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**Publication Date**

2012

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UNIVERSITY OF CALIFORNIA

Los Angeles

Partisanship and Economic Policies of Developing Countries  
in Dismal Times

A dissertation submitted in partial satisfaction of the  
requirements for the degree Doctor of Philosophy  
in Political Science

by

Julia Hyeyong Kim

2012

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## ABSTRACT OF THE DISSERTATION

# Partisanship and Economic Policies of Developing Countries in Dismal Times

by

**Julia Hyeyong Kim**

Doctor of Philosophy in Political Science  
University of California, Los Angeles, 2012  
Professor Barbara Geddes, Chair

Facing unsustainable economies, why are some regimes successful in recovering by instituting drastic reform of the economic system, while others fail? If a country's leaders implement some reforms, why do they later reverse them? Why do some governments that come to power on mandates to reverse reform not fulfill their promises? Some scholars argue that government leaders' ideologies strongly influence their economic policy decisions. Others argue that ideology does not matter in developing countries because ideologically defined parties do not follow their ideologically framed preference after they come to power. For example, the first group of scholars would consider President Menem's drastic economic reform a major deviation from his party but identify as an outlier. On the contrary, the latter group would identify the occasion as an example of how ideology does not matter in developing democracies.

This dissertation asks an empirical question: does ideology really influence economic policies in developing countries? My view is that during economic crisis, partisanship does not impact governments' efforts to correct the failing economic situations. This in turn leads to another empirical question: what systematic factors make ideology irrelevant in economically dismal times? When testing the impact of partisanship on economic policy, the literature usually treats government as one entity and scholars use the percentage of left or right in legislature as a proxy for ideological orientation of government. However, I suggest disaggregating government into at least two entities: executive and legislative and looking at agenda setting executives' and government parties' ideologies separately. History has shown that in some presidential systems executives often times deviate from their own party agenda. I argue that it is not because ideology does not matter in developing democracies that governments tighten their budget and adopt structural adjustments, but rather it is because the calculation of costs and benefits change due to external pressure and failing economy. Economic crisis renders the status quo unsustainable and beneficial to nobody so that coalitions of interests and veto players, which blocked or wished for reversal, will no longer exert their oppositions, and we see less of ideological influence on economic policies.

To test the validity of my arguments, I conduct statistical analyses on the panel data of developing countries. I use several measures of ideology: executive party's ideology regarding economic policy, the usual percentage of left in legislature, the existence of left-wing veto player in legislature, and the categorized percentage of left in legislature. I use the measures of inflation, external debt as % GDP, and official development aid as % GDP to define economic unsustainability. I test how ideology and economic unsustainability affect the executives' efforts to reform, which I indexed by investigating the executives' proposals and statements and

*Economist Intelligence Unit's* reports. Then, I test how ideology, economic unsustainability, and the executives' reform efforts affect the level of budget balance. Lastly, I disaggregate budgets to study whether partisanship affects social spending as government's way to compensate the group that lose most from reform. I find that at the end, both left-wing and right-wing increase social security and welfare spending when government initiate reform during economically difficult times.

The dissertation of Julia Hyeyong Kim is approved.

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Michael Lofchie

Barbara Geddes, Committee Chair

University of California, Los Angeles

2012

to  
Chongwon  
and  
Seohan



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## ACKNOWLEDGEMENT

First and foremost, I want to thank my advisor and dissertation chair, Professor Barbara Geddes for everything she has done for me. Without her advice, care, understanding, guidance, patience, and knowledge, I would not have finished the PhD program, not just this dissertation. She has been my mentor, teacher, and second mother to me. She has shown me how to be a great mentor for students, and I aspire to be just like her when I become a professor.

I also want to thank Professor Michael Lofchie for giving me opportunity to work with him and for providing funding for the last two years. With his funding, I was able to pay for my tuition and daycare for my son. I also have to thank him for giving me thoughtful insights in politics of economic reform, which became a big part of my argument. Professor Lofchie always encouraged me when I was having trouble managing work and family.

I have to thank Professor James DeNardo for being there for me every time I asked help. He helped me with not only statistical analysis but also theoretical foundation and formulation of the model. I even felt sorry for taking so much of his time. Also, I had so much fun when I TAed for him. I learned so much how to teach a statistical class but also how to be a true teacher. His teaching philosophy and care for students inspire me to be a teacher like him.

I would also like to thank Professor Kathleen Bawn for giving me thoughtful comments and advice ever since she read my first qualifying paper. It was my luck that she read both of my qualifying papers. I was so happy when she said yes to my invitation to be in my committee.

I also have to thank Professor Namhee Lee for her guidance, encouragement, and comments. Her being Korean, being professor with two children, and being married to a person in academia just like me, she gave me a lot of advice and encouragement on handling family and

work at the same time. Also, I learned a totally new perspective on Korea from her class on History of Korea. Ever since I moved to the United States, I never seriously studied Korea, and her class gave me a shock and surprise as it rekindled my enthusiasm and interests in Korea.

Besides my committee members, I would like to thank other professors that helped me along the way to PhD: Barry O'Neill, Jeffrey Lewis, Michael Chwe, Daniel Treisman, Bob Hager, Richard Anderson, Michael Ross, Ronald Rogowski, Andrew Sabl, Michael Thies, James Tong, Brian Walker, and John Zaller, whom I learned a lot both in class and outside class.

I would have to thank the staffs in the department of Political Science at UCLA. I would like to thank Joseph Brown, graduate advisor, for everything he did for me. Without his help, understanding, and encouragement, I would not be graduating. I also want to thank James Bondurant, Jenny Wang, Jen Smith, Belinda Sunnu, Adra Tinnin, and Jason Lo for their valuable help.

I would also want to thank my colleagues. I appreciate help, thoughtful insights, and comments from Kyung Joon Han, Wooyeal Baik, Eunyong Ha, Kuyoun Chung, Risa Toha, Kim Yi Dionne, Melissa Willard, Jae Hyeok Shin, Jae Kwon Suh, Dane Swango, Joshua Eisenman, Linda Hasunuma, Jeff Shih, Koji Kagotani, Dov Levin, John McCauley, Hye Jee Cho, Brian Min, Eun Kyung Kim, Xin Zhang, Flori So, Julia Yujung Lee, Joonbum Bae, Mac Bunyanunda, Jonathan Liljelblad, Heather Bergman, Liz Carlson, Jeff Paris, and Seth Hill.

I want to thank Seong Min Bai, who has been my best friend and the last resort of rest since I met her at UCSD library in 1997. I also have to thank Chakhan Laura Lee, my other best friend, without whom I would not be finishing the graduate school. She always prayed for me and gave me council because she was also a graduate student. I want to thank Nayoung An and Gawon Chung who were my friends and roommates. They laughed and cried with me and

always kept me in their prayer. I cannot miss other friends: Mina Huh, Sang Hee Park, Ran Gelles, Sanjam Garg, Ji Young Park, and Seung Hee Kim. I also have to thank daycare providers: Ms. Jung Ah Choi, Miss Judy, Miss Gabby, Miss Annette, Miss Cruz, and Miss Jen. They took care of my son when I was at work.

I am deeply indebted to my family. Especially, I want to thank my mother, who supported me in every possible way. I want to thank my father for pushing me to the finish line. I want to thank my mother-in-law and father-in-law for financial and emotional support. I cannot thank my sister, Bo Yong Kim, enough. She was always on-call when I called her, drove two hours, and took care of us. I literally would not have finished dissertation without her help.

Last but not least, I want to thank my husband, Chongwon Cho and my son, Brent Seohan Cho. They bring joy and happiness in my life. I dedicate this dissertation to them.

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# Chapter 1. Ideology and Its Effects on Economic Policy in Dismal Times

## INTRODUCTION

In times of economic crisis, not only developed countries like the United States but especially developing countries suffer from huge price increase in domestic goods, mass unemployment, large public debt, and hyperinflation, to name a few. Among them, however, some countries are recovering faster and recuperating better than other countries. Some scholars attribute this slow recovery to inefficient market system and economic structure that have not been fully reformed due to frequent reversal of structural adjustment or austerity programs, which were pursued by developing countries and international institutions since the 1980s debt crisis in Latin America, democratic transitions in post-Communist countries in 1990, and the 1997 financial crisis in Asia. For instance, when President Hugo Chávez reversed the structural adjustment efforts in Venezuela and nationalized several key industries such as electricity, steel, and telephone along with oil, his policies were immensely popular. Yet, when the fiscal oil revenue fell due to price drop in oil from 2007, Venezuela's economy fell into severe recession. Venezuela's inequality has increased, and the standard of living, especially that of the poor, plunged as a result. Also, some cases surprisingly indicate that left-wing governments keep the reform momentum despite of public sentiments against it or even that the left-wing governments initiate drastic reform while others that were expected to favor reform policies failed to actually implement such policies. President Menem's peronist government implemented one of the most radical reform at that time while Uruguay's center-right coalition government was slow to implement the necessary measures.

My research has started with a puzzle why some regimes were successful in recovery by taking on drastic reform of the system, while others failed or even reversed reform efforts, which were advocated by international financial institutions such as the IMF or the World Bank. Some political economy literature states that government leaders' ideology influences their economic policy decisions. However, a closer look at cases revealed that some right-wing governments that were elected on the base of orthodox economic policy agenda ran huge deficits. I observe that some right-wing parties in post-communist countries are slow to implement economic liberalization, and some right-wing parties in other regions such as the Uruguay's Colorado and Blanco coalition government also had hard time changing their inefficient economic system. Some left-wing governments that were elected on the populist mandates to reverse orthodox austerity programs do not fulfill their promises and keep tight fiscal policy. Therefore, my puzzle has turned to more challenging empirical questions: does ideology really influence economic policies in developing countries, and does the left-wing exist in "developing" countries? This in turn led to another empirical question: what systematic factors could make ideology irrelevant in both economically good and economically dismal times?

To answer why some governments renege on their campaign promises and even impose economic policies that are opposite of their party platform or reputation or why some governments who prefers reformist and liberal policies fail to impose their preferred policies, first, I disaggregate the executive and the legislature as separate entities. I argue that executives and legislature have different constituencies and that the executives as national representatives receive more pressure from international institutions and foreign investors to change the policies and domestic market environment. The executives are more likely to renege on their party ideology when they face unsustainable and failing economy because the executives are

responsible to the larger electorate than the legislative members and often times the finance ministry is consisted of technocratic members. Furthermore, the government—the cabinet—not party members in legislature negotiate with the multilateral lenders and international institutions such as the IMF or the World Bank.

Second, I argue that when calculation of costs and benefits of policy reform changes due to external pressure of unsustainable economy or economic crisis, policy makers will be able to propose and implement changes. This also implies that policy makers will have hard time changing the status quo during normal times because the existing costs and benefits scheme does not change. Three universal features can summarize the status quo economic conditions in developing countries: heavy state intervention, large public sector, and heavily subsidized industrialization. Most developing economy started with subsidized industrialization as Latin American and African countries implemented import substitutions industrialization and East Asian countries adopted export-oriented industrialization. Notably, East European and Post-Communist countries have large public sector and generous—inefficient most of time—pension systems. From development economics tradition, state intervention was seen as one of the most necessary components for the “backward-looking” economies to develop. The urban interests—industrial manufacturers, public employees, and industrial workers are the usual main anti-reform forces.

No matter what the ideology of party is, the governing party usually selects to keep the level of government spending as long as economy is in good condition because government is the biggest employer, consumer, and investor in developing economies.. When economic crisis hits, costs of austerity efforts and liberalization no longer outweigh benefits from the expansionist policies because when economies fail and countries increasingly depend on foreign

aid or IMF's conditional loan (condition upon structural adjustment or austerity packages), governments are no longer able to provide for the groups (and especially the partisan supporters) that received rents in the form of pension support, wages, social security benefits, subsidies for imports (or exports), price control on wage goods and staples, or low interest rates for lending. Also, calculation of costs and benefits of reform changes for the public as the rent-seeking groups likewise face direct losses from hyperinflation, negative growth, unemployment, and decline in real wages. Coalitions of interests and veto players, which blocked or wished for reversal of reform, will no longer exert their oppositions, and agenda setters will have more leverage on their policy decisions. The argument of this dissertation is that failing economy affects the costs and benefits calculation of government and the public so that reform is more likely. It also explains the opposite scenario when left-leaning governments reverse their policy reform and reinstitute their ideological preference, once again implementing expansionist spending policies, increasing social spending, expanding the public sector, or subsidizing particular sectors. Once the economic crisis is appeased, governments and coalitions no longer find a need to further execute structural adjustment efforts and tighten fiscal policy, so they have an option to exert their ideologically geared economic policies.

In this chapter, I explain that under the pervasively bad economy, the public's preference for economic policy reform changes, and the cost-benefit calculation for both voters and elected officials changes, resulting in policy changes. During normal times, the public favors the expansionist policies over reformist policies, and rents and subsidies from the old system will make government officials choose expansionist policies because such redistribution will increase their probability of reelection or winning the general election.

In the following empirical chapters, I examine how agenda setters behave in normal times, (when economy is good or slightly bad) and in crisis times (when economy is severely bad). I test whether agenda setters behave differently from their original ideological party identity when they face unsustainable economy, measured by inflation, external debt, and net official development aid. The good place to start testing the argument is whether agenda setters pursue structural adjustment and austerity measures that were endorsed by international institutions from the early 1980s, regardless of their party ideology. The second empirical chapter will test whether such efforts result in policy outcomes—more balanced budget—and whether economic unsustainability affects even the left-wing legislators not to block ideologically conflicting economic policies or allow the right-wing legislators to reveal their true preference and not to block reformist policies. The third empirical chapter will test whether ideology really has lost its importance in developing countries during economic crisis by looking at changes in welfare policies and changes in composition of budgets.

In the following sections, I briefly review the literature on economic policy reform and partisan effect on economic policy and then present my argument.

## **LITERATURE REVIEW**

It is true that economic liberalizations are usually observed after the 1980s, when developing economies experienced economic crisis. The sudden exogenous shock of the debt crisis caused many governments to implement liberal economic policies and reform their welfare policies, but not immediately (Krueger 1993, Ranis and Mahmood 1992, Pereira in Williamson 1994). Since then, the lending countries and the international agencies such as the World Bank or IMF encouraged so-called Washington Consensus—the neo-liberal approach to development..

Structural adjustment or austerity package is usually set as a condition for foreign aid or financial support from the World Bank or the IMF, and delay in reform is seen as inefficient by economists since it will increase the necessary adjustment costs (Alesina and Drazen 1991). Nonetheless, this argument that crisis-hit countries adopt economic policy changes does not necessarily explain why some governments postpone reform, some reverse their structural adjustment efforts even during crisis, or explain why some governments do not reverse reform efforts once the crisis is under control if adaptation of reform was purely crisis-driven.

Recent literature, studying the effect of political institutions on economic policies and welfare states in OECD countries, has focused on the effects of partisanship and labor unions' interaction with parties. The spatial model of policy making predicts different policies for ideologically driven parties (Alesina et al. 1997; Alt 1985; Barro 1981; Boix 2000; Drazen 2000; Franzese 2002; Hibbs 1977; Hibbs 1987; Imbeau et al. 2001; Schmidt 1996; Schneider and Frey 1988; Woldendrop et al. 1998). Particularly, arguments about the effects of social democratic political control argue that countries governed by the left-wing parties do not necessarily experience high inflation nor pursue expansionary policies when left-wing governments have support of the centralized and densely organized labor. It is because the labor union will restrain its wage demands in order to avoid hyperinflation (Garrett and Mitchell 2001; Cameron 1984; Kenworthy 2003).

Scholars working on Latin American countries have found that strong union and social democratic governments historically implement expansionist fiscal policies (Kaufman and Segura-Ubiergo, 2001). Given that societal interests have incentives to influence the governments so that changes in economic policies will either benefit them more or not harm their interests, certain parties will represent these groups' interests. Haggard and Kaufman (1995)

look at party systems and find that left-wing or populist governments are more reluctant to implement neo-liberal economic reform. The left-wing parties' economic platform includes stronger role of governments in redistribution and development, and they are closely associated with the working class, one of the main initial losers from economic reform (Coppedge 1997). Likewise, Rudra (2002) argues that the bargaining power of labor in developing countries has made difference in types of welfare regimes. Left-wing parties or popularly based parties tried to expand social spending targeted at labor. Kaufman and Segura-Ubiergo (2001) find that in Latin America, popularly based parties will advocate social security transfers to labor supporters.

Utilizing the veto players argument, which extends standard arguments about the effects of interests on policy making, some have blamed the ideological disposition of the left-wing or the populist of delaying reform and expect that the left-wing would veto any drastic neo-liberal orthodox policies including tight fiscal policy. Parties representing societal interests act as veto players when they are part of the government coalition, blocking any change that harms their interests. When there are a large number of veto players (that is, the coalition supporting the government is large and/or the political system contains multiple institutional veto players), it is hard to change the status quo unless veto players have very similar preferences (Tsebelis 2002). This can imply that it is hard to implement drastic policy changes when there are a large number of veto players. Previous empirical research using this basic veto players argument has only taken the simple approach, testing the effect of the number of veto players on the likelihood of policy change without taking into account their dispersion in the issue space.<sup>1</sup> Scholars fail to test the effect of policy preferences of the veto players (Hellman 1998; Wibbels 2005; Wibbels 2000).

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<sup>1</sup> Hellman (1998) uses the number of parties in coalition and Wibbels (2000 and 2005) uses the fractionalization in legislature as a proxy for number of veto players.



## **THEORY**

My puzzle is why some left-wing governments were able to start radical reformist programs, sometimes despite the public voted for them to reverse the reformist policies while some right-wing governments that were expected to carry out reform were slow to implement it. In order to answer the puzzle, one first needs to look at the elected officials' incentives and goals in office. Every office-holder, whether there is a term-limit or not, has a strong desire to win reelection or hold higher office. One way is to satisfy popular demands, which means that candidates promise to stand by the public's wants and actually implement policies accordingly. Stokes (2001) calls this "responsiveness," which means "the tendency of governments to pursue policies that a majority of voters prefers." Another way is to maintain the partisan support by implementing policies that are in line with party agenda and platform. A candidate would announce her platform according to party agenda and follow through even after she takes an office. What about cabinet members, especially of finance or economic ministry that propose economic plan? Prime minister or president usually appoints the finance or economic ministers, so some might argue that is the reason why finance ministry is technocratic and unresponsive to the public. However, the ministers are also office-seekers in the future, and most of finance minister usually serve as deputy-prime minister, who usually take premiership after servicing the finance ministry or often times they form their own party and run for election as Poland's famous pro-reform finance minister, Balcerowicz did. This school of thought, that government responds to the public mandates, comes from the democratic theory.

However, the other school of thought, that politicians are rent-seekers, considers campaign promises as incredible and suggests that politicians can have other goals such as filling

their own pockets with public money. In contrast, Alesina and Speer (1988) point out the possibility that politicians can be ideologue and pursue ideological yet unpopular policies once they are elected. The quote from Ferejohn's study best summarizes this argument: "... once in office, the politician's preferences may diverge from those of his constituents and that he may therefore choose policies at variance from his platform" (1986).<sup>2</sup> This will be especially applicable to offices with term-limit because future office may not depend on the same pool of voters but rather depend on party leaders, not voters. The campaign promises or party platform can be just politicians' lies to win election. Once elected, office-holders can satisfy their own pockets, they can pursue policies that reverse their campaign promises and public mandates, or they can respond to circumstances that change the costs for voters of pursuing the promises made during campaigns. Stokes (2011) studies such violation of mandates observed in Latin American countries during structural adjustment and neo-liberal reform periods. I start from this observation that elected officials can deviate from their party platform and campaign promises once they are in office and pursue economic policies that might be unpopular.

Then, why do voters vote for parties or candidates if they know that there is such a possibility of violation of mandates? Stokes answers that voters are faced with opposite policy choices—efficiency-oriented policies (reformist policies) and security-oriented policies (expansionist policies).<sup>3</sup> Left-wing partisan voters know that there is a chance that their party will renege from campaign platform of expansionist policies and implement reformist policies once in office. However, left-wing partisan voters also know that still, their left-wing party is

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<sup>2</sup> quoted in Stokes (2001).

<sup>3</sup> Stokes (2011) defines "efficiency-oriented policies" as "reducing the size of the state, privatizing state-owned enterprises, and opening trade and "security-oriented policies" as "job creating, industrial policy, and a gradualist approach to inflation stabilization."

more likely to implement expansionist policies than right-leaning parties. Therefore, partisan voters have better chance of getting their preferred policies when they vote for their own party.

Still, if voters see violation of public mandates, they can penalize the party. Therefore, one cannot help but ask why parties or government officials would violate public mandates if they should care about reelection or even fear impeachment just like President Pérez of Venezuela, who were impeached soon after introducing drastic structural adjustment programs. Stokes explains that once in office, it might be the case that government officials see the problems in the real magnitude and realize that implementing efficiency-oriented policies, even if it is against public opinion, is in the best interests of the public in the longer run. It is the act of good representative attempting to “represent their constituents” (Stokes 2011). Another case might be that a candidate believes that the country needs efficiency-oriented reform in order to rescue failing economy, but she knows that once she reveals her intention, the public will not vote for her. Then, she has two choices: reveal her true intention and do not get elected, or conceal her intention and tout the security-oriented policies. A rational actor will choose to conceal her intention and campaign on the base of the popular security-oriented policies and win election.

Following Stokes’ arguments on how voters and candidates decide during election when they face two policy choices, I consider costs and payoffs from implementation of economic policies. Because economic policy redistributes income and rents to specific groups, any change of the existing economic system will bring strong opposition from those groups that benefit from the status quo. Then, the executives will not be able to carry out liberalization and austerity measures because of opposition from legislators representing these particular interests. Yet, Stokes does not consider that voters’ preferences might have shifted. When economy is in dire

situations, voters might change their preferences and support candidates who promise neo-liberal structural adjustment programs. Unless we understand the interaction between governments and voters and the calculation of cost-benefit, especially for groups that have political voice and power to influence governments and parties, it is hard to answer why some government officials from both the left-wing and the right-wing deviate from party platform or campaign promises (the right-wing official not implementing liberal policies and the left-wing official implementing them) while others decided to stick with their party agenda.

First, we need to look at literature on special interest groups and rent-seeking politics and understand the history of development and industrialization policies that resulted in formation of economic interests during periods of state intervention in the economy. Office holders, knowing that they can manipulate economic policies to benefit certain groups, will pursue policies that will reward their supporters. There are many studies done on rent-seeking behaviors (Ames 1995; Baron 1991; Dixit and Londregan 1996; Krueger 1974; Shepsle and Weingast 1981). Moreover, vested interests that benefit from the state's expansionist and interventionist policies hold onto their political power through economic advantages by special interest group lobbying or by forming coalitions of interests to elect responsive politicians. Interest groups have various means to pressure parties to their political advantage. Interest groups can use information, take arguments to the public, conduct disruptive activities, or contribute to political parties (Grossman and Helpman 1994). Coalitions of interests are even materialized into coalitions of parties that represent their interests (Bawn and Rosenbluth 2003). When these coalitions win elections, they implement distributive and redistributive policies in order to maintain and satisfy their supporters, and ultimately retain their offices.

Since the start of development and industrialization after independence, most of newly independent developing countries, whether democratic or authoritarian adopted interventionist economic policies including inward-looking Import Substitution Industrialization policies or export-led industrialization: protectionist policies, overvalued exchange rate policy, and heavy subsidies to industrial sectors. Krueger (1984) argues that the export-led growth is more pro-market and reduces market distortion and subsidies, but export-led industrialization (mostly in East Asia: South Korea is the main example) also led to heavy incentives to export sectors and distorted exchange rate to give industrialists cheap capital goods and raw materials that were scarce in developing countries. Nationalist policymakers and some development economists argued that (temporary) protectionism was necessary for infant industries to grow and mature. Governments bore most of costs of industrialization with high public spending and publicly guaranteed letters of credit to develop capital-intensive industries in capital-scarce environment. This was problematic as governments in developing countries had to borrow from the foreign capital, as the tax collection system was usually fragile and inconsistent.

In Africa, Asia, and Latin America, with protection from free trade<sup>4</sup>, industrial entrepreneurs produced goods and sell them at a higher price at domestic market than at the world market. Second, overvalued currency cheapened imports of capital goods, intermediate goods, and raw materials so that industrial sectors could utilize artificially cheapened capital.<sup>5</sup> Of course, with overvalued currency, governments indirectly taxed the export agricultural sectors as foreign earnings brought home so little local currencies. Third, expenditure on wages and

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<sup>4</sup> Quantitative restrictions were used rather than tariffs because under overvalued exchange rate system, tariffs became meaningless. Even with high tariffs, the imported capital goods, intermediate goods, and raw materials were so cheap.

<sup>5</sup> Overvaluation was an artificial way to make capital inexpensive and abundant in capital-scarce developing countries. Therefore, ISI policies encouraged capital-intensive industries rather than labor or land-intensive industries that the developing countries should have adopted. (factor-mix argument by Anne Krueger)

subsidies increased as bureaucracy involved with protectionist policies and development plans expanded. These rent-seeking activities benefited both politicians and bureaucrats in the form of bribe and subsidies and increased income for the urban sectors while putting inefficiency costs and deadweight loss on the general public, especially on rural and agricultural sectors.

The so-called Asian Tigers—Taiwan, South Korea, Hong Kong, and Singapore—pursued export-led growth, promoting export sectors. Nonetheless, the problems of inefficiency and distortion existed although they achieved remarkable economic growth until 1997. The Asian financial crisis of 1997 revealed that they were borrowing heavily from the foreign capital and the public sector and bureaucracy were huge. Price controls on staples and wage goods also put pressure on governments as governments had to subsidize. For instance, in South Korea, the price of rice, which is the principle food in Korea, is very high even though the demand does not meet the supply because government heavily subsidizes rice farmers.

After the collapse of the common Communist block, the post-Communist and Eastern Europe countries tried to liberalize their inward-looking economy. One of the main problems was the distorted labor market where unemployment was nonexistent. Once the market was liberalized, the unemployment rate skyrocketed. The interventionist and state controlled economy created inefficient loss-making huge state owned enterprises. In order to avoid unemployment, the state owned enterprises got bigger and produced low-quality goods and products that would not sell. Moreover, some countries' heavy dependence on the trade to the Soviet Union, like Bulgaria, became a heavy blow to economy when the Soviet Union fell apart. The inefficient loss-making state owned enterprises with powerful trade unions later refused to accept restructuring efforts and turned militant in some countries (Poland, for example).

During the 1980s and the 1990s, these policies were usually liberal because international pressures pushed in that direction, because the old policies that seemed to have failed were statist, and because most citizens in ex-communist countries supported transition to capitalism, at least at first. Following economic crisis or democratic transitions, there is strong international pressure for structural adjustment and austerity measures and domestic pressure for liberalization, introduction of private property, and capitalization in post-communist countries. The public did not welcome any spending cuts—especially on subsidies on items such as food, energy, or bus fare, but the first thing most governments did when they adopted (usually IMF-led) reform programs was to cut subsidies on food and energy or unfreeze the price control. Governments might have to deviate from their original partisan support base and propose policies that will change the status quo, which often has been benefiting their support groups and constituents. Alternatively, citizens who could not take any more of economic crisis and lack of decisive actions from governments might have elected new party with different support coalitions. In some post-communist countries, democratic opposition movement came to power with the public mandate for democratization, had to implement reformist policies once in office because of dysfunctional economy, and often met strong opposition from the groups that benefited from the old system, which slowed down liberalization.

Farejohn and Stokes both recognize that office holders, once elected, may violate public mandates and campaign promises. Stokes treats the government party as a unitary entity that violates the public mandates. I argue further that the executive can deviate from her party and propose policies that her own party or coalition opposes once she is in office. In most developed democracies (except the United States), the executive, usually the party leader, has a strong discipline over their party members. The executive can propose a bill, and the bill usually passes

if the government party has the majority. However, in developing democracies, absolute majority by one party is hard to find, especially in new democracies. Also, some parties are personalistic party, and we see more incidents of party defection and formations of new party as a result. Presidents, who were elected based on their own popularity rather than on party support, are also more likely to defect from party platform once in office. Thus, in developing democracies, we should not automatically assume that the government party and the cabinet are the same entity. Moreover, the executive and the legislative branches should be considered separately for economic policies because the executive branch is the one that usually proposes and sets agenda in developing countries, and the legislative branch is the one that approves or vetoes the proposals. I define agenda setters as president, prime minister, or ministers who propose economic plan, set exchange rate, or introduce budget proposals, and sometimes also have power to announce executive decree.

The literature on the power of agenda setters is considerably well developed (Alemán and Schwartz 2006; Alemán and Tsebelis 2005; Tsebelis 2002 and 2006), but it does not consider a possibility that agenda setters can have separate preference from their parties. Agenda setters can deviate from parties' ideologically set platform because international or multinational pressure from donors and general public's distress influence agenda setters' policy preference and choice more than the legislature's preference and agenda. Because executives have more encompassing constituencies, the general public blames them for economically difficult times and prolong recession (Mansfield, Milner, and Rosendorff 2002). Deviation from government coalition also happens more frequently when government coalition is formed among parties with different ideological positions in policy space because each party would want cabinet posts according to their ideological importance of cabinet position, and multi-party cabinet will result



in friction within government and deviation from the government coalition's general platform. For example, the national election of 1997 in Poland introduced a coalition government between Marian Krzaklewski's party, a center-right but populist party of Solidarity Electoral Action (AWS) and the liberal Democratic Union (UW), led by a former finance minister, Leszek Balcerowicz. There was a serious disagreement between Mr. Krzaklewski, the prime minister, who promised populist measures, and Mr. Balcerowicz, who pushed for neo-liberal reform as a deputy prime minister and finance minister. Later, the AWS party blamed Balcerowicz and his neo-liberal economic policies for the growing unpopularity of the government and complained that Balcerowicz had deviated from the coalition agreement, and eventually, the UW withdrew from the government coalition in 2000 (Economist Intelligence Unit).

Also, deviation from the public mandate, if the mandate was to reverse the reform and the winning party actually ran on that platform, is more likely because prime minister or president can select cabinet members without consideration of partisanship and selects them based on technocratic expertise, especially for the ministry of economy or finance. Once in office, president or prime minister, realizing how bad the economy is, will be likely to appoint finance or economy minister with people that are likely pro-liberal, educated abroad, and business-minded.<sup>6</sup> In Latvia, when the country's largest bank collapsed with allegations of fraud in 1995 and the general election was held later that year, dissatisfied voters voted for left-of-center Democratic Party "Saimnieks" (DPS) and the ultranationalist People's Movement for Latvia. To exclude this ultranationalist party from government coalition, President Ulmanis selected Andris Skele, a non-party independent businessman, as prime minister. With left-leaning party in legislature, and pro-reform prime minister, the government clearly deviated from the majority policy preference in legislature and pushed for faster reform and tighter fiscal policy. In short,

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<sup>6</sup> In some countries, president selects prime ministers to lead the cabinet like Latvia and South Korea.

executive agenda setters face pressures to initiate policy changes when economy is in trouble. In order to carry out usually unpopular reformist policies in developing countries, executives resort to deviation from legislature and carry out liberalization and prudent fiscal policies. The legislature or coalition partners as veto players, however, represent narrower interests and will therefore oppose policies—spending cuts, less subsidies, or restructuring of the state-owned enterprises to name a few—that will hurt the existing interests and beneficiaries, which voted them to power.

These interests and beneficiaries of the old and inefficient economic system have economic power, which translates to political power through trade unions and special interest groups. In developing democracies, the public mandates bind the office holders, and people's interests and special interests will either hinder or expedite change in the existing economic system. As long as the costs of changes in the economic system outweigh benefits from the old system, the existing beneficiaries of the old system will oppose reformist economic policies, and such opposition can translate into partisan support for parties that oppose the reformist proposals. Dani Rodrik (1995) studies how distributional impacts of trade and exchange rate policies deter liberalization of trade in developing countries. He questions why some countries, that were slow to liberalize trade, suddenly opened their borders, pursued freer trade, and devalued their currencies. He demonstrates the costs and benefits calculation for general consumer (nation as a whole), protected sectors, and government during normal times and hyperinflation. During normal times, costs of implementing trade liberalization and devaluation outweigh costs of keeping the existing economic structure. With trade liberalization and devaluation, sectors benefited from ISI policies would have to adjust their prices, which in turn have negative effect on their income. Thus, they would oppose the policy reform, and politicians who represent them

would do so likewise. He observes that although the policy makers realized the problems of infant industry protection argument—lack of maturity in infant industries as people hoped and spread inefficiency throughout the economy—, they could not pursue trade liberalization because of opposition from beneficiaries of the status quo. Yet, during crisis times, the extra benefits that import protected sectors used to receive are no longer attainable. Troubled economy usually has a high external debt because government had been borrowing heavily to fund subsidies and industrialization, and hyperinflation adds to the problem. Once this certain threshold is reached, costs of keeping the status quo become equal to costs of initiating reform. Once the economy stops functioning and nobody gains, the costs to government of keeping the old system become bigger than costs of adopting a new system. Then, a government has good reason to pursue policy changes that would benefit the general public and help the economy as a whole. Only when the economy experiences “pervasive crisis,” “distributional considerations” are less important than general welfare, and the resistance to reform will dissipate (Rodrik, 1995).

The right-wing party, even though their preference is to support more liberal policies, might not openly support agenda setters’ programs if the public is not favorable to reformist policies. Moreover, in developing democracies, many right-wing parties’ support base is vested interests and urban sector that receive the benefits from the status quo. If the existing status quo distributes enough rents to rent-seeking groups and if the right-wing does not want to upset the urban sector and trade unions (especially powerful in post-communist countries), knowing that they face legislative reelection, right-wing party members might oppose reformist policies, hiding their true preference unless it is apparent that the economy is not functioning and that the current system no longer provides extra benefits to voters who will elect or reelect them. For the left-wing government party, which prefers expansionist economic policy to start from, will

oppose any reformist attempt by agenda setters, more so if the public mandates are unfavorable to reformist and free market economy.

Then, when will or can agenda setters deviate from their party platform and ideological preference and as a result, we see changes in economic policies? Do ideology and partisanship just not matter in developing democracies? Or do certain factors affect decision-making of policy makers so that we see less of ideologically driven economic policies? As Stokes (2001) argues, some elected officials might be just practical and non-ideological people. Once they see the magnitude of the economic situations, they implement efficiency-oriented policies that are expected to cope with severe economic conditions. I argue that elected officials including agenda setters have certain ideological preference but choose to hide it during normal times if the public dislikes reformist policies but become “practical” during prolonged or severe economic crisis because crisis changes the cost-benefit calculations of both voters and politicians.

I argue that when economy is not functioning, in other words, when a country has high inflation, its external debt as % GDP is beyond its capacity to pay back, and economy basically depends on foreign aid as in Africa, even left-wing agenda setters cannot help but deviate from their original ideological position and they are as much likely as to propose reform as right-wing or centrist government. Also, the right-wing party, which had been as reluctant to reveal its true preference in normal times, is more likely support to agenda setters’ reformist agenda. When winners from the previous system of statist economic strategy no longer benefit from keeping government away from change, agenda setters and legislators make a new cost and benefit calculation.

If crisis hits and gives the executive a good reason to initiate reform and liberalization, what would be the best strategy for the legislators? During normal times, when economy is good

(subjectively for the public), and rents are available, both candidates from the right and the left will choose to support expansionist policies. The right-wing candidate will choose expansionist policy no matter what the left-wing candidate does because rent distribution from the status quo will increase his/her probability of winning elections. Also, when the existing system no longer provides rents, but the public does not believe that new efficiency-oriented policy is necessary, then both right-wing and left-wing legislators will be reluctant to openly support agenda setters' reform and tighter budget proposal.

What about when economy stops functioning, and it is apparent that something needs to be done? The costs of keeping the old economic structure are negative or zero, and even the public will not support candidates who tout expansionist policies. Campaigning on expansionist policy and promises will cost any candidate an election unless the previous government tried reform and it failed to correct the crisis or even worsen the problem. Even in that case, however, candidates are not likely to tout expansionist policy but rather campaign on correcting the economic problem. Therefore, we will not see much partisanship at work. In other words, once the government starts tighter fiscal policies, for example, the budget balances will improve and it is unlikely partisanship will have effect on budget balances once economic conditions and agenda setters' proposals are taken into account.

For both the executive and the legislature, one of the key elements in deciding whether to implement reformist policies is public's preference and the special interests with political voice through unions. As I discussed earlier, one of the assumptions of democracy is that elected officials are responsive to the electorate. Even if the general public recognizes the need to reform the existing economic system, reform and liberalization will incur short-term costs to the public and especially will hit hard on the public sector employees and labors when restructuring

of the existing industries start and subsidies on food and energy decline. Ruggie (1982) first introduced the argument of “embedded liberalism” and argued that as countries liberalize, government compensates the losers of the new system. The main assumption is that the public will not oppose liberalization if governments distribute benefits from liberalization to the public, not just relying on the market to redistribute.

I argue along with the compensation theory of liberalization that in order to appease the public opposition, governments increase a particular type of social spending that will directly benefit the most affected group. I argue that it does not need to be redistribution of benefits from liberalization and reform. It is unlikely that countries will gain lots of benefits from the new system at the start of liberalization and reform. Besides, as one of the liberalization and structural adjustment efforts, government is expected to cut spending and carry out tighter fiscal policies (usually as conditioned by the IMF or the World Bank). Thus, one of the ways to cut government spending but at the same time to compensate the most affected group from liberalization and reform is to increase the social protection spending compared to other types of social spending such as education and health. In order to test this argument, I disaggregate the government social spending into social security and welfare spending (that includes unemployment benefits and pension benefits) and education spending. Social security and welfare spending is a more narrowly targeted social spending than education spending, which targets the universal population.

## **RESEARCH DESIGN**

Empirically, I develop a series of regression models to estimate the effect of economic unsustainability on agenda setters’ preference and the interactive effect of partisanship and

economic factors on economic reform initiatives and budget balances from 1980 to 2006. My first implication drawn from the argument is that during normal times, both right-wing and the left-wing politicians will be more likely to keep the old system and tout expansionist policies. Despite the right-wing's usual preference for liberal policies, the right-wing will not campaign on the promises to reform economy because the public and the rent-receiving groups will not understand the need to reform the existing system when economy looks good.

My argument leads to another expectation that executives, who are the usual proposers of policy change in developing countries, are more likely to propose efficiency-oriented, liberal policies regardless of their ideological disposition, once the country has passed the sustainability threshold. By the economic sustainability threshold, I mean that the economy no longer functions and there are few benefits of keeping the existing system. I test that expectation by regressing economic unsustainability and the *executive ideological orientation* regarding economic policy on *agenda setters' proposals*, which I coded myself, using *Economist Intelligence Unit Country Reports* of presidents' statements about their economic reform proposals. The explanatory variable, *economic unsustainability* is measured by *inflation rate*, *external debt*, and *net official development aid*. Also, I use interaction terms between the *executive party ideological orientation* and *economic unsustainability* to test whether ideology affects economic policy proposals of executives.

My third implication is that as agenda setters propose reformist policies and economy is under severe conditions, the left-wing legislature will not veto reformist policies and approves tighter budgets. I test this implication on the level of budget balances.

The last implication is that when there is drastic reform, even if the public approves it, governments will have to appease the losers. As a part of structural adjustment and liberalization

efforts, tighter fiscal control and more open market bring pressure to reform labor market and change social spending policies.<sup>7</sup> Some scholars argue that liberalizing the economy results in pressures to reduce social spending. Others, however, expect that with neo-liberal reform and more globalization, governments might try to compensate losers with new welfare policies targeted at specific groups.<sup>8</sup> I test this expectation by looking at the composition of budgets and examine if a particular spending—subsidies to workers or pension subsidies—has increased even with budget cuts. I test whether partisanship predicts difference in social welfare and security (social protection) spending or whether government, regardless of partisanship, increases social protection spending over other types of spending.

## **OVERVIEW OF DISSERTATION**

In Chapter 2, I demonstrate how governments diverge from their ideological party identification during failing economy, using constructed index of agenda setters' efforts to implement structural adjustment and tight fiscal policy in developing countries from 1978 to 2006. I show how the executive government parties' ideological identification regarding economic policy does not predict what the agenda setters—president, prime minister, or ministries—actually propose and announce as their economic policies when they face failing economy. Also, I test whether the right-wing parties were reluctant to implement efficiency-oriented economic policies during normal times. In Chapter 3, I further investigate whether the agenda setters' efforts to implement tighter fiscal policy result in more balanced budget and whether left-wing parties in legislature can exert their influence to satisfy their constituencies, who expect expansive government spending. I expect that ideology does not have any

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<sup>7</sup> This is the general argument of the efficiency hypothesis.

<sup>8</sup> This is the general argument of the compensation hypothesis.



substantively significant effect on the level of budget deficit. In Chapter 4, I show how ideology still matters in developing democracies by disaggregating the budgets into two parts: 1. general consumption; 2. subsidies and welfare spending. Under economic and financial crisis, left-wing governments seem non-ideological or deviating from their ideology on the surface, and actually, by closely looking at spending patterns, I find that they are shifting the focus to social welfare policies in order to appease their main voters—public sector workers and labors, and possibly creating new rents that will help them in the future election. Even the right-wing parties increased social security and welfare spending during crisis, confirming the embedded liberalism argument. In Chapter 5, I closely look at several countries and their structural adjustment efforts and budget balances in regions of Africa, Asia, Latin America, and Eastern Europe (post-Communist countries). In Chapter 6, I present my conclusion.

This dissertation will make a significant contribution to the existing literature on the effect of partisanship on economic policy decision-making in two respects. First, my dissertation will answer how redistributive and distributive politics and costs-benefits calculation affect elected officials' decision and instigate change of the existing system. Second, my research will show whether the ideological position of government really affect government's macroeconomic and fiscal policies. My research will demonstrate that policy decision does not just involve partisanship bargaining but more complex costs and benefits calculation between rational economic actors and the government.

## **Chapter 2. Why Left Does Not Act like Left? – Cases of Agenda Setters and Their Deviation during Crisis**

### **INTRODUCTION**

When testing the impact of ideology on economic policy, the prominent literature usually regards government as one entity. That is why the literature usually looks at the percentage of left or right in legislature when looking at ideological tendency of government policies. However, one needs to disaggregate government as at least two entities—executive from legislature—because history has shown that in presidential systems, the executives often deviate from their own party position and platform. Some have explained that because ideologically defined parties do not follow their ideologically framed preference after they come to power, ideology does not matter in developing countries. For example, President Menem’s drastic economic reform in Argentina was considered a major deviation from his left-wing Peronist party reputation, and scholars have identified the occasion as an example of how partisanship does not affect economic policies in developing democracies. I argue that, actually, Menem’s radical reform was not an abnormality but rather a rational choice taken by Menem’s administration as the country was experiencing over 3,000% inflation. Their policy shifted because cost and benefit calculation changed under such circumstances. When economy is no longer sustainable, agenda setting executives make policy change regardless of their ideological position. When external pressure renders the status quo unsustainable and beneficial to nobody, coalitions of interests and veto players will no longer exert their opposition to reform, and we see less of ideological influence on economic policies on the surface.

Extending on Rodrik's cost and benefit model of trade reform (1995) to calculate the costs and benefits under economic crisis, I seek to estimate the threshold when the public, governments, and the usual beneficiaries of the existing economic system become willing to accept proposals of reform. The urban sectors—industrial sectors, public sectors, and industrial workers—that benefit from the Import Substitution Industrialization policies that prevailed in developing countries usually resist economic policy reform. However, when economies collapse with hyperinflation, negative growth, gigantic external debt, unemployment, and decline in real wages along with increased dependency on foreign aid, governments are no longer able to support these rent-seeking groups with subsidies. The rent-seeking groups also face direct losses from failing economies. Their industries go bankrupt, and industrial and civil workers lose their jobs. These losses change the cost and benefit calculation for the beneficiaries of ISI development policies. Thus, agenda setters can implement policy changes regardless of their ideological disposition and campaign promises, and as a result, we see left-wing governments implementing neo-liberal structural adjustment and austerity policies as successfully as the non-left.

I test my argument using cases of economic liberalization and structural adjustment during economic and financial crisis in developing countries from 1978 to 2006. I hypothesize that executives, who are the usual proposers of policy change in developing countries, are more likely to propose economic liberalization once the country has passed the sustainability threshold, which is defined as “bad economy” if the measure of inflation (% change), external debt as % GDP, or net official development aid as % GDP is over 50 percentile, and as “severe economy” if one of three measure is over 75 percentile. This leads to an implication that executives will propose or implement reform regardless of their ideological position during

crisis, which means that their inherent or prior ideological position regarding economic policy will not have substantial effect on government policy. It indicates that, therefore, left-wing government is as much likely as right-wing or center government to take on neo-liberal reform when economy is failing and the current policy no longer provides rents and subsidies to certain sectors.

## **LITERATURE REVIEW**

The spatial model of left-right policy dimension predicts different policies for ideologically driven parties (Alesina et al. 1997; Alt 1985; Barro 1981; Boix 2000; Drazen 2000; Franzese 2002; Hibbs 1977; Hibbs 1987; Imbeau et al. 2001; Schmidt 1996; Schneider and Frey 1988; Woldendrop et al. 1998). Haggard and Kaufman (1995) look at party systems and find that left-wing or populist governments are more reluctant to implement economic reform because their main constituents are the public sector, labor, and the poor who are hit most by neo-liberal reform.<sup>9</sup> The left-wing parties' economic platform includes stronger role of governments in redistribution and development, and they are closely associated with the working class, one of the main initial losers from economic reform (Coppedge 1997).

The general public resists reform of the existing system partly because of a time-inconsistency problem (Sachs and Warner 1995). It takes some time for a new market to fully operate and increase output, and the public does not see the positive effect of new policies in the short run unless they end hyperinflation as Menem's administration did; thus, new policies are

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<sup>9</sup> In the literature of political economy of the developed countries, left-wing parties are defined as communist, socialist, or social democratic. Right-wing parties are parties that are conservative or Christian democratic (Keefer 2004). The liberal economic policies are associated with the right-wing parties as the liberal policies are against state intervention and the main constituents are the elite. Haggard and Kaufman (1995) also discuss the populist movement and popular sector support of the populist parties, but they assume that the populist movement is ideologically close to the left-wing.

perceived as “worse.” Additionally, reform puts burden of short-term costs on the public. As most economic reform measures bring a reduction in government spending and subsidies for public goods, the public—especially the poor—will have to suffer the immediate loss, such as an increase in bus fare or gas price. Then the government faces threat of electoral loss or even popular uprising.

More recently, in an exciting new turn in economic reform literature, scholars began to study the effect of individual players in economic policy making. Since economic reform redistributes economic benefits, some groups will lose from the change and will try to pressure governments not to implement economic adjustment. Hence, change in economic policy will face resistance from the groups that will lose from policy reform. Even the less-powerful poor or labor can exert their opposition through a mass uprising. For example, in 1989 when President Pérez of Venezuela announced a reform package called *The Great Turnaround*, bus fare increased to the point where workers could not ride the bus to work. This led to a popular uprising, which killed at least 300 people (Pérez-Liñán 2006). Eventually, Pérez was impeached, and the subsequent governments could not or would not impose drastic liberal economic reform.

Therefore, it seems that left-wing governments have convincing reasons not to change the status quo. Some scholars try to understand why ideologically driven parties deviate from the popular mandate against reform. Stokes (2001) has found that parties in some Latin American countries came to power on the ground that they would fight liberalization pressures, but they liberalized as soon as they came into office. Stokes argues that governments’ deviations from the popular mandates happen when elected officials realize the real magnitude of the economic crises or when elected officials have hidden their true intentions to reform during elections.

Leith and Lofchie (1995) examine Ghana's history of structural adjustment and conclude that because of urban bias that increased the size of urban sectors, successful structural adjustment was not possible. These urban sectors benefited from ideologically driven state owned enterprises and heavily protected import substituted industry while the cocoa sector suffered from highly overvalued currency. Nonetheless, once economy became unsustainable with the existing system along with shock events such as famine, draught and political instability, reluctant political leaders did not have any other option than to accept structural adjustment programs designed by donor countries and international financial institutions. The urban beneficiaries of Import Substitution Industrialization policies were no longer receiving benefits from the existing economic structure—heavy protection and subsidies on industrial sectors—once the economic crisis went beyond the level, which the economy could handle. Leith and Lofchie argue that then the opposition to more liberal economic policies and structural programs declined.

## **MY ARGUMENT**

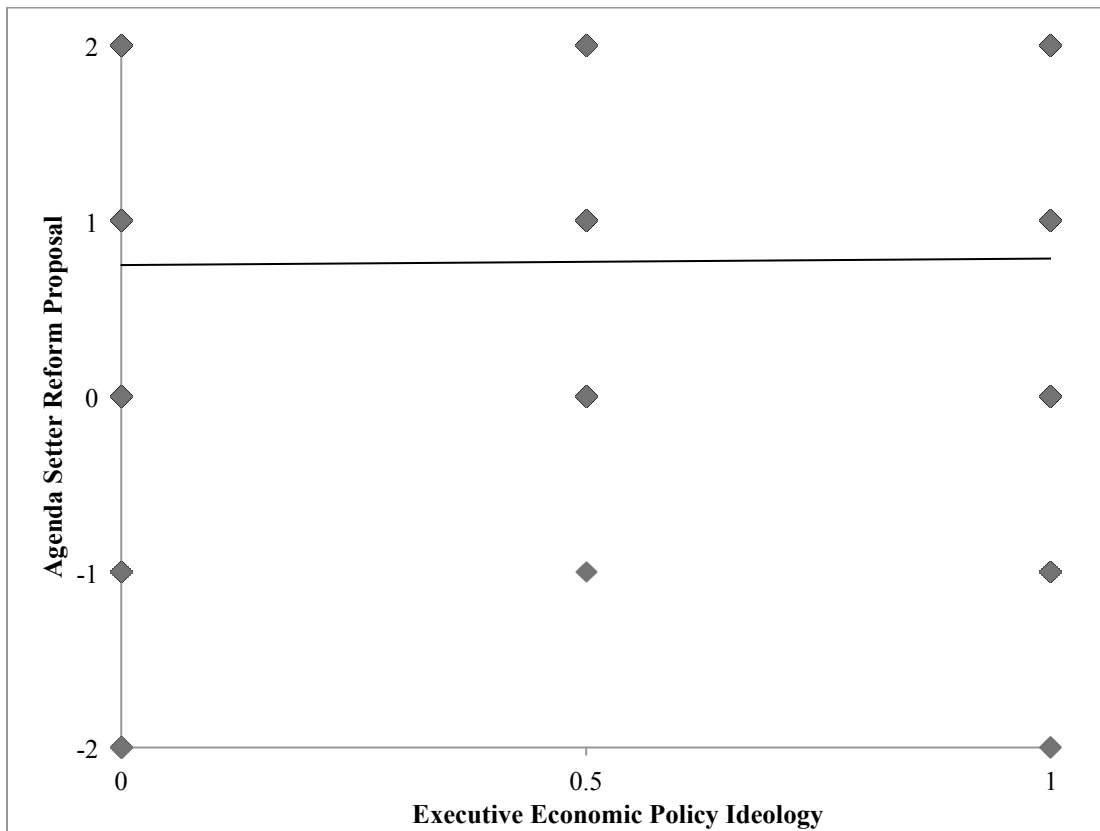
The power of agenda setters is well recognized in the literature (Alemán and Schwartz 2006; Alemán and Tsebelis 2005; Tsebelis 2002 and 2006), but literature does not look at agenda setters—president, prime minister, or cabinet members—separately from their parties. It is necessary to separate the agenda setters from ruling parties because regardless of their party origins, preferences of the agenda setters can deviate from those of parties in government coalition.

Figure 2.1, which is a simple scatter plot with the linear regression line between agenda setters' reform proposals and executive's party ideological identification regarding economic

policy (0=left, 0.5=center, and 1=right), shows that there is no correlation between executive's ideological position and what agenda setters actually propose. Table 2.1 also illustrates that left-wing executive and right-wing executive propose reform almost identically often. There is no big difference between the right-wing and the left-wing when it comes down to agenda setters' actual policy decision. The Pi-charts (Figure 2.2) below show that right-wing governments rather have 1% higher probability of proposing no reform and 1% lower probability of proposing minor reform than left-wing governments. Left-wing governments have 1% higher probability of radically reversing reform efforts and 1% lower probability of proposing major reform than right-wing governments.

[Figure 2.1 Here]

Figure 2.1. Agenda Setters Reform Proposal vs. Executive Ideology Regarding Economic Policy



[Table 2.1 here]

Table 2.1 Agenda Setters' Reform Proposal vs. Executive Party ID

Agenda Setter's Reform Proposal	Executive ID regarding Economic Policy			Total
	Left (0)	Center (0.5)	Right (1)	
Major Reform (2)	68 (15.32%)	20 (16.84%)	72 (15.96%)	160 (15.78%)
Minor Reform (1)	238 (53.6%)	73 (61.34%)	241 (53.44%)	552 (54.44%)
No Reform (0)	93 (20.95%)	25 (21.01%)	99 (21.95%)	217 (21.40%)
Minor Reversal (-1)	38 (8.56%)	1 (0.84%)	37 (8.20%)	76 (7.49%)
Radical Reversal (-2)	7 (1.58%)	0 (0.00%)	2 (0.44%)	9 (0.89%)
<b>Total</b>	<b>444 (43.79%)</b>	<b>119 (11.74%)</b>	<b>451 (44.47%)</b>	<b>1014 (100%)</b>

[Figure 2.2 Here]

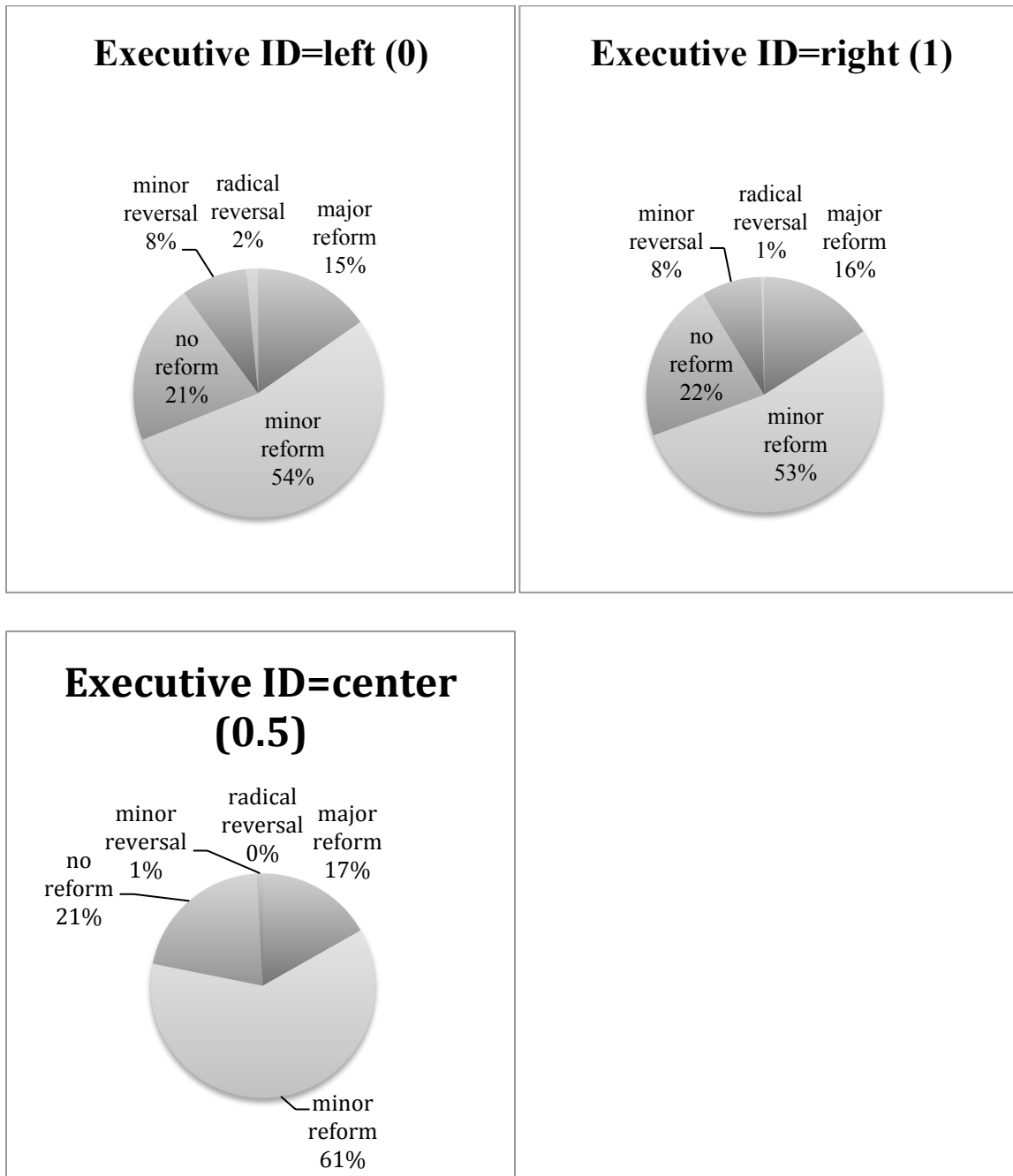
The pattern in Table 2.1 raises the question why agenda setters deviate from their party ID. What makes the left-wing as likely to propose liberal reform as the right-wing, contrary to its ideological commitments? Why doesn't executive ideological disposition or campaign promises predict what agenda setters propose once they are in the government? I observe that agenda setters, because they usually have more encompassing constituencies than the members of their coalitions, can have different preferences from other members of government coalitions. When economic crisis hits, the public becomes more willing to mandate the government to act (Haggard and Kaufman 1995).<sup>10</sup> When economic crisis hits, the general public usually blames the governments' inactions for economic downturns (Mansfield, Milner, and Rosendorff 2002). Therefore, power flows to office holders with broader agendas during times of crisis. Moreover, the international institutions and the bilateral lenders will pressure governments to adopt more liberal economic policies and to start structural adjustment and austerity programs in return for continuation of development aid or loan programs. Some have argued that crisis makes governments change the course, but it does not offer systematic explanation of why and when

<sup>10</sup> It also depends on the depth of the crisis and on the extent of the failed efforts by the previous administration (Haggard and Kaufman 1995).



reluctant government and public accept the change. Besides, it is difficult to change the status quo because the winners from the status quo or possible losers from the change will oppose any change.

Figure 2.2 Pie Charts of Agenda Setters' Reform Proposal vs. Executive Party ID



The usual beneficiaries of the ISI development strategies are the industrial sectors and urban sectors including civil servants. First, protectionism on trade with quantitative restrictions<sup>11</sup>, benefits industrial entrepreneurs with almost no competition from the world market, allowing them to produce goods and sell them at a higher price than the world market in domestic market. Second, with highly overvalued currency, industrial entrepreneurs enjoyed huge subsidies since overvalued currency made import of capital goods, intermediate goods, and raw materials so cheap, making input price low.<sup>12</sup> Of course, with overvalued currency, the export (mostly agricultural) sectors were heavily taxed as foreign earnings brought home so little local currencies. Third, the number of civil servants became enlarged with related works on protectionism and development plans. Fourth, rent-seeking activities brought more rents to both politicians and bureaucrats (in the form of bribe) and subsidies and increased income for the urban sectors while putting costs of inefficiency on the general public, especially on rural and agricultural sectors.

As developing countries' ISI strategies became a failure, resulting in stagnant or even declining growth, hyperinflation, and massive debt, the beneficiaries of ISI policies started to absorb the loss. With the small domestic market and barriers of trade, the industries could not expand production. Decreased demand because of falling wages and price increase doubled the trouble. Capital-intensive and heavily protected industries in developing countries were not fit to survive from the start because of the indivisibility of capital goods with the small domestic market (Krueger, 1984). Economic crisis made the situation worse as governments no longer

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<sup>11</sup> Quantitative restrictions were used rather than tariffs because under overvalued exchange rate system, tariffs became meaningless. Even with high tariffs, the imported capital goods, intermediate goods, and raw materials were so cheap.

<sup>12</sup> Overvaluation was an artificial way to make capital inexpensive and abundant in capita-scarce developing countries. Therefore, ISI policies encouraged capital-intensive industries rather than labor or land-intensive industries that the developing countries should have adopted.

were able to cover the industries' losses. The urban sectors, especially the industrial workers, and the public sectors experienced drastic fall in wages in real terms. Unemployment rate skyrocketed as companies and factors went bankrupt, unable to pay their debts.

Given that such shock makes the status quo unsustainable, it gives government and agenda setters justification to change the structure of economic system, and the beneficiaries of the failing system—who usually have economic and political power—will have less incentive to oppose the new policies as they no longer receive rents and profits from the failing economy. I argue that when economy is failing, in other words, when a country has high inflation, its external debt as % GDP is beyond its capacity to pay back, and economy basically depends on foreign aid, even left-wing agenda setters cannot help but deviate from their original ideological position and they are as much likely as to propose reform as right-wing or center government. When winners from the previous system—Import Substitution Industrialization policies—no longer benefit from keeping government away from change in structure of economy, agenda setters with more general constituencies make a new cost and benefit calculation.

As already discussed in the theory chapter, I use the Dani Rodrik's cost and benefit argument of trade reform (1995) and apply to policy change. To recapitulate briefly, Rodrik (1995) looks at why some countries that were reluctant to take on the trade reform, suddenly liberalized their trade and devalued their currency. He demonstrates the costs and benefits calculation for general consumer (nation as a whole), protected sectors, and government during normal times and hyperinflation. With trade liberalization and devaluation, sectors who had benefited from ISI policies would have to adjust their prices that would in turn have negative effect on their income, which makes it difficult for politicians to impose changes because the sectors that would have to bear the costs are usually the group with the most economic and

political power. Yet, when crisis makes the extra benefits that import protected sectors used to receive no longer attainable, nobody gains. Once a certain threshold is reached, costs of keeping the status quo become equal to costs of initiating reform. Once the economy falls apart, the costs of keeping the status quo become bigger than costs of initiating reform. Government has more mandates to pursue policy changes that would benefit the general public and help the economy as a whole. By looking at economic reform efforts in developing democracies from 1978 to 2006, I estimate that threshold and test if governments, regardless of their ideological orientation, pursue economic policy changes during crises.

The first implication of my argument is that when I include economic unsustainability measures, executive ideological identification will not show any effect on agenda setters' proposal to reform.

The second implication is that once I include interaction terms between measures of executive ideological identification regarding economic policy and economic unsustainability, the measure of executive ideology regarding economic policy will become significant. Once the threshold of economic unsustainability is reached, left-wing under economic crisis will not have a big negative effect on agenda setters' reform efforts. We will see that the left-wing implements drastic reform as much as the counterpart right-wing government.

## **RESEARCH DESIGN**

To test these arguments, I use a dataset of developing democracies from 1978 to 2006. I only look at democratic countries because the argument is based on an assumption that elected officials are responsive to their constituents and face re-election or re-appointment in other government jobs. The dataset starts from 1978 because it was after the second oil shock of 1979

that international agencies recognized the need for liberal economic policies, and it expands to 2006 to include financial crisis and aid crisis in the 2000s.

The dependent variable identifies whether agenda setters propose economic reform or initiate reform by introducing new policies (*AGENDA*). I have constructed a 5-point scale ordinal variable from -2 to 2 to measure reform policy proposals. I looked at Economist Intelligence Unit's *Country Profile* and *Country Report* to identify agenda setters and their economic policy proposals for each year from 1978 to 2006. *Agenda Setter* is coded 2 if the executive proposes many or extensive liberal reforms or pursues radical liberal policy. 1 indicates that the agenda setter proposes a few minor liberal reforms or maintains the liberal policy as the status quo. 0 indicates that the agenda setter proposes no liberal reform. -1 indicates that the agenda setter proposes minor reversals in liberal reforms or maintains the non-liberal policy as the status quo. -2 indicates that the agenda setter proposes major reversals in liberal reforms. For example, in 1989, right after President Menem was elected, Menem's finance minister, Miguel Roig, a former vice president of the Argentine multinational Bunge and Born group, launched the economic emergency program, which called for "massive public sector price rises (up to 600% in some cases), a 53.5% devaluation of the austral..." (Economist Intelligence Unit 1990). After Miguel Roig died of heart attack, Menem appointed Nestor Rapanelli, a former top executive of the Bunge and Born group, as the new finance minister. Economist Intelligence Unit reports, "The message was clearly that although the minister might change, the economic program remained the same." I coded these years of economic emergency program in Argentina as "major reform efforts." Tanzania's 2001 *Country Report* reports that "The main features of the 2001 budget statement, which was published in June, are greater fiscal discipline and increased donor-funded expenditure on health and education." This kind of

information does not describe the actual outcomes of policy changes, such as balanced budget or well-managed inflation, but proposals and intentions of government. The variable *AGENDA* does not measure the actual macroeconomic or microeconomic outcomes of policies, allowing us to test the effect of ideology or party orientation towards economic policy on government's preference on economic policies once the government is put in place.

One of my main explanatory variables is the executive or government party's ideological identification with respect to economic policy (*EXEC ID*). I use the variable, EXECRLC from *Keefer's Database of Political Institutions* (2010), which is the government party orientation with respect to economic policy.<sup>13</sup> When the government party identification is left, *PARTY ID* is 0, center 0.5, and right 1. Keefer et al. describe that EXECRLC records the executive's ideological orientation when there is evidence that the executive deviated from his/her party orientation, such as the socialist party implementing neo-liberal structural adjustment programs, but they do not specify which cases fall into such category. Therefore, the variable *EXEC ID* will be a different measure from *AGENDA* since I coded *AGENDA* by looking at government proposals, statements, and agreement with international financial organizations that were reported in *Country Reports* without considering the government party's ideological orientation.

Another main explanatory variable is economic unsustainability, and it is measured by three separate variables of the total net official development aid as % GDP (*NET AID*), inflation, and the total external debt as % GDP. When a country depends too much on the official development aid as a large part of GDP, it indicates the country is not producing enough gross domestic products on its own, and the economy is not functioning well. *NET AID* also measures donors' pressure to liberalize, and I test this point in data analysis. To measure the inflation rate, I use the consumer price percent change over previous year (*INFLATION*). Inflation is, of

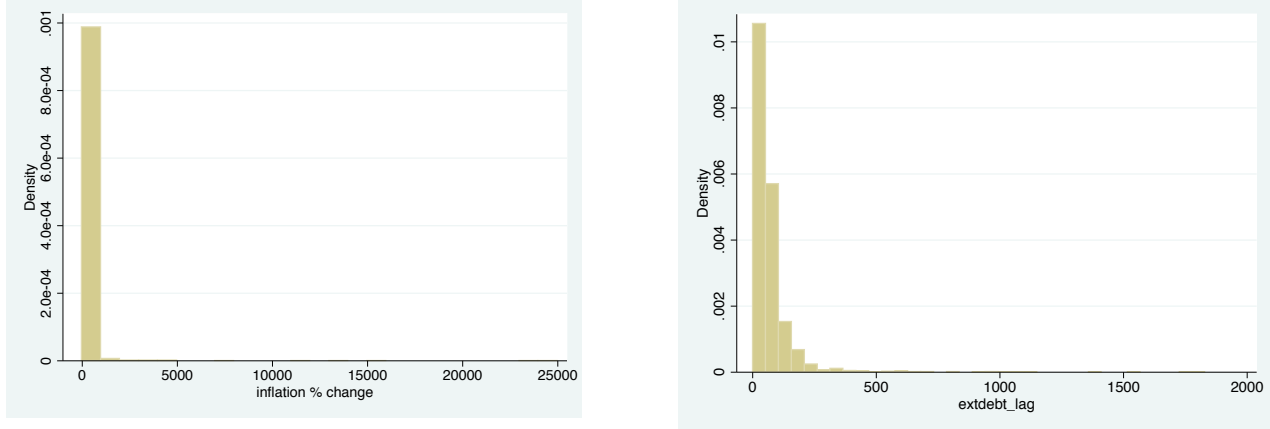
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<sup>13</sup> *Party ID* is a recode of EXECRLC, which lists 1 as right, 2 as center, and 3 as left.

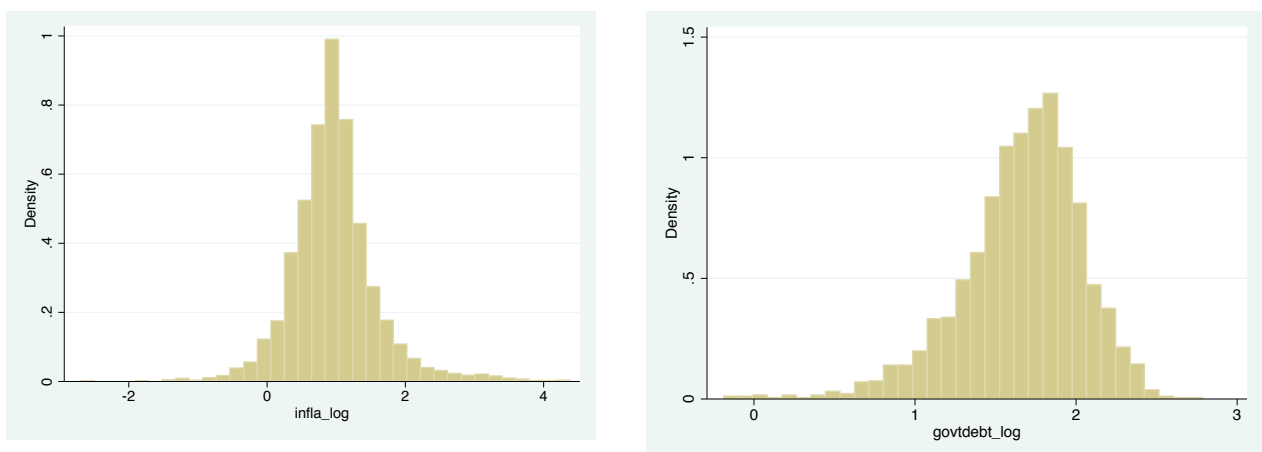
course, a classic indicator of economic crisis. When Argentina hit a record high 3000% inflation rate, it was clear that the economy was not sustainable. The total external debt as % GDP (*EXTERNAL DEBT*) is a good indication of a country going into debt crisis. The problem with inflation as annual percent change and the total external debt as % GDP is that they are extremely skewed to the left (Figure 2.3). I transformed the inflation and external debt data using logs of the base 10, and the data become normally distributed (Figure 2.4).

[Figure 2.3 here]

**Figure 2.3 Density Distribution of Inflation and Total External Debt % GDP**



**Figure 2.4 Transformed Inflation as Annual % Change and Total External Debt % GDP**



After logging the measures of economic conditions (except Net Official Aid), I constructed the categorical indicator of economic unsustainability by dividing the measures by the quartiles (*ECON CONDITION\_DEBT* or *ECON CONDITION\_INFLA* or *ECON CONDITION\_NET AID*). If a measure of economic conditions is below 25 percentile, I code it as *GOOD ECONOMY*. If a measure of economic conditions is between 25 percentile and 50 percentile, I code it as *MODERATE ECONOMY*. If a measure is above 50 percentile and below 75 percentile, I code it as *BAD ECONOMY*. If a measure is above 75 percentile, I code it as *SEVERE ECONOMY*. I also lag *INFLATION* and *EXTERNAL DEBT* to get rid of possible temporal correlation because the inflation rate or the volume of external debt of previous year certainly determines the starting point of the rate and the volume in the following year. Also, lagging *INFLATION* and *EXTERNAL DEBT* mitigates possible endogeneity problem. I do not lag *NET AID* because the net official development aid does not add up from previous year, and it is usually distributed by quota and can be interrupted any time by aid agencies or donor countries.

In addition to my main explanatory variables, I include variables to control for other factors that might influence agenda setters' decision to implement neo-liberal reform and structural adjustment programs. For political control variables, I include the election variable, an indicator of whether a country has any legislature or executive election during each year. The business cycle argument (Alesina et al. 1997) finds that when there is election, government tends to increase its spending and hold off on structural adjustment efforts. I expect to see a negative coefficient for the election dummy variable.

Another political variable is democracy to test whether greater democratic accountability makes economic reform more or less likely. I use the indicator of *Democracy (POLITY)* from



the Polity IV Project. Even though my sample includes only democratic countries, their level of democracy differs greatly. A more democratic country should be more accountable to the general public; thus, it is more likely to implement reform despite the pressure from special interests. On the other hand, if democratic governments respond to anti-reform pressures because they are accountable to citizens' interests, I expect less reform efforts by agenda setters.

Lastly, a dummy variable for *WAR* is included. A state in the middle of interstate or intrastate warfare will find it unusually hard to implement or continue sound economic policies. During civil war, it is unlikely that the economy will function well, any liberal reform policy will be halted. I compile a variable of war, using a dataset by Fearon and Laitin (2003) and datasets by the Correlates of War Projects (COW) (Sarkees and Wayman 2010).

I put in regional dummies in order to control for regional variation. It is especially helpful because particular regions have specific missing years. For example, most post-Communist and Eastern European countries have data from 1990, and most data for African countries start from the late 1980s when they started democratization. My sample excludes the North Africa and Middle East region because the countries are not democracies.<sup>14</sup>

Because the dependent variable, agenda setters' reform proposals and efforts (*AGENDA*), is a five-point scale ordinal variable, I employ Generalized Linear Latent and Mixed Model estimation (GLLAMM)<sup>15</sup>, which will allow random effects estimation while controlling for heteroskedasticity and possible serial correlation in the panel data set. Nevertheless, GLLAM model is not specifically designed for ordered logistic regression for panel data, so I also use ordered logistic regression with robust cluster standard error adjustment, but its estimation of

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<sup>14</sup> They were not intentionally excluded during data collection. After data collection, I realized that no North Africa/Middle East country was included because of missing values in various variables, especially in *Agenda* and *Executive ID* variables.

<sup>15</sup> `glamm` command in Stata and `ologit` with `vce(cluster)`. Most results are similar between `glamm` and `ologit`.

standard errors might ignore the serial correlation and panel heteroskedasticity. Therefore, I show linear regression estimations using random and fixed effects estimation models (Mixed Maximum Likelihood Linear Regression) and OLS regression with panel-corrected standard errors by assuming the ordinal variable<sup>16</sup>, *Agenda*, as a continuous quasi-interval variable. Running linear regression achieves two tasks that are helpful in understanding the relationship between ideology and actual policy implementation in crisis: one is to show that the model is robust and the other is to provide interpretation of results and to allow post-estimation techniques that are more readily accessible.

I estimate the effect of the executive party's ideological orientation regarding economic policy and the economic conditions on agenda setters' efforts to reform with the model below.

$$\begin{aligned}
 AGENDA = & \alpha + \beta_1 Left + \beta_2 Right + \beta_3 Moderate Economy + \beta_4 Bad Economy + \\
 & \beta_5 Severely Bad Economy + \beta_6 Left * Moderate + \beta_7 Left * Bad + \beta_8 Left * \\
 & Severe + \beta_9 Right * Moderate + \beta_{10} Right * Bad + \beta_{11} Right * Severe + \\
 & \beta_{ctrl} Controls
 \end{aligned}
 \tag{1}$$

## EMPIRICAL RESULTS

My argument is that ideologically defined government often deviates from its original position regarding economic policy when the beneficiaries of the existing system change their cost and benefit calculation during economic crisis. When the costs of keeping the status quo outweigh the costs of expected reform, the rent-seeking groups that benefited from Import Substitution Industrialization strategies will not block the new policies. Thus, I hypothesized that when there is economic crisis or when economy is unsustainable, agenda setters will disregard their original ideological position and pursue neo-liberal structural adjustment, which international institutions or bilateral donors request. My first implication specifies that the ideological orientation of executive or government party does not predict agenda setters' actual

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<sup>16</sup> xtmixed with country random effects and xtpcse

reform proposals and efforts because economic unsustainability mostly explains why agenda setters choose to pursue more orthodox and tight macroeconomic and fiscal policies. Therefore, I expect to see an insignificant coefficient for *EXEC ID* and significant coefficients for each measure of economic unsustainability. I show the results in Table 2.2.

To find when is the tipping point where agenda setters deviate from their original position, I use an interaction model of economic unsustainability and executive party identification and find out when executive party identification loses. My second implication is that once I include interaction terms between measures of executive id and economic unsustainability, the measure of executive id will become statistically significant; in other words, ideology should predict ideologically preferred policy during normal time but not during crises. Once the interactive effect is controlled for, the true effect of executive party identification will emerge. I present the results in Table 2.3.

Table 2.2 presents the results of gllamm (Generalized Linear Latend and Mixed Model) on effect of executive ideological identification on agenda setters' proposal to reform economy or carry out structural adjustment programs. *Model 2A* is a simple bivariate ordered logistic model. Executive's ideological disposition (*EXEC ID*) does not have a statistically significant effect on agenda setters' proposal to reform (*AGENDA*), which confirms the first implication and the previous conjecture from the two-by-two table (Table 2.1) that *EXEC ID* does not predict the actual policy proposals of governments.

*Model 2B* includes other control variables that might have effect on agenda setters' decision to carry out neo-liberal reform or structural adjustment policies. Only *DEMOCRACY* is statistically and substantively significant. All else equal, when a country with a minimum polity

score from the sample (-7) increased its polity score by one standard deviation (roughly 3), the expected ordered odds of agenda setter escalating reform efforts increases by 23.8%.

[Table 2.2 Here]

Table 2.2 Effects of Executive Party ID on Agenda Setters' Reform Proposal (1978 to 2006)

	<u>Dependent Variable: Agenda Setters' Reform Proposal (-2 to 2)</u>					
	<u>Model 2A</u> with just executive id	<u>Model 2B</u> with control variables	<u>Model 2C</u> with Net ODA	<u>Model 2D</u> with external debt	<u>Model 2E</u> with inflation	<u>Model 2F</u> Net ODA and inflation
<i>Explanatory Variables</i>						
Executive ID (0, 0.5, 1)	0.16 (0.17)	0.09 (0.32)	0.22 (0.19)	0.26 (0.20)	0.19 (0.19)	0.25 (0.19)
Net Official Dev. Aid (% GDP)			0.06† (0.02)			0.05† (0.02)
External Debt (log) <sub>t-1</sub>				1.34† (0.39)		
Inflation (log) <sub>t-1</sub>					0.38† (0.12)	0.34† (0.13)
<i>Control Variables</i>						
Democracy (Polity)		0.07* (0.04)	0.10† (0.03)	0.14† (0.03)	0.13† (0.03)	0.14† (0.03)
Election Year (dummy)		-0.003 (0.10)	-0.13 (0.15)	-0.08 (0.15)	-0.06 (0.15)	-0.09 (0.15)
War (dummy)		-0.40 (0.37)	0.32 (0.26)	0.11 (0.26)	-0.04 (0.23)	-0.05 (0.27)
East, Southeast Asia	-1.31‡ (0.57)	-0.87* (0.54)	-1.10* (0.58)	-1.12* (0.64)	-0.89 (0.60)	-1.10* (0.60)
Latin America	-0.65* (0.40)	-0.18 (0.36)	-0.32 (0.40)	-0.64 (0.43)	-0.41 (0.41)	-0.47 (0.41)
South Asia	-0.92 (0.75)	-0.33 (0.53)	-0.93 (0.74)	-0.91 (0.78)	-0.69 (0.77)	-0.72 (0.76)
Sub-Saharan Africa	-0.31 (0.46)	-0.17 (0.40)	-0.91* (0.48)	-0.41 (0.48)	0.02 (0.47)	-0.52 (0.50)
Log likelihood	-1125.73	-1067.62	-987.74	-974.95	-998.71	-977.70
Number of Cases	1014	912	901	877	893	882

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$

Statistical significances are based on two-tailed tests. Ordered Logistic Regression using Generalized Linear Latent and Mixed Model (gllamm).

Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummies are the excluded reference dummy.

*Model 2C* shows that *NET AID* has a statistically and substantively significant effect on agenda setters' proposal to reform (*AGENDA*). When I calculate the percent change in odds

ratio<sup>17</sup>, one unit change in Net Official Development Aid as % GDP (1%) will increase the expected likelihood of agenda setters choosing more reformist policies by 4.2%. If Net Official Development Aid as % GDP increases by one standard deviation unit (7.86%), the expected odds in agenda setters' likelihood to escalate reform efforts increases by 38.7%. Estimation using linear regression also shows similar results. If Net Official Development Aid as % GDP increased by 20%, like Malawi did in 1994, the likelihood of escalating reform efforts increases by almost 80%, which is a significant effect.

*Model 2D* includes the lagged total external debt in log (*EXTERNAL DEBT*), and the estimated coefficient is statistically significant. When I calculate the percent change in odds ratio, one unit change in total external debt log (1 unit =  $10^1 = 10\%$  in total external debt as % GDP) will increase the expected ordered log odds by 143.8%, meaning the expected likelihood of more reformist policies increases by 143.8%. Agenda setters choose more reformist policies. However, it is not realistic to assume that a country's external debt to increase from 10% to 100% of GDP (if one assumes that a country starts with 10% external debt as % GDP and increases its external debt by 1 unit of logged *EXTERNAL DEBT*). If one assumes that a country has experienced 1 standard deviation unit increase in logged total external debt (1 standard deviation unit =  $10^{0.2958} = 1.98\%$  increase), which is about 2% increase, the expected ordered log odds in agenda setters' likelihood to raise reform efforts will increase by about 30%. This is a significant effect.

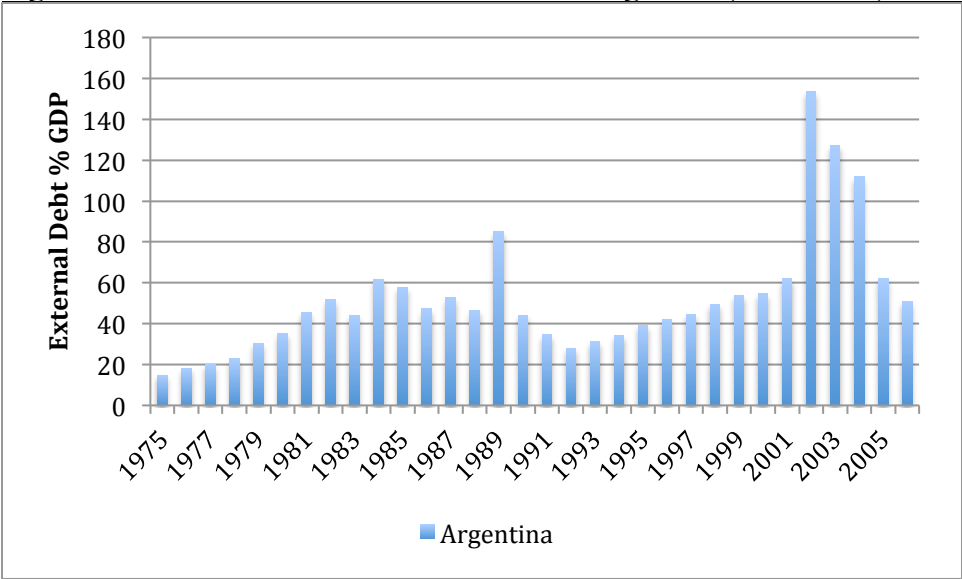
*Model 2E* includes the lagged inflation rate (annual % change) in log (*INFLATION*), and the estimated coefficient is statistically significant. When I calculate the percent change in odds

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<sup>17</sup> For this calculation of odds ratio, I use ordered logistic estimation with robust standard errors adjusted for cluster because gllamm command does not support odds ratio calculation. However, the coefficients are similar to 0.01 degree and estimation is ordinal logistic technique. However, I report gllamm results because its estimation of standard errors is more conservative, so it is less likely to underestimate standard errors and overestimate coefficients.

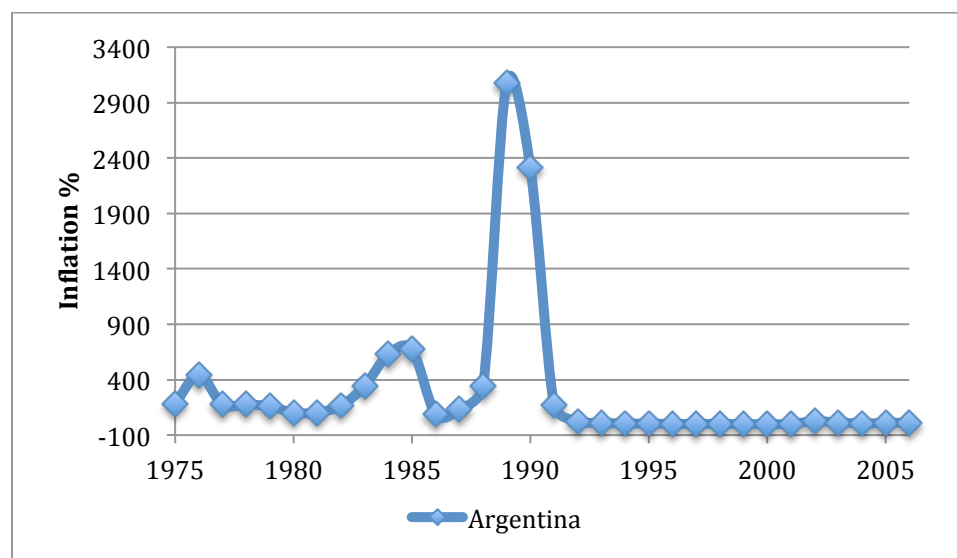
ratio, one unit change in logged inflation rate (1 unit =  $10^1 = 10\%$  in CPI annual % change) will increase the expected ordered log odds by 40.3% as one moves to the next higher category of agenda setters' proposal to reform. Two-unit increase in the logged inflation rate means 100% increase, and it is realistic to assume a developing country (especially in crisis) to have an inflation rate of 100%. Therefore, 40.3% increase in expected ordered log odds means that if a country's inflation rate increased from 10% to 100%, the odds in agenda setters likelihood of choosing reformist policies increases by 40.3%.

Figure 2.5 Total External Debt as % GDP for Argentina (1975-2006)



For example, in 1988, Argentina had 46.61% in total external debt as % of GDP, and it increased to 85.15% of GDP in 1989 (Figure 2.5). Argentina is already 81.43% higher in odds for agenda setters to increase reform efforts than country with 10% external debt as % GDP in 1988. In 1989, the odds increased by 26.26% even more, making it highly probable to move from moderate reform to drastic reform, which President Menem actually proposed and implemented.

Figure 2.6 Inflation (CPA in annual percent change) in Argentina (1975-2006)



Also, in 1988, Argentina had 342.96% inflation rate, and its inflation increased to 3,079.81% in 1989, a record high for Argentina (Figure 2.6). Argentina was already 68.26% higher in odds for agenda setters to adopt more reformist policies than a country with 10% inflation rate to in 1988. In 1989, the odds increased by 38.14%, making it highly probable to move from moderate reform to drastic reform. In 1978, Argentina's inflation rate was 175.51% (already 52.45% increase in odds), and if a country experiences a jump in inflation like Argentina from 175% to 3,000%, the odds of agenda setters adopting more reformist policies increase by 52.45% all else equal. I use lagged external debt and inflation data, so Menem implementing radical reform in 1990 is explained by my argument that left-wing government deviates from its preferred position in order to adjust to the new cost and benefit calculation, imposed by the changed economic situation.

*Model 2F* has both measures of inflation and *NET AID* to test if *NET AID* not only captures economic unsustainability but also international or bilateral pressure to implement neo-liberal reform. However, I do not include net ODA and external debt together because net ODA

and external debt data are highly correlated (over 50% correlation), and it makes sense that a heavy borrower is also a heavy aid receiver. Also, the external debt level would indicate the international and bilateral pressure to accept neo-liberal reform measures that lending agencies or countries imposed after the 1980s.<sup>18</sup> Compared to the model only with inflation or net official development aid, the results are robust. The coefficients of *INFLATION*, *NET AID*, and other control variables do not change much in terms of size nor in significance. This indicates that net Official Development Aid as % GDP not only represents economic or financial crisis but also external pressure that also changes cost and benefit calculation. Government will have to decide whether it will change its preference because their policy implementation and reform will decide how much official development aid they would receive, that might alleviate current crisis and become positive to cost and benefit calculation.

Now that I have shown how partisanship does not predict agenda setters' reformist policies during economic crisis, I use interaction terms between the executive's party identification and economic unsustainability to find how deteriorating economy has to be for partisanship to have no impact on policies. Table 2.3 below presents the results of interaction models.

[Table 2.3 here]

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<sup>18</sup> Nonetheless, I ran the model with both Net AID and External Debt (% GDP), and the coefficients of Net AID and all other control variables are robust, but External Debt measure has smaller coefficient, and it is understandable considering that Net AID and external debt measures are highly correlated. The result is available upon request.



Table 2.3. Interactive Effect of Executive ID and Economic Unsustainability on Reform Proposal

	<u>Dependent Variable: Agenda Setters' Reform Proposal (-2 to 2)</u>								
	<u>Model X1</u>	<u>Model X2</u>	<u>Model X3</u>	<u>Model X4</u>	<u>Model X5</u>	<u>Model X6</u>	<u>Model X7</u>	<u>Model X8</u>	<u>Model X9</u>
	<u>net AID</u>	<u>net AID</u>	<u>net AID</u>	<u>ext debt</u>	<u>ext debt</u>	<u>ext debt</u>	<u>inflation</u>	<u>inflation</u>	<u>inflation</u>
	<u>(gllamm)</u>	<u>(ologit)</u>	<u>(xtpcse)</u>	<u>(gllamm)</u>	<u>(ologit)</u>	<u>(xtpcse)</u>	<u>(gllamm)</u>	<u>(ologit)</u>	<u>(xtpcse)</u>
<i>Explanatory Variables</i>									
Executive ID=Left	-0.46 (0.43)	-0.17 (0.66)	-0.22 (0.16)	-2.95† (0.61)	-1.59‡ (0.78)	-0.74† (0.19)	-0.13 (0.57)	0.36 (0.38)	0.06 (0.17)
Executive ID=Right	-0.51 (0.39)	-0.05 (0.41)	-0.12 (0.14)	-2.43† (0.63)	-0.94 (0.74)	-0.38‡ (0.19)	-0.79 (0.53)	-0.57 (0.45)	-0.33* (0.19)
Moderate Economy	1.44‡ (0.58)	1.47‡ (0.74)	0.60† (0.18)	-0.67 (0.60)	-0.47 (0.49)	-0.13 (0.21)	0.48 (0.51)	0.60 (0.40)	0.20 (0.18)
Bad Economy	-0.20 (0.65)	0.22 (0.47)	0.10 (0.18)	-1.67† (0.64)	-0.27 (0.84)	-0.07 (0.20)	0.85 (0.70)	1.59* (0.65)	0.40 (0.26)
Severe Economy	0.10 (0.64)	0.40 (0.49)	-0.01 (0.18)	-2.44† (0.70)	-0.90 (0.73)	-0.43‡ (0.19)	-0.01 (0.56)	0.83 (0.55)	0.07 (0.20)
<i>Interaction Terms</i>									
Left*Moderate	-1.55‡ (0.66)	-1.78* (0.94)	-0.68† (0.22)	1.70‡ (0.69)	1.19* (0.64)	0.48* (0.24)	-0.69 (0.64)	-1.17‡ (0.52)	-0.53‡ (0.22)
Left*Bad	0.25 (0.73)	-0.51 (0.78)	-0.16 (0.22)	2.57† (0.72)	0.79 (0.97)	0.20 (0.24)	-1.16 (0.79)	-2.21† (0.77)	-0.82† (0.29)
Left*Severe	1.34* (0.83)	0.54 (0.76)	0.46‡ (0.20)	3.81† (0.77)	2.09‡ (0.91)	0.89† (0.23)	0.32 (0.67)	-0.43 (0.65)	-0.18 (0.23)
Right*Moderate	-1.39‡ (0.63)	-1.72‡ (0.78)	-0.64† (0.21)	1.63‡ (0.70)	0.83 (0.63)	0.24 (0.24)	0.09 (0.62)	-0.27 (0.54)	-0.04 (0.24)
Right*Bad	1.52‡ (0.74)	0.16 (0.83)	0.04 (0.23)	2.09† (0.75)	0.04 (1.01)	-0.10 (0.25)	0.15 (0.78)	-0.63 (0.74)	-0.13 (0.29)
Right*Severe	1.73‡ (0.79)	-0.14 (0.54)	0.15 (0.21)	3.85† (0.85)	1.33 (0.89)	0.51‡ (0.24)	1.00 (0.65)	0.71 (0.68)	0.28 (0.24)
<i>Control Variables:</i>									
<i>collapsed</i>									
Constant	5.69† (0.60)		0.76† (0.16)	-0.67‡ (0.34)	-1.59‡ (0.78)	1.08† (0.18)	-0.46 (0.33)		0.75† (0.18)
Log Likelihood	-990.45	-1020.35		-968.03	-1006.82		-1007.52	-1026.73	
R-squared			0.07			0.07			0.06
Wald Chi <sup>2</sup>		41.40	106.9		55.51	78.15		97.3	75.88
Prob >Chi <sup>2</sup>		0.002	0.00		0.00	0.00		0.00	0.00
Prob >Chi <sup>2</sup> (interaction)	0.00	0.15	0.00		0.15	0.002		0.01	0.002
Number of Cases	901	901	901	882	882	910	910	910	910

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$

Statistical significances are based on two-tailed tests. Generalized Linear Latent and Mixed Model estimation (gllamm), Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummies are the excluded reference dummy.

The estimated coefficients of categorical executive ideological identification (*EXEC ID*) are not statistically significant through different specifications (Models X1 to X9) except Model X4 using external debt as economic unsustainability indicator, estimated with gllamm and Model X6 using external debt and estimated with xtpcse (assuming agenda variable to be continuous).

It is interesting to note that the coefficients of both left-wing (*EXEC ID*=left) and right-wing (*EXEC ID*=right) are negative (except insignificant Models X8 and X9). The negative coefficients actually indicate that both left-wing and right-wing are less likely to adopt reformist policies than centrist government all else equal because the base category is centrist, (*EXEC ID*=center). Overall, the models run with external debt as % GDP as economic unsustainability work best among three measures of economic unsustainability. Actually, models run with inflation give the least significant results. Also, models run with ordinal logit do not give significant results. The interaction terms are only significant with 85% confidence for Models X2 and X5.

**Table 2.4 Marginal Probabilities of Agenda's Reform with Executive ID and Net AID<sup>19</sup>**

Probability of Reform	Executive ID regarding Economic Policy			Total
	Left (0)	Center (0.5)	Right (1)	
Prob(1<Agenda<2)	0.1551	0.2007	0.1754	0.1721
Prob(0<Agenda<1)	0.7126	0.7802	0.7144	0.7220
Prob(-1<Agenda<0)	0.9063	0.9355	0.9079	0.9107
Prob(-2<Agenda<-1)	0.9903	0.9940	0.9909	0.9911

**Table 2.5 Marginal Probabilities of Agenda's Reform with Executive ID and External Debt**

Probability of Reform	Executive ID regarding Economic Policy			Total
	Left (0)	Center (0.5)	Right (1)	
Prob(1<Agenda<2)	0.1590	0.2090	0.1872	0.1771
Prob(0<Agenda<1)	0.7157	0.7733	0.7243	0.7267
Prob(-1<Agenda<0)	0.9100	0.9362	0.9114	0.9139
Prob(-2<Agenda<-1)	0.9903	0.9937	0.9997	0.9908

**Table 2.6 Marginal Probabilities of Agenda's Reform with Executive ID and Inflation**

Probability of Reform	Executive ID regarding Economic Policy			Total
	Left (0)	Center (0.5)	Right (1)	
Prob(1<Agenda<2)	0.1597	0.2073	0.1799	0.1772
Prob(0<Agenda<1)	0.7179	0.7749	0.7222	0.7272
Prob(-1<Agenda<0)	0.9100	0.9346	0.9095	0.9130
Prob(-2<Agenda<-1)	0.9909	0.9938	0.9907	0.9912

<sup>19</sup> Marginal probability calculated using the actual values within the sample, constrained by categories of Executive ID, left, center, and right.

Using Generalized Linear Latent and Mixed Model estimation (*Model X1*), the interaction terms between *EXEC ID* and *ECON CONDITION\_NET AID* are significant with 99% confidence. Looking at the marginal probabilities of agenda setters' reform efforts by categories of executive ID (Table 2.4), all else at their actual values, it is clear that there exists not much difference between the left-wing and the right-wing. The difference in probabilities of agenda setter taking on general reforms,  $\text{Prob}(0 < \text{Agenda} < 1)$ , between the left and the right is only 0.0124—1.24%. Still, the marginal probability shows that the right-wing slightly higher probability of implementing gradual reform than the left-wing.

Using external debt as % GDP as a measure of economic unsustainability (*Model X4*), the difference between the left-wing and the right-wing in probability of general reforms is only 0.0086—0.86%, a very small difference (Table 2.5). Likewise, use of inflation as a measure of economic unsustainability also gives us similar results (*Model X7*), difference between the left and the right being only 0.0043—0.43% (Table 2.6). It is also notable that centrist governments always have a higher probability in every category of agenda setters' reform proposals compared to both the left and the right. Moreover, right-wing governments have a higher probability in almost every category of agenda setters' reform proposals compared to the left-wing government (except minor reversal category with inflation as a measure economic unsustainability where left-wing has a higher probability than the right-wing). My hypothesis was that partisanship does not predict agenda setters' economic policy proposals during crisis. The usual assumption about the centrist governments is that they usually adopt moderate position. It is not easy to see how the centrist governments behave during crisis by looking at the results. The fact that they have a higher probability in every category may be indicating that indeed, centrist or moderate government does not act as expected during crisis. The marginal probabilities tables,

nonetheless, show that probability of adopting reformist policies or probability of adopting no reform or reversing reform is not so different among three parties.

Nevertheless, post-estimation technique of gllamm is limited because marginal probabilities are calculated using the actual point values-average-for each data point, which makes it hard to see how the effect of executive identification on agenda's reform efforts changes as *NET AID*, *EXTERNAL DEBT*, or *INFLATION* varies. Therefore, I report linear regression models in order to get the general idea of interaction effects of executive identification and economic unsustainability using OLS with panel corrected standard errors estimation (xtpcse)—*Model X3*, *X6*, and *X9*. All three models produce statistically significant interaction terms.

Table 2.7 below lists the coefficients under different conditions using the *equation (1)* above. Once the conditions of economy are accounted for, we see bigger negative coefficients for the left-wing in each category of economic condition. The left-wing always has bigger negative coefficient than the right-wing.<sup>20</sup> The most interesting finding here is that when economy goes into bad condition and further into severe condition, the negative coefficient of the left-wing becomes smaller compared to the coefficient under good economy.<sup>21</sup> This clearly shows that economic conditions affect agenda setters' reform efforts, and agenda setters would propose reforms regardless of economic conditions when economy is in bad or severe condition. This also proves that the null hypothesis, which argues that only partisanship or ideology matters in economic policy-making, is wrong. Nonetheless, the change in coefficients for centrist party as economic condition changes does not seem to make sense. Why would a centrist agenda

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<sup>20</sup> I do not discuss the specific number because agenda setters are not continuous variable, and here I am assuming that it is.

<sup>21</sup> I do not discuss moderate economy here because actually the coefficient of *MODERATE ECONOMY* was not statistically significant.

setter propose less reform as economic conditions get worsen? A deeper examination of the centrist party is thus necessary.

Table 2.7. Estimated Marginal Coefficients under Different Economic Conditions (Model X4)

Agenda Setters' Reform Efforts	Executive Identification Regarding Economic Policy		
	Left (0)	Center (0.5)	Right (1)
Good Economy	$\alpha + \beta_1$ = -3.62	$\alpha$ = -0.67	$\alpha + \beta_2$ = -3.1
Moderate Economy	$\alpha + \beta_1 + \beta_3 + \beta_6$ = -2.59	$\alpha + \beta_3$ = -1.34	$\alpha + \beta_2 + \beta_3 + \beta_9$ = -2.14
Bad Economy	$\alpha + \beta_1 + \beta_4 + \beta_7$ = -2.72	$\alpha + \beta_4$ = -2.34	$\alpha + \beta_2 + \beta_4 + \beta_{10}$ = -2.68
Severe Economy	$\alpha + \beta_1 + \beta_5 + \beta_8$ = -2.25	$\alpha + \beta_5$ = -3.11	$\alpha + \beta_2 + \beta_5 + \beta_{11}$ = -1.69

## CONCLUSION

I try to explain why government party identification does not predict actual policy implementation. The general assumption regarding economic policy is that left-wing government usually implements expansive policies and do not readily pursue structural adjustment programs. However, some empirical studies (Stokes, Lofchie) have found that ideologically driven parties often deviate from their original position. Some attribute this deviation to lack of explanatory power of ideology. On the other hand, I argue that when economy becomes unsustainable, left-wing and right-wing do not show much difference in actual policies. It is not because ideology does not matter in party politics and institutional setting, but it is because external constraints make different cost and benefit calculation, which makes rational government act non-ideologically.

The data measuring economic conditions, net Official Development Aid as % GDP, Inflation as % change, and total external debt as % GDP in this chapter, show that the left and the right may have different starting point regarding their economic policy. For instance, the market itself might be more liberalized under the right-wing government, or total external debt as % GDP was already pretty high under the left-wing government. Yet, when economy is not

functioning, ideological difference disappears. Some models (models run with *NET AID* and *EXTERNAL DEBT* with xtpcse) even indicate that left-wing executives are more likely to propose more reformist policies than right-wing government under extreme economic situations. Given that right-wing government would have already implemented somewhat neo-liberal policy, the actual policies or policy outcomes might be similar. In the next chapter, thus, I test my arguments on actual policy outcomes: budget balance.

I have shown that even left-wing government can and will propose neo-liberal reform when economy is not sustainable. This does not mean that ideology does not function in developing democracies as it does in most developed countries. It is clear that ideologically branded parties often deviate from their party agenda and try to change the policy. From the outside, once the policies are announced or implemented, it could be seen as ideology does not matter in developing democracies. However, it could be that at some threshold, executives do not have any other choice than to implement non-ideological policy measures. Then, what about executive party or coalition parties in legislature? When do they stop blocking the change and accept new policies? Do they have different threshold? In the next chapter, I discuss whether the left-wing parties in legislature, including the government parties, act to veto any change in economic policy and whether government parties in legislature actually act different from the president, prime minister, or cabinet members. Because budget is approved by legislature, it is a good place to test whether legislature works similar to executive agenda setters regarding economic policy under the extreme crisis.

## **Chapter 3. Does the Left Really Act like Left in Legislature? – Cases of Budget Balance**

### **INTRODUCTION**

In the previous chapter, I looked at agenda setters' deviations from their original party orientation with respect to economic policy. In this chapter, I actually look at policy outcomes to test whether parties in legislature also deviate from their original platform during crisis and do not veto agenda setters' reformist proposals. I discuss whether left-wing parties in legislature, including the government parties, act to veto any change in economic policy and whether government parties in legislature actually act different from the president, prime minister, or cabinet members. Because a budget proposal is approved by legislature, it is a good place to test whether legislature works similarly to executive agenda setters regarding economic policy under the extreme crisis conditions. Especially in this chapter, I incorporate the veto player argument and argue that even left-wing parties, who might have blocked a tighter budget proposal, change their position when economy is not sustainable. Therefore, there is not much difference between non-left and left in legislature when we take economic crisis into account. I test whether left-wing parties in legislature become ideologically unresponsive to their traditional role when economy is no longer sustainable. The game that was discussed in the theory chapter predicts that during normal times, left-wing candidates or office-holders will not support reformist, efficiency-oriented policies. During normal times, left-wing candidates are more likely to oppose reformist policies because their ideological preference increases the probability of election given that they follow partisan platform and satisfy the partisan constituency. During normal times, on the other hand, I predicted that the right-wing party candidates also might tout

expansive policies, but given that their partisan base, they are still more likely to support efficiency-oriented policies because of the higher probability of winning elections given that they follow the ideological party line. During severely bad economies, however, both leftist and rightist parties will support efficiency-oriented policies, which are, in this chapter, tighter budgets or cut in budgets.

## **LITERATURE**

Traditionally, the spatial model of left-right policy dimension predicts different policies for ideologically driven parties (Alesina et al. 1997; Alt 1985; Barro 1981; Boix 2000; Drazen 2000; Franzese 2002; Hibbs 1977; Hibbs 1987; Imbeau et al. 2001; Schmidt 1996; Schneider and Frey 1988; Woldendrop et al. 1998). It is more difficult to introduce tighter budget when any of the veto players are left-wing because their main constituents—the labors and the popular sector—oppose orthodox liberal economic policies that usually leave them as losers and demand more expansive policies and government spending (Haggard and Kaufman 1995).

Alesina and Perotti (1995) argue that empirically, however, there is not much difference in balancing budget between non-left and left-wing governments. In the pool of developed democracies, they find that leftist governments have higher probability to have “very loose fiscal policy” than rightist or centrist. However, contrary to general expectations, they find that left-wing governments also have a higher probability of “very tight fiscal policy” and lower probability of unsuccessful adjustment. Alesina and Perotti’s definition of successful fiscal adjustment involves separating government consumption and government subsidies, and these will be discussed further in the next chapter when we test why sometimes left-wing governments



carry out a very tight fiscal policy and whether this indicates that the left have lost their ideological orientation.

Moreover, the usual test of partisanship uses the percentage of left-wing parties in legislature, which might overestimate the power of left-wing parties that do not have veto power, or underestimate the power of left-wing parties that have veto power. This implies that even a small left-wing party can block reform if it is in the coalition or it is in the opposition coalition and has veto power and that the number of veto players does not matter if there are no left-wing veto players. It also implies that even with large percentage of left-wing parties, if they are not a part of government or coalition, then their opposition would not be heard. Thus, more systematic approach is necessary to study effects of partisanship on policy outcomes.

## **MY ARGUMENT**

The institutional approach to understanding economic adjustment policies and outcomes has so far overlooked possibly different behaviors from agenda setter—the executive, who usually proposes a tighter budget proposal—and legislature at the policy-making stage. I claim that in order to test negative, if any, effects of left-wing parties on budget balances because their party agenda is expansive, one needs to distinguish agenda setters and legislature. Thus, in my empirical tests, I include separate measures of government, agenda setters' efforts to implement efficient-oriented policies and legislature's ideological composition.

More importantly, literature does not consider the ideological position of the veto players in their empirical tests. The fact that the agenda setter has the power to propose a bill does not mean that the agenda setter can move the status quo any time. The positions of other veto players and of the status quo are also important. If the usual veto players' preferences are close

to those of the agenda setter on fiscal adjustment policy dimension, their veto power would not matter in this instance of policy making. If the veto players oppose adjustment, the agenda setter can only propose unimproved (loose) budget proposal that is close to the status quo so that the veto players will not veto the change. Alemán (2004), in his study of Latin American presidents, shows that minority presidents passed as many bills as majority presidents did, and most of the presidential bills were passed after being amended by the legislature. The agenda setters would not propose a bill, which would not have passed because the agenda setters know the preferences of the veto players beforehand. Once the status quo is changed to some degree, the agenda setters and the veto players might face a stalemate again. Still, any change—even if it is a small amount—is preferred to stalemate by the agenda setters.<sup>22</sup>

Because fiscal policy is a classic way to correct the failing market and economy, one has to take into account the seriousness of economic condition. If economy is so bad that it is not sustainable, then payoffs of both agenda setters and veto players in legislature will change. The classic Keynesian economics would argue that when economy is bad, government should expand spending, running budget deficits. I reason that when economy goes to the point of no return, regardless of ideology, government will have to follow the guideline of lenders and international institutions by tightening the budget and adopting conservative fiscal policy. Therefore, agenda setters who propose budgets will propose tighter budgets, and their efforts to propose tighter fiscal policies will have positive impact on budget deficits.

However, the legislature with narrower constituencies might veto any tightening of budgets. Recapitulating briefly on the game that was discussed in the theory chapter, I argue that during normal times, left-wing parties are more likely to tout for expansive government

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<sup>22</sup> This can actually explain why there are incremental changes in the economic adjustment process rather than sudden and radical change in economic policy in most countries (Geddes)

spending. Also, because economy is good, the counterpart right-wing parties could conceal their true preference and run election on expansive spending promises given that the public prefers expansive government spending and the rents from the existing economic structure are still available. But, the general probability of election is also a function of partisan support given that the candidates follow the party agenda, the right-wing party candidates are more likely not to veto any tighter budget proposals, given their ideological affiliation, the left-wing representatives.

During crisis times, however, we expect both left-wing and right-wing candidates or elected representatives not to veto tight budget plans because the public would prefer government to balance its budgets during severely bad economy, and the rents from the old existing system are no longer available. For example, pensions would lose their values when there is hyperinflation, high unemployment, and fall in real wages. Then, the subsidies that the workers received, pension subsidies or benefits that were paid with government money, would also lose their values.

My argument leads to an expectation that when agenda setters propose and adopt efficiency-oriented policies, we see tighter budget balances. When agenda setters propose more reformist policies, in other words, we see positive improvement in budget balances.

My argument also leads to an expectation that during normal times, the left-wing parties will veto tight government spending so they have negative effects on budget balances. Using interaction between left-wing and economic unsustainability measure, the effect of left-wing veto players will be negative on budget balances when economy is good or moderate. Once I interact left-wing veto players and severely bad economy, its negative effect will decrease.

By using several indicators of left-wing parties in legislature, I demonstrate that indeed left-wing governments can improve budget deficit as much as non-left wing governments. I use several indicators of left-wing's representation in legislature in order to pinpoint the effect of the left-wing on budget balances. First, I use the traditional percentage of left in legislature (*% LEFT*). Second, I use the left-wing veto (*LEFT VETO*), a dummy variable to test my argument that a large percentage of left might not work as the measure of veto players if they are not a part of government coalition or they are just minority. Lastly, because dummy categorization of left-wing parties could generalize the negotiation and legislation process too much into yes-or-no situation, I categorize the percentage of left in legislature by 10 percentage points to take the level of left-wing orientation into account but to put less weight on exact percentage of left (*LEFT CATEGORY*). I will discuss these indicators in more details in the research design.

Once the economic unsustainability threshold has reached, the effect of left-wing will be mitigated. Rather, we will see that the left-wing legislature approves tight budgets as much as the counterpart right-wing. It is possible that left-wing parties have really abandoned their traditional ideological orientation, but this issue will be discussed in the next chapter.

## **RESEARCH DESIGN**

I test my implications with a dataset of developing countries from 1978 to 2006, using a pooled time-series regression with a panel-corrected standard errors estimator (PCSE). The PCSE estimator assumes that disturbances are panel-level heteroskedastic and that there is contemporaneous correlation across panels.<sup>23</sup> I assume that there exists autocorrelation.

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<sup>23</sup> Beck and Katz (1995) argue that OLS with PCSE, panel-corrected standard errors estimator is better than FGLS, feasible generalized least squares estimator for comparative political science data. OLS estimates of time-series cross-section model parameters are more likely to be biased because OLS estimates of standard errors will be inaccurate due to contemporaneous correlations and panel heteroscedasticity. PCSE retains the estimates from OLS

*BUDGET DEFICIT* is the dependent variable because it is mostly under the control of policy makers, and it is one of the performance indicators monitored by international financial institutions in their efforts to hold countries receiving aid and loans to certain benchmarks. Balancing public accounts and maintaining low deficits are the major steps toward efficiency-oriented economy and austerity efforts. *BUDGET DEFICIT* is a measure of governments' general balances as a percentage of GDP, which is total revenue including grants minus total expenditure including net lending and borrowing (WEO 2011). I collected the budget balance data from IMF's WEO, African Development Bank Database, Asian Development Bank, InterAmerican Development Bank, and EBRD. Data from African Development Bank are central government's fiscal balance while data from ADB and IDB are overall fiscal balance, and data from EBRD are general government balance. I compromised and combined these data, however, because they can represent a country's general fiscal situation and the problem of missing values was bigger than the problem of ignoring differences in central government and general government (which would include central government and local governments) fiscal balance. *BUDGET DEFICIT* ranges from -151.31 to 43.3 (in percentage of GDP). The standard deviation is 7.47% of GDP. *BUDGET DEFICIT* is a good indicator to separately test the effects of agenda setters and the legislature because agenda setters propose the budget and the legislature votes on it every year. Using time-series data for a large number of countries will let me test the non-crisis cases as well.

One of the main explanatory variables is existence of left-wing parties as a veto player. I use several measures of left-wing to test whether discrepancies in economic liberalization efforts

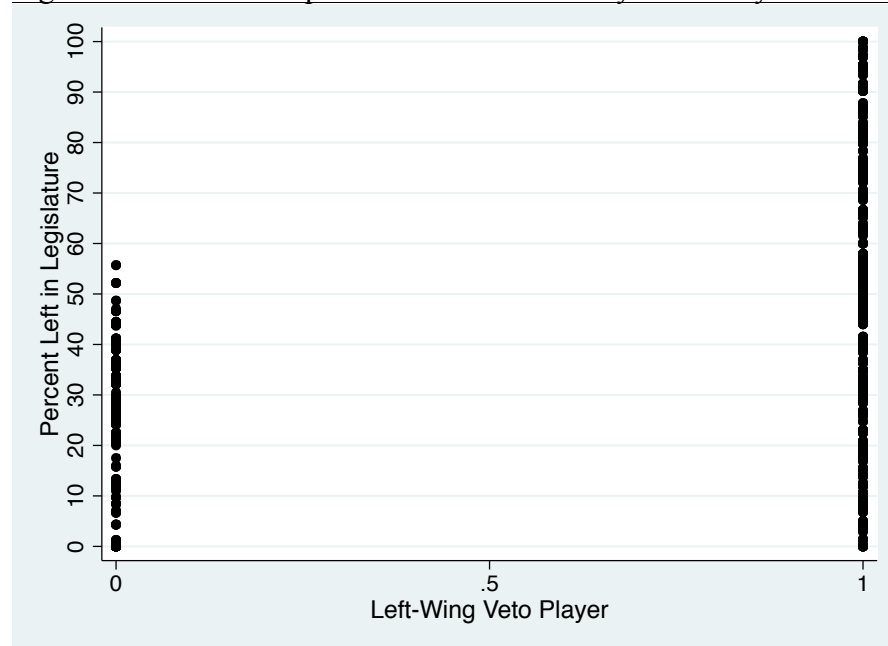
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but corrects the standard errors. By doing that, PCSE gets rid of contemporaneous correlations and heteroscedasticity. FGLS does the same thing and its estimates are more efficient than PCSE, but the estimates of standard errors become downward biased, producing too optimistic coefficient statistical significance. Assuming that the covariance matrix is unknown – FGLS estimator depends on the assumption of known covariance matrix – it is advisable to run with PCSE to avoid bias in estimates of standard errors.

come from just partisan difference or from strategic choice of legislature as a separate entity from agenda setter. First, I constructed a dummy variable using several sources: Keefer's *Database of Political Institutions* (2010), Coppedge's classification of Latin American political party ideology (1997), and the *Political Database of the Americas* by Georgetown University (2006). If government party is left-wing, if there is a left-wing party in coalition government, or if there are left-wing opposition parties against minority government, *Left-Wing Veto Player Dummy* (*LEFT VETO*) is 1, and 0, otherwise. *Figure 3.1* shows that parties that consist less than 10 percent of the legislature can have veto power while parties that consist more than 50 percent can have no veto power.

[Figure 3.1 here]

Figure 3.1. Relationship between Left Veto Player Dummy and % Left in Legislature



Using the conventional spatial model of partisanship, I also include *Percentage of Left-Wing Parties* in legislature (*% LEFT*). I calculated the percentage of the seats held by the left-

wing parties.<sup>24</sup> *Left-Wing Veto Player (LEFT VETO)* and *Percentage of Left-Wing Parties (% LEFT)* are highly correlated. Correlation comes out to be about 0.65.

Another indicator of presence of left-wing is a categorized percentage of the left-wing in legislature (*LEFT CATEGORY*). As briefly mentioned in the *ARGUMENT* section, just including a left-wing dummy compromises some information. It is true that only 5% of left-wing representatives could veto budget bill if they are a part of government. However, the power of 5% left-wing parties will be definitely smaller than the power of 80% left-wing parties in government. To account for such difference but to weigh less of the tiny percentage differences, I group % *LEFT* by 10 percentage-points and constructed a categorical variable of a range from 1 to 10. I coded 0% to 10.999% as 1, 11% to 20.999% as 2, and so on.

Another explanatory variable is the variable identifying whether agenda setters propose efficiency-oriented policies (*AGENDA*), which usually start from improving budget deficits or introducing tighter budget. *AGENDA* was used as the dependent variable in the previous chapter.

The last explanatory variable is the categorical economic unsustainability, which ranges from 1 (*GOOD ECONOMY*), 2 (*MODERATE ECONOMY*), 3 (*BAD ECONOMY*), and 4 (*SEVERE ECONOMY*). I constructed the indicator by dividing the total external debt as % GDP by the quartiles (*ECON CONDITION\_DEBT*). I lag the external debt quartiles variable (*ECON CONDITION\_DEBT*) because the preceding years' external debt will have negative effect on budgets while seeing the huge external debt and realizing bad economy will influence the

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<sup>24</sup> Most developing democracies have multi-party systems, and there is no information on partisanship of very small parties. This requires extensive data collection to identify the small parties. Identification and even counting the number of seats held by these small parties are disputed among the scholars. I have identified the small parties to the extent information exists except for some countries like Venezuela where different sources disagree on identification and even on the number of seats held by the parties. Even though the data set is not complete, it will give a fair estimation of the power of left-wing parties because unidentified small parties actually hold less than 1% of the total seats on average. Besides, parties that hold one or two seats are not usually in government coalition.

legislature in the current budgets. In the previous chapter, I used two other indicators of economic unsustainability, Net Official Development Aid as % GDP and inflation rate as % change. Here, I exclude net ODA and Inflation and only resort to the external debt as a measure of economic unsustainability. The reason is that net ODA as % GDP is endogenously correlated to budget deficits. For example, when a country runs huge deficits, it could borrow more money. On the other hand, when a country receives or made a new agreement with international institutions, then its budget balances could have improved. *BUDGET DEFICIT* is already inflation-adjusted as the formula includes lending and borrowing, which are adjusted for inflation. I expect positive coefficients for *GOOD ECONOMY* and *MODERATE ECONOMY* and negative coefficients for *BAD ECONOMY* and *SEVERE ECONOMY* because even if government realizes it needs to tighten its budget when it faces debt crisis, the fact that the country has a huge external debt warrants huge budget deficits outcomes.

I include lagged *BUDGET DEFICIT* to estimate the effect of partisanship on the change in budget deficits. This serves two purposes. One is that I am taking into account the previous level of budget balances. If I just consider the raw percentage of budget deficits, then I would be labeling countries that already had huge deficits before they started adjustment efforts as a failure of adjustment even if they improved their budget balances (just because the figure is still negative). On the other hand, I would be labeling countries that started with small deficit but continued running deficit as a successful adjustment case if their benchmark level was already small. Second, the previous year's level of budget balance can serve as another economic unsustainability.

In addition to the main explanatory variables, I include variables to control for other factors that might influence budget balances. The first control variable accounts for the type of



electoral system, so that I may test whether or not an “inclusive government” (one that is more responsive to the general public and less responsive to special interests) is better at imposing rather unpopular tight fiscal policy. I use a dummy variable for *Proportional Representation (PR)*. Government is able to resist anti-adjustment pressures better under the proportional representation system, according to Rogowski (1987). Thus, we expect to see better economic performance if the country’s electoral system is proportional representation. Yet, it is possible that an inclusive government with the PR system could respond to general public that demands more spending. Then, the estimated coefficient would be negative.

To test whether greater democratic accountability makes tight fiscal policy more or less likely, the variable of *Democracy (POLITY)* is also included. Although all countries in the data set are democratic, some governments are more insulated from popular pressures than others. One expectation is that a more democratic country should be accountable to the general public; thus it is more likely to propose tight budgets despite the pressure from special interests. The same argument can lead to a contrary expectation that, if democratic governments respond to the public’s favor for expansive economic policies, we expect loose fiscal policy, thus bigger deficit. I use the indicator of *Democracy (POLITY)* from the Polity IV Project.

The third control variable is *Federalism (FEDERAL)*. Federalism, according to Wibbels (2000), negatively affects the outcome of economic adjustment efforts because federalism increases the number of veto players as some subnational governments try to avoid the costs of economic adjustment. It is also a collective action problem. Subnational governments have incentives to default their international borrowing at the expense of national governments, not following the stabilization package. Because subnational governments can receive transfers when their budget runs out, federalism often creates a “fiscal illusion,” which in turn leads to

over-demanded public goods and bigger budget deficits. Finally, federalist states often need to take care of heavy provincial debt because oversight of spending is difficult (Treisman 2000; Wibbels 2000).

A lagged dummy variable for the *Election Year (ELEC)* is included to account for the argument of the political business cycle (Alesina et al. 1997). It is argued that a government or a president increases public spending in order to boost economic growth just before election to get reelected. I also include legislative election because the legislature approves budget, and the incumbents would like to increase government spending and rents to their constituencies. I expect to see a negative coefficient for the lagged election dummy variable.

Lastly, a dummy variable for *War (WAR)* is included. A state in the middle of interstate or intrastate warfare will find it unusually hard to tighten their budgets. During civil war, it is unlikely that the economy will function well, any liberal reform policy will be halted, and government will run high budget deficits because its military spending increases. I used the same *WAR* variable in the previous chapter, a compiled set from a dataset by Fearon and Laitin (2003) and datasets by the Correlates of War Projects (COW) (Sarkees and Wayman 2010).

For economic controls, I include the *Logged GDP Per Capita*, and the *GDP Growth Rate*. I include the *Logged GDP Per Capita* to control for the expectation of a wealthy country getting more lenient treatment by international investors. Larger budget deficits are likely when there are less international investors who can discipline the market (Wibbels 2005). We should expect a positive coefficient of the *Logged GDP Per Capita* variable for budget balances. *GDP Growth* is used to control for economic performance of a country. Stronger economic performance will positively correlate with budget balances (Wibbels 2005).

I estimate the effects of the left-wing parties on budget deficits with the specification below.

$$\begin{aligned}
 \text{Budget Deficit (\% GDP)} = & \\
 & \alpha + \beta_1 \text{Left} + \beta_2 \text{Agenda Setters} + \beta_3 \text{Moderate Economy} + \beta_4 \text{Bad Economy} + \\
 & \beta_5 \text{Severely Bad Economy} + \beta_6 \text{Left} * \text{Moderate} + \beta_7 \text{Left} * \text{Bad} + \beta_8 \text{Left} * \\
 & \text{Severe} + \beta_{ctrl} \text{Controls} \tag{1}
 \end{aligned}$$

## EMPIRICAL RESULTS

First, I estimate the model, using % *LEFT* as an indicator of left-wing parties in legislature and present results in *Table 3.1* below.

[Table 3.1 here]

*Model 3A* includes only the percentage of left-wing parties in legislature (% *LEFT*) along with regional dummies and lagged *BUDGET DEFICIT*. This is the model assuming that there is neither economic factor effect nor interaction effect between ideology and economic factor. By and large, % *LEFT* is not statistically significant. *Model 3B* includes the second explanatory variable, agenda setters' reform efforts (*AGENDA*), and *AGENDA* is statistically significant, and there is a substantively significant difference in budget deficits between no reform efforts (*AGENDA=0*) and some reform efforts (*AGENDA=1*). Change from agenda setter's not proposing any structural adjustment plan to proposing drastic adjustment would result in 0.6% improvement in budget deficits, which is a significant improvement since the scale of budget deficit is in difference of percentage of GDP.

Table 3.1. Effects of Percent Left in Legislature on Budget Deficits as % of GDP (1978 to 2006)

	<u>Dependent Variable: Budget Deficit as % GDP</u>				
	<u>Model 3A</u> <u>with % Left</u>	<u>Model 3B</u> <u>with Agenda</u>	<u>Model 3C</u> <u>with Economy</u>	<u>Model 3D</u> <u>with Interaction</u>	<u>Model 3E</u> <u>with Country</u>
<i>Explanatory Variables</i>					
Deficit_lag	0.68† (0.03)	0.61† (0.03)	0.60† (0.03)	0.60† (0.03)	0.45† (0.04)
Percent Left in Legislature (%)	-0.003 (0.003)	-0.006 (0.004)	-0.003 (0.004)	0.01‡ (0.006)	0.02† (0.01)
Agenda		0.27‡ (0.11)	0.34† (0.12)	0.36† (0.12)	0.48† (0.13)
Moderate Economy <sub>t-1</sub>			0.07 (0.27)	0.85‡ (0.37)	0.94‡ (0.46)
Bad Economy <sub>t-1</sub>			-0.18 (0.27)	0.45 (0.36)	0.20 (0.50)
Severe Economy <sub>t-1</sub>			-0.63* (0.38)	-0.26 (0.57)	-0.76 (0.78)
<i>Interaction Term</i>					
% Left * Moderate Economy <sub>t-1</sub>				-0.03† (0.008)	-0.03† (0.009)
% Left * Bad Economy <sub>t-1</sub>				-0.02‡ (0.008)	-0.025‡ (0.01)
% Left * Severe Economy <sub>t-1</sub>				-0.01 (0.01)	-0.015 (0.017)
<i>Control Variables</i>					
Proportional Representation (PR)			-0.59* (0.32)	-0.62* (0.32)	-0.58 (0.83)
Federalism = 1 (Semi-Federal)			0.99* (0.53)	1.06‡ (0.54)	7.07† (1.65)
Federalism = 2 (Constitutional Federal)			0.19 (0.29)	0.16 (0.29)	4.99† (1.48)
Democracy (Polity)			0.04 (0.04)	0.03 (0.04)	0.04 (0.06)
Election Year (dummy) <sub>t-1</sub>			0.08 (0.20)	0.09 (0.20)	0.05 (0.19)
War (dummy)			0.15 (0.26)	0.11 (0.26)	0.25 (0.36)
GDP Growth (% Change)			0.10† (0.03)	0.10† (0.03)	0.13† (0.03)
GDP per Capita (ln)			-0.11 (0.15)	-0.09 (0.15)	-0.06 (0.46)
Trend	0.05† (0.01)	0.07† (0.01)	0.08† (0.02)	0.08† (0.02)	0.10† (0.03)
Constant	-2.43† (0.44)	-2.98† (0.47)	-2.77‡ (1.17)	-3.43† (1.19)	-8.55† (3.24)
R <sup>2</sup>	0.52	0.41	0.42	0.43	0.47
Wald Chi <sup>2</sup>	1321.22	1093.85	1146.85	1247.06	4486.20
Prob > Chi <sup>2</sup>	0.00	0.00	0.00	0.00	0.00
Prob > Chi <sup>2</sup> (for interaction terms)				0.01	0.01
Number of Cases	2413	1195	1042	1042	1042

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests.

Estimated with Panel Corrected Standard Errors. Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummy is the excluded reference dummy. Regional dummies are collapsed due to space limitation. Results are available upon request.

*Model 3C* includes the categorical economic unsustainability variable and all the control variables. The model assumes that there is no interaction effect between ideology and economic condition. The category of *GOOD ECONOMY* is excluded as the base category. The result does not change much for % *LEFT* or for *AGENDA*. The signs of *ECON CONDITION\_DEBT* are as expected, but not statistically significant. *MODERATE ECONOMY* has positive sign while *BAD ECONOMY* and *SEVERE ECONOMY* have negative sign. Only *SEVERE ECONOMY* is statistically significant. Only *PR*, *SEMI-FEDERALISM* and *GDP Growth* (% change) among control variables are statistically significant. *GDP Growth* is positively correlated to budget deficits as expected. As country's GDP grows, its budget balance will improve. However, the estimated coefficient for *Proportional Representation electoral system* is contrary to major theoretical expectation. We see negative correlation between *PR* and budget deficits. When a country has a proportional representation system, its budget balances will be negatively affected. It could be that even though "more inclusive government" can resist special interests better than non-PR, "more inclusive government" could be responding to general public that mandates expansive fiscal policy; thus, *PR* is negatively correlated to budget deficits. Contrary to the theoretical expectation, federalism does not have negative effect on budget balances. This could be due to unbalanced number of non-federalist states, which compose almost 90% of the whole dataset.

*Model 3D* is the complete model, which includes the interaction effects between ideology and economic conditions. I include the interaction term to test the implication that left-wing legislature's negative effects on budget balances lessen as it faces unsustainable economy. I argue that once I interact ideology variable with economic unsustainability variable, negative effects of left-wing parties preferring expansive fiscal policy will vary according to specific

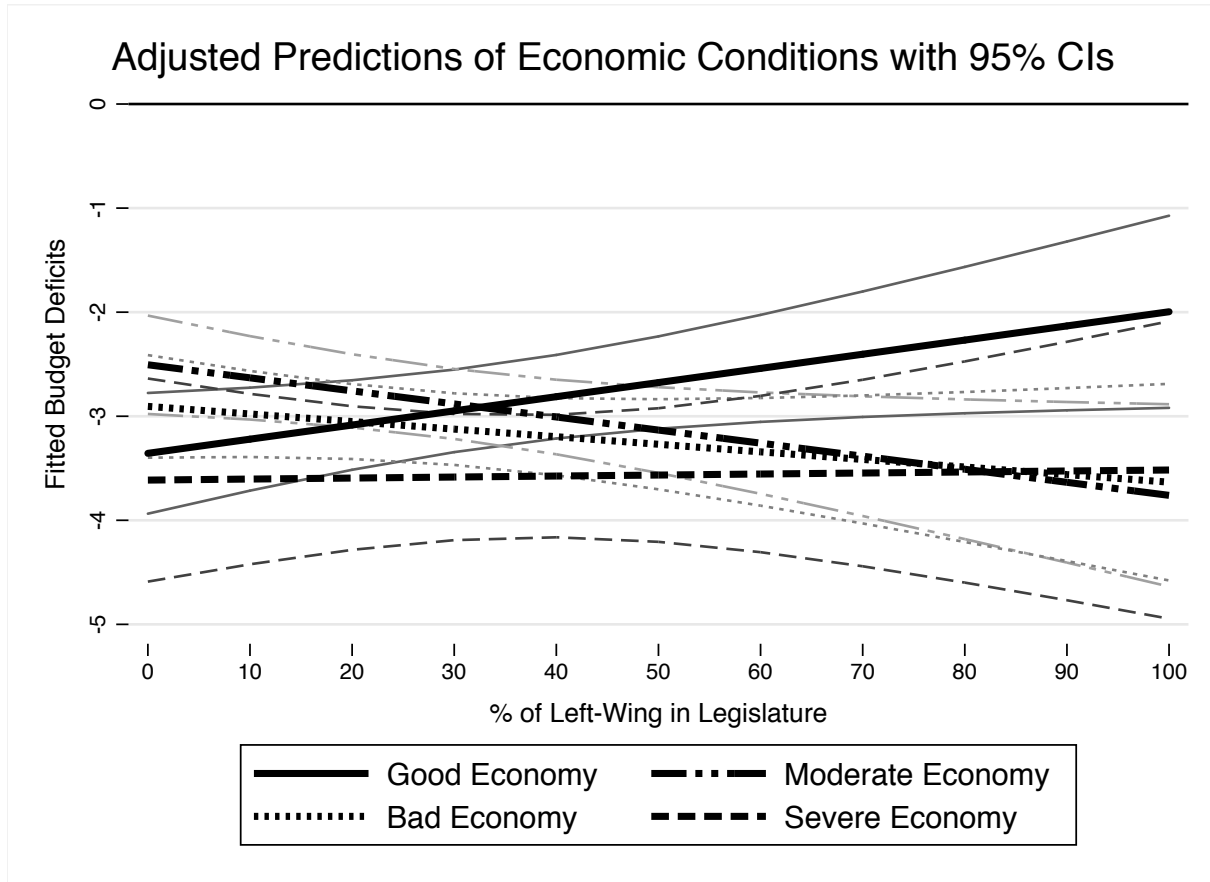
economic conditions. The interaction term as a whole is statistically significant. For robustness test, I run the same model specification with the country fixed effects (*Model 3E*). The result is similar to the result with *Model 3D*, except that the variable PR loses statistical significance while *FEDERAL* is now statistically and substantively significant. Compared to non-federalist states, semi-federalist states have almost 7% better budget balance improvements, and federalist states have almost 5% better budget balance improvements.

Table 3.2 below lists the coefficients under different conditions using the *equation (1)* above. Contrary to the usual spatial left-right model, during economically good times, the left-wing dominated countries enjoy better budget balances than countries with the right-wing dominated or the deadlocked legislature. This supports Alesina and Perotti’s observation that there is not much difference in budget balances between the rightist and the leftist governments. This also proves that the null hypothesis, which argues that only partisanship or ideology matters in economic policy-making, is wrong. During moderate economy and bad economy, the right-wing dominated states experience better budget balances than the left-wing dominated states, which confirms my expectation that during moderate and bad economic conditions, ideological difference will be shown. With the higher probability of winning elections given that candidates or policy-makers support their partisan platform, the right-wing dominated legislature will be more likely to approve tighter budgets than the left-wing dominated legislature.

Table 3.2 Estimated Marginal Coefficients under Different Economic Conditions

Differences in Budget Balances	Percentage of Left in Legislature		
	Right (0%)	Deadlock (50%)	Left (100%)
Good Economy	$\alpha$ = -3.43	$\alpha + \beta_1 * 50$ = -2.93	$\alpha + \beta_1 * 100$ = -2.43
Moderate Economy	$\alpha + \beta_3$ = -2.58	$\alpha + \beta_1 * 50 + \beta_3 + \beta_6 * 50$ = -3.58	$\alpha + \beta_1 * 100 + \beta_3 + \beta_6 * 100$ = -4.58
Bad Economy	$\alpha + \beta_4$ = -2.98	$\alpha + \beta_1 * 50 + \beta_4 + \beta_7 * 50$ = -3.48	$\alpha + \beta_1 * 100 + \beta_4 + \beta_7 * 100$ = -4.98
Severe Economy	$\alpha + \beta_5$ = -3.69	$\alpha + \beta_1 * 50 + \beta_5 + \beta_8 * 50$ = -4.19	$\alpha + \beta_1 * 100 + \beta_5 + \beta_8 * 100$ = -3.69

Figure 3.2 Marginal Effect of Economic Condition on Deficit as % Left in Legislature Changes



Now, during severely bad economy, there is no difference between the right-wing and the left-wing. The marginal coefficient holding other variables at constant, comes out to be -3.69 for both the right-wing dominated and the left-wing dominated legislature. It is interesting to note that when there is a deadlock in the legislature, 50% left and 50% right, budget balances are worse than under the legislature dominated by one ideology. The marginal coefficient of severe economy is more negative than that of good, moderate or bad economy under the right-wing dominated countries, but it is the result of huge external debt during severe economy. The budget balances, because it is the outcome variable, not actual budget proposal, they will be directly natively affected by severely bad economy.

Figure 3.2 also shows that during Good Economy, the fitted budget deficits will become more positive as % Left increases while during Severe Economy, the fitted budget deficits do not change much.

Next, I run statistical estimation with the same model specification but with different indicators of left-wing: left-wing veto player dummy (*LEFT VETO*) and the categorical percent of left-wing in legislature (*LEFT CATEGORY*).

[Table 3.3 here]

Shown in *Model 3F*, the left-wing veto player dummy (*LEFT VETO*) is statistically significant. When there is a left-wing veto player in legislature, the country will have -0.46 % declines in budget balances, all else held at constant. Given that we are estimating the effect on changes in budget deficits, -0.5% of GDP is substantively negative compared to a country without left-wing veto player. Once I include *AGENDA* in the model (*Model 3G*), the coefficient of *LEFT VETO* is smaller even though it is statistically significant. More importantly, the 95% confidence interval for *LEFT VETO* lies between -0.82 and 0.05, indicating that the estimated coefficient could be no effect. With all the control variables and economic conditions categories (*Model 3H*), the coefficient of *LEFT VETO* does not change, but its standard errors increased. The estimated coefficient of *AGENDA* increased, and *SEVERE ECONOMY* will negatively affect budget balances.

To estimate the threshold when left-wing veto player stop opposing tight fiscal policy, I interact *LEFT VETO* with *ECON CONDITION\_DEBT* in *Model 3I* and *Model 3J* with country fixed effects. The interaction term is not statistically significant, but we need to look at the marginal effects. *Table 3.4* below shows marginal effects of *LEFT VETO* as *ECON CONDITION\_DEBT* changes from *GOOD ECONOMY* to *SEVERE ECONOMY*.



Table 3.3 Effects of Left-Wing Veto Player on Budget Deficits as % of GDP (1978 to 2006)

	<b>Dependent Variable: Budget Deficit as % GDP</b>				
	<u>Model 3F</u> <u>with Left Veto</u>	<u>Model 3G</u> <u>with Agenda</u>	<u>Model 3H</u> <u>with Economy</u>	<u>Model 3I</u> <u>with Interaction</u>	<u>Model 3J</u> <u>with Country</u>
<i>Explanatory Variables</i>					
Deficit_lag	0.63† (0.03)	0.62† (0.03)	0.61† (0.04)	0.61† (0.04)	0.48† (0.04)
Left Wing Veto Player (dummy)	-0.46‡ (0.19)	-0.39* (0.22)	-0.39* (0.23)	-0.23 (0.42)	0.06 (0.44)
Agenda		0.22* (0.12)	0.29‡ (0.12)	0.30‡ (0.12)	0.34† (0.13)
Moderate Economy <sub>t-1</sub>			-0.09 (0.29)	-0.12 (0.31)	0.10 (0.38)
Bad Economy <sub>t-1</sub>			-0.10 (0.29)	0.30 (0.32)	0.42 (0.42)
Severe Economy <sub>t-1</sub>			-0.64* (0.39)	-0.76 (0.52)	-0.45 (0.69)
<i>Interaction Term</i>					
Left Veto * Moderate Economy <sub>t-1</sub>				0.04 (0.51)	-0.26 (0.55)
Left Veto * Bad Economy <sub>t-1</sub>				-0.73 (0.51)	-1.06* (0.60)
Left Veto * Severe Economy <sub>t-1</sub>				0.16 (0.76)	-0.42 (0.98)
<i>Control Variables</i>					
Proportional Representation (PR)			-0.51 (0.34)	-0.53 (0.34)	-0.29 (0.0.86)
Federalism = 1 (Semi-Federal)			0.96* (0.52)	1.11‡ (0.52)	
Federalism = 2 (Constitutional Federal)			0.20 (0.27)	0.23 (0.28)	-1.67* (0.69)
Democracy (Polity)			0.04 (0.04)	0.05 (0.04)	0.10* (0.06)
Election Year (dummy) <sub>t-1</sub>			0.07 (0.20)	0.07 (0.24)	-0.01 (0.19)
War (dummy)			0.06 (0.24)	0.05 (0.24)	0.38 (0.28)
GDP Growth (% Change)			0.10† (0.03)	0.10† (0.03)	0.13† (0.03)
GDP per Capita (ln)			-0.08 (0.18)	-0.08 (0.18)	0.04 (0.48)
Trend	0.07† (0.01)	0.06† (0.02)	0.07† (0.02)	0.07† (0.02)	0.07‡ (0.03)
Constant	-2.61† (0.43)	-2.73† (0.48)	-2.65‡ (1.25)	-2.72‡ (1.25)	-7.89‡ (3.32)
R <sup>2</sup>	0.48	0.44	0.46	0.46	0.53
Wald Chi <sup>2</sup>	1116.22	1071.15	1062.24	1110.01	2220.53
Prob > Chi <sup>2</sup>	0.00	0.00	0.00	0.00	0.00
Prob > Chi <sup>2</sup> (interaction terms)				0.27	0.24
Number of Cases	2079	1075	932	932	932

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests.

Estimated with Panel Corrected Standard Errors. Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummy is the excluded reference dummy. Regional dummies are collapsed due to space limitation. Results are available upon request.

Semi-Federalism omitted due to collinearity with country fixed effect for Model 3J.

[Table 3.4 here]

Table 3.4. Marginal Effects of Left Wing Veto Player as External Debt (logged) Changes

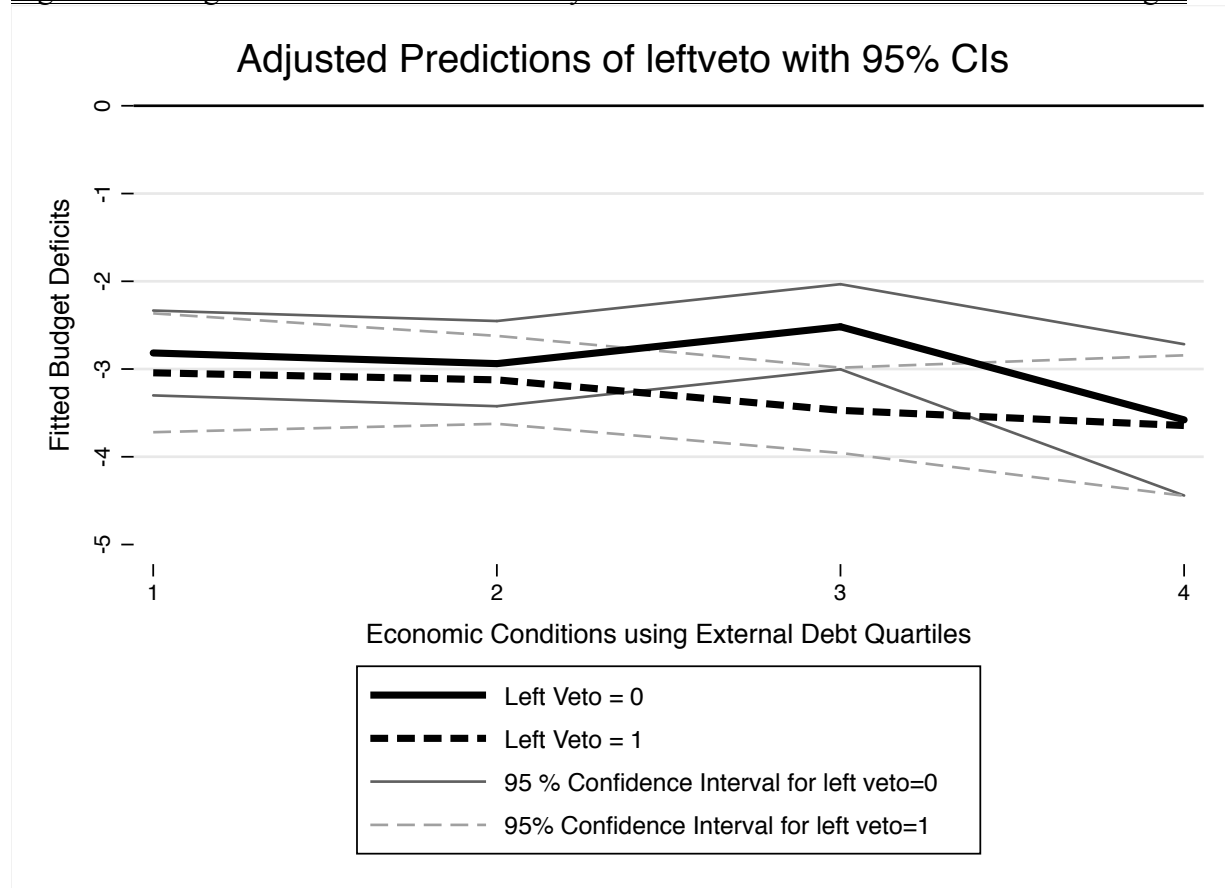
<b>Economic Condition_Debt</b>	<b>Left Veto = 0</b> (95% Confidence Interval)	<b>Left Veto = 1</b> (95% Confidence Interval)	<b>Difference</b>
Good Economy	-2.82 (-3.30, -2.33)	-3.04 (-3.72, -2.37)	-0.22
Moderate Economy	-2.94 (-3.42, -2.45)	-3.12 (-3.62, -2.62)	-0.18
Bad Economy	-2.52 (-3.00, -2.03)	-3.47 (-3.95, -2.98)	-0.95
Severe Economy	-3.58 (-4.44, -2.72)	-3.64 (-4.44, -2.84)	-0.06

My expectation was that as economy gets bad, the difference in deficits between a country with left-wing veto player and a country without left-wing veto player would diminish. Proving my expectation, when economy is severely bad, the difference in the fitted value of budget deficits between the left-wing veto player and no left-wing veto player is smaller than other categories of economic conditions. The difference of 0.06% is negligible. The 95% confidence intervals also indicate that the fitted budget deficits are not so different between the left-wing veto player country and no left-wing veto player country.

*Figure 3.3* below also shows that when there is a left-wing veto player, a country might start with worse budget balances than a country without left-wing veto player during good or moderate economy. When economy is bad, a country without left-wing veto player seems to improve its budget balances better than a country with left-wing veto player. However, once a country reaches a threshold of severe economy, difference between left-wing veto player and no left-wing veto player disappears. We see that the fitted budget deficits are worse than fitted deficits during good, moderate, or bad times, but it is because increasing external debt negatively affects the fiscal policy outcomes. Next, I use the categorical 10-point scale left-wing variable (*LEFT CATEGORY*) and test my argument again.

[Figure 3.3 here]

Figure 3.3 Marginal Effect of Left Veto Player on Deficit as Economic Conditions Changes



There are two ways to run regression with the variable of *LEFT CATEGORY*. I can consider it strictly categorical, or I can run regression assuming it to be a continuous variable. I present both methods and then compare them in Table 3.5 and Table 3.6. If the results are similar, I can choose one method that will allow me to discuss the results in more concrete way. Due to space constraints, for the categorical treatment of *LEFT CATEGORY*, I only present the model with interaction terms. The estimated coefficients of most of control variables do not alter with different specifications, and they are presented in Table 3.6 with the continuous treatment of *LEFT CATEGORY*.

[Table 3.5 here]

Table 3.5 Effects of Categorical % Left on Budget Deficits as % of GDP (1978 to 2006)

<u>Dependent Variable: Budget Deficit as % GDP</u>			
Model 3K			
<u>Explanatory Variables</u>		<u>Interaction Terms Continue</u>	
Deficit_lag	0.58† (0.03)	Left Cat 4 * Moderate	-0.42 (0.79)
Agenda	0.35† (0.12)	Left Cat 4 * Bad	-0.70 (0.74)
Categorical % Left 2 (11%≤x<20%)	-1.87* (0.98)	Left Cat 4 * Severe	0.34 (1.26)
Categorical % Left 3 (21%≤x<30%)	-0.21 (0.65)	Left Cat 5 * Moderate	-1.00 (0.76)
Categorical % Left 4 (31%≤x<40%)	0.20 (0.54)	Left Cat 5 * Bad	0.01 (0.93)
Categorical % Left 5 (41%≤x<50%)	0.78 (0.60)	Left Cat 5 * Severe	0.47 (1.35)
Categorical % Left 6 (51%≤x<60%)	0.50 (0.64)	Left Cat 6 * Moderate	-0.52 (0.76)
Categorical % Left 7 (61%≤x<70%)	0.71 (0.57)	Left Cat 6 * Bad	-1.26 (0.87)
Categorical % Left 8 (71%≤x<80%)	0.74 (0.61)	Left Cat 6 * Severe	-0.36 (1.04)
Categorical % Left 9 (81%≤x<90%)	1.24* (0.73)	Left Cat 7 * Moderate	-2.25* (1.15)
Categorical % Left 10 (91%≤x≤100%)	-4.10* (2.55)	Left Cat 7 * Bad	-0.27 (1.15)
Moderate Economy <sub>t-1</sub>	0.14 (0.38)	Left Cat 7 * Severe	0.57 (1.03)
Bad Economy <sub>t-1</sub>	0.12 (0.37)	Left Cat 8 * Moderate	-1.46* (0.87)
Severe Economy <sub>t-1</sub>	-1.02 (0.64)	Left Cat 8 * Bad	-1.84‡ (0.90)
		Left Cat 8 * Severe	1.04 (1.53)
<u>Interaction Terms</u>			
Left Cat 2 * Moderate	2.68‡ (1.13)	Left Cat 9 * Moderate	-2.06* (1.12)
Left Cat 2 * Bad	0.81 (1.20)	Left Cat 9 * Bad	-2.88‡ (1.37)
Left Cat 2 * Severe	0.44 (2.26)	Left Cat 9 * Severe	-2.58 (2.22)
Left Cat 3 * Moderate	0.52 (0.84)	Left Cat 10 * Moderate	omitted
Left Cat 3 * Bad	-0.45 (0.87)	Left Cat 10 * Bad	3.34 (2.68)
Left Cat 3 * Severe	2.31‡ (1.10)	Left Cat 10 * Severe	3.66 (2.81)
Constant	-2.35‡ (0.45)		
R <sup>2</sup>	0.45	Prob > Chi <sup>2</sup> (for interaction term)	0.041
Wald Chi <sup>2</sup>	1310.01		
Prob > Chi <sup>2</sup>	0.00		
Number of Cases	1042		

Note: † indicates |p|<.01; ‡ indicates |p|<.05; \* indicates |p|<.10 Statistical significances are based on two-tailed tests. Estimated with Panel Corrected Standard Errors. Left Cat 10\*Moderate is omitted because Left Cat 10\*Good is empty set.

*Model 3K* is a model with interaction terms between *LEFT CATEGORY* and *ECON CONDITION\_DEBT*. The interaction terms are overall statistically significant with 96% confidence ( $\text{Prob} > \text{Chi}^2 = 0.041$ ), but individually, each interaction term fluctuates, so I calculate the marginal effects of *LEFT CATEGORY* as *ECON CONDITION\_DEBT* changes from GOOD to SEVERE, *AGENDA*=1 (some adjustment efforts), and everything else at its mean in *Table 3.6*. I only present fitted values for *LEFT CATEGORY* 1 (below 11% left) and *LEFT CATEGORY* 10 (above 91% left). The fitted values show interesting implications. As economic conditions get worse, the difference between two ideological camps gets smaller (from -4.1% to -0.75% and then to -0.43%). Given that left-wing dominated legislature would have had high budget deficits to start from, the difference can be even smaller. In other words, even though the fitted values become more negative due to larger external debt (when a country has a large external debt as % GDP, government deficit is negatively affected), difference in government fiscal policy and outcomes between leftist and rightist legislature goes away as economy becomes severely bad and unsustainable.

[Table 3.6 here]

Table 3.6. Marginal Effects of Categorical % Left as Economic Conditions Change

<b>Economic Condition_Debt</b>	<b>Left &lt; 11% (95% CI)</b>	<b>91% ≤ Left (95% CI)</b>	<b>Difference (LeftCat1-LeftCat10)</b>
Good Economy	-2.89 (-3.43, -2.35)	empty set	
Moderate Economy	-2.75 (-3.26, -2.23)	-6.85 (-11.81, -1.88)	-4.1
Bad Economy	-2.77 (-3.30, -2.24)	-3.52 (-5.12, -1.93)	-0.75
Severe Economy	-3.91 (-5.04, -2.78)	-4.34 (-6.38, -2.31)	-0.43

[Figure 3.4 here]

Figure 3.4. Marginal Effects of Categorical % Left as Economic Conditions Change

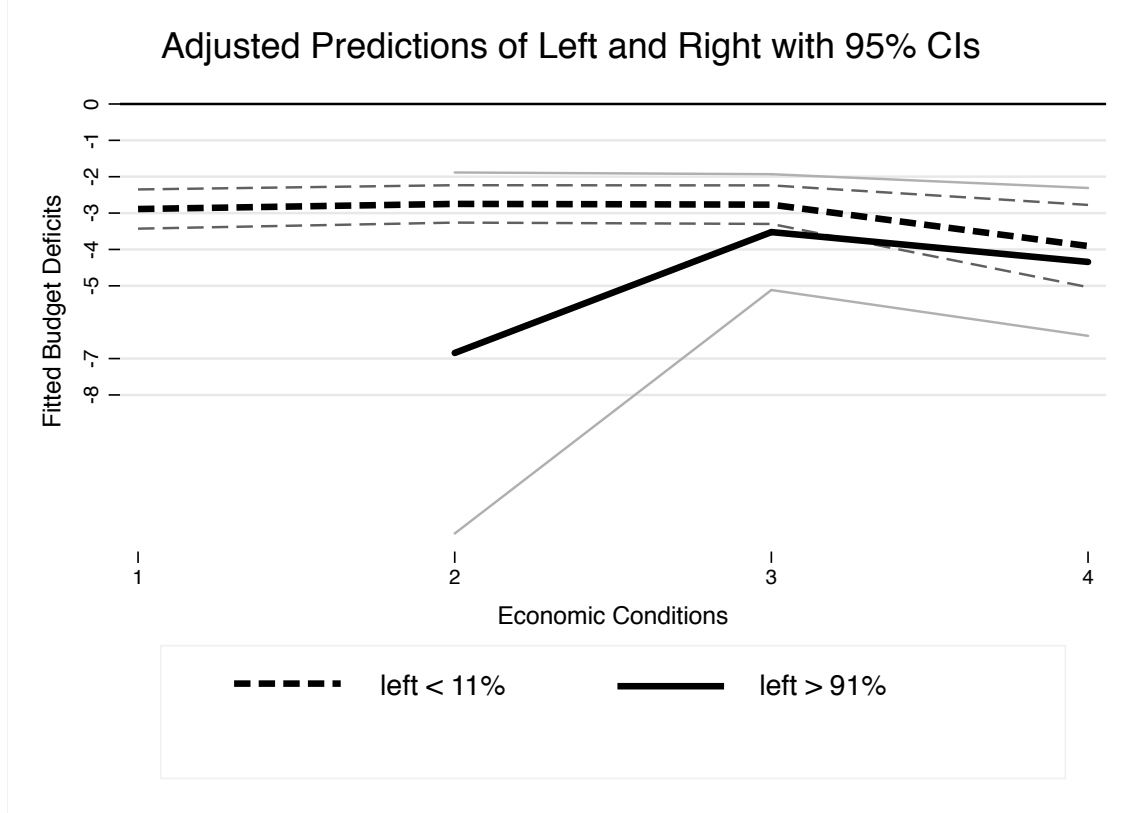


Figure 3.4 above illustrates that, indeed, during good and moderate economic conditions, legislature dominated by no-left has better budget balances than legislature dominated by left-wing. As economic conditions become worse, the lines of left < 11% and left > 91% converge, indicating a small difference between two differently composed legislatures. The results confirm my expectation that as economy becomes more unsustainable, difference between non-left and left-wing disappears, or at least, left-wing government try to run tighter budget than previous years of good times.

Next, I run regression with the same model specification with *LEFT CATEGORY* as continuous variable (Table 3.7). The interaction term is statistically significant with 99.7% confidence as a whole. The interaction terms separately are also statistically significant with an exception of *SEVERE ECONOMY*. It just falls short of significance with 90% confidence. The

negative effect of left-wing legislature in the categorized format by 10% gets smaller as economic conditions become worse. The results in general follow the results of regression using the percentage of left in legislature (*% LEFT*). I present the estimated marginal coefficients in Table 3.8 just like Table 3.2 with *% LEFT* (percentage of left in legislature) variable. During good economy, the largely left-wing dominated legislature has better budget balance performance. This contradicts the spatial left-right model and disproves the null hypothesis that only ideology matters. During moderate or bad economic conditions, the non-left dominated legislature has slightly better budget improvement. However, once a country reaches a threshold of severe economy, difference between left-wing veto player and no left-wing veto player disappears, and basically they have the same marginal coefficients, holding other variables at constant.

Table 3.7 Effects of Categorical % Left on Budget Deficits as % of GDP (1978 to 2006)

<u>Dependent Variable:</u>	<u>Budget Deficit as % GDP</u>	
	<u>Model 3L</u>	<u>Model 3M</u>
	<u>Left Category as</u> <u>Continuous</u>	<u>Country Fixed</u>
<i>Explanatory Variables</i>		
Deficit_lag	0.60† (0.03)	0.45† (0.04)
Agenda	0.36† (0.12)	0.48† (0.13)
Left Category	0.18† (0.07)	0.27† (0.08)
Moderate Economy <sub>t-1</sub>	1.18† (0.42)	1.28‡ (0.53)
Bad Economy <sub>t-1</sub>	0.72* (0.42)	0.48 (0.56)
Severe Economy <sub>t-1</sub>	0.02 (0.64)	-0.47 (0.88)
<i>Interaction Terms</i>		
Left Category * Moderate	-0.31† (0.09)	-0.36† (0.10)
Left Category * Bad	-0.25† (0.09)	-0.30† (0.11)
Left Category * Severe	-0.18 (0.13)	-0.22 (0.18)
Proportional Representation (PR)	-0.63‡ (0.32)	-0.58 (0.82)
Federalism = 1 (Semi-Federal)	1.11‡ (0.54)	
Federalism = 2 (Constitutional Federal)	0.15 (0.29)	-2.11† (0.72)
Democracy (Polity)	0.02 (0.04)	0.04 (0.06)
Election Year (dummy) <sub>t-1</sub>	0.09 (0.20)	0.06 (0.19)
War (dummy)	0.10† (0.26)	0.25 (0.36)
GDP Growth (% Change)	-0.09 (0.15)	0.13† (0.03)
GDP per Capita (ln)	0.81 (1.20)	-0.07 (0.46)
Trend	0.08† (0.02)	0.10† (0.03)
Constant	-3.67† (1.21)	-8.88† (3.23)
R <sup>2</sup>	0.43	0.48
Wald Chi <sup>2</sup>	1263.73	4577.75
Prob > Chi <sup>2</sup>	0.00	0.00
Prob > Chi <sup>2</sup> (for interaction term)	0.003	0.004
Number of Cases	1042	1042

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests. Estimated with Panel Corrected Standard Errors. Left Cat 10\*Moderate is omitted because Left Cat 10\*Good is empty set.



Table 3.8 Estimated Marginal Coefficients under Different Economic Conditions

Differences in Budget Balances	Percentage of Left in Legislature		
	Right (Left Category=1)	Deadlock (Left Category=5)	Left (Left Category=10)
Good Economy	$\alpha + \beta_1 * 1$ = -3.49	$\alpha + \beta_1 * 5$ = -2.77	$\alpha + \beta_1 * 10$ = -1.87
Moderate Economy	$\alpha + \beta_1 * 1 + \beta_3 + \beta_6 * 1$ = -2.62	$\alpha + \beta_1 * 5 + \beta_3 + \beta_6 * 5$ = 3.14	$\alpha + \beta_1 * 10 + \beta_3 + \beta_6 * 10$ = -3.79
Bad Economy	$\alpha + \beta_1 * 1 + \beta_4 + \beta_7 * 1$ = -3.02	$\alpha + \beta_1 * 5 + \beta_4 + \beta_7 * 5$ = -3.3	$\alpha + \beta_1 * 10 + \beta_4 + \beta_7 * 10$ = -3.65
Severe Economy	$\alpha + \beta_1 * 1 + \beta_5 + \beta_8 * 1$ = -3.65	$\alpha + \beta_1 * 5 + \beta_5 + \beta_8 * 5$ = -3.65	$\alpha + \beta_1 * 10 + \beta_5 + \beta_8 * 10$ = -3.65

## CONCLUSION

From Chapter 2, I argued that agenda setters' adjustment efforts could deviate from their partisan orientation when economy is not functioning. In this chapter, I illustrated that those agenda setters' adjustment efforts result in more balanced budget.

The other beckoning question, then, was where the legislature stands in the middle of all this adjustment drive and crisis. As some argue, is there no ideologically driven parties in developing countries? Or, as others argue, is legislature just an institution without real power under strong executives? The statistical analysis reveals that legislature, even if left-wing dominated, could and would support tighter budget as economic failure deepens. The unsuccessful budget balance seems to come, not from ideologically driven opposition, but from no need for change during economically good times.

Then, can we conclude that the left do not act like left in developing countries because there is no outstanding difference between left and non-left? I suggest that we need to look at other policy dimensions and study possibilities that left-wing parties act like left in different areas. Especially, as Alesina and Perotti (1995) suggested, just looking at the sheer number of deficits clouds the true picture of partisan difference in fiscal policy implementations. In other words, we need to distinguish general government consumption and spending from subsidies and welfare spending. It is possible that left-wing governments compensate their constituencies by

increasing welfare spending and subsidies while decreasing other general consumptions. For these quests, I turn to the next chapter.

## **Chapter 4. Does the Left Really Not Act like Left? – Cases of Budget Allocation and Social Spending**

### **INTRODUCTION**

In the previous chapters, I have looked at whether the left-wing governments succeed in implementing tighter budgets and propose reformist economic policies under unsustainable economic conditions. In this chapter, I examine whether agenda setters and left-wing legislature express their partisan preference in selection of government social spending. Following Alesina and Perotti's study on OECD fiscal adjustment efforts (1995), I look for "discretionary change" in government spending by disaggregating government spending into social security and welfare spending and education spending. I argue that in order to appease the losers from liberalization and reformist policies, agenda setters provide compensation as a part of rents to rent-seeking groups. Recent literature on welfare spending and globalization in developing countries examines whether government increases welfare spending as countries liberalize and open markets as a way to compensate workers, who usually lose the most from the new economic system. The main argument of welfare regime and liberalization comes from the socialist democratic argument that left-wing socialist parties with unionized labor will push for greater establishment of welfare regime. However, most of empirical studies do not find significant relationship between partisanship and welfare regime, especially in developing countries. It is not because left-wing parties do not care to compensate the losers of the new economic system. The sequential game of agenda setters and legislature in the theory chapter has shown that the rents that agenda setters provide or promise will benefit the legislature when the public disapproves the reformist policies but when some kind of change has to happen because of

economic conditions. Legislature can blame agenda setters for reformist policies but claim credit for being able to provide rents to dissatisfied constituencies. Agenda setters usually propose new economic policy and budgets, and legislature acts as veto player. Once agenda setters propose new policies but at the same time compensate the working class with higher ratio of social protection spending to other spending that targets the general public such as education spending, left-wing veto players do not have a strong incentive to veto the change. Once I control for economic conditions and the agenda setters' efforts to propose reformist policies, effects of left-wing on welfare spending will be more likely to disappear. In the following section, I discuss the literature on welfare state and liberalization. Then, I present my argument and implications to be tested with a set of panel data. I provide my statistical results and conclude at the end.

## **LITERATURE**

Liberalization and welfare state studies have focused on whether government spending increases when countries open their market. Ruggie (1982) first introduced the idea of "Embedded Liberalism," which basically argues that as countries open up trade, governments compensate the group of people who lose from trade liberalization. The core assumption behind the embedded liberalism is that the public will support more liberalization if governments intervene and distribute benefits from trade to the public, not just relying on the market to redistribute. Nonetheless, several studies have found that there is no significant positive relationship between liberalization and social spending (Garrett and Mitchell 2001; Rodrik 1997)

Rodrik (1997), for example, shows that trade openness is significantly correlated with reductions of government consumption and social transfers. As a part of social democratic corporatist argument, Garrett and Mitchell (2001) argue that the actual causal mechanism

between liberalization and welfare spending lies in the relationship between corporatist labor union and social democratic governments. Liberalization led to unionization of labors, which became the base of creation of strong social democratic parties. Once social democratic parties came to power, they built welfare states. When labor union power and social democratic parties are controlled for, there is no longer positive relationship between trade openness and government spending.

More recent literature has turned its attention to decomposing liberalization and welfare spending and looks at how specific components of liberalization efforts affect specific types of welfare spending. As an effort to prove the embedded liberalism, Hays et al. (2005) test the embedded liberalism and welfare spending in OECD countries by disaggregating government spending into unemployment benefits, government consumption, and social benefits and by distinguishing imports and exports because import-competing sectors and export-led sectors will have different preferences regarding trade openness. They find that as countries' imports rise, government spending rises. Burgoon (2001) argues that trade liberalization and openness hurt the low-skilled labors and labor-intensive sectors, so more trade in low-wage labor-intensive sectors will result in more demand for social compensation from those affected sectors.

Compared to studies on developed countries, only a few studies examine liberalization and its effect on developing countries' welfare states. Rudra (2002) argues that because developing countries have unlimited labor, labors' main concern is not about social spending but unemployment, and these labors lack motivation and means to organize powerful unions like those in developed countries. If somebody gets fired, one of the surplus labors would just replace him; thus, there is a less chance of getting welfare benefits, as labors do not act collectively to demand more and better benefits. Rudra then shows that more liberalization in

developing countries lowers the social welfare spending. Still, her argument regards the low-skilled labor without any political power, but it has been shown that unorganized labors can mobilize during difficult times and demand for more social protection. When unemployment rate skyrockets or unemployment is widespread, then it is not a matter of surplus labor, and distraught labors will join the protest.

### **MY ARGUMENT**

So far, most of literature does not consider the fact that realization of need for reform comes when the countries are hit hard by crisis. In the previous chapters, I showed that when crisis hits, partisan differences disappear and both agenda setters and legislature are more likely to support the reformist policies. Then, the question is, with economically unsustainable conditions, would most affected groups or sectors not demand compensation for accepting new economic systems? With even more limited resources during crisis, would not governments have more incentive to redistribute to their partisan constituencies and even more so if those are the most affected groups?

When economy is bad and pressure to implement reformist policies is high, one way to compensate the people with losses is to expand social protection spending (social security and welfare spending) and the other is not to cut social protection spending (Burgoon 2001). The agenda setters will try to implement efficiency-oriented economic policies and cut government spending in order to balance the budget. Non-left veto players will not veto economic reform proposals or welfare spending cuts by the agenda setters if their preferences are close to agenda setters. If welfare spending is a zero-sum game—meaning no cut in social security equals cut in health or education spending – centrist and right-wing veto players usually prefer cuts in social

security spending because beneficiaries of health and education spending are more universal than social security spending. Labors also benefit from health and education spending, but given the zero-sum welfare spending cut, labor and the left-wing veto players that represent them are more sensitive to cuts in social security spending.

Thus, as veto players, the left-wing, whose base is largely working-class, will be more likely than non left-wing to contest cuts in social security spending. However, during economically critical time, do left-wing parties veto agenda setters' reformist policies? The previous two chapters have shown that first, agenda setters disregard their partisan preference during economic crisis and that second, left-wing parties in legislature also do not veto agenda setters' reform and support tighter budgets. And one of the ways to run tighter budgets but still maintain public support (even for next election) is to distribute social spending discretely as Alesina and Perotti calls it, "discretionary spending."

Alesina and Perotti in their OECD fiscal adjustment study argue that a careful study on successful and unsuccessful adjustment of budget balances would require a close look at "composition of spending" (1995). When they look at government spending as a whole, the left-wing governments were as successful as the right-wing governments contrary to their expectation. Alesina and Perotti argue that governments will put different weight on certain spending categories, and when governments try to balance their budgets, they will conduct "discretionary change" in government spending. After studying fiscal adjustments by disaggregating government spending into expenditures, public investment, transfers, non-wage public consumption, government wages, and subsidies, they conclude that for successful fiscal adjustments, governments have to cut welfare spending and wages. Nonetheless, they do not employ the same disaggregation of government spending to test whether partisanship makes a

difference once government spending is decomposed into several categories. Therefore, I extend the idea of disaggregating government spending to test for partisan difference in different types of government spending whose recipients represent different groups.

Health and education spending (spending on human capital) will be welcomed by many, but when increase in health and education spending means cut in social security spending, the labor will be most resistant, and the labor and the parties that represent them would prefer cut in social spending that targets the general population to cut in social security spending. Burgoon (2001) shows that groups that are put at higher risk of loss through liberalization would demand more social protection from government but their demand will be most on “active and passive labor market policies,” rather than on health care and family benefits such as education spending from governments that target the youth and the elderly.

In order to get consensus on liberalization and reform of the existing economic system, they need to compensate the groups that lose most from the reform and would oppose most vigorously against reformist policies. The public sector employees are more likely to be laid off when governments try to implement austerity measures and balance budgets through resizing of the state owned enterprises. Simply put, once a group of people becomes unemployed because of new economic policy, then governments are expected to support the group one way or another (usually unemployment benefits or pension/social security benefits). In South Korea after the financial crisis hit, IMF-led reform measures (privatize loss-making state owned enterprises, deregulate labor market, open trade, reform banking system, etc.) meant huge lay-off of workers, and unemployed workers protested on the street, angry and upset with the government.

Pension benefits largely go to the middle class and workers in formal sectors, and spending on health and education can be considered beneficial to the general public, especially



the poor (Kaufman and Segura-Ubierno, 2001). Yet, in some Latin American countries, most of education benefits—free university, for example—go directly to the middle class in urban areas.<sup>25</sup> Thus, making clear disaggregation of welfare spending is necessary for this research. In other words, when governments have to cut spending, left-wing governments might sacrifice health-care spending that usually goes to the poor to protect middle-income labor constituencies (Wibbels 2006). The majority of social security spending in Latin America goes to unionized, middle-income white- and blue-collar workers, especially public-sector employees. In post-communist countries, most of pension benefits—that are considered far generous compared to other regions—go to the blue-collar, unionized workers (usually employed in state-owned enterprises before privatization took place). Poland, for example, had slow privatization and liberalization because trade unions themselves were the main political power behind independence movement (Solidarity Movement) and later became a part of government-coalition as the Solidarity Party.

When countries are in severe economic crisis, governments have to cut down their spending. I argue that left-wing governments will cut down spending that affects the general public rather than social spending. The way to show this is to run statistical analysis on the social security and welfare spending (social protection spending), education spending, and the ratio of social security and welfare spending over education spending. Social security and welfare spending (pension benefits) usually target the industrial workers while education spending does not have specific targets. If education is used as rents to a group of people, it is usually upper-middle class (South Korea is a good example. Education spending in South Korea is concentrated in the capital city, Seoul, and even inside Seoul, it is concentrated in the wealthy

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<sup>25</sup> In fact, Rudra (2006) makes distinction between the primary/secondary education spending and tertiary education spending.

areas). Even if education and health spending is targeted (such as education targeted to urban population or health targeted to the poor), the public does not consider it as specifically targeted rents. Moreover, education spending does not provoke rent-seeking behavior from special groups while social security and welfare expenditure is a big redistributive item for the labors and public sector employees. I exclude health-care spending in this chapter because health-care spending is determined by external factors other than economic crisis, such as sudden outbreak of pandemic disease or chronic illness (AIDS).

My first implication is that once economic conditions are controlled for, agenda setters' efforts to reform have positive effects on social protection (social security and welfare) spending.

Second, agenda setters' efforts to reform will have negative effects on education spending.

Third, agenda setters' efforts to reform will have positive effects on the ratio of social protection spending over education spending as agenda setters would cut education spending more than social protection spending or would not cut social protection spending as much as education spending.

Fourth, once economic conditions and agenda setters' proposal to reform are controlled for, left-wing parties' effect on discretionary spending will not be significant.

## **RESEARCH DESIGN**

Just like the previous chapter, I use the same dataset of developing countries from 1978 to 2006 and employ the pooled time-series regression with a panel-corrected standard errors estimator (PCSE). Because of the data limitation, there are only 581 observations of social

protection spending (% GDP) and 951 observations of education spending (% GDP). The countries included in the data analysis are listed in Appendix 4.1.

My first dependent variable in this chapter is social security and welfare spending (*SOCIAL PROTECTION*) as shares of GDP (% GDP). Social protection spending is defined as “social security and welfare affairs and services” in *Government Finance Statistics*. The data come from budgetary central government account, central government account, or consolidated central government account and do not include local governments. As a way to fill the missing data, I also compare GFS data with World Development Indicators from the World Bank. However, data from *World Development Indicators* include both central and local government spending. Thus, combining the data from two different sources (World Bank and IMF) produces discrepancies for countries whose education and health expenditures are distributed through local governments. This is especially true for a federal system or a semi-federal system (such as Argentina, Brazil, or India). Therefore, when I see discrepancies between GFS and WDI data, I exclude the data entries but try to fill missing values as much as I can, ignoring differences smaller than 0.5% between GFS and WDI. I use only GFS data for social security and welfare spending because social protection spending indicator is not available in the WDI dataset.

The previous works on the relationship between partisanship and social spending usually do not find significant relationship, unable to show that left-wing governments have higher social security and welfare spending. In order to see the real effect of left-wing governments on social spending, whether they really redistribute to working class through social security benefits and pension benefits, we have to consider the economic conditions and control for them. Also, we need to look at other categories of social spending such as education spending and compare it. Left-wing governments strategically choose to spend more on redistributive budget items over

spending that benefits the general public universally. Therefore, I compare the social security spending by looking at education spending as shares of GDP, which is my second dependent variable. If governments want to compensate the general public, it will increase education spending and if governments want to compensate the targeted group, it will increase social protection spending.

The third dependent variable is the ratio of social protection spending to education spending. When the ratio is smaller than 1, it means that a government is spending more on education compared to social protection (social security and welfare). When the ratio is bigger than 1, it means that a government is spending less on education compared to social protection. Testing on the ratio of social security spending over education spending will further tell us whether governments increase the ratio of social security spending over education spending even when they cut the overall spending as % GDP. The ratio of social protection spending to education spending will tell us whether governments increase social security and welfare spending compared to the spending that targets the general public. In other words, during crisis even when left-wing governments have to balance the budget and cut spending, they would cut general public spending such as education or health more than they would cut spending such as social security or pension benefits. Then, governments could have shown to the international institutions and lending countries that they are balancing their budget but still provide redistributive rents to their main constituencies.

Figure 4.1 shows that social protection spending as % GDP data are highly skewed to the left. In order to avoid the problem of outliers that can bias the results, I log the variable by the base of 10. After log transformation, the data on social security spending behave more nicely, resembling the normal distribution.

[Figure 4.1. here]

Figure 4.1. Density Distribution of Social Welfare Spending and Log-Transformation

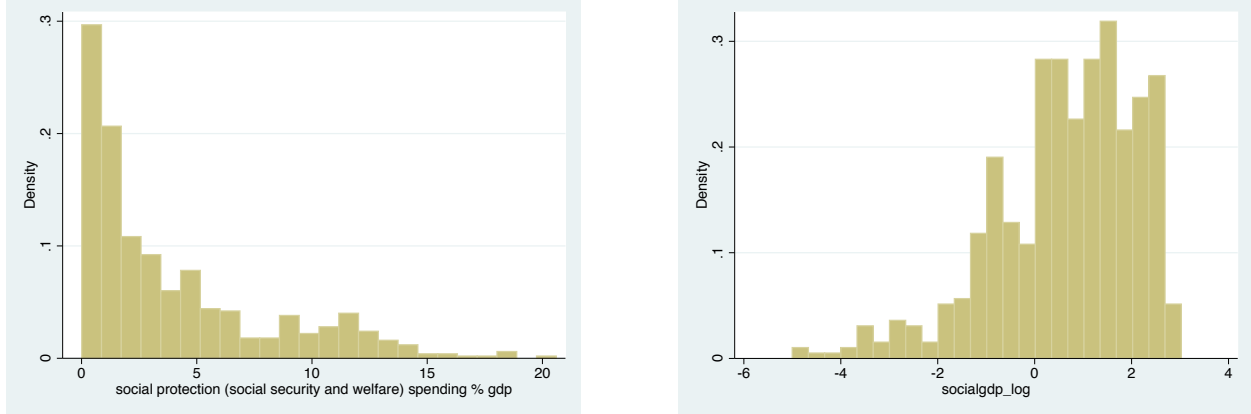


Figure 4.2. Density Distribution of Education Spending (% GDP) and Log-Transformation

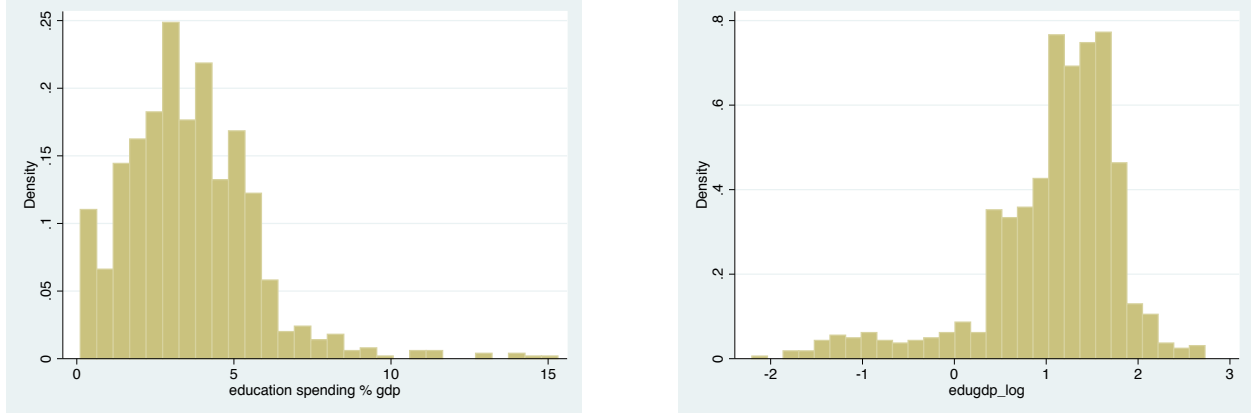


Figure 4.3. Density Distribution of Ratio of Social Spending to Education Spending

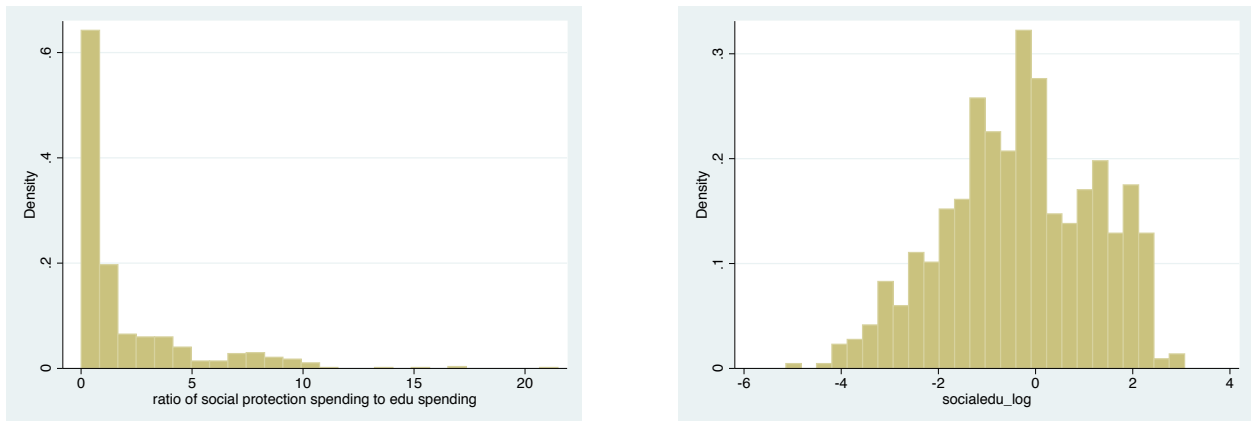


Figure 4.2 above shows that education spending data are a little skewed to the right. I transform the variable by log of 10 and I run regression on both. Figure 4.3 shows that data on the ratio of social protection spending to education spending are highly skewed to the left. I log-transform the data, and the density distribution becomes fairly normal. With normally distributed data, the estimated coefficient will be less biased and closer to the real value.

I run regression with the lagged dependent variable on the right side and without it. By adding the lagged social protection spending (as % GDP), I test the effect of left-wing and economic crisis on the changes in social protection spending. This makes sense because we are interested in whether governments can either keep the current social protection spending or even increase social security spending to appease their constituencies. Moreover, adding the lagged dependent variable on the right side of the equation will solve some serial correlations. I expect that the lagged dependent variable to have the positive coefficient. By not including the lagged dependent variable on the right side of the equation, I will be testing the effects of partisanship on the actual amount of social protection spending, education spending, and the ratio of social protection spending to education spending.

My independent variables are the same as the previous chapter: measures of partisanship: left-wing party composition in legislature (*% LEFT*) and existence of left-wing in government party (*LEFT VETO*), agenda setters' efforts to implement tighter budget and neo-liberal economic policies (*AGENDA*), and economic unsustainability (*ECONOMIC UNSUSTAINABILITY*).

I expect to see insignificant coefficient of *% LEFT* or *LEFT VETO* on social protection spending and on education spending because left-wing governments are also expected to cut spending and try to balance budgets. Therefore, on the surface, there will not be significant

positive effects of left-wing governments on welfare spending. I expect to see, however, positive effects on the ratio of social protection spending to education spending. The positive coefficient means that government has increased the ratio of social security spending compared to education spending.

I argue that agenda setters propose cuts in government spending during crisis, but try to compensate the biggest losers during liberalization process. One of the biggest losing groups is labors and public sector workers through privatization and tight fiscal policy. The international institutions pressure governments to cut down public sectors and privatize loss-making state-owned enterprises (SOEs), and the results are lay-off of workers. I expect that the effect of agenda setters' reform efforts on the social protection spending to be positive. This is regardless of their partisanship. Nonetheless, the effect of agenda setters on education will be negative since agenda setters would more likely to cut spending that targets the general public. Likewise, the effect of agenda setters on the ratio of social protection spending to education spending will be positive because agenda setters will be increasing the ratio of social protection spending to education spending if they have to cut government expenses.

During economic crisis, governments will try to compensate by increasing the social protection spending, and I expect a positive coefficient of *ECONOMIC CONDITION* for BAD and for SEVERE.

For control variables, first, I test the globalization effect on welfare spending by adding two measures of globalization: trade as % GDP (*TRADE*) and net inflows and outflows of foreign direct investment (*FDI*), following Rudra (2002). Ruggie (1984) finds that more liberalization increases welfare spending because governments use social spending as bargaining chip to win public support for free market. On the other hand, some argue the opposite, saying

that liberalization lowers the welfare spending to attract foreign capital, who would not invest if welfare commitment is too high. Other scholars have argued exactly the opposite with the same reasoning. Governments would increase welfare spending to attract foreign capital because with increase social welfare benefits, labor market will be stable, and stable labor market will attract more foreign investors.

Garrett and Mitchell's argument is that labors unionize and demand more benefits from the government to compensate for loss from liberalization (2001). The measure of unionization data are available for developed countries, but not for developing countries. I use, instead, the measure of employment in industry as % of total employed population (*INDUSTRY EMPLOYEE*) to proxy for labor power. It does not exactly capture the unionization effect, but it does show how many industrial workers are in a country.

I include the dependency ratio of non-working groups—population younger than 15 and older than 65 as percentage of working age population (*DEPENDENCY*) or population over 65 as percentage of total population (*POPULATION65*) to control for groups that receive retirement and elderly benefits and family benefits targeted at the youth (Burgoon 2001). Also, one of the big parts of welfare benefits includes unemployment benefits, so I put the unemployment rate as percent of total labor force (*UNEMPLOYMENT*). I also include the level of urbanization to test whether urban bias exists when governments make budgetary decisions. Some argue that urban sectors will demand more social protection and more education spending. In developing countries, it has been observed that education benefits go to urban middle class. I use the population in urban areas as shares of total population (*URBANIZATION*) as a proxy for the level of urbanization.



For political controls, I include the level of democracy (*DEMOCRACY*) to test whether more accountable governments respond to the demand to increase social spending. I also include election year dummy (*ELECTION*) to control for the business-cycle argument that government increases spending before election.

For economic controls, I include GDP growth to account for the trend of reduction in welfare spending as economic activity grows (Burgoon 2001). I also include GDP per Capita (ln) to control for Wagner's law, which states that as per-capital real income rises, government spending as shares of GDP will increase (Hays et al. 2005).

The ratio of social security and welfare social protection to education spending shows that post-communist and East European countries have higher ratio of social security spending than countries in Africa, Asia, or Latin America. Thus, I include regional dummies to account for regional differences.

I estimate the effects of the left-wing parties on social welfare spending with the specification below.

$$Social\ Spending = \alpha + \beta_1 Left + \beta_2 Agenda\ Setters + \beta_3 Moderate\ Economy + \beta_4 Bad\ Economy + \beta_5 Severely\ Bad\ Economy + \beta_{ctrl} Controls \quad (1)$$

## **EMPIRICAL RESULTS**

Table 4.1 presents the regression results on social protection spending as shares of GDP (*SOCIAL PROTECTION*). Model 4A and Model 4B use the same model specification but uses different measures of left-wing power (*LEFT VETO* and *% LEFT*). Both *AGENDA* and *LEFT-WING* variables are not statistically significant.

Table 4.1. Effects of Left-Wing on Social Protection Spending as % of GDP (1978 to 2006)

	<b>Dependent Variable: Social Protection Spending as % GDP (logged)</b>				
	<u>Model 4A</u> with LeftVeto	<u>Model 4B</u> with % Left	<u>Model 4C</u> with LeftVeto	<u>Model 4D</u> with %Left	<u>Model 4E</u> 4D+lag dep
<i>Explanatory Variables</i>					
Social Protection_lag					0.81† (0.04)
Left-Wing (% Left or Leftveto)	0.08 (0.09)	0.003 (0.002)	0.01 (0.09)	0.003* (0.002)	-0.00 (0.00)
Agenda	0.05 (0.04)	0.05 (0.04)	0.07 (0.04)	0.08* (0.04)	-0.009 (0.03)
Moderate Economy <sub>t-1</sub>			0.15 (0.11)	0.14 (0.11)	0.11 (0.08)
Bad Economy <sub>t-1</sub>			0.36† (0.13)	0.35† (0.13)	0.16‡ (0.08)
Severe Economy <sub>t-1</sub>			0.37‡ (0.16)	0.34‡ (0.15)	0.16‡ (0.09)
<i>Control Variables</i>					
Democracy (Polity)	0.03 (0.03)	0.04* (0.02)	0.03 (0.02)	0.04* (0.02)	0.009 (0.01)
Election Year (dummy) <sub>t-1</sub>	-0.04 (0.04)	-0.03 (0.04)	-0.06 (0.04)	-0.04 (0.04)	-0.03 (0.04)
Trade (% GDP)	0.003* (0.002)	0.003* (0.002)	0.003* (0.002)	0.003* (0.002)	0.00 (0.00)
FDI Net Flows (% GDP)	0.008 (0.01)	0.01 (0.009)	0.004 (0.01)	0.01 (0.03)	0.007 (0.00)
Unemployment (% Population)	0.009 (0.01)	0.004 (0.01)	0.008 (0.01)	0.004 (0.01)	-0.012‡ (0.006)
Age over 65 (% Population)	0.03 (0.03)	0.03 (0.03)	0.01 (0.03)	0.01 (0.03)	0.008 (0.01)
Urban Population (% Population)	0.009‡ (0.005)	0.01‡ (0.005)	0.01‡ (0.005)	0.01† (0.005)	-0.00 (0.002)
Employee in Industry (% Total Employment)	0.02‡ (0.01)	0.02* (0.01)	0.02‡ (0.01)	0.02‡ (0.01)	0.01† (0.004)
GDP Growth (% Change)	-0.003 (0.006)	-0.003 (0.005)	-0.006 (0.006)	-0.006 (0.006)	-0.01‡ (0.005)
GDP per Capita (ln)	0.001 (0.10)	-0.02 (0.10)	-0.07 (0.10)	0.04 (0.10)	-0.04 (0.04)
East, Southeast Asia	-0.97† (0.30)	-0.82† (0.31)	-0.97† (0.30)	-0.81† (0.29)	-0.19 (0.12)
Latin America	-0.68‡ (0.29)	-0.76‡ (0.30)	-0.78† (0.29)	-0.86† (0.28)	-0.04 (0.11)
South Asia	-0.71 (0.48)	-0.60 (0.48)	-0.76† (0.45)	-0.58 (0.45)	-0.14 (0.14)
Sub-Saharan Africa	-0.91 (0.67)	-0.96 (0.69)	-0.91 (0.68)	-0.98 (0.70)	-0.04 (0.28)
Constant	-0.47 (0.74)	-0.42 (0.73)	-1.07 (0.75)	-1.03 (0.73)	0.25 (0.32)
R <sup>2</sup>	0.27	0.26	0.29	0.29	0.86
Wald Chi <sup>2</sup>	201.56	166.62	198.07	181.78	1763.35
Prob > Chi <sup>2</sup>	0.00	0.00	0.00	0.00	0.00
Number of Cases	349	364	334	349	313

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests. Estimated with Panel Corrected Standard Errors. Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummy is the excluded reference dummy.

Once I control for economic conditions with the categorical *ECONOMIC UNSUSTAINABILITY* variable, the *LEFT-WING* and *AGENDA* variables become somewhat statistically significant. From Model 4D, which includes the percentage of left-wing in legislature, when the legislature is 100% left, the social spending would increase by 0.3 in logged social protection spending, compared to the legislature with 0% left. That roughly translates into 2% increase in social protection spending as shares of GDP. It is substantively significant. However, once I choose different measure of left-wing (*LEFT VETO*), the effect of left-wing disappears.

Model 4C and Model 4D show that economic conditions variables are statistically and substantively significant. When economic condition is bad, the social protection spending in log of 10 will increase by 0.35. This roughly equals to 2.24% increase in social spending as % GDP. When economic condition is severe, the social protection spending in log of 10 will increase by 0.36, which roughly equals to 2.3% increase in social spending as % GDP. It is interesting to note that during economically difficult times, governments increase their social protection spending. It might seem natural, but considering that governments are pressured to cut down spending, it actually shows that governments compensate the narrowly targeted social protection program. Below in the next table, I present regression results on education spending as shares of GDP, and economic conditions variables do not have statistically and substantively significant effect on education spending.

Some results support my expectation that agenda setters' efforts for more efficient economic policy do increase the social protection spending and bad and severe economic conditions also increase social protection spending. However, they are not robust enough to support my argument that governments compensate the biggest losing class, which is working

class. Once I include the lagged dependent variable, the institutional variables lose their significance, and economic-conditions variables also have their magnitude of effect almost halved (Model 4E).

Some of the notable control variables are *TRADE*, *URBANIZATION*, and *EMPLOYEES* in *INDUSTRY*. Trade as shares of GDP ranges from 13.7% to 199% with a mean of 79% and standard deviation of 35% in the regression sample. If trade increases by 40% (almost one standard deviation), for instance, social protection spending would increase by about 0.12 in logged social spending as shares of GDP. It means  $\log_{10} X = 0.12$ , and  $X$  is  $10^{0.12}$ , which is about 1.3%. This seems substantively significant increase in the social protection spending as it ranges from -3 to 3 with a mean of 1.11 and standard deviation of 1.31. One standard deviation increase in trade will roughly increase one standard deviation in social protection spending.

When urban population increases by 10%, the logged social protection spending will increase by 0.1. This comes out to be 1.25% increase in social protection spending as shares of GDP. The urban population ranges from 9% to 93% in the sample with a mean of 60% and standard deviation of 18.77%. For example, if urban population increases by 20%, this will result in 1.58% increase in social protection spending as shares of GDP. This is substantively significant increase and supports my expectation that as population increases in urban centers, there will be more demand for social protection.

The percentage of population employed in industrial sectors ranges from 3% to 43% with a mean of 25% and standard deviation of 7.4% in the sample. When the percentage of population employed in industrial sectors increase by its standard deviation, roughly 8%, the logged social protection spending will increase by 0.16. This translates to be an increase of

1.45% social protection spending as shares of GDP. This supports the argument that more workers in industry will demand more social protection from government.

[Table 4.2 here]

Next, I run regressions on education spending as % GDP, and results are in Table 4.2 below. Model 4F and Model 4G are models without economic crisis variables and without lagged education spending as shares of GDP. I report regression results on education spending as % GDP, not on log-transformed education spending because the results are similar and using the untransformed dependent variable will make interpretation of results easier. In Model 4F, the existence of left-wing veto player does not have statistical significance while the agenda setter variable is statistically significant. Model 4G uses the percentage of left-wing in legislature (% *LEFT*), and % *LEFT* is actually statistically significant. Yet, 95% confidence interval reveals that the estimated coefficient can fall between -0.0004 and 0.01, which includes 0, no effect.

*TRADE*, *POPULATION65*, *URBANIZATION*, *GDP GROWTH*, and *GDP PER CAPITA* (ln) are statistically significant and robust. More open market seems to increase the education spending. Trade as shares of GDP ranges from 6% to 280% with a mean of about 77% and standard deviation of 39%. If trade increases by 40%, for instance, the education spending would increase by about 0.6% to 0.7%. Population over 65 and urban population variables all have negative coefficients. Population over 65 meets my expectation that more aged population is, less demand for education spending. However, I expected more urban population would increase education spending, but the data show that increase in urban population results in reduction in education spending as % GDP. As a country's growth rate increases, education spending decreases as I expected. As people become wealthier (GDP per Capita), government spends more on education, supporting the expectation of the Wagner's Law.

Table 4.2. Effects of Left-Wing on Education Spending as % of Total Expense (1978 to 2006)

	<u>Dependent Variable: Education Spending as % Total Expense</u>				
	<u>Model 4F</u> <u>with LeftVeto</u>	<u>Model 4G</u> <u>with % Left</u>	<u>Model 4H</u> <u>with % Left</u>	<u>Model 4I</u> <u>4G+lag dep</u>	<u>Model 4J</u> <u>4H/logged edu</u>
<i>Explanatory Variables</i>					
Education Spending_lag (%)				0.84† (0.05)	
Left-Wing (% Left or LeftVeto)	0.08 (0.12)	0.005* (0.003)	0.004* (0.003)	0.002 (0.001)	0.001 (0.001)
Agenda	-0.16† (0.05)	-0.16† (0.05)	-0.17† (0.05)	-0.08‡ (0.03)	-0.07† (0.02)
Moderate Economy <sub>t-1</sub>			0.05 (0.16)		0.08 (0.07)
Bad Economy <sub>t-1</sub>			0.14 (0.18)		0.14* (0.08)
Severe Economy <sub>t-1</sub>			0.26 (0.25)		0.17* (0.10)
<i>Control Variables</i>					
Democracy (Polity)	-0.006 (0.03)	-0.02 (0.03)	-0.03 (0.03)	-0.004 (0.01)	-0.003 (0.009)
Election Year (dummy) <sub>t-1</sub>	-0.007 (0.06)	-0.01 (0.06)	-0.002 (0.06)	0.01 (0.07)	-0.024 (0.03)
Trade (% GDP)	0.015† (0.002)	0.014† (0.002)	0.014† (0.002)	0.00 (0.00)	0.005† (0.00)
FDI Net Flows (% GDP)	0.04 (0.03)	0.04 (0.03)	0.04 (0.03)	0.02* (0.01)	0.008 (0.006)
Unemployment (% Population)	-0.01 (0.02)	0.002 (0.02)	0.003 (0.02)	-0.008 (0.009)	-0.009 (0.006)
Age over 65 (% Population)	-0.07‡ (0.03)	-0.07‡ (0.03)	-0.07‡ (0.03)	-0.02 (0.01)	-0.03‡ (0.01)
Urban Population (% Population)	-0.02† (0.005)	0.02† (0.005)	0.02† (0.005)	-0.003 (0.002)	-0.008† (0.002)
Employee in Industry (% Total Employment)	-0.001 (0.01)	-0.004 (0.01)	-0.004 (0.01)	-0.00 (0.00)	0.007 (0.006)
GDP Growth (% Change)	-0.02‡ (0.008)	-0.02† (0.008)	-0.02† (0.009)	-0.02‡ (0.008)	-0.009‡ (0.004)
GDP per Capita (ln)	0.42† (0.16)	0.55† (0.15)	0.59† (0.15)	0.14† (0.05)	0.22† (0.05)
East, Southeast Asia	0.12 (0.33)	0.05 (0.30)	-0.005 (0.31)	-0.09 (0.10)	-0.10 (0.14)
Latin America	0.87† (0.25)	0.77† (0.22)	0.75† (0.23)	0.07 (0.09)	0.25‡ (0.10)
South Asia	-0.72‡ (0.34)	-0.52 (0.33)	-0.51 (0.34)	-0.06 (0.13)	-0.61‡ (0.26)
Sub-Saharan Africa	5.11† (1.47)	4.12† (1.12)	4.13† (1.13)	1.23* (0.70)	0.87† (0.24)
Constant	-0.22 (1.06)	-1.07 (0.97)	-1.38 (1.01)	-0.19 (0.38)	-0.75‡ (0.39)
R <sup>2</sup>	0.56	0.56	0.56	0.81	0.39
Wald Chi <sup>2</sup>	208.32	199.16	198.44	1772.65	160.05
Prob > Chi <sup>2</sup>	0.00	0.00	0.00	0.00	0.00
Number of Cases	431	469	452	420	452

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests. Estimated with Panel Corrected Standard Errors. Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummy is the excluded reference dummy.

Model 4I includes the lagged dependent variable on the right side of the equation. *AGENDA* is still statistically significant, but the magnitude of effect has gone down by more than 50%, and all the control variables either lost their statistical significance or the magnitude of effect. This result is explained by the  $R^2$ .  $R^2$  without the lagged dependent variable has been around 56%, explaining 56% of variance. Once the lagged dependent variable is included,  $R^2$  has increased to 81%. Also, adding the *ECONOMIC UNSUSTAINABILITY* variable does not make any difference. Model 4I tells us that there might not be much difference of education spending from year to year within a country. Therefore, unlike my expectation, economic conditions do not seem to influence education spending as shares of GDP. There is not much difference from the previous year within a country for education spending.

Even with log-transformed dependent variable (Model 4J), *ECONOMIC UNSUSTAINABILITY* is not statistically significant. Separately, *BAD ECONOMY* and *SEVERE ECONOMY* are statistically significant at 90% confidence, but 95% confidence intervals include 0 for both. Unlike my expectation, during economic downturns, governments are reluctant to cut education spending if not increase it. It could mean that during economically hard times, governments increase social spending rather than education spending. In other words, education spending neither increases nor decreases significantly. Or it could indicate that certain education spending items cannot be cut down, such as maintaining primary school. It is more likely that governments will try to cut down teachers' wages and school employees. In most developing countries, teachers are public-sector employees, so any cut in wages would result in decrease in *Compensation of Employees* data (wages, salaries of public sector employees plus employer contributions in WDI data set), not in education spending data. Still, running regression on a panel data set allows us to test whether difference in economic conditions and institutional

setting have effect on the level of education spending in different countries. Thus, I turn to Model 4H and 4J, which do not include the lagged dependent variable and discuss robust results on *AGENDA*.

When agenda setters propose reform (*AGENDA*=1) from not proposing any reform (*AGENDA*=0), education spending will decrease by 0.16% of GDP. Education spending as % GDP in the model sample ranges from 0.18% to 14.32%, and the mean is 3.09% with standard deviation of 1.67. Substantively, the increase would mean 10% change of one standard deviation. One can say it is a small difference between no proposal of reform and some proposal of reform, or others can say it is a substantive increase considering that the base unit is % of GDP. 0.16% of GDP can be a big difference if the education spending was a very small percentage of GDP to start from. For example, Lithuania, whose average education spending as shares of GDP from 1993 to 2000 was 1.6% of GDP, the decrease would mean 10% decrease in education spending.

Model 4J tests the same model as Model 4H (with % *LEFT* and *ECONOMIC UNSUSTAINABILITY*) on the log-transformed education spending as shares of GDP. Left-wing in legislature is not statistically significant as other model specifications. *AGENDA* is still statistically significant. When agenda setters propose reform (*AGENDA*=1) from not proposing any reform (*AGENDA*=0), logged education spending will decrease by 0.07. This means that education spending as shares of GDP will decrease by 1.17% ( $\log_{10} X = 0.07$ , and  $X$  is 1.17). This is substantively significant as the mean of education spending as % GDP was around 3%.

As I briefly discussed in the research design section, in order to test whether the left-wing particularly compensates the working class more than non-left governments, we need to look at the ratio of social protection spending to education spending. With the same model



specifications, I test my model on the ratio of social protection spending to education spending (*SOCIAL\_EDU*) and the results are presented in Table 4.3 below.

[Table 4.3 here]

Model 4K and Model 4L have the same model specification. The dependent variable for Model 4K is the ratio of social spending to education spending, and for Model 4L it is the log-transformed ratio of social spending to education spending. The percentage of left-wing in legislature does not have any statistically significant effect. Using the left-wing veto player variable instead of *% LEFT* has the similar results. Against my expectation, I cannot find any positive nor negative effect of left-wing on the level of social protection spending compared to education spending.

The *AGENDA* variable, on the other hand, shows consistently robust positive effect on the ratio of social spending to education spending without the lagged dependent variable. However, with lagged dependent variable on the right side of the equation makes almost every variable statistically insignificant and zero-effect on the ratio of social spending to education spending. The  $R^2$  of 78% (*SOCIAL\_EDU*) and 93% (*logged SOCIAL\_EDU*) explain that most of variances in the data are explained by the previous ratio of social spending over education spending.

**Table 4.3. Effects of Left-Wing on Ratio of Social Spending over Education (1978 to 2006)**

	<b>Dependent Variable: Education Spending as % Total Expense</b>			
	<u>Model 4K</u>	<u>Model 4L</u>	<u>Model 4M</u>	<u>Model 4N</u>
	with ratio	with ratio (log)	4K+lag dep	4L+lag dep
<i>Explanatory Variables</i>				
Ratio_lag (%)			0.70† (0.05)	0.89† (0.02)
Left-Wing (% Left in legislature)	-0.00 (0.006)	0.002 (0.002)	-0.004 (0.003)	-0.00 (0.00)
Agenda	0.18* (0.11)	0.09‡ (0.04)	0.12* (0.06)	0.01 (0.02)
Moderate Economy <sub>t-1</sub>	-0.04 (0.34)	0.04 (0.11)	-0.01 (0.20)	0.06 (0.07)
Bad Economy <sub>t-1</sub>	0.33 (0.39)	0.14 (0.13)	0.30 (0.21)	0.09 (0.07)
Severe Economy <sub>t-1</sub>	0.13 (0.48)	0.08 (0.15)	0.24 (0.26)	0.07 (0.08)
<i>Control Variables</i>				
Democracy (Polity)	-0.16 (0.10)	-0.03 (0.03)	0.01 (0.04)	-0.003 (0.01)
Election Year (dummy) <sub>t-1</sub>	0.04 (0.11)	-0.04 (0.04)	0.14 (0.10)	-0.009 (0.04)
Trade (% GDP)	-0.02† (0.005)	-0.003 (0.002)	-0.006† (0.002)	-0.00 (0.00)
FDI Net Flows (% GDP)	0.02 (0.02)	0.007 (0.007)	0.01 (0.02)	0.002 (0.005)
Unemployment (% Population)	0.06‡ (0.03)	0.03† (0.01)	0.02 (0.02)	-0.002 (0.005)
Age over 65 (% Population)	0.15* (0.08)	0.09† (0.03)	0.05 (0.03)	0.01 (0.01)
Urban Population (% Population)	0.04† (0.01)	0.02† (0.005)	0.005 (0.004)	-0.00 (0.001)
Employee in Industry (% Total Employment)	0.01 (0.03)	0.01 (0.007)	0.01 (0.02)	0.006 (0.003)
GDP Growth (% Change)	-0.005 (0.02)	-0.001 (0.007)	-0.02 (0.01)	-0.008* (0.004)
GDP per Capita (ln)	-0.53* (0.28)	-0.13 (0.10)	-0.02 (0.12)	0.002 (0.03)
East, Southeast Asia	-0.56 (0.89)	-0.21 (0.37)	-0.18 (0.36)	-0.09 (0.10)
Latin America	-1.87‡ (0.78)	-0.66‡ (0.31)	-0.33 (0.27)	-0.03 (0.08)
South Asia	-1.96‡ (0.84)	0.16 (0.40)	-0.23 (0.33)	-0.09 (0.11)
Sub-Saharan Africa	-2.86† (1.10)	-1.60† (0.47)	-0.37 (0.46)	-0.33 (0.24)
Constant	5.65† (1.89)	-1.01 (0.70)	0.07 (0.92)	-0.09 (0.27)
R <sup>2</sup>	0.24	0.34	0.78	0.93
Wald Chi <sup>2</sup>	89.82	215.57	756.73	3568.08
Prob > Chi <sup>2</sup>	0.00	0.00	0.00	0.00
Number of Cases	414	414	378	378

Note: † indicates  $|p| < .01$ ; ‡ indicates  $|p| < .05$ ; \* indicates  $|p| < .10$ . Statistical significances are based on two-tailed tests. Estimated with Panel Corrected Standard Errors. Middle East and North Africa dummy is dropped because the sample does not include any country from that region. Eastern Europe and Post-Communist dummy is the excluded reference dummy.

Some of the regression results show that agenda setters compensate the workers by increasing the ratio of social security and welfare spending to education spending even when they tried to balance the budgets by introducing fiscal austerity programs and liberalization efforts. Why can we not see the effect of left-wing parties in government spending? The reason is that agenda setters who try to impose unpopular reform efforts (most of time) appease the possible losers from the reform and at the same time also appease the left-wing parties in the legislature. In other words, as they propose tighter budget, increasing the social security and welfare spending or not reducing it is a way to appease the possible veto players and a way to increase the rents that are available for the legislatures to claim credit for. Agenda setters propose either expansive or reformist policies. The legislature has an option to veto or support the proposals. If reformist policies include some rents that can be used to target some constituencies, who will be losers from the reform and who has enough political power to voice against such policies (such as trade unions, public sector unions, teachers unions, etc), then veto players use these rents to increase their probability of winning election as they can claim the credit for those rents, even if reform takes place during economic downturns.

## **CONCLUSION**

In this chapter, I have shown that agenda setters increase or do not cut social protection spending while cutting or not increasing education spending. I do not find positive relationship between left-wing parties and social security and welfare spending nor negative relationship between left-wing parties and education spending. Once economic conditions are considered and agenda setters' role is accounted for, left-wing parties do not seem to affect discretionary budget items. Does this mean that left-wing parties do not matter or does this even mean that

ideology just does not matter in developing countries? I believe that just the existence of left-wing parties as potential veto players put some pressure on agenda setters when they propose budgets. However, if government can gain more public support through more social protection spending, right-wing government might do the same, and this is why we do not see much difference between left and right. Therefore, I now turn to case studies of some countries in the next chapter to look deeper in this matter.

#### **APPENDIX 4.1.**

Countries included for social protection spending as shares of GDP and ratio of social spending over education and health spending:

Albania, Argentina, Bangladesh, Belize, Bolivia, Brazil, Bulgaria, Chile, Colombia, Costa Rica, Croatia, Czech Republic, Dominican Republic, Ecuador, El Salvador, Estonia, Fiji, Georgia, Ghana, Grenada, Guatemala, Hungary, Jamaica, Kenya, South Korea (Republic of Korea), Latvia, Lesotho, Lithuania, Madagascar, Malaysia, Mauritius, Mexico, Moldova, Mongolia, Namibia, Nicaragua, P.N. Guinea, Panama, Paraguay, Philippines, Poland, Romania, Russia, Slovakia, Solomon Island, South Africa, Sri Lanka, Thailand, Trinidad and Tobago, Turkey, Ukraine, Uruguay, Vanuatu, Venezuela, Zambia

## Chapter 5. Economic Policies during Crisis: Country Cases

### INTRODUCTION

In this chapter, I present case studies in ten countries in the regions of Africa, Eastern Europe/Post Communist countries, and Latin America. For the case studies, I select cases to provide cases in which all governments included the left, none included the left, and governments varied over time. I exclude the cases that had major external factors that would overwhelm the reform efforts such as major flood or famine. From Africa, I look at Ghana whose governments vary from left to right, and Madagascar whose governments always include left from 1993 to 2002 and no left since 2003. From Asia, I include India whose governments always include left until 1998 and South Korea whose governments never include left. From Eastern Europe and Post-Communist countries, I examine Bulgaria whose governments vary, Poland whose governments always include left, and Latvia whose governments never include left. From Latin America, I look at Argentina whose governments vary, Uruguay whose governments never include left, and Bolivia whose governments usually include left. No Latin American cases include countries who always had left-wing in government. I compare countries within regions and across regions at the end. I discuss each country's economic and political conditions and then present budget deficits, economic unsustainability data, and welfare spending data.<sup>26</sup>

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<sup>26</sup> Information on countries comes from Economist Intelligence Unit's *Country Profile* and *Country Report*, otherwise noted.

## **AFRICA**

### **Ghana (from 1992 to 2006) – sometimes include left in government**

Jerry John Rawlings had run Ghana as a military ruler from 1981 to 1992. From 1992 to 2000, he served as a democratically elected president. In 1981, the Provisional National Defense Council led by Rawlings was at first radical and socialist. This technocratic military government abolished the corrupt party politics and purged the former government leaders. They implemented socialist economic policies, which froze bank accounts. In 1983, however, the PNDC government implemented one of Africa's first and longest running IMF-led structural adjustment programs. In 1992, J. J. Rawlings won the presidential election with his newly-founded party, the National Democratic Congress (NDC). The opposition party, New Patriotic Party (NPP) won 66 seats out of 200 seats. The New Patriotic Party (NPP) was a right-leaning political party with commitment to market-based economy.

John Agyekum Kufuor and his New Patriotic Party (NPP) won the presidential and parliamentary elections in 2000, ending the Rawlings' rule. Mr. Kufuor and his party won again in the presidential and parliamentary elections in 2004. Since coming to power, the Kufuor administration and the NPP party have continued the IMF-led economic adjustment programs. Economist Intelligence Unit reports that the structural adjustment efforts even though continued, were slow and expansive spending policy was prominent during election years.

Throughout the 1990s, the fiscal deficits in Ghana continued to rise until the NPP came to power in 2000. From 1992 to 2000, the fiscal deficits averaged 8.66% of GDP. In 2000, Ghana was hit hard by debt crisis. When it came to power, the NPP identified the economic problems as high fiscal deficit, huge public-sector debt, falling economic growth, rising inflation, and high unemployment. The New Patriotic Party announced its first budget plan in March 2001,

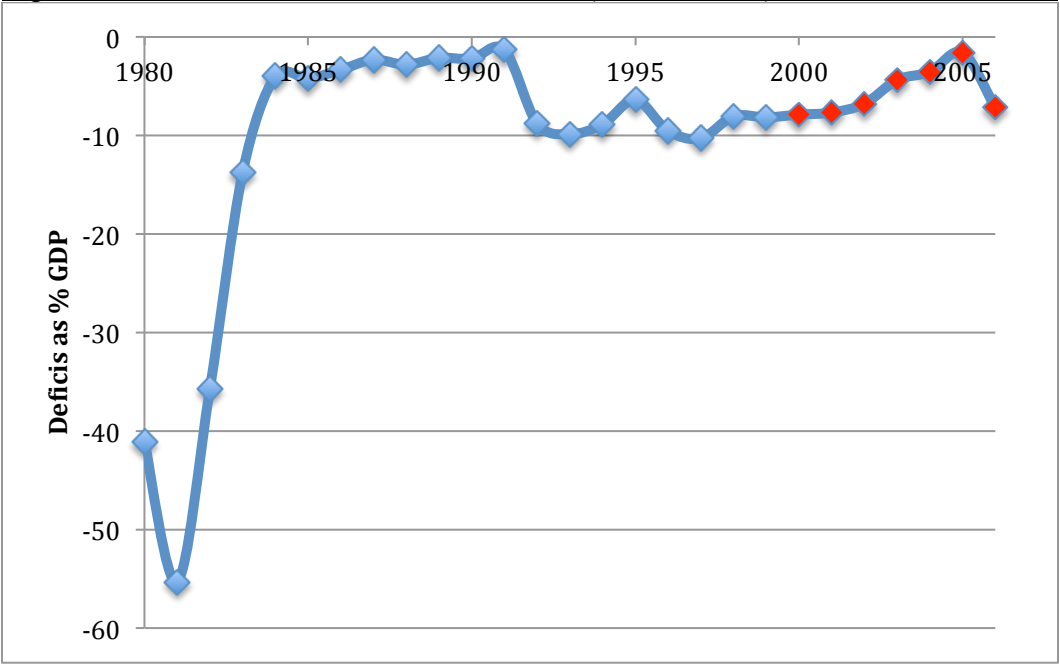
promising to promote macroeconomic stability and to create stable environment for sustainable growth. The administration's commitment to neo-liberal reformist policies pushed for tighter fiscal policy. Also, the NPP government signed the agreement with the IMF, a "poverty reduction and growth facility (PRGF)" agreement in May 2003, lending 258 million US dollars over 3-year period. The agreement asked the government to reduce public spending and reform the banking and financial sector. Since then, the average fiscal deficits have been -4.72, and the deficits were reduced by 1.6% of GDP in 2005. However, in 2006, the NPP government's renewed infrastructural project along with new public-sector wage settlement relaxed the fiscal discipline, causing the deficits to reach 7.12% of GDP in 2006. With prudent fiscal policy and Ghanaian cedi's stability, inflation declined from 32% in 2001 to 10.9% in 2006.

Even though Ghana held its first multi-party election in 1992, because J. J. Rawlings continued his rule from 1980, his administration and later party identification to investigate partisanship effect on economic policy during crisis. After coming to power in 1980, Rawlings' government was socialist and implemented socialist policies, freezing the bank assets. However, once the economy went into severe conditions, in 1983, the government reversed its policy direction and accepted the IMF-led economic programs and continued until handing power over to the right-leaning NPP party in 2000. This supports my argument that once economy becomes so bad, even left-leaning government (we will refrain from giving it party since it was the single party military dictator regime until 1992) adopts reformist policies.

Figure 5.1 below shows Ghana's budget deficits change over the years from 1980 to 2006. From 1980 to 2000, the government party was left-wing. From 2000, the NPP party was right-wing (denoted with the red dots). The right-wing NPP government was more successful at balancing the budgets, but left-leaning NDC governments was also very successful at balancing

the budgets from 1984 to 1992. But once economy seemed stabilized, and as the party was up for multi-party election for the first time, the NDC government started to expand its spending and the deficits increased from 1.32% in 1991 to 8.78% in 1992. Right before the 1992 elections, government increased the public-sector pay in large term, and the result was a large deficit, which fuelled inflation. In 1994 and 1995, the government exercised moderate fiscal discipline, but Ghana once again faced elections in 1996, which resulted in a large deficit of 9.54% of GDP and suspension of the IMF assistance program from 1996 to March 1998. The finance minister, Richard Kwame Peprah, took corrective measures in 1997, but these measures failed to balance the budgets, which led to the debt crisis in 2000 and presidential and legislative win by the right-wing party. From 2000 onward, the budget balances seem to improve and hits the low 1.6% of GDP in 2005.

Figure 5.1. Ghana: Fiscal Deficits as % GDP (1980 to 2006)



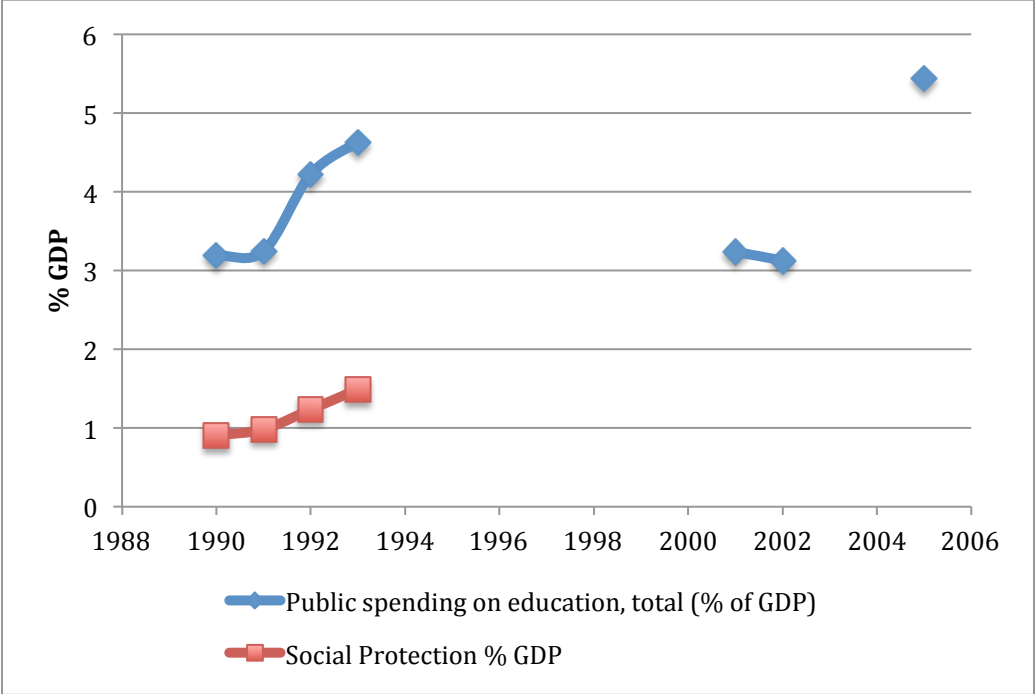
Source: African Development Bank. On-line Data

Then, what about social welfare spending? I argued that during economic crisis and implementation of reformist policies, governments increase the social protection spending or do



not cut the social protection spending compared to other spending such as education and health spending. Figure 5.2 below illustrates that both education spending (% GDP) and social protection spending (social security and welfare) (% GDP) increased from 1990 to 1993. Then, education spending decreased from by almost 1.5% from 1993 to 2001. There are missing years in the data and one can assume that the decline was continuous from 1993 onward.

Figure 5.2. Ghana: Spending on Education vs. Spending on Social Protection (% GDP)

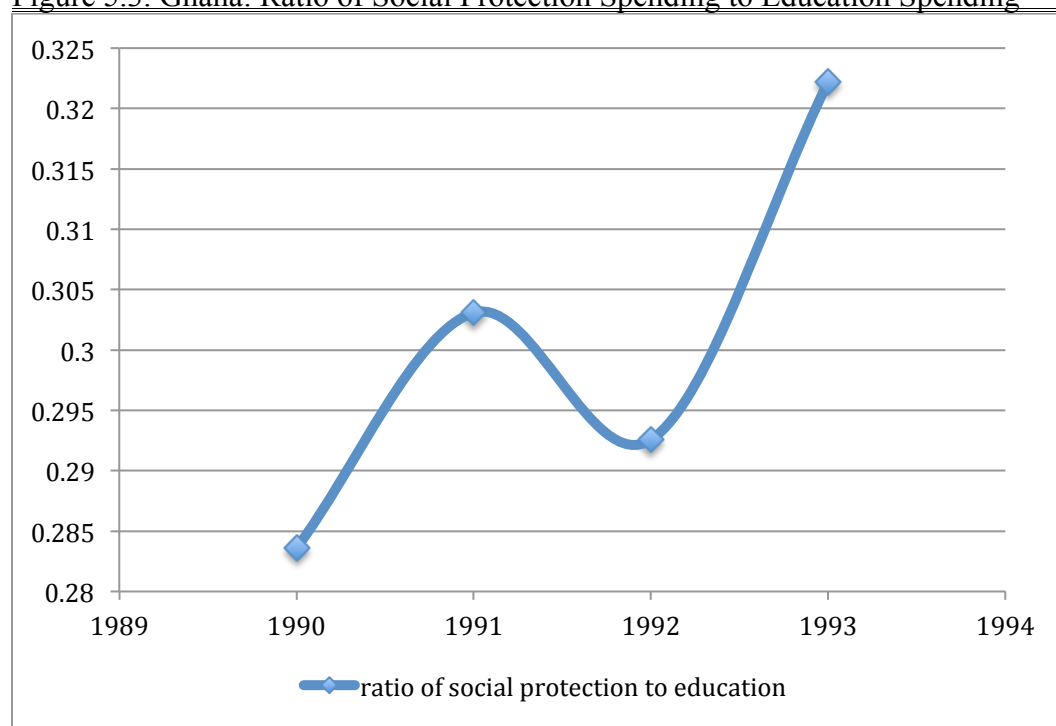


Source: IMF. *Government Finance Statistics* (various years).

Figure 5.3 below actually illustrates the spending trend better, using the ratio of social protection to education spending. With limited data, there are only 4 data points, but still it shows the trend of government spending for Ghana. Ghana spent more shares of government spending on education than on social protection to start from. However, the ratio of social protection spending to education spending shows that the rate of increase is greater in social protection spending. It shows that government indeed increased social protection spending. From 1992 to 1994, however, the government increased its spending and increase in both social

protection and education spending could be the result of it. Still, the ratio of social protection spending to education spending data in Ghana shows that government increase social protection spending more than it does education spending.

Figure 5.3. Ghana: Ratio of Social Protection Spending to Education Spending



Source: IMF. *Government Finance Statistics* (various years).

### **Madagascar (from 1993 to 2006): Always Include Left until 2001 and No Left in Government since 2002**

Since 1975, post-colonial Madagascar embodied socialism, disrupting foreign private ownership and co-operation with French investors from the French colonial rule. In 1980, the country faced the balance-of-payments crisis and gradually started liberalization efforts, only ending in failure of economic revival, but triggering democratization. Madagascar first held its multi-party election in 1993. Albert Zafy, leader of Forces Vives (FV), an opposition alliance of 16 groups, defeated Didier Ratsiraka, the former dictator and became the new president. Zafy was a radical populist and his party, Forces of Vives (FV) was radical left. But once the

government took office, the prime ministers pushed for the IMF supported economic programs, and Zafy disputed with the succession of three prime ministers, who all believed that Madagascar should accept the austerity and structural adjustment programs.

In August 1996, President Zafy was finally impeached by the parliament, which supported the prime minister's efforts to reform and the finance ministry's negotiation with the IMF. In the following presidential election, the former dictator, Didier Ratsiraka was elected and formed a coalition government consisting of his party, Avant-garde de la revolution malgache (Arema) and the Leader-Fanilo party. The government also relied on the centrist opposition parties for the support of economic adjustment programs. This isolated the radical left, Forces of Vives, which opposed the reformist economic policies as opposition; thus opposition to economic reform and adjustment programs were weak.

In the 1998 legislative election, Association pour la renaissance de Madagascar (Arema) and its main ally, Leader-Fanilo won a narrow majority with 79 seats out of 150 seats in the National Assembly. The coalition government included small left-wing parties. The moderate opposition Ny asa vita no ifampitsara (AVI; "People are judged by the work they do"), led by a former prime minister Norbert Ratsirahonana, won 14 seats. Zafy's radical party, Asa, Faharaminana, Fampanrasoana, Arinda (AFFA; "Action, Truth, Development, Harmony"), won only six seats. President Ratsiraka appointed Tantely Andrianarivo, the technocratic deputy premier for finance in the outgoing administration, as prime minister, showing the government's resolution to continue the reformist economic measures led by technocratic prime minister and the cabinet. The liberalization and privatization, however, were slower than the IMF or donor countries would have like to be.

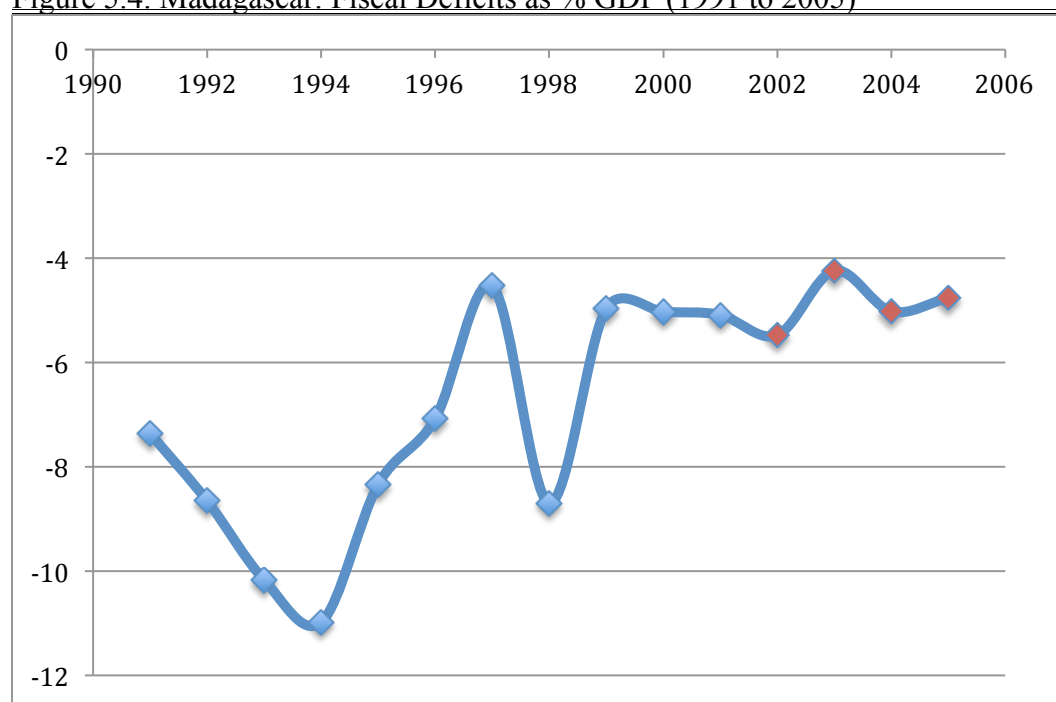
*Economist Intelligence Unit* reports that the public-sector trade unions did not express their opposition in any way militant, but the business more vigilantly voiced their dislike of the tight fiscal and regulatory policies. Some privatization income was used to pay off salaries owed to the former employees of the parastatals and to finance the severance packages and social measures to those who lost jobs due to the privatization and liberalization efforts during the Arema administration.

In 2002, Marc Ravalomanana, a businessman, who is committed to market-driven economic system, won the presidential election, and his party, the right-leaning Tiako-i-Madagasikara (TIM) and its coalition claim the majority in the parliament. The coalition government did not include left-wing parties. The government's top priority in agenda was faster liberalization and acceleration of privatization programs. Madagascar continued the poverty reduction and growth facility (PRGF) programs, and reform was more rapid and progress of liberalization and privatization were pursued more vigorously.

Figure 5.4 below illustrates Madagascar's fiscal balance as % GDP from 1991 to 2005. From 2002, the government did not have left-wing veto players, so I denote it in red dots. I show the data from 1991 even though its first democratic election was held in 1993 to show how bad economy was before a democratic government started. One of the poorest countries in the world, Madagascar's economy was in bad shape. From 1993 to 1996, when there was a stalemate between the President and the Prime minister regarding reformist policies, the average fiscal balance was 9.14% of GDP, which are high. In 1997, the deficit improved to 4.5%, but in 1998 during election year, the deficit plummeted again to 8.7% of GDP. However, since the right-leaning government, although it included left-wing, improved the fiscal deficit quite successfully, reaching 5.66% of GDP on average under Arema government. Since the right-

wing TIM party took over in 2002 whose coalition does not include left-wing, the average fiscal deficit has been 4.67% of GDP.

Figure 5.4. Madagascar: Fiscal Deficits as % GDP (1991 to 2005)

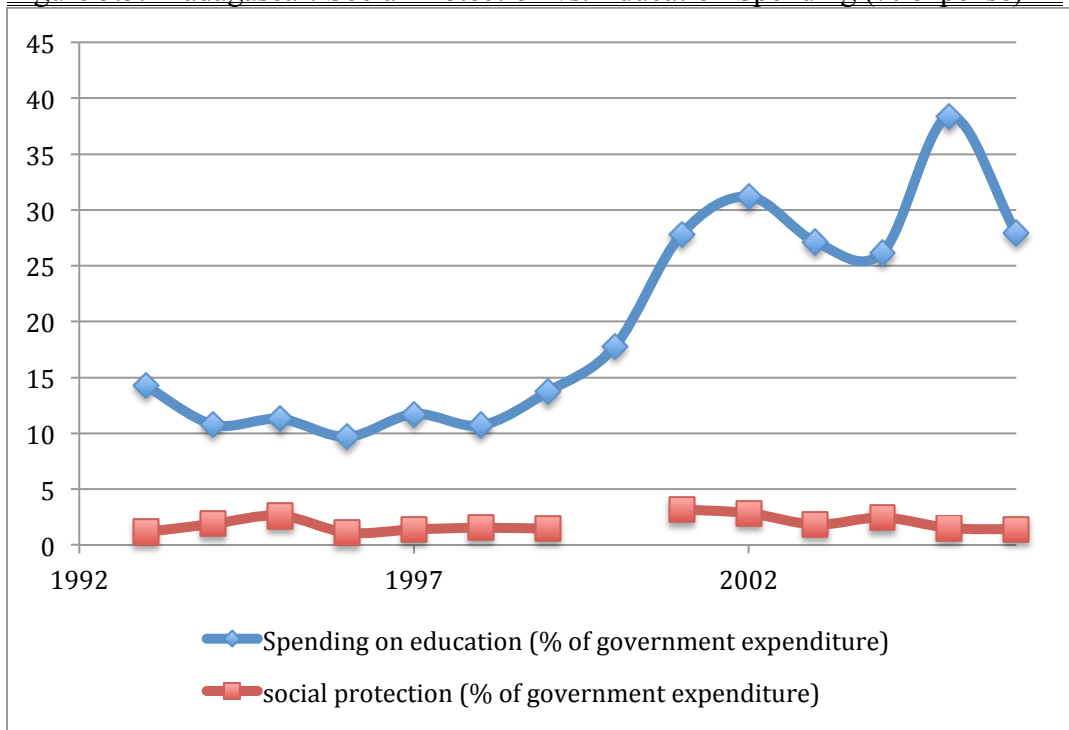


Source: IMF. *World Economic Outlook*. (various years).

Figure 5.5 below shows the education spending as % expenditure and social protection (social security and welfare) spending as % expenditure from 1993 to 2006.<sup>27</sup> Madagascar originally has spent on education far more than on social protection. The education spending seems to have increased steadily, but it is hard to tell whether social protection spending has increased in general. From 1993 to 1999 under the coalition governments which included left-wing, social protection spending seems to have increased a little. Under the TIM coalition without left-wing, social protection spending seems to have decreased a little.

<sup>27</sup> I show spending as % expenditure, not as % GDP for Madagascar because % GDP data have too many missing values.

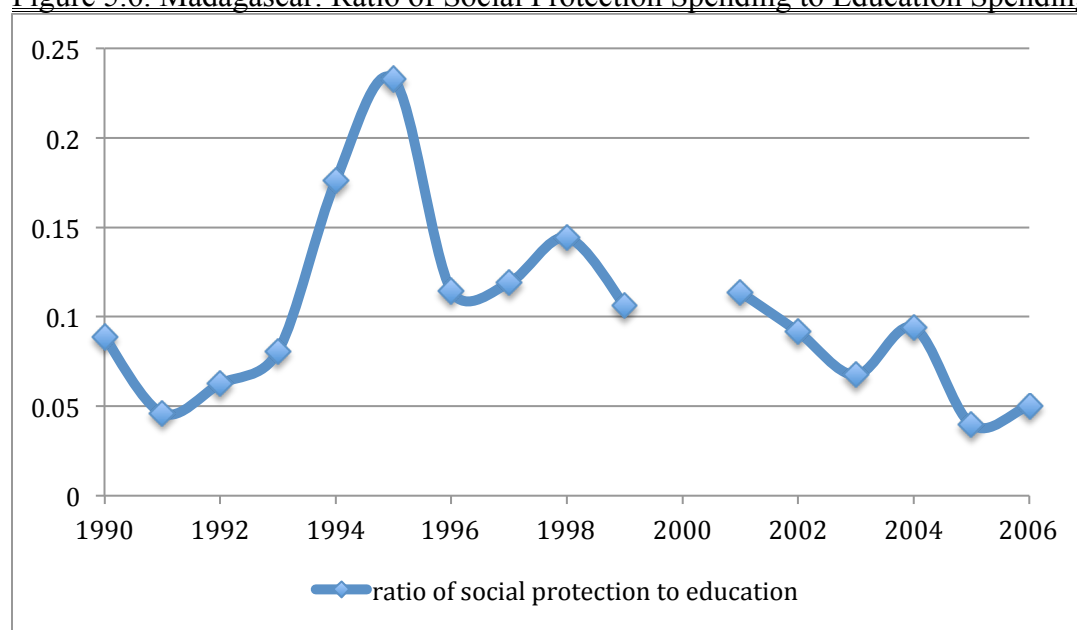
Figure 5.5. Madagascar: Social Protection vs. Education Spending (% expense)



Source: IMF. *Government Finance Statistics* (various years).

In order to compare social protection spending and education spending, I look at the ratio of social protection spending to education spending (Figure 5.6). From 1993 to 1996, when the radical political party and the President openly opposed the government (technocratic prime minister, so the agenda setters would be the prime minister), the ratio of social protection to education spending seemed to increase, meaning that the government increased the social protection spending at a faster rate than it increased education spending. Actually, Figure 5.5 above shows that from 1993 to 1996, education spending decreased. When the government switched to Arema, right-leaning government, and technocratic prime minister with market-oriented policies, the ratio of social protection spending to education spending started to decline and reached very low under the new TIM government with radical reform agenda.

Figure 5.6. Madagascar: Ratio of Social Protection Spending to Education Spending



Source: IMF. *Government Finance Statistics* (various years).

## ASIA

### India (from 1978 to 2006) – Always Left in Government or Left Majority in Opposition until 1998

Since its independence from the British Empire, India's first prime minister, Jawaharlal Nehru and his successor Indira Gandhi (Nehru's daughter) established a socialist economic system, which continued until the early 1980s. The economic policy focused on increasing self-sufficiency through Import Substitution Industrialization and development of state-owned enterprises.<sup>28</sup> Indira Gandhi founded the left-wing party, Congress I. In 1984, Gandhi was assassinated, and her son, Rajiv Gandhi succeeded her as prime minister and secured the unprecedented majority in legislature in the general election.<sup>29</sup> Once he was in office, Gandhi

<sup>28</sup> Many development economists find that the reason why early developing countries set up state owned enterprises was that foreign investment in developing countries did not come in as they hoped to occur (foreign investors and multilateral bankers, for example, would rather lend money with high interests than actually investing in high-risk environment in developing countries), so the state had to come in and take the role of investor in order to start the industrialization.

<sup>29</sup> "Congress" is the name of the party in India.

gradually started economic liberalization. In 1989 election, Gandhi's administration lost its majority, and Gandhi was assassinated in 1991 during election campaign. After the 1991 general election, a minority government was formed under Narasimha Rao from the Congress, who started more comprehensive economic reform after the financial crisis hit the country. In 1996, the Congress party lost the general election to the Hindu nationalist Bharatiya Janata Party (BJP), whose government lasted just thirteen days. A minority left-leaning United Front (UF) coalition supported by the Congress formed a government and continued economic reform packages and liberalization efforts. In 1997, the Congress withdrew support, which triggered the general election. In March 1998, the Bharatiya Janata Party (BJP) formed a coalition government with thirteen different parties, but collapsed in less than a year. From the 1999 general election, the BJP formed a coalition government with twenty-five parties.

In India, vested interests—protected industrialists from Import Substitution Industrialization and unions—with connection to politicians made sure that the economic reform initiatives were limited to a little export liberalization, minor modification in tax system, and minor industrial deregulation during the 1980s. However, the balance of payments crisis in 1991 prompted the government to seek emergency packages from the IMF, forcing more significant changes to largely inefficient economic structure. In 1991, the Congress government liberalized the fixed exchange rate regime, devaluing rupees by 22% against the US dollars. In 1994, the efforts to convert foreign exchange to capital account led to the current-account convertibility law.

The BJP coalition represent traditional Hindu values and is closely associated with middle class and small businesses and traders. In 1996, the nationalist BJP-led government continued the liberalization process due to sanctions from the nuclear testing and downgrading of



credit rating. The BJP government significantly reduced the bureaucratic red-tapes on industry and opened the financial and insurance sectors and telecommunication sectors to encourage foreign direct investment. The government also lifted the quantitative restrictions on imports abiding by the WTO guideline in 2001. However, privatization of state-owned enterprises, deregulation of labor market, and reduction of subsidies in state budget met considerable opposition from the coalition and from the opposition Congress party. Only two state-owned enterprises, Modern Foods and Bharat Aluminium Company (Balco) were privatized.

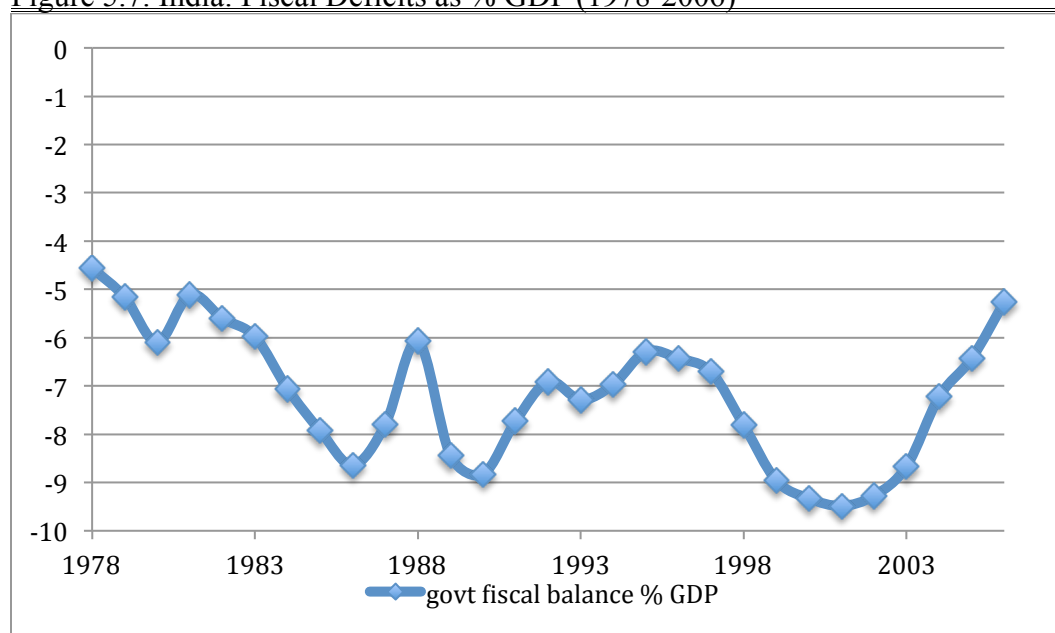
In 2004, the United Progressive Alliance—dominated by the Congress party—formed a minority government but supported by the Left Front—several left-leaning parties including the Communist Party of India (Marxist). Prime minister, Manmohan Singh, a former governor of the Reserve Bank of India—central bank of India—and the deputy chairman of the Planning Commission. Singh was considered pragmatic economist and therefore was able to hold the coalition together. With finance minister, P. Chidambaram, former finance minister of 1996-1998 administration, was known to be pro-market and to prefer prudent budget. Interestingly, the Congress party in the legislature acted like the opposition to the United Progression Alliance, in which it is the largest group. The main split between the government (prime minister and cabinet) and the coalition-government party (minority in legislature but supported by the left) is regarding economic liberalization.

India's reform efforts and especially the fiscal discipline were hard to achieve because of powerful interest groups. The United Progressive Alliance relies heavily on trade unions in three regions: West Bengal, Tripura, and Kerala for electoral support. When there are more than 10 employees, they are considered an "organized sector" in India, and there are about 30 million works in some type of "organized sector" out of 400 million of total workforce. They have

become politically powerful and openly oppose the reformist policies. Economist Intelligence Unit reports that reducing subsidies, raising the tax take, laying off government employment and privatizing the state owned enterprises were typically difficult to implement. The problem of fiscal deficits in India is partly because of lack of tax collection: only 32 million people out of 1224 million people—only 2.6% of total population—pay tax in India.

Figure 5.7 below show the fiscal deficits of India from 1978 to 2006. It is clear that India has a chronic fiscal deficit problem. Fiscal deficits have never been below 4% of GDP. Still, there were ups and downs. One of the most notables is from 1995 to 1998 when the Congress or Congress-supported coalition of parties were in power, 1999 to 2003 when the non-left, nationalist BJP coalition was in power, and after 2004 when the United Progressive Alliance with left-wing coalition partner or supporter took office.

Figure 5.7. India: Fiscal Deficits as % GDP (1978-2006)

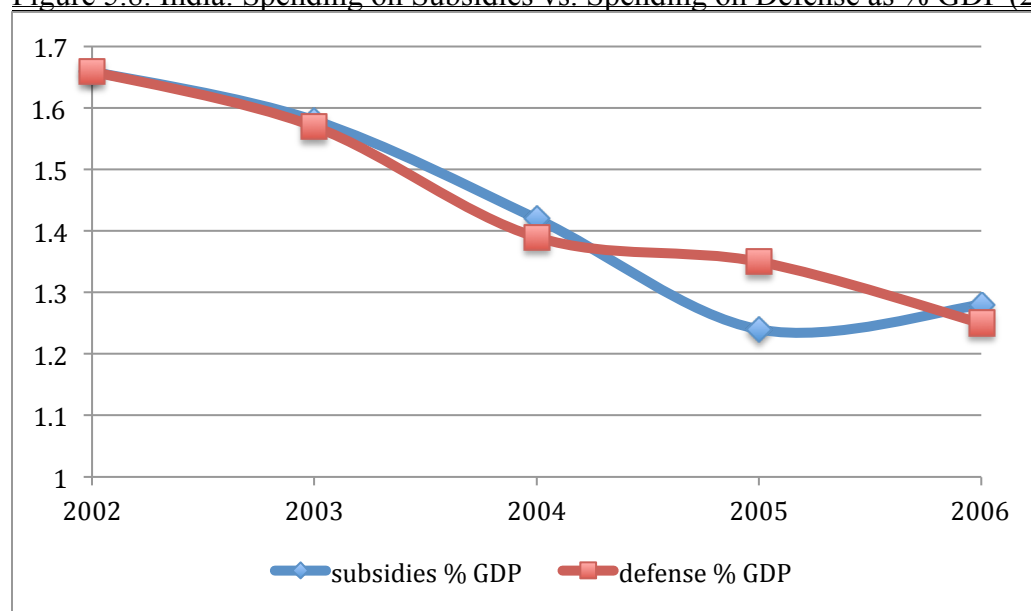


Source: from 1978 to 1987: Wibbels (2001); from 1988: IMF. *World Economic Outlook* (various years).

One of the major spending burdens on India’s budgets is government subsidy. Indian government subsidies almost everything from food, utilities, to even fertilizers for farmers.

Figure 5.8 shows the central government spending of subsidies and of defense. India's defense expense is also a big part of GDP because of nuclear development and conflict between neighboring Pakistan. Surprisingly, from 2002 to 2006, spending on subsidies has been as much as defense spending. This shows how much important role subsidies play in India. In 2002, both subsidies and defense spending were 1.66% of GDP and in 2003, subsidies were 1.58% of GDP while defense spending was 1.57% of GDP. Nonetheless, as India increasingly liberalized through gradual but consistent efforts, spending on subsidies has declined.

Figure 5.8. India: Spending on Subsidies vs. Spending on Defense as % GDP (2002-2006)

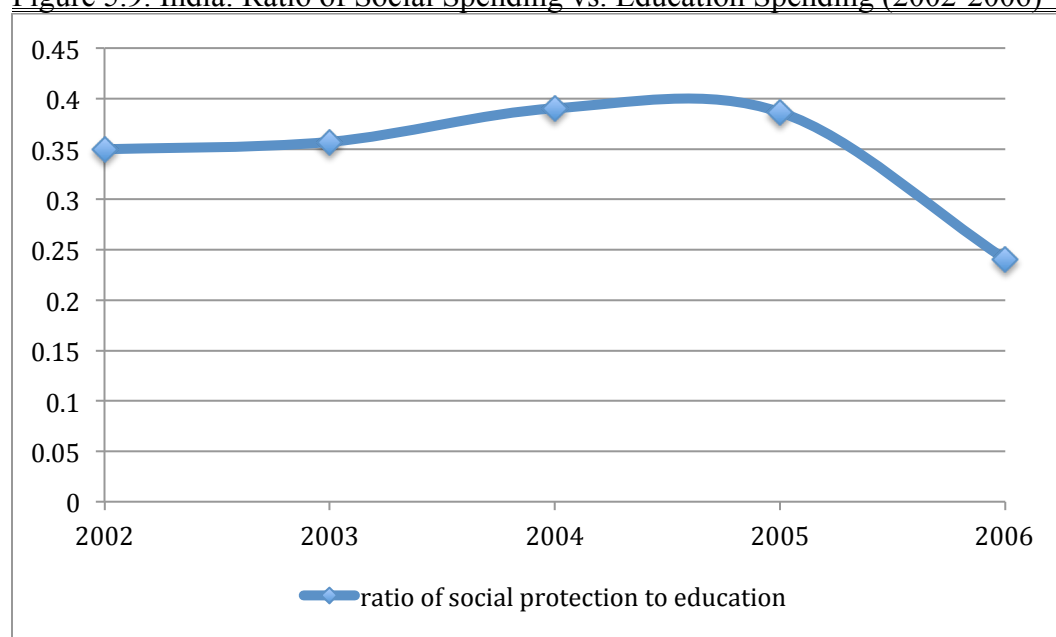


Source: P. R. Jena (2010).

The social protection data for India from *Government Finance Statistics* do not exist because states, not central government, are in charge of social spending. However, Jena (2010) finds that the central government's aids to state governments on social spending have risen because of the Centrally Sponsored Schemes (CSS). The Centrally Sponsored Schemes are implemented at the state and local level, but the central government funds the programs. Still, the share of social security and welfare spending is relatively low compared to other social

services such as education and health because social security and welfare spending are distributed from the state governments. Using data from Jena (2010), Figure 5.9 shows the ratio of social spending including welfare of state, social welfare and nutrition, and other social services to education spending. Figure 5.9 shows that from 2002 to 2004, the ratio of social spending to education spending had increased, but after 2004, when the new government with pro-reform prime minister and finance minister came to office, the ratio dropped. In 2006, the ratio was dropped by almost 100% compared to 2004 (from 0.39 to 0.24). This corresponds to decline in fiscal deficits from 2004 (Figure 5.6).

Figure 5.9. India: Ratio of Social Spending vs. Education Spending (2002-2006)



Source: P. R. Jena (2010).

India is an interesting case because Indian party system is more based on religious, caste, and regional bases rather than on broad ideological left-right spectrum. The Congress I party started from the socialist (Marxist) economic policy, but once the crisis hit, the party actually turned around to embrace the more liberal views. We can call the nationalist BJP party as center-right, but the BJP party is also a coalition of small factional parties, rooted in religious, caste, and regional differences. Therefore, such factional nature of party system and

impossibility of securing the absolute majority in legislature has stalled reform efforts rather than ideological driven preference of government and legislature. Once economic conditions were not sustainable any more, the government and divided legislature came together. This also explains why India has been slow but rather consistent with reform efforts, which inevitably resulted in more liberalized and modern economy by the end of 20th century.

### **South Korea (from 1998 to 2006): Government Never Includes Left**

South Korea since its independence from imperial Japan in 1945, it was under dictatorship until 1988 when the first elected president Roh, Tae-Woo became president. In December 1993, Roh, Tae-Woo peacefully handed over power to the first civilian-president-elect, Kim, Young-Sam, one of the former democratic movement leaders, for the first time in history of Republic of Korea. In December 1997, Kim, Dae-Jung, another former democratic movement leader and the opposition leader, won the presidential election.

From the democratic movement in the 1980s, two parties emerged based on regionalism. The National Grand Party (GNP) (after series of renaming)<sup>30</sup> is the conservative party whose political base is the southeastern part of Korea, the Kyeong-Sang province. Traditionally, the conservative grouping was anti-communist and rightist (nationalist at first). The Kyeong-Sang province has been the power base of all the former dictators and next two democratically elected presidents, Rho and Kim. Besides the regional base, the conservative grouping became center-right and pragmatic pro-market forces, and naturally, the conservative party's main supporters

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<sup>30</sup> Renaming of party is common in South Korea whenever a party leader changes, a party realigns itself with other groupings, or forms a coalition with other small parties (that are usually personalistic). For instance, most recently, the Grand National Party renamed itself to New before the general local election in early 2012 to distance itself from unpopular president and to get ready for the next legislative and presidential election in December 2012.

come from the business sector, upper-middle-class, and high-income groups. The conservative forces often split into small parties by personality of leaders, not by principle.

The long-time democratic opposition movement under the leadership of Kim, Dae-Jung, has become the United Democratic Party (after series of renaming) and actually came to power in 1997 and stayed in power until 2008 when the Grand National Party's Lee, Myung-Bak won the presidential election. The liberal grouping's regional base is the southwestern province of Jeolla. The liberal parties are also largely swayed by personality of leaders. Broadly, the UDP is considered center-left since its supporters are concentrated in blue-collar workers and the poor. However, the liberal grouping is not much like socialist democratic parties in other countries, so the party is coded as centrist party, not as left.<sup>31</sup> Because of relationship with North Korea and the fact that the country is still at war technically, both conservative and liberal parties are anti-communist and anti-Marxist.

The point of interests is South Korea's experience in the Asian Financial Crisis at the end of 1997. That year is also the year that the long-time opposition party, the UDP, won the presidential and general election. Historically, South Korea pursued prudent fiscal policy, not spending unless revenue was secured. Figure 5.10 clearly shows that South Korea's average fiscal balance was actually a surplus of 0.05% of GDP from 1988 to 1996.

Before the 1997 crisis, the average economic growth was 6.7% from export-led industrialization, which started from 1967. However, the country financed the industrialization with large foreign debt to buy the expensive capital goods and the raw materials. Also, the financial sector and banking sector were highly distorted to give subsidies to industries and businesses and to finance long-term investment by borrowing heavily from the foreign capital.

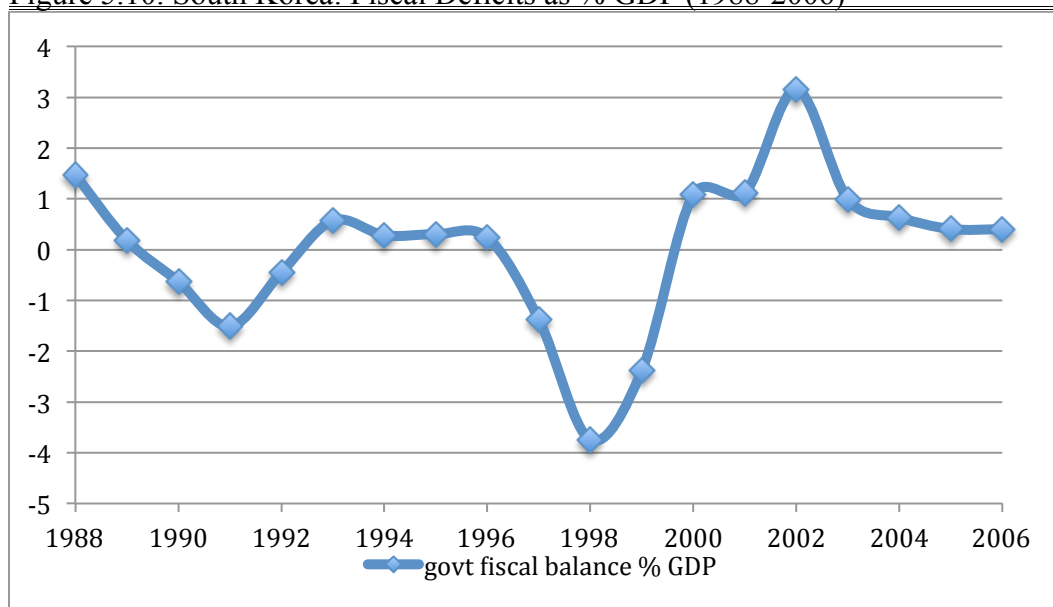
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<sup>31</sup> This coding is similar to the United States. The Republic party is coded as right and the Democratic party is coded as centrist, not as left.

The public sector and the state-owned enterprises were large. The exchange rate was highly overvalued, and once *won* was liberalized in December 1997 after the crisis, the exchange rate was devalued from 1000 won to almost 2000 won per US dollar. High interest rates and a tight monetary policy (conditioned by the IMF for the bail-out agreement) resulted in significant drop in private investment, which in turn resulted in the unemployment rate of 6.8% of total population, the highest unemployment rate recorded in post-war Korean history. This affected private consumption, and as a result by the end of 1998, the real GDP fell by 6.7%, the worst economic downturn ever (except during the Korean War). Nonetheless, South Korea bounced back so quickly as real GDP grew by 9.4% in 1999 and by 8.5% in 2000. Economist Intelligence Unit reports that this was a result of prudent fiscal and monetary policy. This came as surprise to many because South Korea has been infamous for aggressive trade unions and restrictive labor market. Especially, trade unions from the car manufacturing and state-owned enterprises are strongly organized and most militant. Certainly, the trade unions resisted more radical liberalization and structural adjustment.

After the financial crisis and bail-out agreement with the IMF to recover from the crisis, the government borrowing sharply rose from 1998 to 1999 to finance the restructuring of the state owned enterprises and improvement in social welfare. After 1999, the fiscal balances improved and reached a surplus again in 2000 when privatization and sales of major state owned enterprises to foreign investors were mostly completed (Figure 5.10). However, when more liberal Roh, Moo-Hyun from the UDP became president in 2003, the trade unions' militancy increased, and this made Roh's government to reconsider privatization of rail company and state-monopoly Korean Electric Power. From 2002 to 2003, the fiscal balances came down from surplus of 3.15% of GDP to 0.9% of GDP.

Figure 5.10. South Korea: Fiscal Deficits as % GDP (1988-2006)

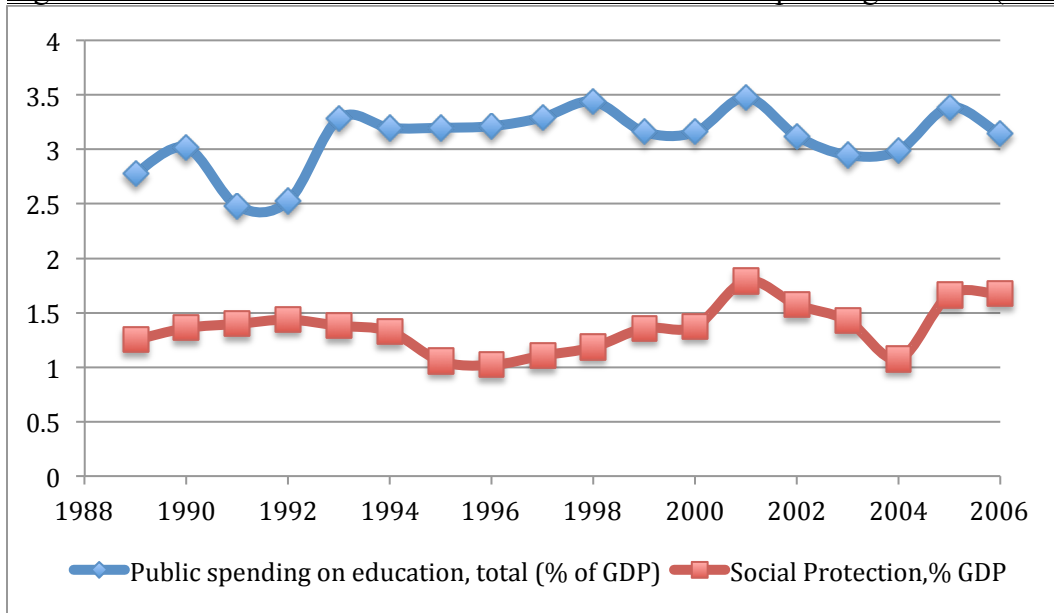


Source: Asian Development Bank. On-line Data.

Figure 5.11 also reflects the social spending of the liberal party's reform efforts and compensation efforts. From 1997, the social protection spending steadily increased and continued to increase even during structural adjustment periods of 1999 to 2000. In contrast, education spending has steadily declined from 1997. It is apparent that the ratio of social protection spending to education spending would be on the rise since government increased social protection spending and cut education spending during the radical reform (Figure 5.12). Then, from 2001, social protection spending declined almost to pre-1997 period. This is usually considered the year when government completed the bail-out packages and radical reform. Then, in 2003 the government with more liberal president, social protection spending started to increase, possibly reflecting more militant trade union activities. Moreover, even though both education and social protection spending increased after 2004, the Roh government increased social protection spending faster than it increased education spending as illustrated in Figure 5.12.

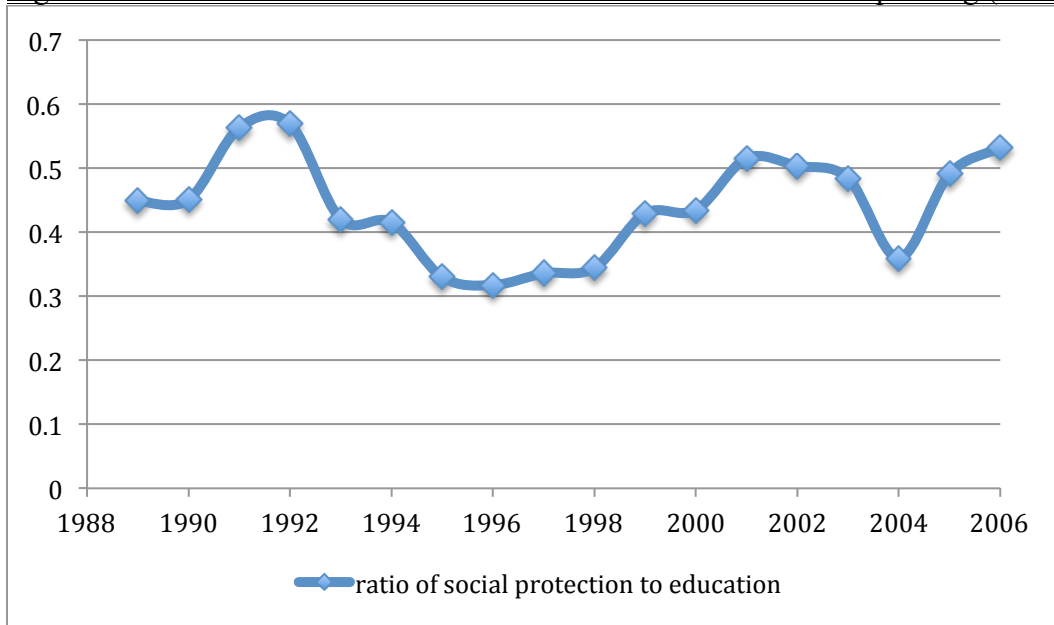


Figure 5.11. South Korea: Social Protection vs. Education Spending % GDP (1988-2006)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.12. South Korea: Ratio of Social Protection to Education Spending (1988-2006)



Source: IMF. *Government Finance Statistics* (various years).

## EASTERN EUROPE AND POST-COMMUNIST COUNTRIES

### **Bulgaria (from 1990 to 2006) – 1990-1996: Left in Government; 1997-2004: No Left; 2005-2006: Left in Government**

Since democratic transition, two major parties have been switching powers back and forth by forming coalition with small parties. The first major party is the Bulgarian Socialist Party (BSP), which renamed itself from the Bulgarian Communist Party (BCP) after the transition. The BSP successfully maintained their status as the major force in parliament in the first two elections (in 1990 and in 1991) by maintaining the party's links to the economic and administrative *nomenklatura* (the elite). The BSP embraces the ideas of democratic socialism and social market economy while holding onto the pro-communist and nationalist members. The major supporters include pensioners, villagers, elderly or low-educated people, who are opposed to structural reform and welfare reform. Andreev (1996) argues that the BSP party distanced itself from taking over the government until 1995 because if the party was in power, it would have been forced to carry out reforms, which many of its supports would not accept (Andreev 1996).

As the only viable alternative to the BSP, the Union of Democratic Forces (UDF) is a coalition of heterogeneous groups. Because of the heterogeneous characters, the UDF does not possess distinctive ideological profile, but the policies the party pursues have indicated that they are center-right oriented. The common platforms include anti-communism, commitment to structural and market reform, pro-Western orientation, and guarantee of democratic rights and liberties to citizens. Even though the party is internally divided as it is formed out of several groups, it stands firmly opposite of the BSP, making the country highly polarized, blocking the formation of a centrist party in Bulgarian society (Andreev 1996). Then, the Bulgarian political

scene met a sudden rise of a political star, Simeon Saxe-Coburg in 2001, and the new personalistic party, The Simeon II National Movement (SNM), emerged, self-defined as right-of-center party.

In June of 1990, the Bulgarian Socialist Party (BSP) came into power. It held the majority in the legislature. After series of unstable government changes and rule of government under experts<sup>32</sup>, in October 1991, the Union of Democratic Forces (UDF)—reform minded, on the right—came into power with a coalition with the ethnic Turkish Movement for Rights and Freedoms (MRF) party under the leadership of radical anti-communist Filip Dimitrov as Prime Minister. The UDF reform-minded government passed a privatization law and a revamped foreign investment law, but the government met dissent both from MRF and within its own party.

By November 1991, the stabilization program attached to the standby agreement with the IMF was carried out (Wyzan). Most consumer prices except the basic food products, petroleum, major energy sources, and pharmaceutical products, were liberalized, hyperinflation was contained, import controls were removed, interest rates were liberalized, and unified exchange rate was introduced. In 1992, restitution law is enacted and privatization law is adopted.

This government too, however, was short-lived. A scandal of arms exports to former Yugoslavia triggered vote of no confidence. In October 1992, the coalition government crumbled down as the UDF lost support of the MRF and internal friction intensified within the party. By the end of 1992, another “Government of Experts” emerged, headed by Lyuben Erov, a politically unaffiliated economic historian with support of the MRF, the BSP, and a breakaway faction of the UDF (EIU, Country Profile). Under the Government of Experts, reform was slow

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<sup>32</sup> One of them was coalition government of experts led by Prime Minister Dimitur Popov with ministers from both the UDF and the BSP.

as it did not have mandates from the UDF, and the BSP supported the government only when they wanted to. In early 1993, large-scale privatization began. However, privatization, especially the mass privatization was stalled as the legislature failed to pass privatization programs regarding tourism and mass privatization in 1993 and early 1994 (Pamouktchiev et al. 1997). In response to slow structural reform, the IMF and the World Bank delayed further release of the standby loans.

In March 1994, the *lev* crashed and inflation surged by almost 22% in April. As the international loans started to come in again, the general macroeconomic performance was favorable from June 1994 to June 1995. In December 1994, in the Parliamentary election, the Bulgarian Socialist Party and junior left-wing allies secured 125 seats, an absolute majority. The BSP under Zhan Videnov formed a government supported by the Bulgarian Business Bloc party (BBB).

In June of that year, 1994, privatization law was amended. In January 1995, EU association agreement was reached. Under the Videnov government, some liberal measures were reversed. Price policy became less liberal, especially in agriculture. In 1996, the percentage of price control increased to 45%, a substantial increase from 18% in 1992 (Wyzan). In 1996, it was clear that economy was deteriorating. With large bank failures, the *lev* began to decline rapidly in April. The government failed to reach agreement with international financial institutions, and the multilaterals, unsatisfied with the progress of reform, declined money supply to replenish the foreign reserves. In November presidential election, Petur Stojanov of the UDF was elected. The socialist BSP government resigned, and political turmoil's ensued.

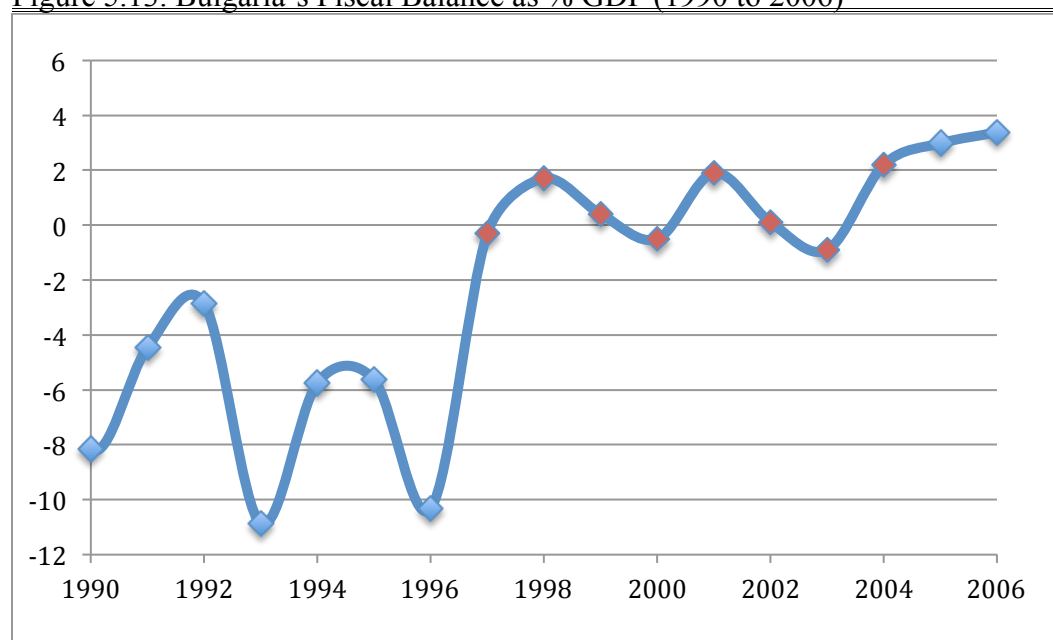
In February 1997, macroeconomic crisis worsened. The CPI rose by 242.7%, and the *lev* fell from 70.4 per dollar in 1995 to 2936.7 per dollar (Wyzan). A new caretaker government

under the UDF politician, Stefan Sofiianski, took over, and it immediately started stabilization process by removing price controls on all goods except eight staples and increasing utility prices. The new government came to power in April 1997, a mostly centrist-right coalition, comprised of the UDF, the Bulgarian Agrarian National Union (BANU), the Democratic Party (DP), the Social Democratic Party (SDP), and the ethnic Turkish Initiative Committee for Renewal (ICR). The coalition was named as the United Democratic Forces (UtdDF), led by Ivan Kostov. The Bulgarian Socialist Party (BSP) and the Bulgarian Business Bloc (BBB) accounted for less than one-third of the legislative seats (EIU Country Profile 1997).

In response to the economic crisis, a currency board was set up in July 1997. The government successfully stabilized the economy by dealing with fuel shortage, stabilizing the *lev*, and bringing down inflation. Bulgaria also concluded a three-year agreement with the IMF. By the end of 1997, much of the industry was privatized. In September 1998, IMF again approved extended fund facility for Bulgaria (Country Profile and EBRD Transition Report).

The results of reform in Bulgaria are mixed. Bulgaria has successfully liberalized its trade, but the progress of privatization has been slow. Only by late 1998 under the right-wing UtdDF, a large chunk of state-owned firms were privatized. Figure 5.13 shows the fiscal deficits as % GDP from 1990 to 2006. From 1990 to 1996, when there was left-wing parties in government coalition and when there was political instability with several government changes, the average of fiscal deficits was 6.1% of GDP. From 1997 to 2004, when there was no left-wing party in government coalition, Bulgaria actually achieved the average fiscal surplus of 0.6% of GDP.

Figure 5.13. Bulgaria's Fiscal Balance as % GDP (1990 to 2006)

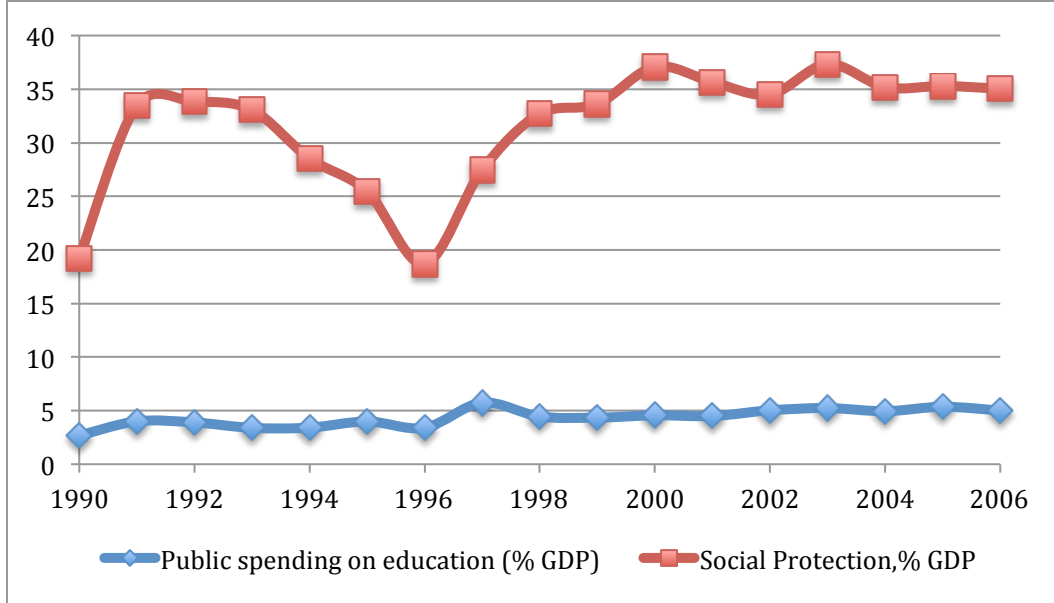


Source: EBRD. *Transitional Reports* (various years).

European Bank of Reconstruction and Development (EBRD) reports that a high degree of political polarization pressured government to offer over-provision of social benefits to losers of reform in post-communist countries. In Bulgaria, this was evident in relatively generous support for the unemployed (newly unemployed due to the structural reforms) and substantial social benefits program (EBRD 1999). Figure 5.14 shows an interesting pattern of spending on social security and welfare spending (social protection spending). Social protection spending steadily declined from 1991 to 1996. Then, when economic crisis hit in 1996 and the new government took over more radical liberalization and structural adjustment programs, social protection spending started to increase. From 1996 (18% of GDP) to 1997 (24.5% of GDP), social protection spending increased by almost 30%. Since 1997, the average social protection spending was about 34% of GDP. For education spending, from 1996 (3.4% of GDP) to 1997 (5.7% of GDP), education spending increased by 67%, but then it decreased to 4.5% of GDP.

Since 1997, education spending was fairly constant with 4.9% of GDP. Then, center-right-wing government compensated the working class more by increasing social protection spending?

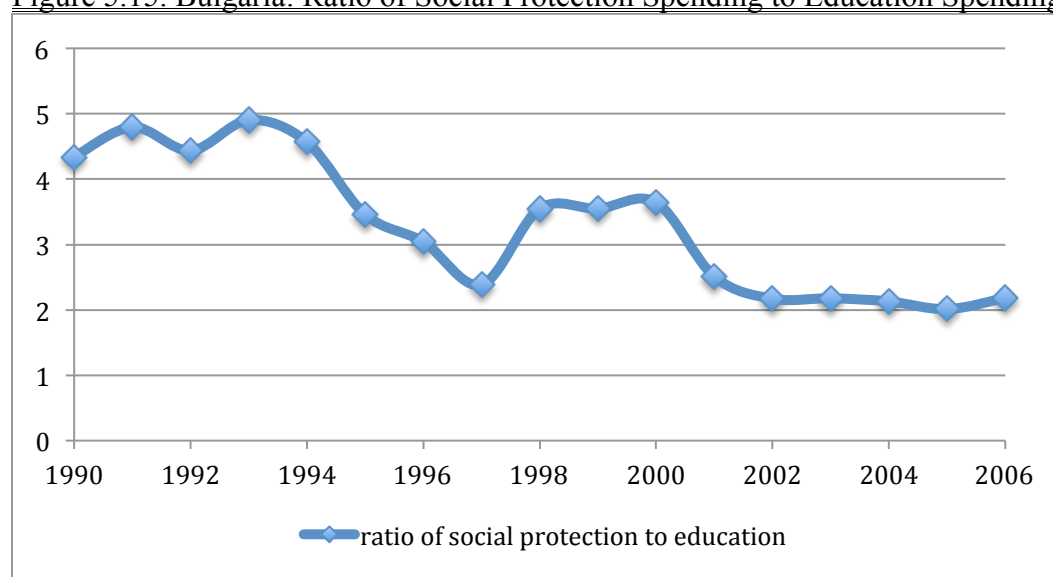
Figure 5.14. Bulgaria's Spending on Education vs. Spending on Social Protection (% GDP)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.15 shows the ratio of social protection spending to education spending. Looking at the ratio of social protection spending to education spending clearly tells us that actually, coalition government without left-wing decreased the ratio of social protection spending to other welfare spending like education spending. The actual amount of social protection spending is high, but Bulgaria initially had high social protection spending to start from (like most of post-communist countries. Other regions, especially Africa, have higher education or health spending and very low social protection spending).

Figure 5.15. Bulgaria: Ratio of Social Protection Spending to Education Spending



Source: IMF. *Government Finance Statistics* (various years).

Bulgarian case shows that under the left-wing party (BSP) with the legacy of previous communist regime, the progress of reform was slow even under the international regime's pressure (from 1994 to 1996). Nevertheless, the center-right wing party (UDF) was not successful either at the start of liberalization and structural reform (from 1990 to 1993). Only after the country was hit hard by economic crisis in 1997, the newly-elected center-right coalition government was able to go ahead with more radical reform of economy. Bulgaria also reformed its social welfare policies as a part of structural adjustment program. Yet, it does not mean that Bulgaria is spending less. Bulgaria actually increased its spending on social security and pension benefits to employees and decreased its spending on health and education. Nevertheless, the ratio of social protection spending to education spending data illustrate that right-leaning governments actually decreased the proportion of social protection spending compared to other welfare-related spending. On the surface, government seemed to increased social protection spending, but closer look at the composition of spending reveals that



government is actually spending increasing portion of GDP on other welfare spending than social protection.

### **Latvia (from 1993 to 2006): No Left-Wing in Government**

Latvia, after independence from the Soviet Union, established unicameral parliamentary democracy and first held its multi-party election in 1993. Since independence, the People's Front of Latvia (LTF), the independence movement, led the new government, but its popularity faded as the country fell into recession. The real GDP fell about half of that of 1990. In 1993 general election, the Latvia's Way, a right-of-center party won the largest number of seats in the parliament, led by Anatolijs Gorbunovs. The Latvia's Way formed a government with the Farmers' Union as Valdis Birkavs, for prime minister. Guntis Ulmanis-the nephew of the inter-war leader, Karlis Ulmanis, and a member of the Farmers' Union-was elected president by the Saeima in 1994.

The Farmers' Union left the coalition as the government refused to raise the agricultural tariffs in April, 1994, however, and the Latvia's Way found a new coalition partner, the Political Union of Economists. In 1995, the country's largest bank collapsed with allegations of fraud, and the general election was held later that year. Dissatisfied with the current politics, voters voted for the left-of-center Democratic Party "Saimnieks" (DPS), and the ultranationalist People's Movement for Latvia pulled off very strong. To exclude this party from government coalition, President Ulmanis selected an independent candidate for prime minister, Andris Skele, a non-party independent businessman. Skele worked with several parties and kick-started structural adjustment and liberalization, but by mid-1997, center-right coalition parties withdrew

from the coalition. Since then, Skele's own party became one of the main center-right-wing parties in Latvia.

Latvia had short-lived six governments since 1993, but the government coalitions were consisted of center-right leaning parties. Among the center-right parties, the largest party is the People's Party, formed in 1998 by Andris Skele, a former prime minister.<sup>33</sup> The People's Party draws their support from the emerging middle class and business interests. Among the left-wing parties, the most notable is the coalition of left-wing parties, the For Human Rights in a United Latvia (PCTVL) coalition led by the People's Harmony Party (TSP). The TSP won six seats in parliament in 1995 and joined forces with three more radical left-wing parties, one of which is Latvia's Socialist Party. Even though the PCTVL performed well in 1998 general election, they were not invited to form government because center-right parties were wary of including the left-wing parties. The left-wing parties were intentionally excluded from government coalition because of distrust towards the left-wing to be pro-Russian and pro-communist.

After independence, Latvian government implemented liberalization and market reform, establishing an independent central bank, liberalizing the price, introducing an independent local currency, the lat (pegged to the SDR basket of currencies, the accounting unit of the IMF until 2005 and pegged to the euro after joining the European Union), and pursuing land reforms and privatization. Since 1995 successive governments with center-right orientation have pursued tight monetary and fiscal policies.

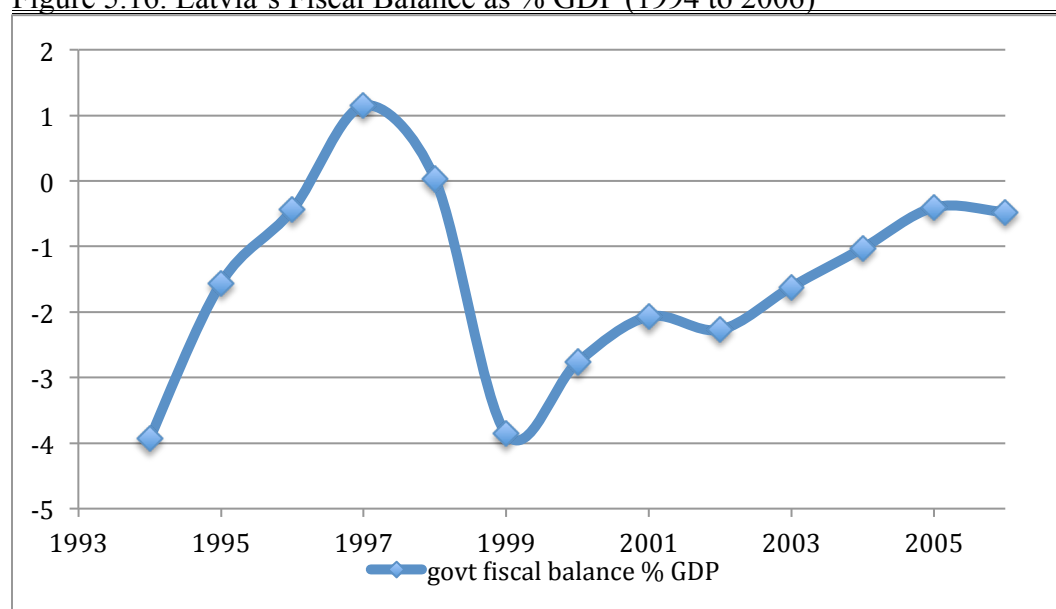
After recession that started after independence, Latvia faced its first economic crisis of liquidity-crisis with bank failure. In 1994, the fiscal deficits were almost 4% of GDP (Figure 5.16). The government tightened budgets with the IMF guidance and reached surpluses in 1996 and 1997 with economic growth and higher than expected tax yields. However, in mid-1998,

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<sup>33</sup> He served twice as prime minister in 1995 and in 2000.

Latvia was hit by the Russian crisis. In 1999, the fiscal deficits hit the bottom again, almost 4% of GDP. The government announced its fiscal austerity program in 2000, aiming to halve the fiscal deficits. Economist Intelligence Unit reports that their efforts seemed successful, but their external borrowing increased due to overspending on social security and economic subsidies.

Figure 5.16. Latvia's Fiscal Balance as % GDP (1994 to 2006)

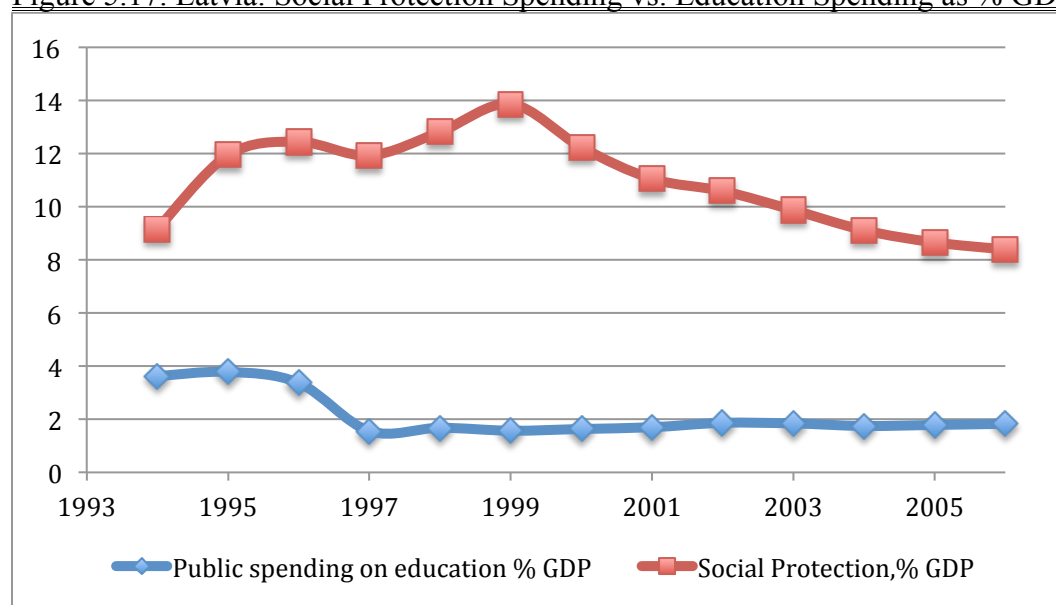


Source: EBRD. *Transitional Reports* (various years).

Latvia has had high spending on social protection (social security and welfare benefits) spending over the years (Figure 5.17). The average social protection spending from 1994 to 2000 was 12.02% of GDP (not of expenditure). Economist Intelligence Unit reports that the social security bill has once reached to a high 15% of GDP. In 1999, the government of Andris Skele tried to implement pension reforms as a measure of fiscal austerity, but it failed as the public fiercely opposed to the pension reform. At the core of the plans was to increase “the retirement age to 62 for both sexes (from 60 for men and 57.5 for women) and to stop pension payments for those who work beyond the retirement age.” Nonetheless, since 2000, the social protection spending steadily declined and averaged to a 10% of GDP from 2001 to 2006,

reaching 8% of GDP in 2006. Social spending put heavy burden on fiscal stance of Latvia as the social protection spending consisted a big part of the total social public outlays—public-sector wages, pensions, unemployment and other social benefits—on which 40% of the total population relied on. Compared to the social protection spending, education spending does not seem to change much through the years.

Figure 5.17. Latvia: Social Protection Spending vs. Education Spending as % GDP (1994-2006)

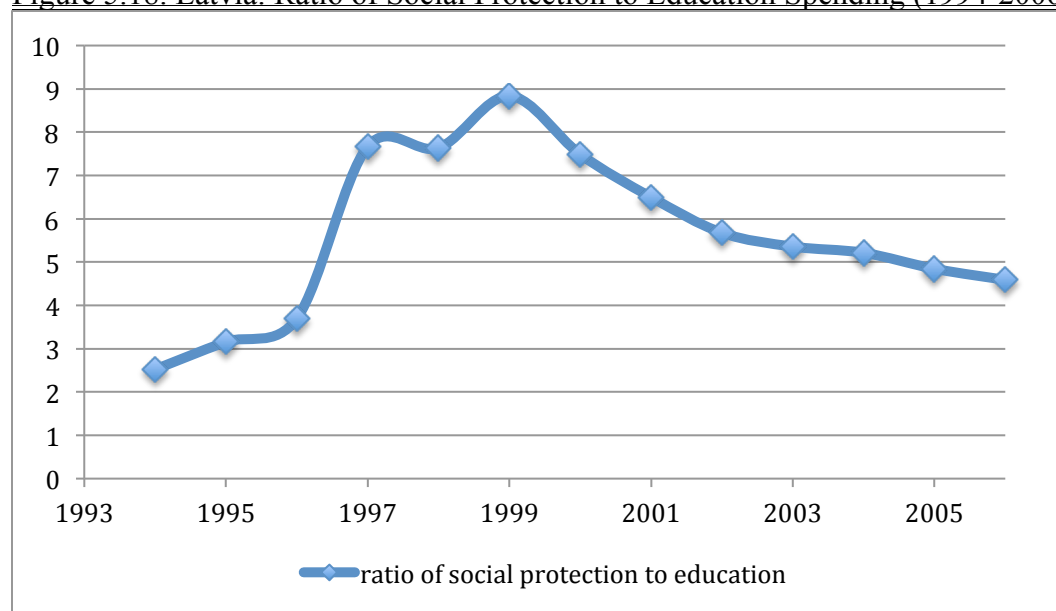


Source: IMF. *Government Finance Statistics* (various years).

The ratio of social protection spending to education spending (Figure 5.18) shows that indeed from 1999, the ratio of social protection spending to education spending steadily declined. The center-right wing coalition of governments decreased the social protection spending while fairly keeping the education spending. The left-wing opposition parties fiercely opposed to pension reforms and any cuts to social protection spending scheme, but the government kept the momentum. This follows my argument that left-wing government will compensate the losers from structural adjustment more than right-wing counterparts. In Latvia,

where left-wing parties are completely excluded from government coalition, the left-wing's voice does not seem to exert.

Figure 5.18. Latvia: Ratio of Social Protection to Education Spending (1994-2006)



Source: IMF. *Government Finance Statistics* (various years).

### Poland (1990-2006): Always Includes Left Until 2005

As a result of the power-sharing agreement between the Solidarity and the former Polish United Workers Party (the Communist), in June of 1989, the Solidarity won the general election, getting the most of 35% of lower house seats that were up for election. In September 1989, the Solidarity government (Council of Ministers) was established and the government quickly initiated structural reform supported by the IMF in January 1990. Leszek Balcerowicz launched the Balcerowicz plan, named after the finance minister. This was a "shock therapy": a fierce anti-inflationary package, stabilizing and liberalizing the economy, tight fiscal and monetary policy, and a start of restructuring from the centrally planned economy. The public generally welcomed this move towards free market.

However, soon, the reform backfired as the unemployment rate rose from 0% to 1.6%, and the real income declined. In January 1990, farmers and coal miners went on a strike, asking for compensation for input price increases. Balcerowicz pushed for tighter fiscal and monetary policy, and such austerity measures brought opposition from the trade-union factions in the Solidarity, especially left-leaning faction led by the employment minister. Despite such opposition, Balcerowicz presented vigorous stabilization and reconstruction bills in Parliament. The government liberalized all prices except some goods and services (dairy products, heating, gas, electricity, medicines, transport, and alcohol). The government also raised the supply price of coal, gas, and electricity, resulting in 600% rise in coal retail prices and 400% rise in gas and electricity. Consequently, he raised train and bus fares.

In mid-1990, the Solidarity movement split into two factions over liberalization and austere economic policies. The first group, right-leaning Centre Agreement (PC) supported Lech Walesa (who later ran for presidency). The second group, Citizens Movement for Democratic Action (ROAD) included the rural faction of the Solidarity and left-leaning trade unions and later became the Democratic Union, center-left social democratic party.

By mid-1991, Poland was in deep recession. The government started imposing increasingly interventionist policies. In October 1991 general election, no one party secured the absolute majority, showing public discontent over economic policy and performance of the government. In 1992, President Walesa settled for the leading Solidarity leader, Jan Olszewski as the prime minister. Olszewski was a conservative and supported by most right-leaning groups, including the Centre Alliance, and Christian Democrats, and the United Peasants' Party. However, the Olszewski government moved away from unpopular Balcerowicz's austerity programs and adopted a surprisingly interventionist policies. In June of 1992, the friction

between the government and the president intensified and the Olszewski's government collapsed due to the disclosure of a list of alleged communist collaborators, including some members of the President's office.

After collapse of the Olszewski's government due to corruption scandal, the Democratic Union (UD), Congress of Liberal Democrats (KLD), and National Christian Union (ZChN) and other smaller parties (Polish Beer Lovers' Party and Peasants' Party) formed a coalition government, led by Hanna Suchocka from the Democratic Union (UD). Overall, frictions in coalition slowed down the liberalization efforts ever since democratization. In 1993, for example, the budget proposal included spending cuts and reform on the pension system, and the Parliament kept rejecting the proposal. In April 1993, Peasants' Party left the coalition, and then Parliament voted to increase pension that would topple 1993 budget. In May, with vote of no confidence, the Parliament dissolved. The Solidarity trade unions held strikes, and public sector workers, especially teachers and healthcare providers, went on strike over low wages.

At the end of 1993, discontented with the current government and its economic policies, the public turned to the left. In September 1993 election, Union of Democratic Left (SLD, former Communists) and United Peasants' Party (PSL) won most of seats and formed a coalition government under Waldemar Pawlak (PSL). The former Communist Party, SLD, ran on the campaign promises to raise pension benefits and public sector wages. From the political right, only the Confederation for an Independent Poland (right-wing nationalist) won the seats in Parliament with 5.8% popular votes. However, the new left-leaning government under the deputy prime minister and economic affairs minister Marek Borowski (SLD), who was considered "liberal," continued the economic policies of the previous government.

This led to disputes between the Peasants' Party (PSL) Prime Minister Pawlak and SLD finance and privatization ministers, and Borowski resigned. The SLD wanted tighter monetary and fiscal policy whereas the Peasants' Party wanted increase in social spending and subsidies for agricultural sector. Grzegorz Kolodko from the SLD became the new finance minister and proposed the "Strategy for Poland", whose main component was pension system reform. Finally in 1995, PSL prime minister Pawlak resigned, and SLD's Jozef Oleksy, the speaker of the Sejm (Parliament), became the new prime minister, and pro-reform Borowski returned to the government as the Chief of the Cabinet Office. Meanwhile, President Walesa kept opposing government proposals such as the new privatization law and wage-control laws because prime minister Oleksy was from the different faction of the Solidarity.

In September 1997 general election, the Solidarity Electoral Action (AWS)—a center-left coalition of about forty small parties and Solidarity trade unions—won the election but failed to secure the absolute majority yet again. The AWS formed a coalition government with the pro-liberal centrist party, Freedom Union (UW). Not surprisingly, the leader of the UW, Leszek Balcerowicz returned as finance minister, which was a signal for more vigorous structural reform and liberalization. The AWS includes pro-reform centrist, contradicted by nationalist, religious conservatives, and the Solidarity trade unions with social policy agenda. Naturally, with the coalition partner UW added to the picture, disputes within the AWS and between the US were inevitable. Adding to the difficulty, the president Kwasniewski was from the left-wing (former Communist party) SLD. For instance, President Kwasniewski vetoed army pension and education cuts that were meant to help with the fiscal deficits, and the AWS and the UW coalition did not have 60% majority in Parliament to overturn the veto.



From 1997, the government again was torn between two coalition partners whose interests conflicted between tight fiscal and monetary policy and preservation of the Solidarity trade union workers' rights and employment. This slowed down privatization and public sector reform. Still, finance minister Balcerowicz announced the new economic policy, for the next three years, to be achieved by eliminating the structural budget deficit, targeting budget surplus by the year 2003, real GDP growth, slowed inflation and low unemployment rate. Balcerowicz pushed for a radical tax proposal, steel industry restructuring plan, and coal sector restructuring plan, which brought outcry from the trade unions.

One of good cases in Poland where the trade unions' fierce opposition stalled restructuring the loss-making parastatal is the coal sector. The core problem with the coal sector is that it is a loss-making sector with output that cannot be sold. Because of close tie with the governing party—factions of the Solidarity—, the coal sector was immune to restructuring in the 1990s. The surplus output either has to be domestically consumed or exported. However, because of high extraction costs, Poland's coal is too expensive to be sold in the international market; thus, government has to subsidize, which puts a heavy burden on government fiscal stance. The coal sector has been losing around 13,000 workers a year, but still holds around 235,000 workers, who are highly unionized. The government proposed a restructuring plan, which includes generous social support. The plan includes approximately 2% of GDP a year to pay off the mining enterprises' debts and to provide financial aid to miners to leave the coal sector. The final goal was to set up a profitable coal sector and get it ready for privatization by 2002. The trade unions reacted hostilely, and the prime minister, Jerzy Buzek and the deputy prime minister, Leszek Balcerowicz added 20% to the initial proposed incentive payments to

retiring miners. This case clearly shows that government that is closely connected to labor unions has to compensate the workers when it has to restructure and privatize the targeted sector.

The AWS and the UW coalition government's popularity faded by June of 1999. The part of the reason was that the AWS campaigned with the platform of cautious reform, but economic policy was in the hands of the finance minister and head of the UW, Leszek Balcerowicz, hard-core economic liberal. The AWS, the Solidarity movement based party, was losing support among the loyal core constituencies—blue-collar workers and agricultural sectors to the left-wing Democratic Left Alliance (SLD).

Finally, in September general election, the Democratic Left Alliance (SLD) won the largest seats but failed to command the majority. The new coalition government was formed by the SLD led by Leszek Miller with the center-left Polish Peasants' Party (PSL), which has been skeptical of economic restructuring and liberalization and the center-left Union of Labour (UP) party. However, when the outgoing government acknowledged that the budget deficit situation was critical, and when the projection for 2002 came out to be 10% of GDP, the SLD-PSL government announced tighter fiscal policy. However, by March 2003, the coalition dissolved due to continuation of economic weakness and scandals, and Miller continued his administration as a minority government until May 2004. Marek Belka, a former finance minister, formed a caretaker government until September 2005 general election.

In 2005 general election, the right-wing, Law and Justice party (PiS), won and formed a minority government with Kazimierz Marcinkiewicz as prime minister, and the Civic Platform (PO) party became the largest opposition party. Both PiS and PO parties are right-wing, but the PiS party campaigned with more of "solidaristic" social policy and PO with liberal economic policy. The PiS candidate, Lech Kaczynski, won the presidential election. It was the first time

for Poland not to have a left-leaning coalition partner in government. However, the Law and Justice party is more close to populist and appeared to be more “socially conservative and patriotic”, and in 2006, the new prime minister Karoslaw Kaczynski formed a coalition government with two small populist parties and announced “national champions” in the economic sectors, plan to expand social spending, putting heavy pressure on fiscal stance.

Poland, unlike most of post-communist countries, has unique party politics. First, the democratization movement was led by the trade unions, the Solidarity Movement, which translated to several small parties that carry the Solidarity tradition. In other words, even if a party identifies itself as right-wing or economically liberal, because its main constituencies consist of trade unions, government always faced strong opposition from the trade unions when they tried to carry out restructuring and social spending cut or meet demands of the Solidarity trade unions.<sup>34</sup> Second, because parties are fractions from the Solidarity Movement, there was no one dominant party and they always had to find coalition partners, most of time several, to form a government, which made it more difficult in forming consensus in economic policy making. Therefore, when center-right party (AWS) with the largest number of seats found a coalition partner (UW), the AWS members were usually reluctant to carry out radical reform because of the Solidarity affiliation, and when the AWS prime minister let the UW to take over the finance ministry, and Balcerowicz proposed a radical reform package, he met constant disputes within the administration and in the parliament, which slowed the restructuring and liberalization. Thirdly, unlike other post-communist and Eastern European countries, Poland’s former communist party made a comeback in the political scene and actually came to power in 1993 and 2001. However, the SLD party was center-left, trying to distance itself from the past

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<sup>34</sup> There were non-Solidarity trade unions, mostly affiliated with former communist parties, and they were more militant. Nonetheless, their demand was taken less seriously by the Solidarity governments.

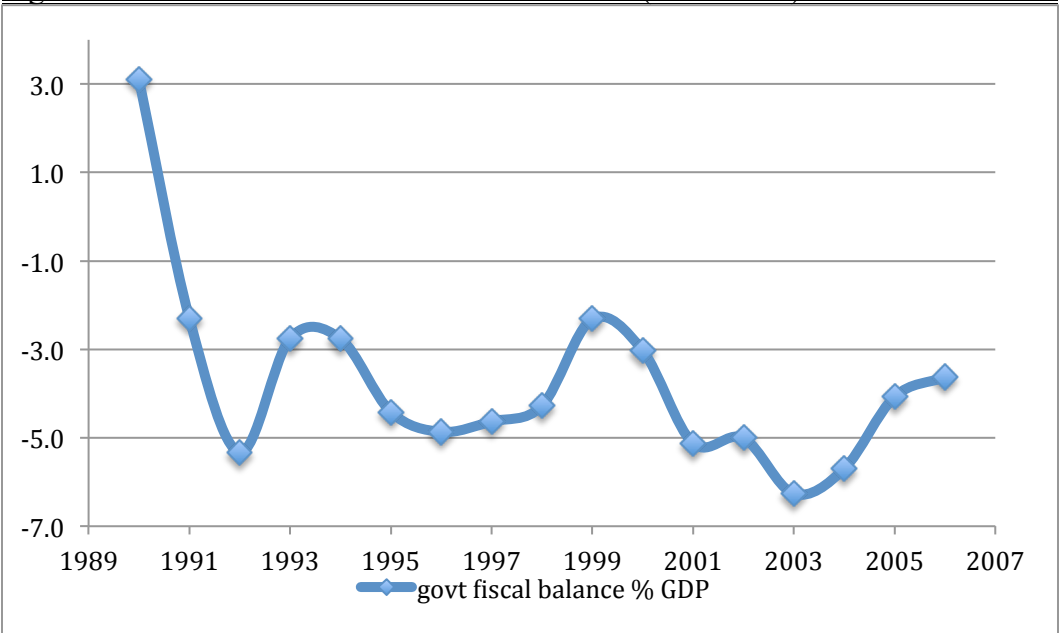
communist party, so its economic policy was not so much different from the center-right governments, which included center-left parties as coalition partner and had to satisfy the Solidarity trade unions. Throughout different coalition governments, finance ministers, who were usually reform-minded pro-liberal politicians such as SLD's Borowski and UW's Balcerowicz, largely determined economic policy.

Figure 5.19 below shows the yearly trend of fiscal deficits of Poland and reflects the complicated party politics of Poland and determination of finance ministers that were liberal. From 1993 to 1994, even under the SLD government, with the pro-liberal finance minister Borowski, Poland maintained average fiscal deficits of 2.8% of GDP, close to the EU standard. 1998 and from 2001 to 2002 reflect tight fiscal policy of finance minister Balcerowicz. Then, fiscal deficits hit low in 1996 when there was a change in government back to the right-leaning coalition of AWS and UW. Under Balcerowicz, from 1997 to 2000, the average deficits were 3.6% of GDP. During that time, even with ambitious tight fiscal policy, Polish government had to compensate trade unions in the middle of privatization and restructuring. Then, the economy became worse and there was another switch back to the SLD-led coalition government in 2001.

Unfortunately, social protection spending data are available only from 1994 to 2000 (Figure 5.20). With an effort to cut social spending, both the social protection spending and education spending steadily declined since 1994. It is noticeable that the education spending jumped from 1.5% to 5.3% of GDP in 2001. However, it is hard to tell what happened to social protection spending without data. Still, from 1994 to 2000, the ratio of social protection spending over education spending (Figure 5.21) illustrates that even during efforts to cut social spending, government actually increased the ratio of social protection spending relative to other spending like education. Only from 1997 to 1998, the ratio decreased by 0.5 each year. It tells

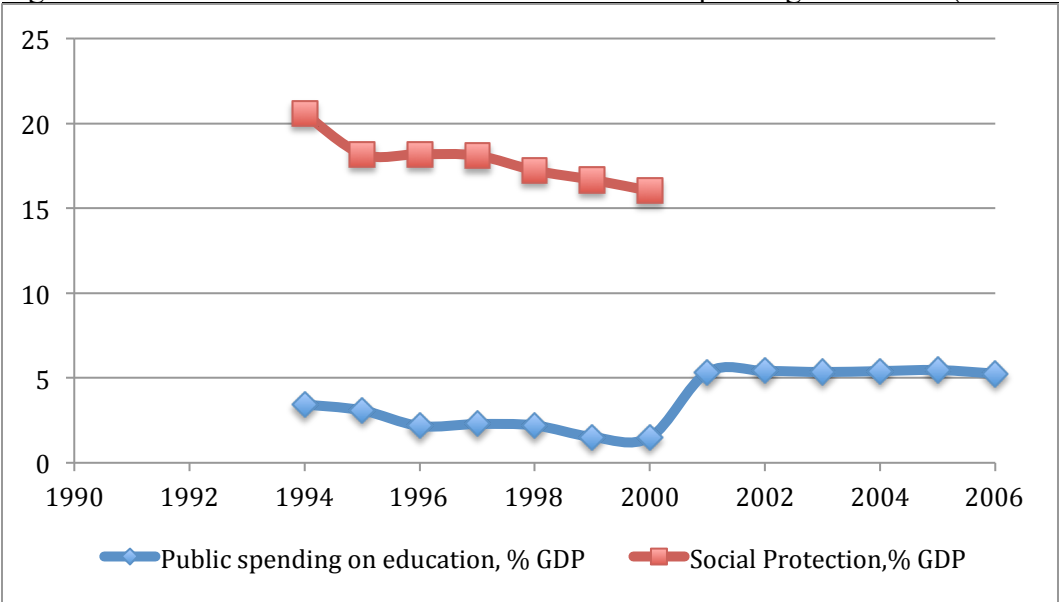
that the rate of spending cut was steeper for education spending as % GDP. This supports my argument that government that includes left-wing party in government compensates the constituencies by increasing the social protection spending or not cutting social protection spending as much as other spending.

Figure 5.19. Poland: Fiscal Deficits as % of GDP (1990-2006)



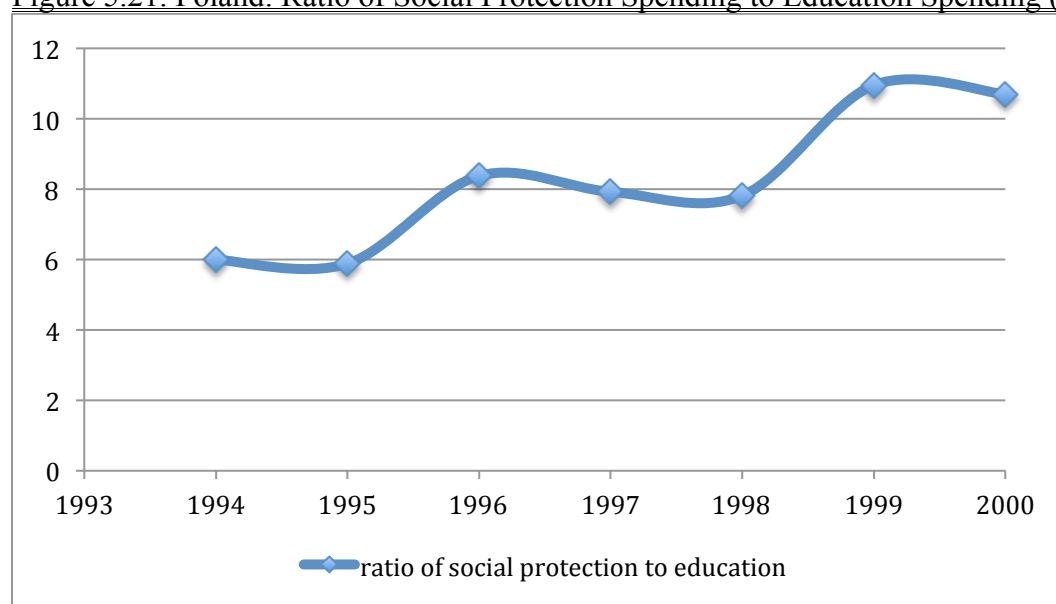
Source: EBRD. *Transitional Reports* (various years).

Figure 5.20. Poland: Social Protection vs. Education Spending as % GDP (2000-2006)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.21. Poland: Ratio of Social Protection Spending to Education Spending (1994-2000)



Source: IMF. *Government Finance Statistics* (various years).

One of the main reasons of slow reform is that Poland always included the left-wing element in government. The Solidarity used to be unified as one political force because they were against the Communist regime. However, as soon as they were the government, the factions within the Solidarity had disputes over economic policy. The trade unions' (coal and steel workers, especially)—both the Solidarity and SLD-affiliated OPZZ—and public sector workers (healthcare providers, especially) intensified whose subsidies payrolls, government credits, and protections were about to be tackled by the government reform. For instance, the OPZZ trade union held a protest at Warsaw in early 1997, where between 15,000 and 25,000 workers came onto the streets. Polish farmers also went out onto the streets protesting lack of government credits and tariff protection in March.

The other reason was that the government did not have the public mandate for reform because the Polish economic, despite some inflation, had positive growth since 1994 until 2001 Russian financial crisis. Interestingly, when the economy was bad in 1994 and in 2001,

(unemployment rate rose to unprecedented 5% of total population in 1993 and fiscal deficits hit high—10% of GDP), the post-Communist left-wing party came to power, but did not revert to the old system but strived to continue reform efforts of the Balcerowicz program (twice in 1994 and in 2002). The fact that they were left-wing did not stop them from carrying out reforms. It shows that the left-wing veto player argument does not alone explain why left-wing governments sometimes carry out the reform as well as the right-wing or the centrist government. Because the economy was not sustainable, and the public wanted some kind of change in the system, and the government knew that something had to be done, even the left-wing government continued reform efforts.

## LATIN AMERICA

### **Argentina (from 1978 to 2006): Some governments include Left**

As one of the most discussed cases of economic reform in the early 1990s, Argentina is a good case offering how left-wing governments were able to implement drastic reform. Particularly, comparison of the Alfonsín administration and the Menem administration will illustrate how ideology does not work during crisis and how government compensates the constituencies. When the debt crisis hit Argentina in 1983, President Alfonsín of the *Union Civica Radical* party could not implement radical reform even though the country was suffering from financial instability and hyperinflation. Around 1990, under President Menem of the *Partido Justicialista* party, the Argentine government started to cut government expenditures and implemented privatization and tax reforms (Krugman and Obstfeld 2006).

In 1986 in the midst of debt crisis, President Alfonsín administration announced the Austral program, which included wage and price freeze, devaluation of the austral, privatization,

and tighter budget. The government proposed the program but never actually materialized it. In late 1986, the government again announced a new reform program called “Reform of the State,” which included reduction in government employment, privatization, and banking system reform. By the second quarter of 1987, the Alfonsín government had announced four different reform programs but had to scale down the magnitude every time the administration tried to implement them. Making the situation worse, the Radical Party lost its majority in the Congress to the Partido Justicialista (PJ) party, making the government minority. Starting in 1988, the Radical Party (UCR) was divided over the economic policy and the worsening economic conditions. In May 1988, Alfonsín delivered the annual address to Congress, promising to tackle fiscal deficits, which were considered the main culprit of hyperinflation. The Plan Primavera announced at the beginning of August: exchange rate adjustment (devaluation), voluntary price restraint, realignment of public sector prices and costs and import liberalization. The privatization efforts were stalled in Congress. The new two-tier exchange rate system collapsed by the run of the austral, and economic conditions did not improve at all.

In 1989, Carlos Menem from the Partido Justicialista (PJ), the Peronist party won the presidential election on a populist campaign agenda. However, as soon as he took office, Menem pursued austerity measures and pro-market, reformist policies. Menem appointed Manuel Roig, a former vice president of the Argentine multinational Bunge and Born group as the new finance minister, and it was a sign that the new government meant to pursue a pragmatic pro-free market policy. As soon as Menem’s administration took office, Miguel Roig launched the first economic emergency program: massive public sector price rises (up to 600% in some cases), a dramatic 53.5 % devaluation of the austral, a backdated price freeze and compensatory wage adjustments to be followed by privatization and restructuring of the economy. Only six



days later of announcement, Roig died of a heart attack. Menem appointed Nestor Rapanelli, a former top executive of the Bunge and Born group as the new finance minister. It was a message that economic policy would remain the same even though the minister changed. Other measures and bills were sent to Congress for approval, including massive public utility rate increase, “Economic Emergency Law” of restructuring of the public sector, a large-scale privatization, tax reform, and central bank independence.

By late 1989, The new economy minister, Antonio Erman Gonzalez announced the second reform package, which included sharp price increase in public sector goods and services: oil by 61%, bus fare by 86%, electricity by 69%, telephone by 60%, postage by 40%, and water by 20%, and liberalization efforts: export tax increase, import tariffs reduction, and floating exchange rate. However, the fiscal deficits continued, and in March 1990, more public spending cut was announced.

Due to intense party fragmentation and opposition to reform by his own party (PJ), Menem could not pass any significant economic reform bills. In fact, it is natural that the ruling party (PJ) opposed Menem and even questioned the president’s identity as a Peronist (Corrales 1997). Indeed, in 1989, the Peronist party was divided over three issues, challenging the president: cabinet selection, economic policy, and foreign policy. In 1990, eight Peronist legislators defected from the party, criticizing Menem’s neoliberalism. The legislators refused to pass reform proposals, forcing Menem to issue decrees, which in turn infuriated the legislature and divided the PJ party even more. Therefore, from 1989 to 1990, only two economy-related laws passed in the legislature. Congress approved only two economy-related bills that Menem proposed in 1990. Therefore, Menem issued decrees, enacting seven stabilization packages, but the result was severe recession along with high inflation and increased labor conflicts, further

increasing tensions with Congress (Corrales, 1997). Aleman (2004) reports that Menem issued two decrees successfully, and only one decree was regarding economic reform (Airport Privatization).

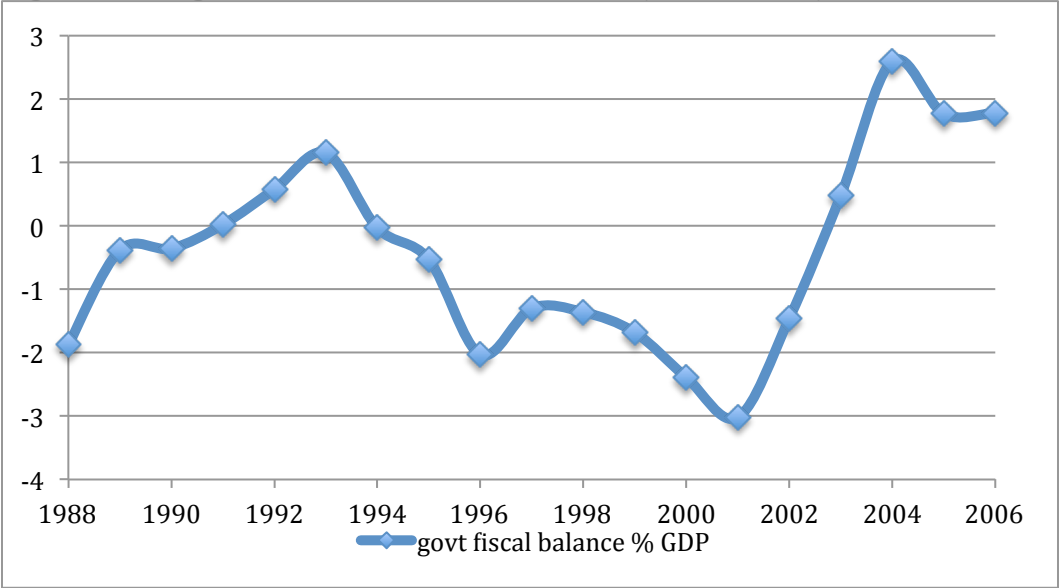
Finally, under the new finance minister, Domingo Cavallo, the Convertibility Law of 1991, which fixed the currency to dollar, was the major reform, and the Argentine economy began to stabilize (Corrales 1997; Krugman and Obstfeld 2006). Menem started to co-opt his own party and began to address the primary concerns of the ruling party (PJ). Menem also made a tacit agreement with party leaders: the PJ party (the majority) would approve economic reform proposals by the president in exchange for party leaders' participation in other policy making such as "high presence in the cabinet, more frequent congressional consultations," safeguards against labor market flexibility, and party control over social spending (Corrales 1997, 636). By March 1991, Menem successfully ended party fragmentation regarding economic reform, and in April 1991, the Convertibility Law passed the legislature. By the end of 1992, both the PJ party and the main opposition party, Union Civica Radical (UCR) were fully committed to privatization and liberalization of the economy. The Convertibility Law was fully in place, and most of trade barriers were eliminated.

With hyperinflation under control and strong economic growth since 1991, Menem won reelection in 1995. Nonetheless, along with the Mexican foreign exchange crisis, the Convertibility Law was in jeopardy by early 1995 and Argentina was going into recession. The finance minister Cavallo proposed the superpowers tax bills, which would restructure the public sector and increase taxes without Congressional approval and stressed that the country needed to raise tax revenue and balance the fiscal deficits while Congress wanted the government to lead the country out of recession. Dissatisfied with the Menem administration, the public voted for

the Alianza por el Trabajo, La Justicia y la Educación (Alianza), a coalition between the UCR and the centre-left Frente del País Solidario (Frepasso) in the 1997 congressional election. By the end of 1998, Argentina was in deep recession, and the public was unhappy with social costs that economic reform had brought. The UCR’s presidential candidate Fernando de la Rúa won the 1999 presidential election. However, de la Rúa was forced to resign after two years in office by violent protests in December 2001 for severe economic crisis and failure to recover economy. The currency board was abandoned and the peso was devalued with the meltdown of the economy in January 2002 and collapse of banking sector in February.

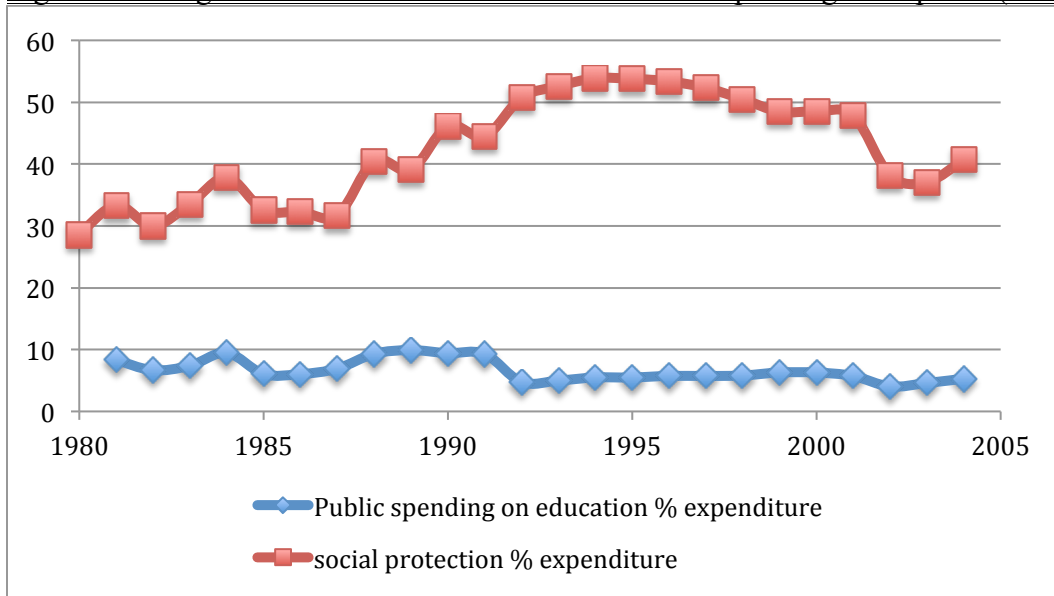
After several interim presidents and stabilized foreign exchange market with the multilateral and IMF packages, in 2003, Néstor Kirchner from a new peronist party, Frente para la Victoria (FV), won the presidential elections and came to power on the mandate to recover severely meltdown economy. Kirchner turned the peronist party back to left-leaning party with interventionist economic policy. Kirchner pursued expansionary fiscal and monetary policies to boost economic growth while trying to curb inflation.

Figure 5.22 Argentina: Fiscal Deficits as % GDP (1988 to 2006)



Source: from 1988 to 1992: Wibbels (2001); Latin American Development Bank. On-line data.

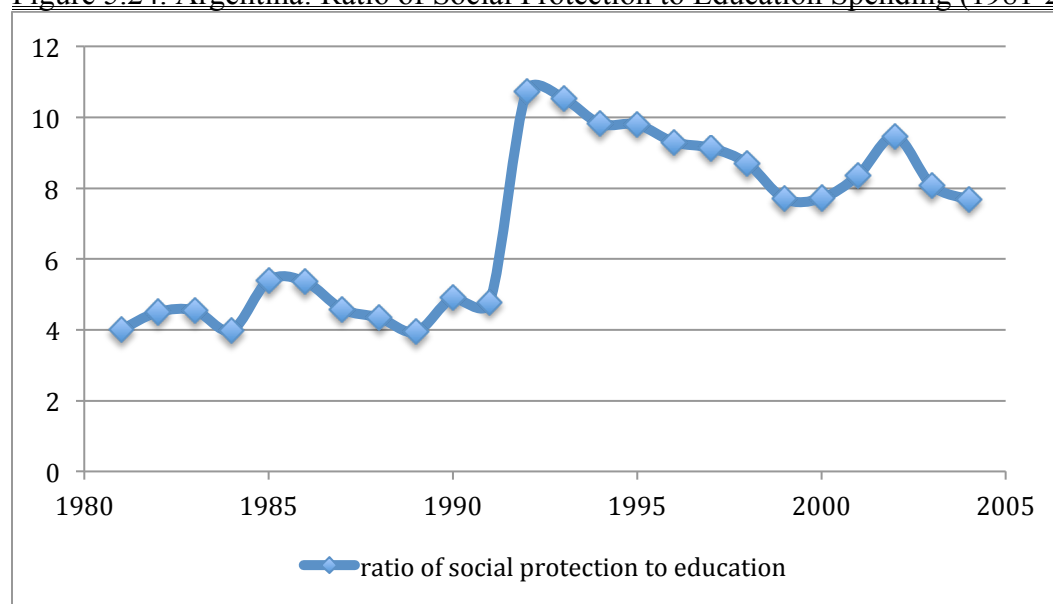
Figure 5.23 Argentina: Social Protection vs. Education Spending % Expense (1980-2004)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.23 illustrates that from 1991 to 1992, the social protection spending increased from 44.5% of total expenditure to 50.7% of total expenditure while the education spending halved from 9.3% to 4.7% of total expenditure. The level of social protection spending maintained its level until 2002 when another severe economic crisis hit. After Kirchner took office in 2003, however, social protection spending once again began to rise. It is interesting to note that social protection spending increased when Menem's administration tried so vigorously to cut government spending and balance the budgets. With receipts from privatization and restructuring, the Menem's government was able to provide more compensation. Also, social protection spending as % GDP shows that in 1992, social protection spending as % GDP decreased from 6% in 1991 to 1.9% of GDP, but the actual percentage out of total expenditure increased from 50% to 52%. This clearly shows that the PJ government compensated its main constituencies while cutting back other expenditures.

Figure 5.24. Argentina: Ratio of Social Protection to Education Spending (1981-2004)



Source: IMF. *Government Finance Statistics* (various years).

It is interesting to see that the ratio of social protection spending to education spending skyrocketed from 1991 to 1992 when economic reform was most radical in Argentine history with the introduction of the Convertibility Law and the currency board (Figure 5.22). The data confirm that indeed social protection spending increased compared to other spending in the midst of aggressive spending cut drive.

The Argentine case illustrates several key features of my argument. One is that when severe economic crisis hits, even left-leaning government will abandon its original partisan base and employ reformist policies. Second is that in order to implement unpopular reformist policies among its main partisan supporters (in Argentina, the peronist party's main supporters are labors), the agenda setters—president and finance minister—had to negotiate with their own party members though compensation and party discipline. Third is that once economy is stabilized, the left-wing party goes back its root like Kirchner did. With disgruntled public, expansionary economic policy would be more popular.

## **Bolivia – (1983-2006): Governments include Left except from 2003-2005**

Bolivia is the first democratic country in Latin America following only autocratic Chile to adopt the IMF-led structural adjustment programs. Bolivia started its structural adjustment programs as early as 1985 but always has included left-wing in government except years from 2003 to 2005. When the radical left-wing party returned to power in 2005 after economic crisis and social unrest from 2003, the government of the first indigenous, socialist president, Evo Morales reversed the two-decade-old reform efforts. Thus, it is an interesting case to look at.

Since the debt crisis of 1982 in Latin America, foreign loans had been leaving the country, and with price drop in tin materials, one of the biggest sectors in Bolivia, the country faced the fourth largest inflation recorded in the world. In 1985, newly elected-president Victor Paz Estenssoro from the Revolutionary Nationalist Movement, (MNR)—a reformist revolutionary movement later turned centrist party—launched a free-market radical neo-liberal reform, “New Economic Policy,” aimed at taming hyperinflation, lifting restrictions on trade and price controls, reducing subsidies, holding down public sector wages, and preparing the public sector for restructuring. The plan was carried out through severe repression of labor movements against the reform. The next administration of Jaime Paz Zamora from Revolutionary Left Movement (MIR), radical Marxist movement later turned center-left after democratization, kept the economic policies, but with social unrest and protests, the government did not carry out the reform energetically.

In 1993, the former minister of planning, the author of the radical economic reform policy, “New Economic Policy,” Gonzalo Sánchez de Lozada from the centrist MNR party became the president by forming a coalition government with the small center-left, Bolivia Libre party. During the term from 1993 to 1997, the Sánchez de Lozada administration pushed for

further neo-liberal policies to transform Bolivian economy as a modern market economy, including the 1994 Ley de Capitalización (Capitalization Law), removing restrictions on direct foreign investment and capital account liberalization. The government started the five largest scale privatizations of state-owned enterprises, and for a reform of social security, it created two private pension fund administrations, transferring pension investment to private sector.

In 1997, the former dictator, right-wing conservative Hugo Banzer Suarez from the ADN party (Acción Democrática Nacionalista) won the plurality vote with the help of the former president Victor Paz Estenssoro from the left-leaning MIR party<sup>35</sup>. Banzer Suarez continued the former administration's economic policy direction but in a surprisingly conciliatory manner. When the privatization of water company in the third largest city Cochabamba was announced in 2000, the people protested on the streets and protests turned violent. The administration announced that it abandoned the project. The president resigned in 2001 due to his illness, and his vice-president Jorge Quiroga succeeded.

Gonzalo Sánchez de Lozada (MNR) became president for the second time in coalition with the MIR. As known for the free-market oriented economic policies, Sánchez de Lozada administration inherited economic and social crisis from the previous administration such as negative growth of 4% of GDP and fiscal deficits of 8% of GDP. However, political and social protests and unrest which started in late 2002, led by union leaders (among them, Evo Morales, radical socialist who later becomes president), toppled government's efforts to pursue some austerity measures—new income tax, restructuring the corporate and financial sectors, and tighter budget—and finally forced the president to resign after protests turned into violent clash

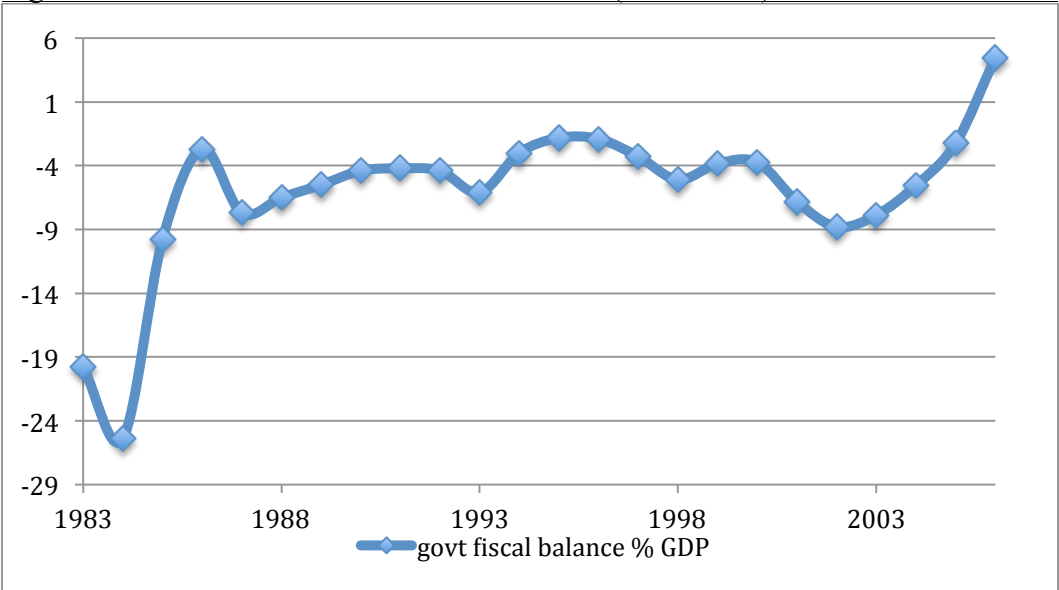
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<sup>35</sup> Victor Paz Estenssoro became president by making a deal with Hugo Banzer Suarez to support him in the future presidential election.

against the police, resulting in over 60 civilian deaths in October 2003. The vice-president Carlos Mesa became succeeded Sánchez de Lozada.

In December 2005, the radical socialist, indigenous leader of the Movimiento al Socialismo (MAS) party, Evo Morales became president with a popular mandate. In the legislative elections, the president’s party won a comfortable majority in the lower house with 72 seats out of 130. It was clear that president Morales would pursue more expansionist economic policies, and after 4 months later he took office, the government nationalized the hydrocarbons sector with the presidential decree as a first step to socialist reform.

Figure 5.25. Bolivia: Fiscal Deficits as % GDP (1983-2006)



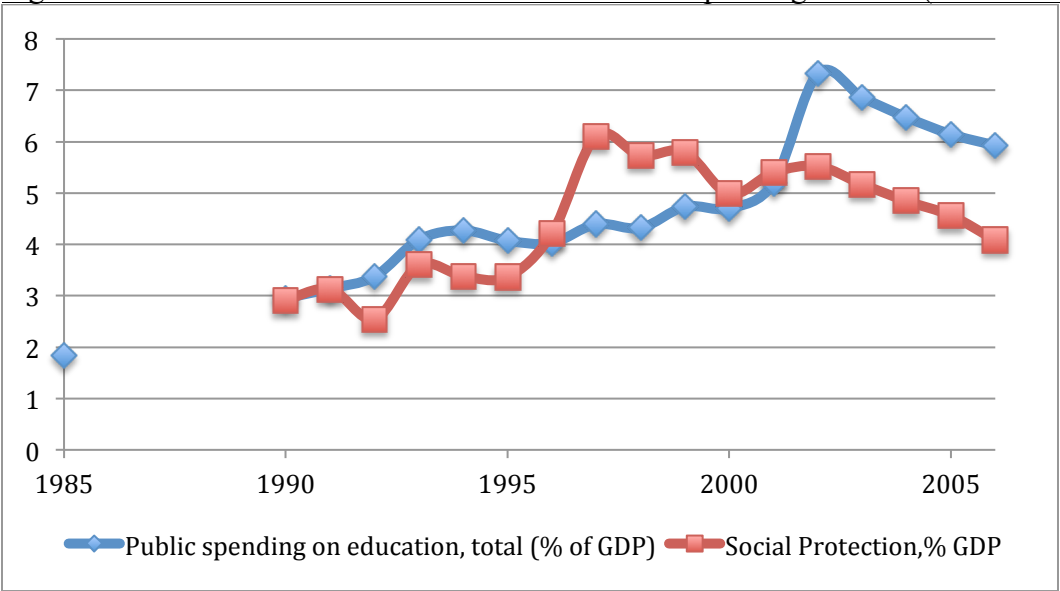
Source: IMF. *World Economic Outlook* (various years).

Unfortunately, there are no data on social protection and education spending from 1983 to 1989 when one of the most radical structural adjustment packages was implemented. Nonetheless, one can see that from 1994 when pro-reform minded president Sánchez de Lozada was in power, the fiscal deficits improved while the ratio of social protection spending to education spending increased. The fiscal deficits were 6.1% of GDP in 1993, but from 1994 to 1997, the average fiscal deficits were only 2.5% of GDP, one of the lowest deficits in Bolivia’s



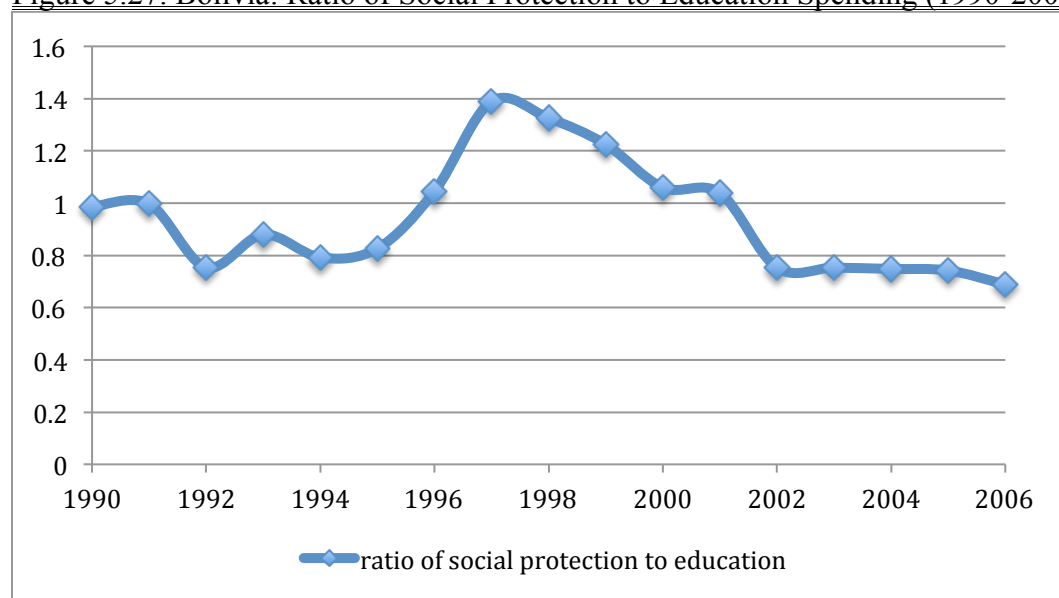
modern history (Figure 5.25). With left-wing government coalition partner, the government had to increase the ratio of social protection spending among expenses (Figure 5.27). It is also interesting to note that since 1998, the ratio of social protection spending fell steadily along with the actual social protection spending. The education spending also fell (Figure 5.26), but the rate of fall was faster for the social protection spending. Since 1998, Bolivian government did not pursue reformist policies as vigorously as Sánchez de Lozada’s administration.

Figure 5.26. Bolivia: Social Protection vs. Education Spending % GDP (1985-2006)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.27. Bolivia: Ratio of Social Protection to Education Spending (1990-2006)



Source: IMF. *Government Finance Statistics* (various years).

### Uruguay (1985-2006) – Never Includes Left until 2005

Since returning to democracy in 1985, Uruguay's politics were dominated by two center-right parties – the Colorado (Partido Colorado: PC) and the Blanco (Partido Nacional: PN). The coalition of two parties has governed Uruguay until 2005 when the left-wing coalition, EP-FA (Encuentro Progresista-Frente Amplio), came to power. Uruguay is an interesting case where center-right wing parties governed as a coalition for almost 30 years with slow reform efforts with the growing dissatisfied public and where the first-time left-wing government with the majority in both houses continued reform efforts with social compensation programs and carried the popular mandate during most of the term.

No single party had the majority in both houses (until 2005), and the coalition government of the Colorado and the Blanco implemented structural adjustment programs and pursued reformist policies sporadically and slowly. The PC-PN coalition governments successively agreed on Uruguay's need to open the economy, privatize the large public sectors,

reduce the size of the bureaucracy, and pursue modernization. However, when election year came around, the coalition partners split over economic policies, as they had to present to the voters separately, hoping to secure the majority in Congress. This resulted in sporadic implementation of reform and stop-and-go style fiscal prudence. As the election neared, government would relax fiscal discipline and the new government (the majority in the coalition) would have to face fiscal deficits challenges and come up with emergency measures. Most of major reform efforts, therefore, happened during the early years of each government. For examples, after Luis Alberto Lacalle from the Blanco took office in 1990, Congress approved the major privatization law in 1991, later to be rejected by a referendum in the following year. Also, in 1991, Uruguay signed the Mercosur free trade agreement with Brazil as a founding member.

When Julio Maria Sanguinetti, the leader of the Colorado and the former president (1985-1989) returned as president in 1995, the country was in high inflation due to the Mexican financial crisis of 1994. The government implemented fiscal austerity packages and stopped rise in fiscal deficits with severe cuts in health (9.9% cuts), education (8% cuts), and defense (3.4% cuts) spending and by 1996, the deficits had gone down to 0.8% of GDP. Also, the Sanguinetti's administration successfully reduced the public sector employment and reformed the social security system that required heavy government subsidies. However, still, structural reform and privatization were slow. The government only privatized the airline and leased the gas company to a private company in 30-year term. Other important state-owned enterprises remained in the public sector. With declining real wages in both public and private sectors and slow growth, Uruguay fell into recession by 1999. In 2000, the Colorado candidate succeeded and formed another Colorado-Blanco coalition government, and there was not much change in both direction

and performance of reform. By 2003, popularity of the governing parties hit the bottom as the recession worsened and the banking system almost collapsed.

Tabaré Vázquez of the left-wing Encuentro Progresista-Frente Amplio (EP-FA) won 2004 election. It was a history in the making as Tabaré Vázquez ended 170 years of two-party governance in Uruguay, became the first left-wing president, and his party won the absolute majority of seats in both houses, giving him the single-party government for the first time in 30-year democracy. Tabaré Vázquez campaigned on promising moderate gradual modernization, liberalization and reform with social consciousness. Also, the economy had been improving with good economic growth and good fiscal performance by the end of 2004.

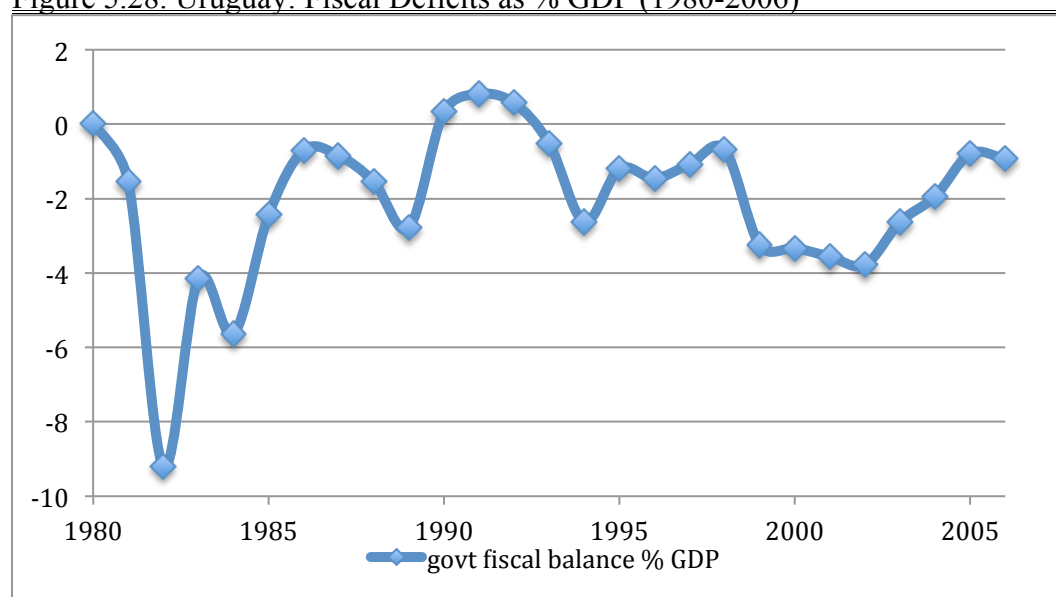
The Encuentro Progresista-Frente Amplio (EP-FA) is a coalition of left-wing parties that range from radical to moderate center-left. Thus, President Vázquez appointed the leaders of the main factions to the cabinet, but the center-left factions dominated the economy ministry, led by pro-reform minister of finance, Danilo Astori, as a move by the new government to continue the tradition of the neo-liberal, pro-business, market-friendly economic policies. Their economic policy was to implement “pro-investment policies with social inclusion” (EIU).

As one of the efforts of “social inclusion,” the left-wing government launched the several social plans. One of the most notables is the Plan de Atención Nacional de Emergencia Social (PANES)—new two-year social emergency program—which distributed a cash transfer to the poorest households in the country.

Figure 5.28 shows the fluctuating fiscal deficits, reflecting the sporadic reform efforts by the center-right wing coalition government. The electoral business cycle clearly is at work because of the unique coalition government system between the two traditional, dominant political parties. Even though they always formed a coalition government, the Colorado and the

Blanco were rivals during elections, vying for presidency and for absolute majority (which was never materialized until the left-wing EP-FA came to power in 2005). Also, the fiscal deficits pattern shows that once the deficits hit the bottom, fiscal discipline kicked in as emergency packages.

Figure 5.28. Uruguay: Fiscal Deficits as % GDP (1980-2006)

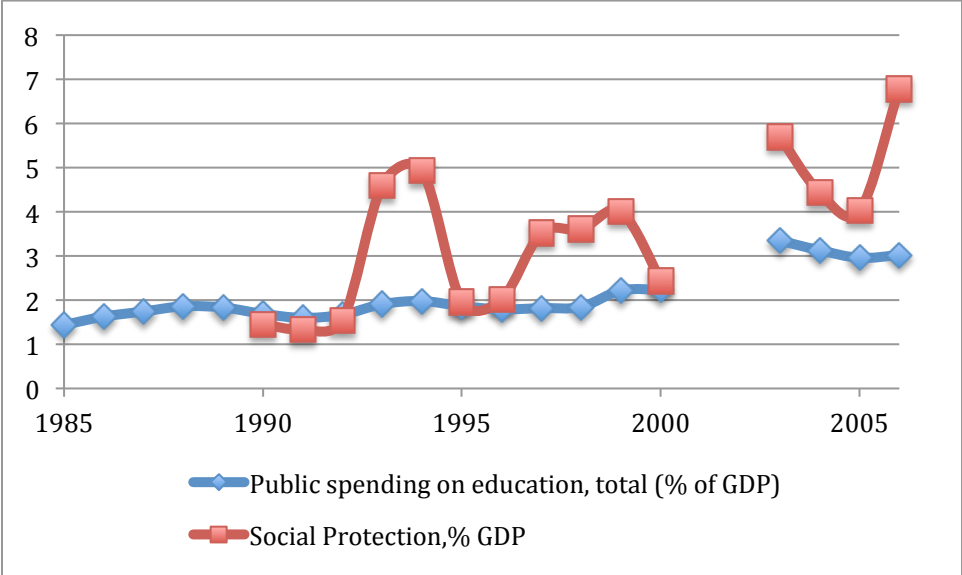


Source: from 1978 to 1998: Wibbels (2001); Latin American Development Bank. On-line Data.

The social protection spending closely reflects the fiscal deficit pattern and the business cycle (Figure 5.29). When government starts to increase spending before election years, the social protection spending jumped and then after the new government came in, it dropped sharply (from 1994 to 1995, and 1999 to 2000—1994 and 1999 were the election years). This does not follow my argument, which says that government increases social spending when they implement structural adjustment and liberalization. However, from 2005 to 2006, the social protection spending increased from 4% to almost 7%, which reflects the left-wing's effort to carry out reform and compensate with the moderate reformist policies with social inclusion policies. This case follows my argument that left-wing government can implement reformist policies, especially when economy is bad, but compensate their main constituencies by

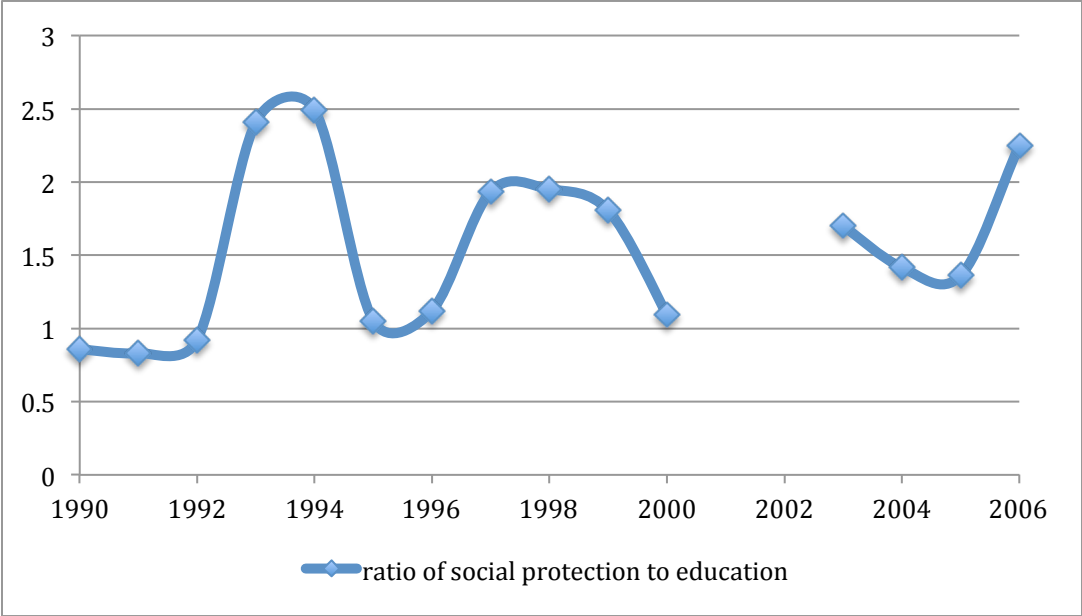
increasing the social protection spending. The ratio of social protection spending to education spending also clearly indicates that the left-wing government increased its social protection spending while reducing education spending (Figure 5.30).

Figure 5.29. Uruguay: Social Protection vs. Education Spending % GDP (1985-2006)



Source: IMF. *Government Finance Statistics* (various years).

Figure 5.30. Uruguay: Ratio of Social Protection to Education Spending (1990-2006)



Source: IMF. *Government Finance Statistics* (various years).

## CONCLUSION

So far, I have looked at each country's historical background and political and economic history. To conclude this chapter, I compare by region and look at the pre-reform and post-reform when countries experience crisis. Most of countries in my case studies implemented some kind of emergency measures when they faced economic crisis. There are 18 economic crisis-reform cases (Table 5.1 below). Among 18 cases, 8 cases involve the right-wing government, 1 involves the centrist, 9 involves the left-wing. Surprisingly, six right-wing governments implemented gradual reform out of 8 and two right-wing governments implemented radical reform. Only 25% of my cases of right-wing implemented radical reform. However, out of nine left-wing cases, four left-wing governments implemented radical, four left-wing governments implemented gradual reform, and one of them reversed reform. Around 44.5% of my cases of left-wing governments pursued radical reform even though around 11% of my cases of left-wing reversed the reform efforts. This clearly shows that when agenda setters face economic crisis, they pursue reformist policies regardless of their ideology. I am cautious to say that left-wing governments are more likely to implement radical reform than right-wing governments, but my cases seem to suggest that right-wing governments usually go for gradual approach while left-wing governments are more aggressive if they take on the reform.

[Table 5.1 here]

Table 5.1. Countries by Region during Economic Crisis

Region: Country Crisis Year: (Reform Year)	Gov. Party (during crisis)	Agenda Reform Efforts	Average Deficit % GDP		Inflation (annual %)		Social Protection Spending % GDP	
			Pre- Reform	Post- Reform	Pre- Reform	Post- Reform	Pre- Reform	Post- Reform
Ghana 2000: 2001	Right	Gradual	-8.64	-4.8	27.3	20.4	1.36	NA
Madagascar 93-2001: (1996) 2002-06: (2002)	Left Right	Gradual Radical	-9.14	-5.66 -4.87	29.44	7.88 11.75	1.7*	1.9* 2.2*
India 1991: (1991) 1996: (1999) <sup>36</sup>	Left L to R	Gradual Gradual	-6.8 -7.0	-6.8 -8.8	8.8 9.7	9.5 4.1	NA NA	NA 0.88
S. Korea 1997: (1998) <sup>37</sup>	Center	Radical	-0.27	0.18	6.1	3.3	1.3	1.5
Bulgaria 1997: (1997)	Right <sup>38</sup>	Radical	-5.7	1.3	263	7.3	28.7	35.2
Latvia 1995: (1996) 98: (99-2004) <sup>39</sup>	Right Right	Gradual Gradual	-2.7	0.3 -2.3	280.2	10.2 3.1	10.4	12.4 11.1
Poland 1990: (1990) 1994: (1995) 2001: (2001)	Left Left Left	Radical Gradual Gradual		-2 -4.1 -4.9		149.5 13.9 1.9		20.6 17.4 NA
Argentina 1986: (1990) 2002:	Left Left	Radical Reverse	-0.9	-1.1 1.0	638.9	4.1 12.8	35.1*	51.2* 38.7*
Bolivia 1983 <sup>40</sup> : (1985) 2002: (2004)	Left L to R	Radical Gradual	-18.3 -8.3	-4.4 -1.1	4435 2.1	27.0 4.7	NA 5.3	4.3 4.5
Uruguay 1985 <sup>41</sup> : (1985) 2000: (2000)	Right R-L <sup>42</sup>	Gradual Radical		-1.2 -2.4		56.2 8.96		2.9 4.7

Source: African Development Bank; Economist Intelligence Unit; IMF; World Bank; Latin American Development Bank; Asian Development Bank; European Bank of Reconstruction and Development (various years).

\* Because of missing data, it is social protection spending as % expense.

<sup>36</sup> change in government from left-leaning coalition to center-right coalition

<sup>37</sup> change in government from long-time ruling center-right party to long-time opposition center-left party at the end of 1997 after the financial crisis.

<sup>38</sup> change in government from the left to the right.

<sup>39</sup> In 2005, new government reversed the reform efforts.

<sup>40</sup> debt crisis in 1982, but the democratic government took over in 1983.

<sup>41</sup> debt crisis in 1982, but the democratic government took over in 1983.

<sup>42</sup> Government change from the right-wing coalition to left-wing coalition in 2005



One of the most interesting findings in the case studies is that almost all governments except India, which has missing social protection spending data, making it impossible to compare, increased social protection spending while they tried to balance the budgets. This supports the compensation theory, that governments compensate the losers from the reformist economic policies, such as tight fiscal and monetary policies, the restructuring of the public sector, privatization, and price liberalization, to name a few.

## **Chapter 6. Conclusion - Ideology, Economic Policy, and Developing Countries**

In this dissertation, I look at relationship between ideology and economic policy in developing countries during economically dismal times. I asked whether ideology really influences economic policies in developing countries, and whether left-wing exists in developing democracies. Then, I tried to find the answers by looking for systematic factors that could make ideology irrelevant.

In Chapter 1, I laid out my argument about agenda setters and their relationship with legislators, and I argue that one needs to look at agenda setters and legislators as separate entities because agenda setters are the main players proposing economic policies in developing countries. Second, I argue that given that there is a possibility for agenda setters to deviate from their party platform, it is more likely when economy is in dismal situation. When economy does not function, ideological difference disappears for agenda setters and also for legislators. Thirdly, I argue that in order to appease the public and particularly the vested interests and trade unions that lose from liberalization, prudent fiscal policy, and structural adjustment, government compensates them with social spending.

In Chapter 2, I test my argument by looking at relationship between agenda setters' reform proposals and their original ideological identification regarding economic policy. I found that there is no correlation between actual agenda setters' reform proposals and their ideological identification once economic conditions are controlled for.

In Chapter 3, I look at whether legislature would also act non-ideologically when it faces economically difficult times by testing the implication on budget balances. I do not find strong

correlation between left-wing and high fiscal deficits that are usually a result of expansionist policy. I found that when economy is in bad or severe conditions, both left-wing and right-wing government pursue more prudent fiscal policies, leading to better fiscal balances.

In Chapter 4, I test whether government compensates the people who lose from liberalization and reform of the status quo. I expected that left-wing will increase social spending more than right-wing government. Instead, I found that when governments initiate reform during crisis, again, ideology does not matter in distribution of different types of social spending—social security and welfare (social protection) spending and education spending. However, I found that governments either increase social protection spending or do not cut social protection spending as much as education spending.

Through case studies of ten countries from all the region of Africa, Asia, Eastern Europe and Post Communist countries, and Latin America, I found strong support for my argument. During normal times, countries kept the status quo, which benefited the existing vested interests. Only when crisis hits the economy, government, whether left or right, would initiate radical reform, which would try to change the economic system and the existing distribution systems.

Still, some questions need to be studied further. First, it is not clear how centrist party government react to changing economic conditions compared to left-wing and right-wing. Some centrist parties jump-started radical reform, and they were successful by relying on the support from the moderates like in South Korea during the Asian financial crisis. And because they were in the middle, some centrist parties could handle both the right-wing and the left-wing's opposition well. However, some centrist parties failed at initiating radical reform and just settled for gradual and ambivalent approach, which even slowed down the recovery from the crisis and cost them heavily in elections like in Uruguay.

For future study, in order to clarify the magnitude of reform efforts, I suggest disaggregating the reform efforts into privatization, liberalization of market, exchange rate regime liberalization, banking sector reform, labor market reform, tighter fiscal policy, and restructuring of the state-owned enterprises. This will allow us to match the specific policy and the vested interests or particular sectors that are most affected by reform of the policy. Then, it will be easier to identify which sector is most resistant to reform and why it is more resistant than other sector. Also, it will allow us to identify whether partisan difference results in different ordering of reform process. For instance, I found that left-wing SLD government of Poland was quick to liberalize the exchange rate regime and pursue tight monetary policy (partly through by setting up independent central bank) while efforts to privatize the state-owned enterprises met militant opposition from both trade unions and legislature.

Ideology is an interesting problem. Ideology should influence politicians' decisions and behaviors somehow, but it is hard to identify through what channel it sometimes works and other times not.

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