

Political Constraints and Public Support for Market Reform

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Abstract

As concerns about “reform fatigue” in lower- and middle-income countries have become more widespread, so has the search for ways of boosting support for market-oriented reforms. While the effects of political institutions on reform results have been extensively analyzed, there has been relatively little investigation of their effects on public opinion. We argue that constitutional and extra-constitutional reforms that place limits on the discretionary authority of public officials, and that enable voters to better monitor, reward, and sanction politicians can enhance the legitimacy of market reforms. We present a voting model with asymmetric information to illustrate that these formal-legal reforms provide a credible signal of reformers’ commitments to ensure that the benefits from reforms are widely shared. Using panel data based on public-opinion barometers from Eastern Europe and Latin America we examine the effects of changes in the constraints of executive power on public support for markets. We find that political constraints boosts support for markets, but that this effect declines as the reform process matures.

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1 Introduction

“Reform fatigue” in lower- and middle-income countries has become a concern of country governments, donors, and multilateral development institutions alike. There has been much recent recognition that, without legitimacy, economic reforms can erode public trust in markets—even as they may succeed in other respects (World Bank 2004a). In this regard, many reform efforts in the 1980s and 1990s fell short, as their processes and outcomes were often perceived as inequitable, unjust, or otherwise inconsistent with prevailing social norms in the countries in which they were implemented. These episodes also generated backlashes against “reform-oriented” governments, as opposition groups from Poland to Peru discovered they could win elections by promising to repair the adverse effects of market reforms.

One of the solutions commonly sought as a means of preventing reform fatigue is “good government,” specifically, expanding political constraints on policy decisions by strengthening the legislative branch, making the civil service more transparent, improving the independence of judiciaries, and enhancing both the autonomy and responsiveness of sub-national governments (see, e.g., Camdessus 1997; Ortiz 2003). These actors constitute “veto players” in the political process—actors whose assent is required for policy decisions—that can effectively restrain the political executive and limit the discretion of public officials. There is now general acknowledgement, moreover, of the need to pair economic reforms with reforms to political institutions (Kuczynski 2003). This represents something of a reversal from the conventional wisdom of a decade ago,

when strategists typically emphasized the need to insulate reformers from public pressures (Williamson 1994).

We seek to understand whether reforming the institutions of the state can boost public support for market reforms. While there have been numerous investigations into the effects of political institutions on market-oriented reform outcomes, there has been comparably little analysis of their influence on public opinion—even as the role of public opinion in shaping the success or failure of economic reforms has been accepted (see, e.g., Cabanero-Vervosa and Mitchell 2003). We begin by examining the potential ways in which economic reform can shape public opinion towards markets. In particular, we examine how the political consequences of economic reform can push public opinion in potentially opposite directions. We then present a simple voting model with asymmetric information to illustrate the political benefits of implementing formal-legal reforms that increase the risk of engaging in corrupt behavior when voters are concerned about expropriation by governmental and economic elites. Here we focus primarily on restructuring the rules and procedures of government in ways that place limits on the discretionary authority of public officials, and thereby enable voters to better monitor, reward, and sanction politicians. At the core of the model is the assumption that these political-institutional reforms provide credible signals to voters of politicians' commitments to improve the welfare of all citizens. Reformers who are willing to establish constitutional and extra-constitutional mechanisms that make politicians and public officials more accountable to citizens restrict their ability to accumulate private benefits, and can boost public perceptions of the legitimacy of markets. The benefits of

signaling intent through these political reforms, however, diminishes as the complexity of market reforms advances.

Our analysis focuses on two regions whose countries have experienced significant reforms to their market mechanisms: the post-communist “transition” countries of Eastern Europe and the Commonwealth of Independent States (CIS), and Latin America. Based on public opinion barometers for a sample of countries in each region, we examine the effects of changes in political constraints on public confidence in and support for markets. We find that increasing the number of veto players in government can make the public more favorably disposed towards markets, but that this effect declines as the reform process matures. We find, additionally, that these relationships often vary as much within each region as they do between regions.

2 Neo-liberal Reform and Public Opinion

There has been relatively little cross-national investigation of what moves public opinion during periods of pro-market reform. The conventional approach to understanding these changes is to assume that citizens’ opinions are based on how they perceive their own economic situation to have been affected. This approach—captured formally in retrospective voting models —has come under greater scrutiny in recent years, though. Empirical analyses of the United States and Europe, for example, has suggested that voters are as likely to be concerned with wider economic outcomes as with their personal welfare. Moreover, it is not clear when voters blame the actions of

governments for adverse economic conditions (Harrington 1993; Anderson 1995). Finally, it is also likely that, during periods of extraordinary economic transformation, citizens interpret changes in economic conditions differently than under normal conditions (Stokes 2001a). We explore below some alternative explanations of what may move public support for reform based on the principal experiences of two regions: Eastern Europe/CIS and Latin America (Figure 1).

<<**Figure 1 here**>>

Although the countries of Eastern Europe/CIS and Latin America initiated reforms under different circumstances, there were several commonalities to them. Countries in both regions liberalized financial markets, opened up markets to foreign investment and trade, privatized public enterprises, and deregulated markets. Moreover, reforms in both countries often occurred alongside major political transformations, namely, the end of Communist Party rule and the breakup of the U.S.S.R., or the eclipse of authoritarian rule.

Leaving aside the effects of economic performance on public opinion, citizens in these countries have also blamed market reforms for endemic corruption, political stalemate, instability, and the increased vulnerability of many segments of the population to economic deprivations. In particular, citizens face two types of risks that threaten to undermine support for markets—expropriation and fragmentation.

2.1 Expropriation by Elites

The first risk is that public officials will exploit their position to extract private benefits at the expense of other citizens. All reforms offer numerous opportunities for arbitrage and rent-seeking. In the 1990s, this came to be seen as one of the main obstacles to growth recovery—not that reforms would not be implemented, but that they would be partially implemented only to be halted by elites who prospered from arbitrage between reformed and unreformed parts of the economy, and who then managed to “capture” legislative and policy-making institutions (Hellman 1998). Middlemen collected large profits by importing goods at subsidized exchange rates and selling them to final producers at higher domestic prices. Mafiosi extorted protection payments where property rights and contracts were poorly enforced. In Russia and Ukraine the “oligarchs” typically acquired wealth by underbidding for natural resource firms in non-competitive auctions, by obtaining subsidized credits in specific industries, or by trading in commodities purchased domestically at regulated prices and sold abroad at deregulated prices. The typical oligarchs were former government officials who had exploited their relationships with ministries, privatization agencies, and state-owned banks to acquire wealth (see, e.g., Shleifer and Treisman 2000).

In these countries it was common for oligarchs to “buy off” legislators (in Ukraine, several oligarchs eventually *became* legislators), and thus control lawmaking processes (Åslund 2000). In Central Asian nations, former high-ranking members of the Communist Party remain in control of both the apparatus of government and of the levers of the economy. Even in the states of Central Europe and the Baltics, asset stripping by

new enterprise owners threatened to undermine popular support for reform by the mid 1990s (Johnson et al. 2000).

Inevitably, left-wing governments replaced initial reform governments in many transition countries. Two electoral outcomes, however, attest to the fact that support for reforms was undercut not by any animus toward markets, but rather, by resentments towards the new-rich or towards those who had obtained their wealth as a result of illegal activities, or due to their status in the old regimes. First these new governments generally continued the reform process initiated by their predecessors. Second, the Communist Parties that transformed themselves into pro-market social democratic parties tended to be better represented than those that retained their hard-line platforms or evolved into other anti-market (e.g., nationalist) parties (Åslund, Boone, and Johnson 2001). Survey data from transition countries suggest that a majority of citizens often demanded *more radical* reforms, and that citizens in countries implementing rapid reforms were more likely to believe their country was heading in the right direction (Warner 2001).

Political constraints serve as a potential protection against expropriation by inter-linked political and economic elites. In particular, political reforms that disperse political power beyond narrow elites should limit the ability of these groups to expropriate rents from the reform process. In sum, the establishment of additional veto points, in limiting the expropriation risk in market reforms, should boost their popularity.

2.2 Policy Fragmentation

The second risk is that, due to political struggles between organized groups—unions, business associations, farmers, etc.—vital reforms will be delayed, will not be implemented, or will become characterized by polarization and paralysis in government. In Latin America, the reform eras are commonly remembered as periods of protracted struggles between fractious political parties and of electoral volatility (Corrales 2002). Moreover, populist excesses of politicians may have, more recently, led to disappointments with the functioning of democratic government (Lora and Olivera 2005; Kurtz 2004).

The possible side effects of fragmentation in reform processes are numerous, but all have the potential to turn public opinion away from support for economic reform and for markets in general. By many accounts, after the “lost decade” of the 1980s many citizens were persuaded that the “bitter pills” of reform entailed both costs and benefits. Debates about these costs and benefits occupied a prominent place in critical elections (in Mexico in 1988, in Argentina and Brazil in 1989, in Chile and Peru in 1990, and in Bolivia in 1993). Although some of the winning candidates (e.g., Menem in Argentina, Fujimori in Peru) may have campaigned as anti-reform candidates, the winners of these elections generally accepted the need to adopt reforms that might be opposed by some of their constituencies (Stokes 2001b).

Reform governments, therefore, could not claim extensive mandates. Moreover, in-fighting and conflicts with opposition groups represented in legislatures often delayed the adoption of reform programs. Where reform programs were implemented, they were often rife with transfers and remunerations dictated by patronage. In Peru, for example,

prior to elections, Fujimori's government poured money into public works and anti-poverty programs (Schady 2000). In Mexico between 1989 and 1994, the national poverty-alleviation program spent 1.2% of GDP annually on transfers heavily skewed towards municipalities dominated by the governing Institutional Revolutionary Party (PRI) (Diaz-Cayeros and Magaloni 2003). Electorally-driven transfers in Latin American countries had a limited impact on actual poverty reduction; more commonly they merely worsened countries' fiscal stances and exacerbated business cycles (Gonzalez 2002; Schuknecht 2000; Mejía Reyes 2003).

And inevitably, by the end of the 1990s, governments that had reneged on promises and that had been in power for lengthy periods began to face stronger social resistance to their policies as well as electoral punishment. As in Eastern Europe, a number of social-democratic governments were elected by the end of the 1990s in Argentina (1999), Brazil (1998), Chile (2000), Peru (2001), and perhaps Mexico (2000). But as in the transition countries, these new governments did not abandon reform programs as much as they watered down certain components—e.g., health reform, labor reform—opposed by key constituencies.

This basic idea—that political fragmentation can limit reform progress—has appeared in a number of incarnations in formal models. War-of-attrition models argue that coordination failures stem from the political advantage that groups have in “holding out” against their opponents, delaying the implementation of reforms that are in the public interest (Alesina and Drazen 1991). Other models have suggested that coordination failures stem from uncertainty about the post-reform environment (Rodrik

1993; Laban and Sturzenegger 1994). In common-property models of this problem, coordination failures prompt politicians and interest groups to deplete stocks of assets (e.g., government revenues, foreign-exchange generating industries) necessary to sustain reforms (Velasco 1997).

Although these models do not directly address the consequences for public opinion, the implication is clear: where policy fragmentation and stalemate characterize the politics of market reform programs, public opinion will sour towards economic reforms. Under these conditions, incorporating additional veto players into policymaking dialogues and procedures can exacerbate the problems of fragmentation. Meanwhile, limiting executive authority proscribes the ability of the executive to circumvent stalemated legislatures. Consequently, greater political constraints, in this view, can potentially dampen public support for reforms.

2.3 The Effect of Reform Maturity

We are left, therefore, with two diametrically opposed hypotheses regarding the purported effects of enhanced political constraints on public support for market reform. How can these be reconciled? The risk of elite expropriation is greatest in the early phases of the reform process, when relationships between constituencies (supporters and opponents) and reform politicians have not yet crystallized. Reforms in the initial phases are typically characterized by a lack of effective representation of group interests due to poorly-institutionalized political parties, labor unions, and business lobbies, in addition to

greater uncertainty regarding the distribution of costs and benefits. But if the ability of broad-based interest groups to influence policy making in early stages of reform is limited, narrower elites with smaller collective action problems and direct access to the state have few such difficulties.¹ Figure 2 shows this relationship; as structural reform ensues, expropriation risk declines.

<<Figure 2 here>>

As reform programs mature the ties between interest organizations and politicians become clearer. New policies generate their own supporters (and opponents), depending upon the resources available to different groups, and over time acquire greater access to and representation in policymaking. Indeed, “second-generation” reforms—reforms implemented following initial prescriptions such as interest- and exchange rate adjustments, price and trade liberalization, privatization, deregulation—are commonly thought to involve more contentious questions, as well as require more technical skill (see, e.g., Naím 1994; Krueger 2000). More importantly, the number of interests potentially affected in “second-generation” reforms is much larger, and consequently they are often far more vocal (Tommasi and Velasco 1996).

This suggests two separate but related outcomes. First, while the risk of expropriation diminishes as the reform process matures, the risk of policy fragmentation increases. Second, we should expect that the effect of enhanced checks and balances on

¹ At the outset of the post-communist transition, for example, group demands were generally not filtered through formal channels. Rather, smaller groups of firms—often single firms—were more likely to lobby the state directly for specific objectives (European Bank for Reconstruction and Development 1999).

support for market reforms will be positive—if elite behavior is constrained—but this effect will diminish as the reform process matures. In the remainder of this paper we present a formalization of these views, and test these views against data from Eastern Europe/CIS and Latin America.

3 A Simple Model

We develop below a two-period voting model with two sets of players: politicians and voters. We distinguish between “committed” and “opportunistic” reformers, i.e., whether reformers are genuine or whether they are willing participants in rent-seeking. This information, however, is unknown to voters. In the first period the economy faces a reform imperative due to crises, international shocks, or other exogenous conditions. The incumbent chooses whether to implement reforms to the institutions of the state—in particular, reforms that enhance political constraints—which serve as a signal to voters of the incumbent’s “type.” A winning politician’s economic reform agenda is implemented in the second period, following elections.

3.1 Politicians

The period 1 incumbent is a reformer of unknown type, indistinguishable to voters, while the challenger is the anti-reform candidate.² The genuine reformer will try to implement an agenda that benefits the public without collecting private benefits. Motivation and honesty, however, may be insufficient, since reform implementation requires some ability to overcome the anti-reform opposition. In particular, following the discussion of second generation reforms in the preceding section, we will assume that later reforms are harder to implement, i.e., the number and strength of anti-reform groups will grow as the reform process matures. To formalize this idea, we denote the probability of a successful reform attempt as $\delta(x)$, where x indicates the maturity of the reform process and $\delta'(x) < 0$.

Both types of politicians also benefit from holding office. We denote the genuine reformer's benefit as V , while the opportunist's benefit is given by a share, λ , of the elite's surplus from expropriating the reform process, denoted by B .

In addition to choosing the level of economic reforms following elections, the incumbent also influences the extent of checks and balances in the political system, denoted by $\sigma \in [0,1]$. The presence of veto players is costly to any reformer because they increase the number of hurdles through which politicians must pass in order to make

² This model applies not to economies that have yet to reform, but to economies that have already initiated the reform process, and where reform-oriented incumbents face anti-reform challenges. Were it the case that an anti-reform politician was the incumbent, reform outcomes would simply be explained by the preferences of politicians given that, by definition, reform would not be on the agenda of the incumbent government.

policy decisions (Tsebelis 2002). Moreover, and of particular importance here, the presence of veto players also implies greater levels of monitoring by other branches and levels of government, and thus increases the risk that any corrupt practices will be detected and punished. These institutional reforms, therefore, generate some costs and benefits for incumbents regardless of type³, while other costs accrue only to the opportunistic type of politician. The equilibrium level of political constraints, given by $\sigma \in [0,1]$, then corresponds to the optimal trade-off between these costs and benefits. To capture the effect of constraints on the risk of engaging in corruption we assume that the probability of punishment is equal to σ and we normalize the politician's utility, if sanctioned, to zero. The expected payoff from corrupt actions for an opportunist, then, is $(1 - \sigma)\lambda B$.

The utility of a committed reformer can then be formalized as

$$-\frac{(\sigma - \tilde{\sigma})^2}{2} + \text{Pr}(\sigma)V, \quad (1)$$

where $\tilde{\sigma}$ corresponds to the optimal trade-off between the non type-specific costs and benefits of constraints while $\text{Pr}(\sigma)$ is the probability of winning the election as a function of the level of constraints. The first term thus reflects the potential loss of deviating from

³ Benefits can take various forms, including reputational benefits for countries that improve political accountability. But there is also, of course, a personal cost to politicians of institutional reforms that allow closer scrutiny of the governmental activities.

the optimal trade-off in order to increase the chances of winning the election by choosing further constraints.

Following the same logic, the utility of an opportunist is given by

$$-\frac{(\sigma - \tilde{\sigma})^2}{2} + \Pr(\sigma)(1 - \sigma)\lambda B. \quad (2)$$

3.2 Voters

Voters are all identical and vote sincerely for the incumbent or the status quo candidate. The different politicians correspond to three different levels of economic reforms, all generating different levels of welfare for the voters. We refer to the outcome when the genuine reformer successfully overcomes the opposition simply as reform (R), the outcome with the opportunist reformer in power as expropriation (E) and the outcome with the opponent in power, or when the opposition cannot be overrun, as status quo or reform reversal (Q).⁴ It is assumed that voters are best off with reform and worst off with expropriation, i.e.

$$u(R) > u(Q) > u(E, x). \quad (3)$$

⁴ These outcomes correspond to three distinct points along the so called j-curve of transition, a continuous representation of welfare as a function of reform progress (e.g. Przeworski 1991; Hellman 1998). The status quo outcome represents the starting point with an intermediate level of welfare, the expropriation outcome corresponds to “the valley of transition”, with the lowest level of welfare, and the reform outcome represents the end point with the highest level of welfare.

Based on the discussion above we let utility under expropriation be a function of the maturity of the reform process, with $u'_x(E, x) > 0$.

Voters care about the likely outcome in case they reelect the incumbent. We refer to the prior probability that the incumbent is a committed reformer as α , while the updated beliefs are given by $\tilde{\alpha}(\sigma)$ conditional on observing constraints σ . The incumbent's relative popularity also depends on a random variable ε drawn from a distribution $G(\cdot)$ —a valence characteristic that encompasses other factors that may influence the standing of the incumbent, e.g., perceived competency, charisma, or ideology. The realization of ε is unknown to the incumbent, making the mapping from σ to the electoral outcome uncertain. It follows that voters will vote for the incumbent if and only if

$$\tilde{\alpha}(\sigma)(\delta(x)u(R) + (1 - \delta(x))u(Q)) + (1 - \tilde{\alpha}(\sigma))u(E, x) - \varepsilon > u(Q). \quad (4)$$

Rearranging terms, the probability that the incumbent wins is given by the probability that

$$\varepsilon < \tilde{\alpha}(\sigma)(\delta(x)u(R) + (1 - \delta(x))u(Q)) + (1 - \tilde{\alpha}(\sigma))u(E, x) - u(Q) \quad (5)$$

which can be represented as

$$G[\tilde{\alpha}(\sigma)(\delta(x)u(R) + (1 - \delta(x))u(Q)) + (1 - \tilde{\alpha}(\sigma))u(E, x) - u(Q)]. \quad (6)$$

3.3 Pooling and Separating Equilibria

Based on the derivation of voting behavior, the incumbent's maximization problem can be defined as choosing σ to maximize the following function:

$$-\frac{(\sigma - \tilde{\sigma})^2}{2} + G[\tilde{\alpha}(\sigma)(\delta(x)\mu(R) + (1 - \delta(x))\mu(Q)) + (1 - \tilde{\alpha}(\sigma))\mu(E, x) - u(Q)]\Omega \quad (7)$$

where $\Omega \in \{V, 1 - \sigma)\lambda B\}$. The solution to this problem depends upon how voter expectations are shaped by the incumbent's choice of σ . Expectations in this case are not a continuous function of institutional reform so we cannot rely on a first-order condition. For comparative purposes, however, it is instructive to analyze a benchmark case in which the probability of reelection is exogenous, that is, not a function of σ . In this case it is straightforward to see that the committed reformer's optimal institutional reform is given by $\tilde{\sigma}$, while

$$\sigma_o^* = \tilde{\sigma} - \Pr(\cdot)\lambda B \quad (8)$$

defines optimal political constraint for the opportunist (denoted by the subscript "o"). The relationship $\sigma_o^* < \tilde{\sigma}$ clearly holds as long as $\Pr(\cdot) > 0$. Hence, an opportunist would

undoubtedly choose a lower level of constraints than a committed reformer if no strategic electoral concerns were involved.

By contrast, where the probability of reelection is a function of σ , the chance of the incumbent's reelection increases as the percentage of voters who believe that the incumbent is a genuine reformer increases. Hence, opportunists will face incentives to mimic committed reformers while committed reformers will try to distinguish themselves from the opportunists. Both incentives work in the direction of greater constraints than that given above. Depending on the parameters of the model, it is possible to identify two different outcomes: first, a separating equilibrium in which the two types choose different σ and voters, being able to anticipate this, can tell the types apart; and second, a pooling equilibrium in which the opportunists mimic the reformers who, in turn, find it too costly to distinguish themselves from the opportunists, thus forcing voters to base their decision on prior expectations.

It is possible to specify the conditions under which a separating equilibrium exists as follows. There must exist a $\sigma^{**} > \tilde{\sigma}$ such that (i) the committed reformer is better off by choosing σ^{**} in order to be distinguished from the opportunist than by choosing $\tilde{\sigma}$ and having the opportunist masquerade as a committed reformer; and (ii) the opportunist is better off by choosing σ_o^* than by mimicking the committed reformer and choosing σ^{**} even though this means that the opportunist's type is revealed. If the set of such σ^{**} contains more than one element, then the committed reformer will select the lowest level of institutional reforms within that set. Formally we can define these conditions as

$$\begin{aligned}
& -\frac{(\sigma^{**} - \tilde{\sigma})^2}{2} + G[\delta(x)u(R) + (1 - \delta(x))u(Q) - u(Q)]V > \\
& G[\alpha(\delta(x)u(R) + (1 - \delta(x))u(Q)) + (1 - \alpha)u(E, x) - u(Q)]V
\end{aligned} \tag{9}$$

and

$$\begin{aligned}
& -\frac{(\sigma_o^* - \tilde{\sigma})^2}{2} + G[u(E, x) - u(Q)](1 - \sigma_o^*)\lambda B > \\
& -\frac{(\sigma^{**} - \tilde{\sigma})^2}{2} + G[\alpha(\delta(x)u(R) + (1 - \delta(x))u(Q)) + (1 - \alpha)u(E, x) - u(Q)](1 - \sigma^{**})\lambda B.
\end{aligned} \tag{10}$$

Figure 3 shows utility as a function of σ , with the two leftmost functions corresponding to the opportunist, and the two rightmost functions corresponding to the committed reformer. The shaded lines represent respective types' utility in the pooling equilibrium, whereas the black lines correspond to the utility in the separating equilibrium. Note that the opportunist is better off in the pooling equilibrium for any choice of σ , whereas the reformer is better off in the separating equilibrium. Consider the case in which both types choose their unconstrained best, σ_o^* and $\tilde{\sigma}$ respectively. This would correspond to a separating equilibrium since voters can identify incumbent type through the choice of σ , so utility is represented by the solid lines. There are clearly no incentives for reformers to deviate from this strategy unilaterally; opportunists, however, can increase their utility by mimicking reformers and choosing $\tilde{\sigma}$. Hence, this cannot be an equilibrium.

<<Figure 3 here>>

This does not mean, however, that there exists a pooling equilibrium. This can only exist if the committed reformer is better off by choosing $\tilde{\sigma}$ (when the reformer is being mimicked by the opportunist) than by choosing some $\sigma^{**} > \tilde{\sigma}$ such that the opportunist is better off by not mimicking. As the figure is drawn, the condition for a pooling equilibrium is violated. That is, there exists a σ^{**} such that the utility of the committed reformer (in this instance, represented by the solid line) is higher than when choosing $\tilde{\sigma}$ (represented by the shaded line), while the opportunist is better off by choosing σ_o^* than by choosing σ^{**} and pretending to be a reformer.

The model shows how private information creates incentives for both types of reformers to extend political-institutional reforms to boost their political support. Opportunists will implement institutional reforms to mask their true intentions from voters in the pooling equilibrium, while the genuine reformers will overshoot in order to separate themselves from the opportunists in the separating equilibrium. Private information creates a link from political constraints to public support for markets, since constraints effectively signal a lower risk of expropriation. We can summarize this first result of the model as the following hypothesis:

Hypothesis 1: *Support for market reforms is an increasing function of political constraints.*

The reform experiences of lower- and middle-income countries, of course, typically involve a protracted sequence of many different, discrete policies. In latter stages, there is typically an increase in the number and variety of actors who must collaborate, as well as the amount of information necessary, to design and implement

major policy changes. Successive reform phases, therefore, will become harder to implement. As we argued above, we posit that the consequences of expropriation are likely to be greater in the initial phases of the reform process. To see clearly the effect of reform maturity on the incentives to separate and mimic, we assume that $G(\cdot)$ is uniform with support on $[0,1]$.⁵ This implies that $G(\varepsilon) = \varepsilon$, and with some reshuffling the two conditions for a separating equilibrium can be rewritten as

$$(1 - \alpha)[\delta(x)(u(R) - u(Q)) + (u(Q) - u(E, x))]V > \frac{(\sigma^{**} - \tilde{\sigma})^2}{2} \quad (11)$$

and

$$\alpha[\delta(x)(u(R) - u(Q)) + (u(Q) - u(E, x))]V < \frac{(\sigma^{**} - \tilde{\sigma})^2}{2} - \frac{(\sigma^* - \tilde{\sigma})^2}{2} \quad (12)$$

The left hand sides of the two inequalities show the political benefits for the committed reformer of separating from the opportunist, and to the opportunist of mimicking the committed reformer, respectively. Both of these benefits are weakened as reform maturity (x) is increased. The committed reformer will face reduced incentives to impose far-reaching institutional reforms to signal type because voters know that both the cost of expropriation and the probability of successful economic reforms are smaller. On the

⁵ This assumption merely simplifies the exposition; it is by no means necessary for the result.

other hand, this also implies that the political cost to the opportunists of being unmasked is lower, and they will thus have fewer incentives to mimic committed reformers. Hence, the effect on the likelihood of a separating rather than a pooling equilibrium is uncertain, but the political gain from further political constraints is unambiguously lower. This implies the following relationship between constraints, popular support and reform maturity.

Hypothesis 2: *The effect of political constraints on popular support for market reforms is weakening as the reform process matures*

4 Data, Estimation, and Results

4.1 Variables and Data Sources

Our central dependent variable, support for reform, is taken from two sets of regional opinion surveys: the *Central and Eastern European Barometer* (CEEB), and the *Latinobarómetro* (LB). The CEEB was conducted in sixteen transition economies between 1990 and 1997, while the LB has annually surveyed seventeen countries each year since 1996.⁶ Following previous analyses of reform support in Eastern Europe/CIS

⁶ Our core sample includes fourteen countries from each region (in Latin America: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico, Panama, Paraguay, Peru, Uruguay, and Venezuela; in Eastern Europe/CIS: Armenia, Belarus, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine). The question on

(Kim and Pirttilä 2003) and Latin America (Lora, Panizza, and Quispe-Agnoli 2004) we define support for reform as the share (by country) of respondents who answer in the affirmative, less the share of respondents who answer in the negative, to a survey question on whether respondents believe that a market economy is in the country's best interest.⁷

support for a market economy—the responses to which we use to construct our indicator of support for market reform—has only appeared in LB surveys since 1998. Consequently, time periods also differ across regional groups (1990 to 1997 for Eastern Europe/CIS, and 1998 to 2002 for Latin America). When pooling the samples we compensate for these different period observations, as noted below, by including time dummies in our benchmark specifications. Note, finally, that the conducted surveys in the former Czechoslovakia and USSR were republic-specific, allowing us to compare responses before and after the breakups of these unions.

⁷ These questions are worded slightly differently between surveys. In the CEEB:

Do you personally feel that the creation of a free market economy, that is, one free from state control, is right or wrong for our country's future?

In the LB:

Do you somewhat agree, somewhat disagree, or strongly disagree [with the following phrase]: a market economy is best for the country?

Note that this different wording creates some problems for comparison between the two regions. First, in the CEEB survey, the “future” is explicitly stated in the question, whereas in the LB survey it is not. Second, possible answers to the CEEB question are “right,” “wrong,” or “don’t know,” but in the LB survey there are four possible answers in addition to “don’t know.” While there are no perfect corrections for these differences, we feel that the benefits from cross-regional comparison far outweigh the potential for misinterpretation. We try to make responses to these questions comparable by performing two corrections. First, rather than estimate solely the percentages that responded “agree” or “right,” we subtract

Following the model, we hypothesize that institutional constraints on executive power will influence support for market based reforms, and that this effect will be conditioned on progress in previous reform efforts. As a measure of institutional constraints, we use a widely available measure of the effective number of veto players in the political system (Henisz 2000). This “Political Constraints” index relies upon a simple spatial model to assess the extent to which politicians are constrained in decision making, adjusted for diminishing returns to additional veto players.

To approximate the degree of progress in reforms, we derive an indicator of structural reform based on the extent of price and trade liberalization, currency convertibility, and privatization. For Eastern Europe/CIS and Latin America, the indicators are taken from two separate World Bank structural reform indices (De Melo, Denizer, and Gelb 1996 and World Bank 2004b, respectively), both of which incorporate internal and external reforms, including reforms to prices, trade, financial, and public sectors. There is no structural reform index that is strictly comparable between these two regions, given the disparity in reform imperatives, sequences, and programs. In addition to estimating relationships by regional sub-sample, therefore, we also normalize both indices by regional maxima and minima to yield an index ranging from 0 (least reformed) to 1 (most reformed) when pooling our samples. Finally, we also include the following

the percentage that answers in the negative from the percentage answering positively to yield a “net support” for market-based reforms. Second, when pooling responses, we always use country fixed-effects as a robustness check to correct for any country/region-specific effects that cannot be readily observed, including differences in the implementation of the surveys.

variables to control for purely economic voting: inflation (in natural logs), GDP per capita, the unemployment rate, GDP per capita growth, and the Gini coefficient. A time trend is also included in all specifications. Descriptive statistics for all variables by sub-sample are listed in Table 1.

<<Table 1 here>

4.2 Results

Our initial results are presented in Table 2. Estimation is by OLS with standard errors adjusted for correlation across panels (Beck 2001). We also model the error term as a first-order auto-correlated process, i.e., $v_{it} = \mu_{it} + \rho v_{it-1}$, and report rho (ρ) values. The resulting estimation thus yields “panel-correct” standard errors, corrected for both contemporaneous and serial correlation. Column 1 shows results when country-year observations for both regions are pooled; in this specification, only the level of inequality has any effect on support for reform, while the measure of political constraints has no significant effect. In the next two estimations we separate the sample between Latin American and Eastern European sub-samples (16 and 14 countries, respectively). Separating the sample in this way shows diverging effects of executive constraints between regions. In Latin America, an increase of one standard deviation in the level of political constraints lowers public support for markets by 5 percentage points; in Eastern Europe, a similar increase boosts support for markets by 12 percentage points.⁸ This

⁸ These and the subsequent estimated values are obtained holding all other variables at their means.

divergence is shown again when we re-pool the samples, add a regional dummy, and interact this regional dummy with the political constraints index.

<<**Table 2 here**>

Table 3 presents the main tests of our central hypotheses. We include the region-normalized measure of cumulative structural reform, lagged once, and interact this term with the political constraints index in column 1. In this specification, a one standard-deviation increase in the political constraints index alone increases support for markets by over 22 percentage points. A combined increase in both the constraints index and the lagged reform index by a single standard deviation, however, increases support by a mere 2 percentage points. Note that the degree of cumulative progress in reform itself does not have any statistically significant impact on support for markets, suggesting that market reforms alone do not generate or dissipate future support for markets in any appreciable way. Rather, progress in reform conditions the effect of institutional constraints on the legitimacy of markets.

<<**Table 3 here**>

Recall that the pooled sample combines two regions, and time periods in which different reform requisites were evident. To be sure, the character of reforms in transition economies in the early to mid 1990s is quite different than that of reforms in Latin America in the last half of the 1990s. Thus in column 2 we rerun the previous estimation using two-way fixed effects to correct for these potential year- and country-specific factors. In this specification our previous results are replicated, suggesting that the relationship between reform progress, political constraint, and support for markets holds

across time and country. Finally, as a further demonstration of the universality of these relationships, in columns 3 and 4 we rerun our basic interactive specification within regional sub-samples. While there are some differences in the statistical significance of some variables—particularly the Gini coefficient and the lagged reform index—our basic results remain constant across regions. Political constraints boost support for markets, but this effect is decreasing as cumulative reforms proceed. This effect can be seen graphically in Figure 4, which plots the conditional effect of political constraints on support across levels of cumulative reform (the solid line), with 95% confidence intervals (the shaded lines).

<<Figure 4 here>>

Political constraints—essentially, institutionalized commitments to limit executive power and to protect individual and collective liberties from state authority—are only one mechanism that can enhance political constraints in government. The other is democratic procedure, namely, citizen representation through contested elections; one of the central tenets of democratic theory is that elections constitute a sanctioning device that induces public officials to do what voters want (Ferejohn 1986; Manin 1997). In one sense, political constraints and elections are complimentary: elections have been considered a “vertical” mechanism for accountability, while separations of power and the presence of veto players are a “horizontal” mechanism in that they require accountability between different branches of government (O’Donnell 1994). Consequently, it remains to be determined whether elections in which citizens are able to select reform-oriented

politicians can serve a parallel function as political constraints in raising popular support for markets.

Table 4 presents our empirical observations of the effects of democratic elections. Column 1 replicates the first regression from Table 3, with the exception that we substitute a measure of democratic contestation for political constraint. We use the familiar *Polity* index of democracy, which is based on measures of the openness of political participation and the level of competition in the selection of political leaders (Marshall and Jaggers 2001).⁹ The Polity index has a similar effect on support for markets as political constraint in both panel-correct and two-way fixed effects regressions. Once we include both measures in the same regressions (columns 3 and 4), however, the effect of the Polity index disappears.

<<Table 4 here>

This suggests that democratic elections are a relatively weaker accountability mechanism relative to institutional constraints. Indeed there is evidence of several regimes in Latin America and Eastern Europe/CIS holding relatively free elections, but having failed to restrict governmental authority or to protect basic rights (Plattner 1999). Other analysts, similarly, have argued that elections are less likely to serve as sanctioning devices, but rather, are more likely to be perceived by voters as opportunities to choose “good” over “bad” politicians with little expectation of accountability (Fearon 1999). There is also the possibility that, simply stated, political representation may not achieve

⁹ The Polity ranges from -10 to +10. We rescale as $(10 + \text{Polity})/20$ yielding a score that ranges from 0 (least democratic) to 1 (most democratic).

accountability as well as expected in reforming governments, and that citizen control over politicians, in these countries, is imperfect.

5 Conclusions and Implications

At the heart of the issues addressed here lies a question that reformist governments often face at the outset of their tenure: to what extent should reforms, in addition to implementing market-oriented prescriptions, extend to remaking the institutions of the state? Debates on the pace and sequence of the transition in formerly socialist economies addressed the relative advantages of executive constraints vs. executive discretion, with "shock therapy" advocates concerned that changes in political rules would divert resources from more important market-reform components, and with others arguing that a new constitutional order characterized by constraints on state power would reduce the risks of rent seeking. Analyses of the so-called "second stage" of reforms in Latin America have, similarly, been cloaked in the language of "good government" in which the professionalization of the civil service as well as the autonomization of legislatures, of sub-national governments, and of the judiciary have emerged as important goals.

This paper analyzed the effects of political constraints on public opinion towards markets. We proposed a simple model in which politicians could signal their willingness to resist attempts at capture by narrow economic elites, and thus convince voters that the benefits of reform would be widely shared. Data taken from public opinion barometers in

Eastern Europe and in Latin America in the 1990s showed that the creation of checks and balances and other mechanisms that proscribe executive-branch power increases the popularity of markets. The magnitude of this effect is heightened in the earlier phases of reform when the risk of expropriation by elites is perceived to be the greatest, and diminishes as reforms proceed. With reform maturity, the risk of expropriation is gradually supplanted by the risk of stalemate, and of intransigent conflicts between supporters and opponents of specific reform programs, something that strengthened political constraints do little to lessen.

Greater appreciation of the vital function legitimacy and trust in markets plays in undergirding and sustaining economic reforms implies that, above all, reform feasibility should address the issue of how to obtain (and sway) public opinion. If the analysis presented is correct, however, it offers several implications for reform strategies as they are commonly carried out by reformers and international development institutions. We mention two such implications here.

First, a reliance on communicating the benefits of economic reforms through general public relations efforts or through informational campaigns focused on specific segments of the population may easily fail to change minds in the earlier stages of reform. It is always difficult for reformers or their agents to communicate credibly to voters, and it is the most difficult in the early phases when the costs and benefits of reform are unclear. But while talk is cheap, institutional reforms that limit state power are not. They are also the clearest signals that a narrow class of elites will not enrich themselves at the expense of the public.

Second, external “anchors”—in the form of international financing and trading agreements, treaties, regional unions, etc.—may also fail to raise support for market reform. A perceived commitment from reformers is critical for the various private actors if behavioral changes are desired. Policies to restore fiscal balance in public accounts will only increase investment if private agents believe that macroeconomic stability will last. Deregulation will only increase job growth if entrepreneurs believe that the elimination of administrative barriers will not be reversed in short order. Under these circumstances, any institutional reforms widely perceived as externally-imposed will not bolster the credibility of—or replace—signals from politicians to voters, and subsequently may not affect public support for reform. By contrast, multilateral or bilateral support in the form of advice on the mechanics of reforming the state that are then implemented by local reformers are more likely to enhance the credibility of these signals.

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Figure 1: Average Support for Reform by Region

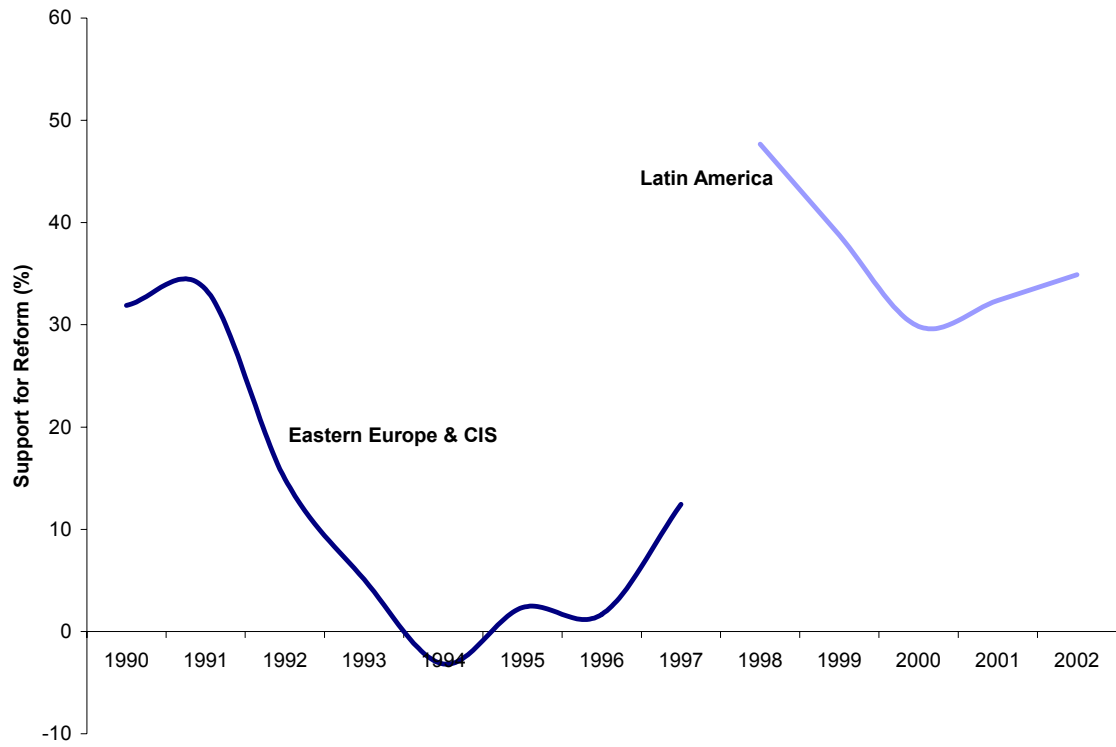
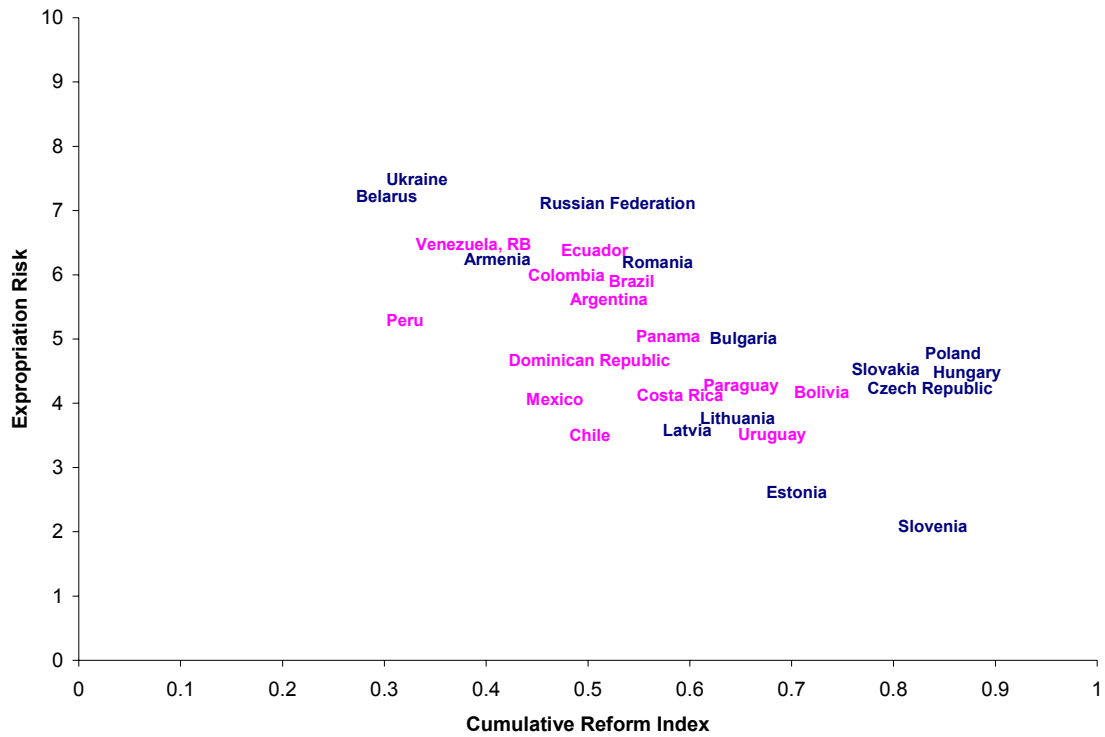


Figure 2: Reform and Expropriation Risk, 1990-2002



Notes: Expropriation risk is taken from the “investment profile” component of the International Country Risk Guide and is rescaled such that higher scores indicate greater risk (Political Risk Services 2005). The cumulative reform index is drawn from indices of structural reform normalized by regional maxima and minima.

Figure 3: Pooling vs. Separating Equilibria

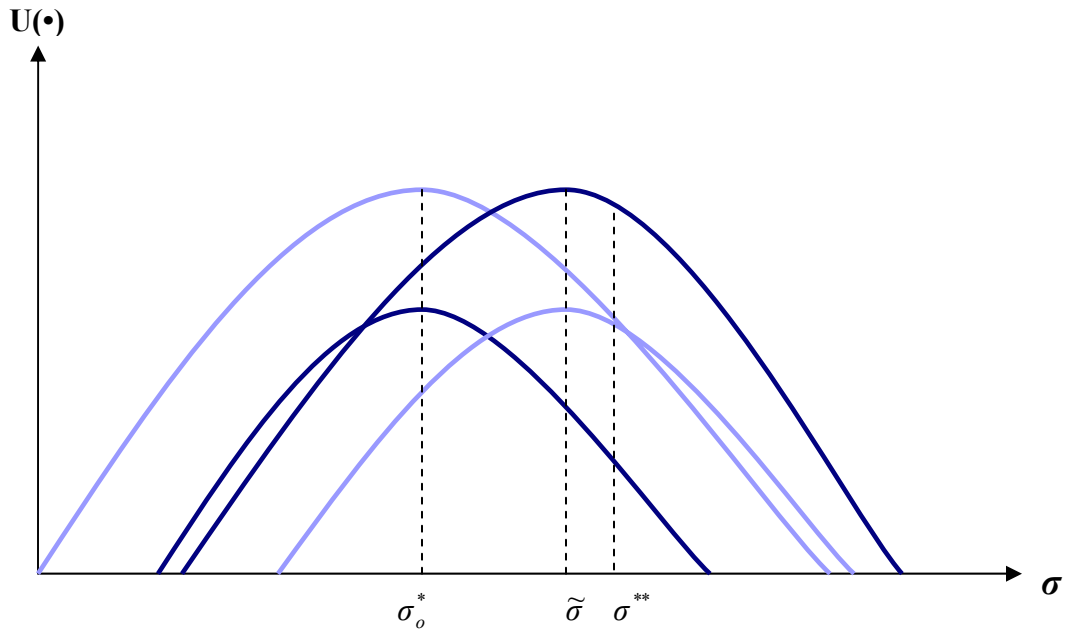


Table 1: Descriptive Statistics by Regional Sub-Samples

| | | Mean | Standard Dev. | | | Min. | Max. |
|---------------------------------------|-----------------------------|-------|---------------|--------|---------|--------|-------|
| | | | Between | Within | Overall | | |
| Eastern Europe/CIS^a | <i>Support for Reform</i> | 10.86 | 21.27 | 14.70 | 23.94 | -46.26 | 63.86 |
| | <i>Inflation</i> | 5.28 | 0.78 | 0.65 | 0.91 | 4.66 | 9.24 |
| | <i>GDP per Capita</i> | 7.88 | 0.63 | 0.11 | 0.58 | 6.64 | 9.23 |
| | <i>Unemployment</i> | 8.25 | 4.29 | 2.23 | 4.59 | 0.08 | 16.40 |
| | <i>Growth</i> | -2.03 | 5.28 | 6.82 | 8.19 | -34.86 | 10.62 |
| | <i>Gini</i> | 31.10 | 6.38 | 3.32 | 6.94 | 18.85 | 48.30 |
| | <i>Political Constraint</i> | 0.37 | 0.17 | 0.14 | 0.22 | 0.00 | 0.65 |
| | <i>Polity Index</i> | 0.87 | 0.17 | 0.80 | 0.16 | 0.15 | 1.00 |
| | <i>Reform</i> | 0.74 | 0.20 | 0.13 | 0.22 | 0.07 | 1.00 |
| Latin America^b | <i>Support for Reform</i> | 33.25 | 14.48 | 7.43 | 15.73 | 4.13 | 62.20 |
| | <i>Inflation</i> | 4.71 | 0.11 | 0.05 | 0.13 | 4.59 | 5.28 |
| | <i>GDP per Capita</i> | 8.10 | 0.59 | 0.03 | 0.56 | 6.84 | 9.07 |
| | <i>Unemployment</i> | 10.14 | 4.32 | 1.40 | 4.48 | 2.10 | 20.50 |
| | <i>Growth</i> | -0.15 | 1.81 | 2.77 | 3.29 | -7.93 | 6.89 |
| | <i>Gini</i> | 51.62 | 5.07 | 0.75 | 4.89 | 42.70 | 58.60 |
| | <i>Political Constraint</i> | 0.42 | 0.19 | 0.08 | 0.17 | 0.00 | 0.65 |
| | <i>Polity Index</i> | 0.89 | 0.08 | 0.06 | 0.10 | 0.55 | 1.00 |
| | <i>Reform</i> | 0.59 | 0.10 | 0.04 | 0.10 | 0.38 | 0.81 |

a. N = 80, n = 14, T (ave.) = 5.71

b. N = 49, n = 16, T (ave.) = 3.69

Table 2: Support for Reform and Regional Effects

| | (1) | (2) | (3) | (4) |
|---|----------------------|-------------------------|-------------------------|--------------------------|
| | Full Sample | Latin America | Eastern Europe/CIS | Full Sample |
| Inflation | -6.8975 (4.6953) | 3.1822 (7.9625) | -0.4662 (2.4862) | -1.3670 (2.5598) |
| GDP per Capita | -2.6865 (3.8242) | -8.8011*** (1.2546) | -4.2920 (5.0447) | -8.2978*** (2.2691) |
| Unemployment | 0.4067 (0.3554) | -0.2817 (0.3488) | 0.7932 (0.5807) | 0.4645 (0.3658) |
| Growth | -0.0015 (0.2969) | -0.3639 (0.2645) | 0.1840 (0.2919) | 0.1838 (0.2176) |
| Gini | 0.8572** (0.3865) | 0.2378 (0.2724) | -1.0075** (0.4259) | -0.7506** (0.3456) |
| Political Constraint | 19.5370 (13.9901) | -22.1266*** (5.2789) | 38.0520*** (14.5754) | 44.9261*** (14.4419) |
| Latin America | | | | 95.4832*** (11.6534) |
| Political Constraint × Latin America | | | | -71.6009*** (15.3922) |
| Trend | -1.8913 (1.6731) | -5.5435*** (1.4316) | -4.6103** (1.8089) | -5.2115*** (1.2433) |
| <i>N</i> | 139 | 59 | 80 | 139 |
| <i>n</i> | 30 | 16 | 14 | 30 |
| <i>R</i> ² | 0.2633 | 0.7415 | 0.3259 | 0.5316 |
| <i>ρ</i> | 0.5618 | 0.6428 | 0.5302 | 0.5527 |
| <i>Wald</i> χ^2 (<i>Prob. > χ^2</i>) | 11.27 (0.1272) | 257.11 (0.0000) | 40.79 (0.0000) | 218.85 (0.0000) |

Notes: Dependent variable is support for reform. Estimation is with ordinary least squares with corrections for contemporaneous and serial correlation. Panel-correct errors are in parentheses. Coefficients on intercepts are not reported. Significance: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 3: Support for Reform and Initial Conditions

| | (1) | (2) | (3) | (4) |
|---|----------------------------|---------------------------------------|---|---|
| | Panel-Correct ^a | Two-Way Fixed Effects ^b | Panel-Correct ^a Latin America | Panel-Correct ^b E. Europe |
| Inflation | -6.3656 (4.1242) | -1.8669 (3.3544) | 21.2256** (9.5635) | -0.0993 (2.5835) |
| GDP per Capita | 4.9030 (4.8809) | 55.9981*** (19.9990) | -8.7816*** (3.0125) | -0.3069 (4.6275) |
| Unemployment | 0.3151 (0.4143) | -0.6775 (0.8106) | -0.1217 (0.3583) | 0.2641 (0.6800) |
| Growth | 0.2569 (0.2796) | -0.4542 (0.3156) | -0.3237 (0.3449) | 0.4236 (0.3224) |
| Gini | 0.4043 (0.3502) | -2.4813*** (0.6236) | -0.1997 (0.1582) | -1.0604*** (0.3796) |
| Political Constraint | 88.3994*** (26.9313) | 120.5693*** (25.9895) | 198.7487** (78.5586) | 105.9750*** (26.9750) |
| Reform ₍₋₁₎ | 2.1272 (23.1488) | 47.5353** (22.6146) | 154.3879*** (55.0458) | 18.8392 (19.6613) |
| Political Constraints × Reform ₍₋₁₎ | -106.1204** (45.4419) | -126.6035*** (39.5901) | -376.0866*** (126.3432) | -110.3526*** (42.1498) |
| Trend | -1.6318 (1.3015) | -1.5826 (1.7291) | -5.3583*** (1.0785) | -4.0631** (1.7128) |
| <i>N</i> | 127 | 127 | 48 | 79 |
| <i>n</i> | 27 | 27 | 13 | 14 |
| <i>R</i> ² | 0.3067 | 0.5201 | 0.6192 | 0.4003 |
| ρ | 0.5407 | | 0.3056 | 0.4987 |
| Wald χ^2/F Test (<i>Prob.</i> > χ^2/F) | 34.86 (0.0001) | 5.29 (0.0000) | 1343.89 (0.0000) | 61.95 (0.0000) |

Notes: Dependent variable is support for reform. Coefficients on intercepts are not reported.

Significance: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

- Estimation is performed using ordinary least squares with corrections for contemporaneous and serial correlation. Panel-correct errors are in parentheses.
- Estimation is performed using country-fixed effects and time dummies. Standard errors are in parentheses.

Figure 4: Conditional Effects with $\pm 95\%$ Confidence Intervals

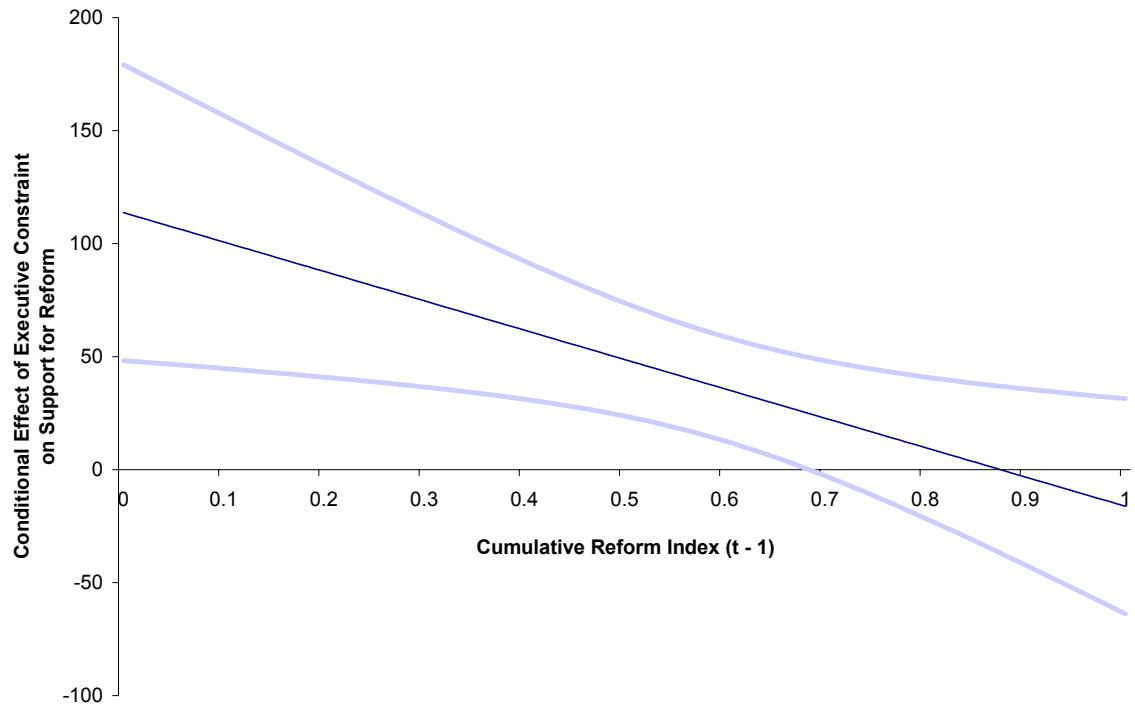


Table 4: Political Constraint, Political Democracy, and Support for Reform

| | (1) | (2) | (3) | (4) |
|---|--------------------------------|---------------------------------------|--------------------------------|---------------------------------------|
| | Panel- Correct ^a | Two-Way Fixed Effects ^b | Panel- Correct ^a | Two-Way Fixed Effects ^b |
| Inflation | -11.7856*** (2.5429) | -3.5552 (2.9551) | -7.5206*** (2.5411) | 0.4273 (3.6714) |
| GDP per Capita | 1.9815 (5.4585) | 22.1116 (18.0859) | 1.3184 (4.1406) | 54.4787** (22.6645) |
| Unemployment | 0.3680 (0.5363) | -0.6619 (0.8887) | 0.1290 (0.4915) | -0.5244 (0.8436) |
| Growth | 0.2108 (0.2211) | -0.0979 (0.3280) | 0.4632* (0.2730) | -0.4733 (0.3290) |
| Gini | 0.5328 (0.3810) | -1.9133*** (0.6594) | 0.3213 (0.3844) | -2.4984*** (0.6670) |
| Polity Index | 110.2778* (65.4844) | 122.5492** (54.4044) | 80.1338 (60.4276) | 28.4906 (64.3184) |
| Reform ₍₋₁₎ | 44.6561 (99.9690) | 194.1664** (83.7050) | 29.6837 (88.2919) | 86.9674 (91.4376) |
| Polity Index × Reform ₍₋₁₎ | -92.6400 (111.8581) | -220.1511** (98.0383) | -31.3971 (99.5162) | -27.9077 (118.5737) |
| Political Constraint | | | 90.7345*** (29.6511) | 123.4656*** (37.4415) |
| Political Constraint × Reform ₍₋₁₎ | | | -133.1945*** (44.6775) | -138.8245** (57.3553) |
| Trend | -1.8664 (1.4512) | 0.4236 (1.9715) | -1.7457 (1.3327) | -1.4705 (1.9066) |
| <i>N</i> | 126 | 126 | 123 | 123 |
| <i>n</i> | 27 | 27 | 27 | 27 |
| <i>R</i> ² | 0.3384 | 0.3427 | 0.3781 | 0.4637 |
| ρ | 0.6876 | | 0.6351 | |
| Wald χ^2/F Test | 48.81 | 2.52 | 517.41 | 3.50 |
| (Prob. > χ^2/F) | (0.0000) | (0.0030) | (0.0000) | (0.0000) |

Notes: Dependent variable is support for reform. Coefficients on intercepts are not reported.

Significance: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

- Estimation is performed using ordinary least squares with corrections for contemporaneous and serial correlation. Panel-correct errors are in parentheses.
- Estimation is performed using country-fixed effects and time dummies. Standard errors are in parentheses.