillar system, based on a private individual contributory worker accounts, complemented by a public redistributive fund. The individual accounts are managed by private funds administrators (AFJP), regulated by a newly created agency (Superintendence of AFJPs). The reform was characterized as a “privatization,” and it was claimed that the new system was invulnerable to political discretion. It was also expected that the new system of individual accounts will increase contributions, given that now workers had a clear property right on their individual savings.

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<sup>56</sup> The discussion in this brief section draws from Ronconi and Tommasi (2003). There it is argued that *marriage* is a case with intertemporal transaction difficulties comparable to those of pensions. No wonder that marriages, like pension systems, are also quite prone to trouble.

Unfortunately, none of those expectations was fulfilled. It seems that people rightly anticipated that the “privatization” of the funds was not enough of a guarantee against expropriation, because compliance even declined. And those pessimistic expectations were dutifully fulfilled by the government during the crisis of the early 2000s, by forcing the AFJP to hold government paper, on which the government later defaulted.

The example (analyzed in more detail in Ronconi and Tommasi, 2003) illustrates the points made in the introductory section of this paper. It seems that some deep governmental capabilities, such as that of committing not to expropriate, are more important for the performance of some policies (in this case, pension policy) than the “inner” content of the policies (in this case, “public PAYG” vs. “individual accounts administered by private pension funds regulated by the State.”)

### *Summary*

In sum, public policies in Argentina are sometimes too volatile, other times too rigid, they are not well coordinated across policymaking actors, and they tend to be of low quality (reflecting among other things insufficient investment in policymaking capabilities).

## **VI.2. Brief Anatomy of the PMP in Argentina**

The above mentioned policy characteristics are explained in ST2003 as the result of a generalized incapacity to strike the intertemporal agreements necessary to sustain effective public policies (and to induce capacity-building for public policy purposes). The configuration and workings of political institutions in Argentina are not conducive to effective political compromise and cooperation. We briefly highlight below several (interactive) features that correspond to the determinants of political cooperation or lack thereof identified in Section V.

Argentina shares some basic constitutional characteristics with the U.S. It has a Presidential, Bicameral and Federal organization of government (24 “provinces” with substantial constitutional powers). If a Martian who has read the institutional literature on American Politics were to land on Argentina and, without knowing anything about the country, were to grab a copy of the Constitution, he would form some expectations about the workings of the polity that would not be fulfilled upon closer scrutiny.

For instance, our Martian will start by exploring the role of Congress in the policymaking process. The first thing he would notice is that Congress does not have such an important role in the making of policy. The actions and powers that he would expect to encounter in Congress, would fade in the direction of the Executive (not too surprising in Latin American perspective), but also, more surprisingly, in the direction of the governors of the provinces.

The fact that Congress is not such a hot place, is a general equilibrium result that depends on electoral rules that make legislators weak political actors; on Constitutional rules and historical (and equilibrium) practices that give the Executive much leeway to undo or modify legislative agreements, both at a “broader” legislative stage, as well as at the implementation stage; and on the lack of alternative (for instance, judicial) enforcement mechanisms for legislative agreements. Perhaps the most crucial factor for legislative weakness is the fact that electoral rules (broadly defined) take power away from legislators, voters, and national party leadership, and place that power in the hands of provincial party elites.

National deputies are elected in closed and blocked party lists under a system of proportional representation, with the provinces being the electoral districts. In spite of a strong overrepresentation of small provinces,<sup>57</sup> many of these provinces elect only 2 deputies at a time, given their allocation of five deputies and the staggered nature of elections. This gives, in fact, a median district size of 3, what breaks the representativeness of the system. It also turns out that provincial party practices are such that provincial party elites play a disproportionately powerful role in the making of those lists. (This is specially so when the party coincides with the provincial executive; as explained in De Luca, Jones and Tula, 2002, and Jones et al, 2003).

One of the implications of the incentives of provincial party bosses (analyzed in Jones et al 2003) is the very high rotation of Argentine legislators, most of which stay in Congress only one term, because their names do not appear on the list for reelection. Argentina presents duration figures that are similar to those of countries with term limits. This has the further implication that legislators do not have the incentive to develop strong legislative institutions, do not specialize, and are neither important policymaking actors, nor an effective control of the Administration (Jones et al, 2002).

Congress has the constitutional right to generate national laws. The masters of (most) legislators are, then, the provincial governors. But what do these powerful political actors care about? They care about two related things. One is maintaining their power in the provincial party and in the province, and the other is to obtain resources from central taxes in order to finance spending in the province. It turns out that in Argentina, the federal fiscal system (fiscal federalism) is a crucial component of the political game and of the policymaking game, even for policies that, in principle, do not have much of a “federal” dimension.<sup>58</sup>

In Argentina, the national government is in charge of most of taxation, especially of the most productive taxes, such as value added and income taxes. Yet, provinces are in charge of a large fraction of total spending, specially the most politically sexy spending,

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<sup>57</sup> The 24 “provinces” are really 23 provinces plus the capital city. These provinces are extremely asymmetric in terms of population, with the city of Buenos Aires, the province of Buenos Aires, and two or three additional provinces containing a very large fraction of the population and economic activity, yet being severely underrepresented in the overall political system. Calvo and Murillo (2003) provide an excellent characterization of these features.

<sup>58</sup> We use “federal” in the non-U.S. usage to refer to intergovernmental relations and to provincial matters. The “Federal” government is called, in Argentina, the “national” government.

such as public employment, social programs, etc. This last fact, in combination with the weaknesses of national Congress, helps to understand why the crucial axes of Argentine politics run through the provinces. The large vertical fiscal imbalance between revenue generation and spending obligations is covered through a politically sensitive system of tax-sharing and intergovernmental transfers, which generates all types of perverse incentives for provincial and national authorities. (It is analyzed in detail in Tommasi, 2002). One of the outcomes of the working of this system is a strange symbiosis between fiscal federalism and national policymaking. Whenever the national Executive needs to pass an important law, it requires the permission of most provincial governors, so that they instruct their congressional underlings to accompany the initiative. Those favors are usually exchanged for fiscal favors from the national to the provincial treasury through a variety of instruments and bailouts whose exact form keeps mutating and adapting to the successive “constraints and reforms” attempted under sponsorship of multilateral organizations (Tommasi, 2002, Braun and Tommasi, 2002).

All of this, plus a series of factors facilitating Executive unilateralism,<sup>59</sup> leaves the central arena of national policymaking in Argentina quite naked, with a bunch of short-term actors, plus some quite powerful actors which are only tangentially interested in national public goods (including intertemporal investment in policymaking capacities in those national public goods).

Furthermore, a potential enforcer of intertemporal political agreements, the Supreme Court, has not tended to play much of that role in recent Argentine history. For reasons analyzed in Iaryczower et al (2002), the Court has tended to be too aligned with the executive, and this has led to a path dependent dynamics of losing credibility to the point that today it is not an effective warrantor of rights, independently of the political configuration of the moment.<sup>60</sup>

A professional bureaucracy, well supervised by Congress, could be another channel for the intertemporal enforcement of political agreements. Argentina, however, in part due to past political instability, but also to the current incentives of key political players, does not have such a bureaucracy either. A shortsighted Congress has left the bureaucracy without a long-term principal. In the absence of long-term political masters who can provide long-term incentives to invest in developing capabilities, the bureaucracy has become an unresponsive and hard to motivate organization. Political appointees, the so-called “parallel bureaucracy,” have then been used to “fill the gap.” These appointees, in turn, rotate very frequently and

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<sup>59</sup> Constitutional features such as the ability to “replament” laws from Congress, path dependency from military times which focused on the Executive actions and expectations of non-governmental actors that in normal circumstances would have focused on the legislature, general equilibrium implications of the lack of strong Supreme Court enforcement, weakness of Congress, budget capabilities, lack of strong Civil Service, etc.

<sup>60</sup> Iaryczower, Spiller and Tommasi (2002) show that, historically, the voting patterns of Supreme Court Justices in Argentina can be explained with a strategic behavioral model similar to the one used to explain the voting behavior of the US Supreme Court. The crucial difference has been in the values of the explanatory variables over time. Due to the many military coups replacing Justices, and to their replacement again during democratic restoration, Argentine Justices have tended to have short durations, to be nominated by the ruling executive, and to face fairly unified governments.

do not develop norms of cooperation across departments, contributing to the fragmentation and lack of coordination of public policies. (Bambaci et al, 2001).

In sum, and attempting to map back into the game-theoretic language of section V, what we have in Argentina is a configuration that fosters non-cooperative behavior in the policymaking process. Key actors have either short horizons, wrong incentives, or both. Some potentially important actors such as legislators, Justices, or key civil servants, have very short horizons. The potentially more long-lived and powerful governors, have only marginal incentives towards provision of national public goods. Furthermore, the political configuration of the last two decades has made almost all governors potential veto players, increasing the cost of political transactions (ST2003). The Executive has had excessive leeway for ex-post moves that can undo previous agreements, reducing the incentive to work towards those agreements in the first place. Third party or other enforcement technologies have been missing. The interaction of the capacity for unilateral moves, history, and the (endogenous) lack of institutionalization of Congress and of legislators' careers has moved the center of the political scene away from the national legislature and into other arenas. Political bargains take place in executive quarters, in meetings of the president with governors, or occasionally in meeting of national political party leaders. These informal arenas have not been structured for the institutional enforcement of bargains.

### **VI.3. A Word about Time Framework and Exogeneity**

Potential endogeneity of the “institutions” that researchers use as explanatory variables is a usual problem in institutional analysis. That is indeed a formidable obstacle for cross-national empirical analysis, and some creative strategies have been followed by researchers to circumvent that problem. The problem is somewhat easier to handle in historically grounded, country-specific, detailed analysis of the type we suggest here. (For related statements, see Buthe 2002, Bates et al, 1998, and Levi, 2000).

In our application to Argentina, we identify electoral rules, fiscal federalism, plus some constitutional characteristics, as well as the inheritance of decades of democratic instability, as the “deep” explanatory variables of modern day political behavior and (hence) of the characteristics of public policies over the last couple of decades. More precisely, our final dependent variables are the characteristics of public policies since the (last) return to democracy in 1983. We feel quite comfortable taking characteristics that the country inherited from the 1853-62 Constitution as exogenous for our purposes. Also, we take as given the configuration of the main electoral rules inherited in 1983, as well as the configuration of federal fiscal arrangements at that moment. Those electoral rules, in turn, had a previous history, which is reviewed elsewhere, for instance in Saiegh and Tommasi (1998) and references there. But given their presence in 1983, they then become self-sustained in equilibrium, as the main power brokers have no incentive to change them. With regards to fiscal federalism, the story (analyzed in Tommasi 2002) is more dynamic, with the actual instruments and rigidities changing in successive renegotiations following economic shocks and dynamics. Nonetheless, the fundamental incentives towards non-cooperative

behavior in the federal fiscal game remain more or less the same, and the potential reforms of the system that could alleviate some of its inefficiencies, cannot be instrumented due to transaction cost problems (Tommasi, 2002).

It is important for researchers applying this methodology to other countries to adequately pick the right frequencies for their dependent and independent variables, also following considerations of data availability.

An additional value of historically grounded, country-specific, institutional analysis is that it allows us to perform more educated guesses about the temporal effects of institutional changes at different frequencies. For instance, the Argentine Constitution was amended in 1994, in the context of a political bargain to permit the reelection of President Menem. Some potentially important rules were changed, such as the introduction of a Chief of Cabinet, the direct election of Senators, and some mandates for reforming the federal fiscal system. Also, some potentially important “second order” institutional changes were instrumented, some of which closed some of the faucets of fiscal leakage from the center to the provinces. Our understanding of the “permanent” game being played, allowed us to be skeptical about the effects of all those measures, unlike other scholars watching the country “from the airplane.”<sup>61</sup>

## **VII. BROADER CONSIDERATIONS**

This paper has presented a methodology for the study of the policymaking process, its impact on policy outcomes, and its political and institutional determinants. As any such attempt, it has several limitations, some of which we want to highlight here.

On the one hand, it is clear that there are factors which are broader and more structural than the ones we have emphasized here that are also important in the determination of policies (and their characteristics) in any given polity. Several of those factors are also important in determining the broader economic and social trajectories of countries. We have no quarrel with that assertion. Our maintained hypothesis is that political institutions matter for policy (even in developing countries); quite possibly in a manner that is interactive with those broader determinants. One such determinant, which could fit quite well within our framework, is the nature of underlying socioeconomic cleavages, i.e., the degree to which

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<sup>61</sup> For instance, Heller and McCubbins (2001), interpret the Argentine dynamics of the 1990’s (including aspects of the 1994 Constitutional reform) as increasing the potential of cooperative policymaking and hence regulatory credibility in Argentina. A more complete and detailed understanding of the case, lead us to exactly the opposite prediction (Spiller and Tommasi, 2003b), in a manner more consistent with what has actually happened. Similarly, observers of the dynamics of federal institutions in Argentina (Dillinger and Webb, 1999, Kopits, Jimenez and Manoel, 2000), had optimistic predictions for the hardening of budget constraints. Our reading of the situation was that the “formal measures” they were interpreting optimistically (such as passage of a Fiscal Responsibility Act, or Fiscal Pacts between the national government and the provinces) were not going to be obeyed in equilibrium when put under stress by bad states of the economy, as indeed it happened (see Braun and Tommasi, 2002, and Tommasi 2002 for more details).

society is fragmented along social, economic or ethnic lines. (Once again, matters of history and timing should be considered in each case).

In any specific country application of the methodology we suggest here, there might be country-specific factors that might not fall under our listing of politico-institutional variables, which cannot be ignored. These might include specific “policy issues” that are so central to the polity that they cannot be ignored in a broad analysis of the overall policymaking process (such as oil in Venezuela, or Colombia’s never-ending internal wars).<sup>62</sup> Or they might include some other important “ever-present” political actors such as the military, strong business associations, or unions.<sup>63</sup>

Furthermore, there is a higher “institutional” level at which it is determined whether the formal aspects of the democratic game tend to be respected or not. That has been (and still is) a very important factor in Latin America; and the transitions to democratic rule have left important imprints even in those countries which have succeeded in keeping the political game within democratic rules. In particular countries in which the military continue to have a very fundamental (but informal) role, it might be problematic to focus too narrowly in the details of formal political institutions. Yet, we believe that the actual workings of those formal institutions that are operational constitute an important building block of the overall analysis.

This relates also to another important conceptual issue we have ignored so far: the fact that formal political institutions are not frozen, and do evolve and change, often in response to their very performance. That is certainly an important consideration and in some specific country cases, such transitions might be taking place. Still, a good understanding of the effect of pre-existing institutions is a crucial component in the whole picture, and given that most of the time only some things are changed (for example, in the Argentine Constitution of 1994), the “general equilibrium” understanding of the previous system is crucial even to predict the possible future impact of the changes under way.<sup>64</sup>

One other point which we have not emphasized enough in this paper, but that might be crucial for understanding policies in many countries, is that of the vertical relationship between official political actors and the citizenry. In principle, and following North (1990)

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<sup>62</sup> Those issues might play a role in National policymaking games similar to the one played by fiscal federalism in the Argentine case. Given our findings for the Argentine case, we encourage all country studies to pay close attention to the nature of intergovernmental fiscal relations, and their connection to national politics.

<sup>63</sup> Other very important factors that might constitute modular components of a broad explanation include the strength of civil society, the way interest groups are organized and how they interact with government (this in turn might contain some “exogenous” elements, but is also dependent on political institutions, Mainwaring and Shugart, 1997), the existence or not of elites with shared values, the role of the media, etc. Furthermore, there might be some very important past policy choices that condition the current political game, such as Convertibility and federal fiscal arrangements in the Argentine case.

<sup>64</sup> The dynamics of institutions is an extremely important issue, to which we cannot do any justice here. We just want to mention that such dynamics could be analyzed, in part, with a similar set of tools that we are deploying here for the study of the effects of institutions. For more articulated and detailed arguments in that direction, see Miller (2000) and Buthe (2002).



and Dixit (1996), the logic of transaction cost politics translates well into that issue.<sup>65</sup> Some undesirable properties of policies can result from transactional problems preventing the implementation of policies that leave the same rents for politicians, while improving the welfare of citizens.<sup>66</sup> Also, the horizontal dimension of political exchange that we have emphasized is in practice deeply intertwined with the vertical dimensions of representation and of agency. In the applied work, one has to be conscious that different configurations of political institutions do have effects on both dimensions.<sup>67</sup>

## **VIII. THE AGENDA AHEAD**

The logic presented in this paper can be applied at different levels of aggregation, focusing on more general characteristics of all policies or focusing on specific policy domains – or even specific policy episodes. In order to look at more narrow policy domains (say, health policy), specifics of that game, including the set of relevant micro actors have to be identified. Yet, what happens at those more “micro” games in general is heavily tainted by the broader characteristics of the overall political game in which those specific games are embedded.<sup>68</sup> Because of that, in the first stage of the broader agenda we will concentrate on building a “macro” diagnostic of the workings of political institutions and their impact on broad properties of public policies.<sup>69</sup> Eventually, after this initial investment, we should be able to progress in developing a matrix with: (**X**) sets of political-institutional variables characterizing a country as rows; (**Z**) different policy issues characterized by a number of “transaction” properties (temporality of exchanges, volatility of the underlying economic environment, observability of the shocks, nature of interests involved, etc) as columns; and (**Y**), the features of the resulting equilibrium policies inside the cells.

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<sup>65</sup> The problem of political agency more generally is a very important topic that we do not have the space to cover here. Some useful references are Persson, Roland and Tabellini (1997), Scharpf (1997, chapter 8), Przeworski, Stokes and Manin (1999), Crisp, Moreno and Shugart (2002), Colomer and Negretto (2002), and Seabright (1996). Relatedly, our emphasis on intertemporal cooperation might have an “oligopolistic” political application in which political parties successfully collude over time to extract rents from the citizenry -- Haggard, McCubbins and Shugart, (2001), suggest that such might have been the case in Venezuela.

<sup>66</sup> See Robinson and Verdier (2001) for a model of clientelism with this spirit.

<sup>67</sup> Sometimes those effects are positively correlated, others negatively. As an example of positive correlation, the large vertical fiscal imbalances characterizing countries like Mexico or Argentina, seem to have negative effects both on the nature of transactions among formal political actors, as well as on the quality of representation (Careaga and Weingast, 2002, Jones, Sanguinetti and Tommasi, 2003). As an example of negative correlation, there is a standard assumption in discussions about decentralization, which implies a trade-off between “bringing government closer to the people” and improving policy coordination.

<sup>68</sup> CEDI (2001) and Fiszbein and Tommasi (2001) provide evidence in that direction for the case of social sector policies in Argentina. See also Ostrom (1999, p. 37): “Decisions made about rules at any one level are usually made within structure of rules existing at a different level. Thus, institutional studies need to encompass multiple levels of analysis.”

<sup>69</sup> As it has been emphasized, cross-policy variation (contrasts) in properties of policies, is in itself an object of interest. For instance, it might be interesting to inquire into why Colombia has reasonably stable, predictable and rather coherent macroeconomic policies, in spite of the clear inability of the Colombian polity to establish cooperative agreements that would allow to solve deep problems such as violence. (Archer and Shugart, 1997).

In building this agenda, we are following Sabatier's (1999) "most important" guideline in attempting to foster the development of policy theory: "Develop a long-term research program involving both theoretical elaboration and empirical testing among a network of scholars."

## **APPENDIX: A Simple Model of Political Cooperation and Public Policy**

Imagine a game between two players or “groups,”  $i = A, B$ . Each player tries to minimize

$$(1) \quad \sum_{t=0}^{\infty} \mathbf{d}^t E[L_i(y_t, \mathbf{q}_t)]$$

where  $\mathbf{d} \in [0,1]$  is a (common) discount factor measuring “patience”, and  $L_i(\cdot)$  is a loss function which depends on the “collectively” chosen policy  $y$  and the economic shock  $\mathbf{q}$ , identically and independently distributed over time, with  $E(\mathbf{q})=0$ . For simplicity, let

$$(2) \quad L_i(y_t, \mathbf{q}_t) = [y_t - (y_i + \mathbf{q}_t)]^2$$

The fact that  $y_A \neq y_B$  captures the elements of conflict, while the fact that everybody’s preferred policy responds in the same direction to the economic shock  $\mathbf{q}$  captures the common interest, or economic efficiency. Assume that  $y_B = -y_A > 0$ .

In each period, after the random shock  $\mathbf{q}_t$  is realized, the policy  $y_t$  is decided through a collective choice mechanism. Also assume that the recognition rule,  $\mu_t=i$ , generates an equal probability that each player  $i \in \{A, B\}$  be the one-period dictator ( $\mu_t=i$  implies that player  $i$  decides  $y_t$  in period  $t$ .) That is:<sup>70</sup>

$$(3) \quad \mu_t = i, \quad i \in \{A, B\} \quad \text{with prob. } 0.5$$

Assume furthermore that there is an initial period (zero) in which, by unanimity, players can make some agreements.

We start defining a first-best utilitarian benchmark as

$$(4) \quad \text{Min} \quad \sum_{t=0}^{\infty} \mathbf{d}^t E[L_A(y_t, \mathbf{q}_t) + L_B(y_t, \mathbf{q}_t)]$$

Given our assumptions, (4) simplifies to

$$(5) \quad \text{Min} \quad \sum_{t=0}^{\infty} \mathbf{d}^t E(y_t - \mathbf{q}_t)^2$$

so that the first-best policy is  $y_t = y^*(\mathbf{q}_t) = \mathbf{q}_t$ , for all  $t$ . This result indicates that the first-best policy is a function of the realization of economic shocks, but independent of the realization of political shocks.

We analyze now the solution to the non-cooperative game. The one-shot Nash equilibrium has  $y_t = y_m + \mathbf{q}_t$ . That is, each political player implements his or her most desired policy, ignoring the interest of others. Turning to the repeated game, the infinite repetition of one-shot Nash is always an equilibrium. We define  $V^N$  as the present value of expected loss for each player from the infinite repetition of the one shot Nash equilibrium. Then we have that

<sup>70</sup> This is a very simplified version of several richer collective decision making mechanisms, as those in Alesina (1988), Baron and Ferejohn (1989) and Dixit, Grossman and Gul (2000).

$$(6) V^N = \frac{1}{2}[0 + (2y_B)^2] + dV^N = \frac{2y_B^2}{1-d}$$

To simplify the analysis we focus now on the possibility of the most cooperative behavior being supported by the punishment strategy of permanent reversion to non-cooperation (as in Dixit et al 2000, and Dixit 2001). This is the strategy (S1) for both  $i$ :

$$(7) y_1^i = y^*(q_1) = q_1$$

$$(8) y_t^i = \begin{cases} y_t^* = q_t & \text{if } y_t = q_t \quad \forall t < t \\ y_i + q_t & \text{otherwise} \end{cases}$$

The payoff along the equilibrium path of cooperation is

$$(9) V^* = \frac{y_B^2}{1-d}$$

for both players, which coincides with the value of the loss function in the first best. In order to verify whether this strategy pair constitutes an equilibrium, we have to consider the value of an opportunistic deviation to  $y_m + q_t$ . Such deviation would move the game to non-cooperation forever, leading to the value

$$(10) V^D = 0 + dV^N = \frac{d}{1-d} 2y_B^2$$

Comparing the loss functions  $V^*$  and  $V^D$ , we can conclude that cooperation can be sustained iff  $d \geq 1/2$ . The first-best can be attained, then, for  $d$  large enough, that is, when players have long horizons.

Consider now what might transpire in the previous stage of the game, what we call the contracting moment. The features of the resulting policies will depend on the set of feasible contracts. Assume that agreements can be enforced, but that the realization of economic shocks is not verifiable. In that case, it will not be possible to sign contracts that prescribe (economic) state – contingent contracts. On the other hand, the parties can agree on simple “rules.” In our example, it can be shown that the best such rule is to set  $y_t = 0$  for all  $t$ . This will deliver an expected loss of:

$$(11) V^0 = \sum_{t=0}^{\infty} d^t E(y_B + q_t)^2 = \frac{y_B^2 + \text{Var}(q)}{1-d}$$

This outcome is inferior to the first best for both players, i.e.,  $V^0 > V^*$ . (Remember that we are dealing with *loss* functions.) The discretionary cooperative equilibrium is preferable to a rigid rule. Thus, whenever the repeated game delivers cooperation, a rigid rule will not be utilized. Comparing the rigid rule to the non-cooperative case, we have that  $V^N > V^0$  iff  $(y_B)^2 > \text{Var}(q)$ . This implies that when the parties have a limited capacity to self-enforce cooperative agreements (i.e., when  $d$  is low), rigid policy rules (not responsive to the economic environment) will be chosen iff the conflict of interest ( $y_B$ ) is large compared to the volatility of the economic environment ( $\text{Var}(q)$ ). Thus, we find that when there is a low capacity to enforce intertemporal political exchanges, depending on the extent of the distributive conflict as related to the nature of economic volatility, we may observe highly volatile political agreements or highly inflexible policies.

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