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Political Economy and Its Application in Latin America: A Review

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ABSTRACT

This article reviews some contributions of two important research areas in political economy which were developed mainly in the US and Europe. Our purpose is to examine some applications of these theories in Latin American countries. Since the complex relationship between economics and politics becomes all the more complicated when the institutional setting does not provide political stability, it is interesting to study if the political economy models developed in the first world are also applicable to Latin America. We conclude that in great part the models developed are consistent with the empirical findings in Latin America. However, much work still has to be done and special consideration must be given to the institutional features of the Latin American countries.

Key Words: political economy, formal models, Latin America

INTRODUCTION

Positive Political Economy, Public Choice, or Modern Political Economy

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is a research program that developed from the seminal works of Kenneth Arrow (1951), Anthony Downs (1957), Duncan Black (1958), and James Buchanan and Gordon Tullock (1962) among others. Dennis Mueller (1997) referred to this field as the application of the methods of economics to political science. Buchanan (1979/1999) was more straightforward when he referred to public choice as "Politics without Romance".

Within the context of this paper, it suffices to view positive political economy as an area where economics and politics interact. Considering such a wide field there will naturally be many different areas of research. Here, however, we will focus only on a subset of themes that deal with the relation between political competition, the rules governing such process, and economic policy. In this sense, we will analyze the direct impact that political considerations can have on economic outcomes, focusing on the relationships between electoral and economic cycles. At the same time, we will examine the behavior of politicians and voters when political competition is considered in a spatial context. All this will be done specifically focusing on applications in the Latin American context. Our goal is not to provide an extensive literature review of these topics[1], but to see if these theoretical developments have been fruitfully applied in Latin America. In this context, we will consider some institutional features in the region that may be relevant in addressing this question.

The early applied studies on the relation between economics and politics dealt with an analysis of the experience in the United States, and later in other developed countries. The more novel interest in Latin America is due to several factors. The ordinary developments in this research program have made such an expansion natural; this is simply a story about the diffusion of knowledge. On the other hand, the fact that many Latin American scholars have been educated on this research program in American and European schools also makes for an increasing application of such theories in the future; this is a story about human capital accumulation.

At the same time, the re-democratization of the region, together with a related institution-building process, have supplemented an interest in political economy, and in applied research in the field in Latin America. This is closely related to an increasing interest on the part of foreign scholars in Latin American issues. In this sense, one can comfortably argue that the nature of the problems faced in the region make for an interesting data-set, so to speak.

1 For a complete literature review see Mueller (1997) and Persson and Tabellini (2000).

The increased popularity of positive political economy in the academic world, specifically in Latin America, can also be linked to the failure of traditional structuralism and dependency based models of offering a viable answer to the economic problems faced in the region. This failure in terms of development programs, and which has also partly been due to a weak methodological basis of these theories, has been made extensive to other areas. Positive political economy seems to be asking the more acute questions, and offering a coherent way of addressing the relevant problems of today in Latin America.

To be sure models based on the experience of the United States may not always be directly applicable to the Latin American experience (Weyland 2002). To the extent that economic theory represents a universal set of theorems, it is important to take account of the influence of some unique institutional features of Latin America. The path dependent nature of institutions is a key element here (North 1990). All said, political economists should have no problems in building theoretical models that take into account the peculiarities of the region or, even more specifically, of some individual nations in the region. The real problem does not lie in the impossibility of analyzing such problems and building such models, but rather in the embryonic nature of such models. But this means that institutional economics must take a center place in the program of positive political economy[2].

In this paper we propose to illustrate and describe a couple of areas of research within the field of positive political economy. Our selection criterion is built on two considerations. On the one hand, we have considered issues that seem particularly important to understanding the problem of political competition in Latin American from a political economy perspective. On the other hand, we had tried to focus on research programs which show a larger incidence of Latin American topics as discussed in the academic literature. While reviews of this kind may be available in professional journals in economics and political science, our focus on Latin American problems and their analysis in the literature is quite unique.

2 The communion we are proposing has of late been applied in examining the problem of long-term development; in this sense, using advanced identification techniques recent studies have explicitly started to address how history matters for economic development (Nunn 2009).

THE POLITICAL BUSINESS CYCLE

In his now classic analysis of economic cycles, Schumpeter (1939) noted that political factors may have an important effect on economic fluctuations. But the analysis of political business cycles under what we have defined as a neoclassical perspective received a greater impulse from the work of Phillips (1958) on the relationship between inflation and unemployment. This seemingly attractive idea, namely that government has the possibility to exploit an output-inflation tradeoff so as to win elections was not, however, developed till the 1970s.

The formal theoretical and empirical work on political business cycles building on neoclassical economics was first developed by Kramer (1977), who examined the relation between macroeconomic outcomes and voting patterns in the American Congress. Nordhaus (1975) formalized a theoretical model that attempted to explain business cycles as a result of an opportunistic behavior on the part of governments. In his model, government policy-makers have an incentive to manipulate economic policy, in particular monetary policy, just before an electoral period with the intention of getting the economy to achieve a short-run output-inflation combination that maximizes the government's re-election chances. This repeated behavior throughout time, whereby governments try to reposition the economy throughout the so-called Phillips curve, produces a cycle characterized by a pre-election boom and a post-election bust, or crisis, which Nordhaus called a political business cycle. It is important to note, before we continue, that in these types of models the institutional framework is regarded as given, and macroeconomic policy is the result of the behavior of a single agent. Thus, the implementation of monetary or fiscal policy only follows the electoral calendar, and it is managed so as to achieve the only goal that government is assumed to have: to be re-elected.

A first reaction to Nordhaus came from Hibbs (1977), who was critical of the assumption that government's only goal was to get re-elected. In his partisan model of economic policy, Hibbs recognized that policy-makers have a more complex set of preferences than that assumed by Nordhaus. Hibbs showed that while Nordhaus' predictions were theoretically consistent, they did not conform to the evidence. After examining data from a series of countries, he discovered that governments follow economic policies according to the interests of their constituents; in other words, if, for example, a government identifies with a nation's business elite, it will be more likely to adopt economic policies leading to low inflation and high unemployment. The rationale for this argument lies in the fact that, presumably, the business elite is more worried about inflation than about unemployment since this is a problem that hits those groups that do not belong to this community harder. On the other hand, if the incumbent government is more strongly identified with popular sectors, it will implement an economic policy that will result in low unemployment and high inflation. From this Hibbs argued that economic booms and busts depend on the preferences of government constituencies, giving rise to the partisan political business cycle theory.

These seminal articles have stimulated a great interest in this line of research, mainly among macroeconomists interested in modeling political features and their relation on economic outcomes. A fundamental critique, however, influenced the development of this research agenda. This dealt with the expectation formation implicit in these models. Both the models by Nordhaus and Hibbs assume a simple, and even naive behavior by voters, such that the final outcomes only depend on the strategic behavior adopted by the government. Voters are considered as myopic and do not seem to use all the available information regarding the characteristics of political agents to form their expectations. But this behavior on the part of voters does not seem rational.

Once we assume rational expectations, on the other hand, voters will respond strategically to the actions of political agents. Thus the situation becomes an interaction, a game, where the strategies implemented by government and by voters must be not only rational, but also credible. The development of rational expectations and of models that formalized the problems of credibility and inter-temporal consistency offered an expanded tool-kit for the analysis of political business cycles (Kydland and Prescott 1977; Fischer 1980; Barro and Gordon 1983).

Alesina (1987) incorporated rational expectations in a model that builds on a Hibbsian partisan behavior by politicians. Since agents have rational expectations, however, governments cannot surprise voters, and business cycles could not be caused by an electoral cycle. This is due to the fact that agents would know beforehand what type of policy a government would implement, and adjust their own behavior so as not to be duped, preventing the government from exploiting the Phillips curve. In Alesina's model, cycles arise from other mechanisms. The main assumptions in this model are that agents determine their nominal contracts before electoral periods and that while agents form their expectations rationally, electoral outcomes are random. In this way, agents determine their nominal contracts based on the expected future value of the price level or output growth, according to the partisan preferences of the possible government types.

Once elections take place and a new government takes power, the effective price level will be different from its previously expected value, and economic cycles, which can be expansionary or contractionary depending on who wins the elections, take place.

On the other hand, Rogoff (1990) and Rogoff and Sibert (1988) have also incorporated rational expectations to political business cycles models. These are opportunistic models with rational expectations, where cycles come about due to asymmetrical information. As voters do not know the real competence of an incumbent government, which is central to their evaluation of its performance, governments will have an interest in signaling their ability through the management of public expenditure prior to elections. The result will be a cycle in government expenditure, accompanied by inflation in post-electoral periods.

Along similar lines of asymmetrical information, Shi and Svensson (2002) propose that the existence of informational imperfections leads to cycles owing to moral hazard problems. Government's ability is not directly observable by voters, who attempt to estimate the characteristics of the government by their performance. Once again, governments will have the incentives to provide a greater quantity of public goods prior to an election to influence voters' decisions[3].

Some empirical studies cast doubts as to whether the actual magnitude of the changes in output during periods previous to elections is significant. In their study of the United States and 18 other OECD countries between 1960 and 1993, Alesina, Roubini and Cohen (1997) find no evidence of an output cycle that responds to an opportunistic economic policy, thus rejecting the relevance of Nordhaus' theory. On the other hand, Alesina, Roubini and Cohen (1997), as well as Faust and Irons (1999) present evidence that confirms the partisan effect for the United States, which is consistent with Alesina's rational-partisan model, but rejects Hibbs' model. Regarding OECD countries, Alesina, Roubini and Cohen (1997) find support for the rational-partisan model, yet Faust and Irons (1999) show that differences in economic activity continue even once you control for the effects of partisan behavior. On the other hand, regarding inflation and the behavior of monetary aggregates there is evidence that suggests an opportunistic behavior á la Nordhaus in several countries, but there is no consensus as to the existence of a partisan-type of behavior (Grier

3 It is interesting to consider that very few models consider both monetary and fiscal policy in a same model. Drazen (2000b) considers a model where a central bank accommodates monetary policy so as to reduce the fluctuations in interest rates caused by changes in fiscal policy reacting to an electoral cycle.

1989; Alesina, Cohen and Roubini 1992; Alesina, Roubini and Cohen 1997; Faust and Irons 1999).

Applications in Latin America

Larraín and Assael (1995) have searched for a political business cycle during the second half of the 20th century Chile in a model that considers the possibility of a strategic use of fiscal, monetary and exchange-rate policies. Working with macroeconomic and electoral data for the period between 1939 and 1989, they find clear evidence of a political business cycle, especially for monetary and exchange rate policies, around presidential elections. However, they find no effects around parliamentary elections. The explanation for this seeming contradiction lies in the fact that Chile has a strong presidential system; thus, competition is much stronger during presidential elections where much more power is at stake.

In a very interesting recent paper, Meloni (2008) addresses the effects of clientelism, a widespread Argentinean phenomenon, on the political business cycle in this country. Maintaining clientelistic relations naturally involves effort on the part of patrons, but this paper focuses on the consequences of organizing and maintaining a clientele on the pattern of local government expenditures through a political cycle. Using a dynamic panel data estimation, the results indicate that these effects do indeed exist; in this sense, government expenditures are not only high during electoral periods, but also in pre-electoral periods.

The work by Ames (1987) is also relevant in this sense; Ames considers a panel of 17 Latin-American countries between 1947 and 1982 and finds evidence suggestive of expansionary fiscal phases during electoral periods and reductions in post-electoral periods, which seems to confirm an opportunistic behavior by governments. Similarly Haggard (1991) and Haggard and Kaufman (1990) argue that there exists a correlation between political events and inflation in Brazil, Chile, Argentina and Uruguay.

Further examples of this type of behavior can be found in the management of the exchange rate policy. The topic of the political economy of exchange rates is a problem that seems unique to developing countries. Fixed exchange rates represent a particular monetary institution, one that may make it possible to solve the time-inconsistency problems involved in the management of monetary policy. At the same time, however, different exchange rate policies offer different tradeoffs between stability and flexibility (Bernhard, Broz, and Clark 2002). In this sense, it should come as no great surprise that we find an extensive literature that examines the political economy of exchange rates; i.e. that deals with the effects of political issues on exchange rate policy. In general this research finds that political considerations can be, and have been, important determinants of the decision to implement one type of exchange regime over another (Wise and Rioett 2000; Stein and Streb 1999; Frieden and Stein 2001).

Stein and Sterb (1999) present an especially valuable theoretical model along these lines. In a manner similar to that of the mainstream literature on political cycles, that is, under a framework of rational expectations and asymmetric information, it is argued that devaluations are delayed in the run-up to elections in order to increase the electoral chances of the party in office. A simple empirical analysis based on 26 countries in Latin America and the Caribbean over the period 1960-1994, tends to confirm these results.

Blomberg, Frieden and Stein (2005) study the problem of the maintenance of a fixed exchange rate in Latin America between 1960 and 1999 and show that the probability that such a system will endure increases as an election approaches. This is related to the countervailing influences of interest groups in the tradeable sector, who would prefer a more flexible exchange rate, and the more general concern governments have over inflation in close to elections periods, which should lead to some type of currency peg. In terms of individual countries several other studies are available. In an examination of the Colombian experience during the second half of the 20th century, Jaramillo, Steiner and Salazar (2001) find that the nominal depreciation of the local currency tends to be smaller in electoral years than in non-electoral years. For the case of Brazil between the mid 1960s through the late 1990s, Bonomo and Terra (2001) find that in pre-election periods the probability of maintaining an overvalued exchange rate increases, as does the probability of switching to such a system. In the same manner, the devaluations experienced in pre-electoral periods in Mexico during the 1970s and 1980s have also been considered as evidence of a political business cycle; according to this view, Mexican governments have, on several occasions, implemented expansionary policies that produce fiscal and external imbalances. But as Cardoso and Helwege (1995) have argued, the policies necessary to correct these imbalances were postponed on several occasions to guarantee the electoral results desired by the government. On the other hand, Obstfeld and Rogoff (1995) have contended that the problem with the credibility of the exchange rate policy established by the Mexican government in 1994 was a result of the recurring post-electoral devaluations of previous periods. Likewise, Kessler (2000) describe how the Mexican government maintained what turned out to be an apparent economic stability until the 1994 elections.

The models of political business cycles existing in the theoretical literature essentially deal with the interaction between macroeconomics and politics in the context of political competition in closed economies. Considering exchange rate policy as a policy instrument represents an important extension of research on the political business cycle. Our knowledge of this question is, however, still subject to improvement as further theoretical and empirical work proceeds further along these lines.

From a different perspective it is possible to focus on the political economy of fiscal policy as a sub-topic of the political business cycle. After all, when fiscal policy is used strategically it is done so with the intention of affecting electoral outcomes, although no model of a business cycle is explicitly included in this literature[4]. Regarding this issue, in the context of the Latin American experience, Cerda and Vergara (2008) have examined the effects of specific government subsidies on Presidential elections in Chile at the municipal level; the authors consider 3 elections (1989, 1993 and 1999) and find that the greater the number of people receiving subsidies the higher the votes the incumbent will receive. Similar types of exercises have been undertaken in other Latin American countries. For example, Nazareno, Stokes and Brusco (2006) examine the case of the expenditures associated to the "Plan Trabajar" across municipalities in Argentina; these authors find that the government engaged in discriminatory spending in order to attract the support of marginal voters. In the case of Peru, Schady (2000) has shown that the Fujimori government was influenced, in terms of the allocation of expenditures on poverty mitigation programs, according to electoral considerations. In the case of Mexico, Magaloni (2006) has shown the differences in behavior on the part of different PRI governments regarding the allocation of government expenditures through the "Plan Nacional de Solidaridad" to different municipalities. These results are consistent with the analysis of Gonzalez (2000) on Mexico's fiscal policy, where the magnitude of the election cycle was exacerbated during the country's most democratic episodes.

In an empirical analysis for Colombia, Eslava (2006) focused on the effects of changes in the composition, rather than the size, of the public expenditures (see, also, Drazen and Eslava 2010). The results suggest that in the year preceding an election the components of the budget

4 The close relation between economic performance and voting offers further arguments for the strategic use of economic policy; on this relationship across different countries see, for example, Fair (1982), Engel and Araos (1989), and Panzer and Paredes (1991). For some extensions and complications, see Benton (2005).

that can be identified with targeted spending grow, and that non-targeted spending contract. Moreover, voters reward such increases in targeted spending, although they punish incumbents who run high budget deficits.

All things considered, while inflation, unemployment and the management of fiscal, monetary and exchange rate policies are all very important phenomena, under the perspective of the political business cycle theory the microeconomic interaction between political actors is neglected. We will examine this angle of political competition next.

THE SPATIAL THEORY OF VOTING

The spatial theory of voting applies microeconomic analysis to the study of elections. Specifically, spatial models of competition examine how governing coalitions try to hold on to power. At the same time, and as we shall see when we consider some applications of these models, they allow us to uncover the political preferences of voters through the construction of "spatial mappings".

This approach to the problem of political competition has been called the "Downsian Theory of Voting", since Downs (1957) was the first to use the spatial concept as a key variable for voting behavior. However, the origins of the spatial theory of voting go back to the 1920s, when Hotelling (1929) developed the principles of what we now know as spatial competition. Hotelling was interested in the problem of why it is usual to find two competing firms located geographically very close one to another. The case of gas stations situated across from each other in large intersections, or department stores located in the same shopping centers are well known examples in this sense. In Hotelling's model, two firms try to maximize their market share, assuming that consumers are distributed uniformly in a bounded area (i.e. a fixed interval). Under certain assumptions, he found that both firms would locate in the center of the interval, which corresponds to the location of the "median" consumer. Hotelling then suggested that this model also seemed pertinent to other situations; in particular he ventured that political competition has many features that are similar to the geographic competition between firms and, thus, the platforms offered by two coalitions that compete politically would tend to be very similar.

Downs (1957) and Black (1958) were the first to apply Hotelling's ideas to formal models of political competition. The famous "Median Voter Theorem" is one of the most important results in this area. In its simplest form this theorem states that when voting occurs on a single dimensional issue, and if the preferences of voters are single-peaked, then a majority-voting rule will lead to the victory of the alternative preferred by the median voter. In other words, it is the median voter who determines the outcome of the election.

As almost every seminal contribution in economics, the median voter theorem depends on a series of simplifying assumptions that would be relaxed in subsequent research. The first assumption to be relaxed was the single dimensionality of the voting issues. In this respect, Davis and Hinich (1966; 1968) introduced a mathematical formulation designed to include multi-dimensional preferences on the part of voters. Their new formulation also induced modifications in other basic assumptions for the theorem to hold.

In an important paper Plott (1967) presented the formal conditions that assure the existence of a Condorcet winner in a multidimensional issue space[5]. This was a generalization of the median voter theorem. Later, Davis, DeGroot and Hinich (1972) expanded Plott's result introducing the concept of a median in different directions as a requisite to achieve an equilibrium under multiple dimensions.

While important and interesting, one cannot ignore the fact that these refinements were still based on highly simplified assumptions that were very unlikely to hold in reality. As researchers were immersed in searching for a better solution to the multidimensionality problem, Richard McKelvey (1976; 1979) published his well-known "chaos" articles. Here McKelvey showed that when multidimensional issues are considered, a majority-voting rule produces continuous cycles and problems of global intransitivities of the set of choices faced by voters. This was a radical result for the theory of voting because, in essence, it implied that it was not possible to implement a stable set of policies since there would always be a different coalition which would inevitably triumph under majority-voting and would prefer to implement a different set of policies.

In the early 1980s, however, Tullock (1981) noted that the predictions of these instability models, derived from the formal mathematical constructions of the spatial theory of voting, did not match the existing evidence which showed a strong pattern of political stability. Several attempts to explain the puzzle and answer these questions were then brought up. Shepsle (1979) introduced the concept of structure-induced equilibria as

5 A Condorcet winner is the alternative that cannot be defeated by any other alternative under a majority-rule; under the median voter theorem, the median voter is a Condorcet winner.

a way of explaining this stability. On the other hand, Romer and Rosenthal (1978) introduced the concept of an agenda-setter, who assures that voting processes, especially committee voting, present strong patterns of stability. And even Tullock (1981) proposed an explanation to this puzzle, arguing that logrolling could be the mechanism that generated stability.

Another line of critique of the spatial theory of voting emerged from the prediction of the median voter theorem that when the conditions for there to be a Condorcet winner hold, political contenders would have the incentives to present the same electoral program (which would be the one preferred by the median voter). Subsequent papers by Hinich (1977), Coughlin (1984) and Ledyard (1984) showed that this convergence result was indeed very general. And yet, this policy convergence is not actually found in the real world. But the critiques by Tullock and others on this point did not result in the collapse of this research agenda. Instead, they induced researchers to build newer models that incorporated this real world feature.

More recently, one of the most important contributions to the spatial theory of voting was introduced by Hinich and Munger (1994). Faced with the problem that, traditionally, the spatial theory assumed that voters have a very high degree of information, which clearly seemed implausible, they proposed that voters really use ideology as a way to simplify their evaluation of candidates. Such a variable helps voters save on time and money, since now voters do not need to know the exact stances candidates have on issues that are central to them. In probabilistic models of this kind, voters form expectations on the real characteristics of candidates, which open the possibility that they, in turn, signal their characteristics so as to try to win an election. Along these lines, and building on Hinich and Munger, Bonilla (2004) has proposed an ideological model of campaign finance where the preferences of voters are endogenized.

Other older refinements of the spatial theory of voting were proposed by Wittman (1973; 1983) regarding the incentives of competing candidates and the use of probabilistic models as opposed to the Downsian model where candidates maximize votes. Even if we assume that candidates have preferences over policies, Calvert (1985) has shown that if the distribution of voters over the set of policies is known, candidates tend to converge to the median voter. It was the probabilistic models that allowed Wittman (1983) to break with the median voter result and predict a differentiated behavior on the part of candidates, much more like the real world evidence.

Applications in Latin America

Applications of the spatial models of voting are relatively scarce compared to political business cycles. As for the United States, the best known such contribution is the seminal book by Enelow and Hinich (1984) who, for different elections, estimated spatial political mappings. Specifically, Enelow and Hinich use the well-known Cahoon-Hinich methodology (Cahoon, Hinich and Ordeshook 1978), which allows for a location of candidates (and parties) in a common Euclidean space, thus making it possible to make interesting comparisons for issues relating to political competition.

Regarding Latin American countries the contributions are even rarer. One exception is the work by Dow (1998a) who studied the spatial composition of the first Senatorial elections in Chile following the end of Augusto Pinochet's military regime in 1990. Dow finds that given the electoral system existing in the country (a d'Hondt type of system), there exist incentives for the candidates of each coalition to adopt extreme positions. These "centrifugal forces" provoke polarized political campaigns, where the left and the right are the real contenders in the senatorial election, putting the center of the political spectrum in a secondary position. In another study, Dow (1998b) examined the importance which Pinochet's figure had on the Presidential elections of 1990, and found that apart from the differing positions candidates held on an economic dimension, the position they held regarding Pinochet's legacy was a decisive factor in determining the behavior of voters.

More recently, Bonilla et al. (2011) have used the Cahoon-Hinich methodology to estimate spatial mappings of the Chilean political situation. Working with polling data from early 2003, they dispute the sociological cleavage model of Lipset end Rokkan (1967) arguing that the Chilean society is still very polarized about Pinochet's government and that a pure political cleavage took place in the Chilean society. The spatial maps also reveal that the variable "change from the status quo" has become an important determinant for Chilean voter's preferences, and it was a key variable in the 2005 presidential election.

Spatial models have also been estimated using roll-call data; that is, recorded votes in legislatures. Poole (2005) and Poole and Rosenthal (1997) have probably been the most important contributors to this literature, and have undertaken important applied research in the U.S. Interestingly, studies that attempt to recover the ideological positions of legislators/ politicians from their votes has also been applied in Latin America[6].

Londregan (2000) has also worked on these issues in the case of Chile. Specifically, Londregan focuses on the Chilean Senate and the transition to democracy after the military rule, and uses sophisticated statistical techniques to recover the positions of legislators over several issues, including political, cultural and social issues. In this sense, it is important to mention that this work is also a great contribution to the different problem of understanding the transition to democracy when an authoritarian government voluntarily cedes power[7].

More recently, Saiegh (2009) has attempted to uncover political party positions in different Latin American countries using surveys on elites. Importantly, the author shows that the results obtained are consistent with what is commonly known about the political landscapes of these countries; indeed, it is argued that the proposed approach provides better estimates than approaches based on roll-call voting procedures.

From a somewhat different perspective, it is important to comment on the role policy-gatekeepers in Latin American legislatures as a feature that restricts the domain of policy change even in a context of political competition. Research by Alemán (2006) represents a key contribution to the literature on political stability in the context of different legislatures in the region.

The spatial theory of voting represents an important theoretical contribution as well as a powerful tool for political analysis. As it is useful to explain candidate competition, it can also be considered an important complement to models of the political business cycle. In this sense, we can expect that we will encounter more frequent applications of this model in Latin America.

INSTITUTIONAL ECONOMICS IN LATIN AMERICA

Standard models of political competition assume that democratic processes, guided by a voting rule such as simple-majority voting, will lead to a given set of outcomes. The previous issues one should examine

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6 The limitations of this kind of approach are, of course, well-known, especially when we consider the possibility of strategic voting and agenda manipulation (Cox and McCubbins 2005).

7 Indeed, the separate focus or emphasis of many articles who use roll-call data in Latin American legislatures is a great problem for a review of the literature such as the one we are undertaking.

here relate to the process through which political institutions come about, and to the effects of different types of rules; this defines the domain of constitutional/new-institutional economics (Buchanan 1990)[8]. This perspective calls attention to the "constitution of economic policy" (Buchanan 1987); that is, it reminds us of the importance of analyzing the rules under which agents act and interact. This recognition that economic policy does not take place in an institutional vacuum is, thus, a common feature of constitutional economics and the new-institutional economics as examined by North (1981; 1990). Institutions can, of course, be viewed from a contractarian-constitutional perspective, as well as through other lenses. Hayek (1960) proposed an evolutionary approach to institutional development, while Hardin (1989), Ordeshook (1992), and Weingast (1993) view constitutions as conventions[9]. For our current purposes, however, this is not an issue that concerns us much here.

The key point we wish to address refers to the problem as to how constitutions work. More specifically, here we wish to focus on this problem as it relates to the issue of political competition as examined in section II above, and the special features that are present in Latin America that may make the application of very basic and minimal theoretical models on these questions inadequate. Several points are important to keep in mind in this respect.

Firstly it is important to point to the issue of institutional persistence associated to legal and institutional setups that have not always been economically efficient. In their research on the long-term pattern of development across societies, North, Sumerhill and Weingast (2000) have convincingly argued that the institutional matrix in Latin America presents a marked path-dependent character following the Spanish colonial heritage[10]. Using a different methodological approach, Chong and Zanforlin (2001)

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8 Here there is a clear difference between a positive and a normative approach to constitutional economics. Normatively the problem is that of choosing "better" rules where this adjective reflects the desire to constrain government, or achieve higher rates of economic growth.

9 Working from the perspective of game theory, these contributions see the constitutional problem as a question of achieving order, which can be analyzed analytically as a coordination problem using the game theoretic approach. To the extent, then, that the constitutional problem is no longer viewed as a social or a prisoners' dilemma, the enforcement of the constitutional rules will be quite straightforward. Moreover, the analogy of constitutions as the rules of a political game seems quite appropriate here.

10 See, also, Fukuyama (2006) and Acemoglu et al. (2001; 2002). This, however, does not suggest that reform in impossible in Latin America; on this see, for example, Larroulet (2003).

also attempt to explain the persistence of some institutional designs harmful for growth in Latin America; for these authors the problem can be explained using Olson's (1993) model on stationary versus roving autocrats where it is assumed that Latin American stationary autocrats had an encompassing interest in society and, thus, an incentive to provide better governance than transitory autocrats, who would tend to extract abusive rents.

On the other hand, one should recall that by its very nature the institutional/constitutional perspective is concerned with the evaluation of alternative rules or systems of rules, and a comparative analysis of their economic consequences. Several of the issues that appear in this literature are relevant to the problems of political competition in political business cycle and spatial models (Mueller 1996; Persson and Tabellini 2003). They are also particularly relevant to our discussion, especially given the variance in terms of rules (and institutional quality) within Latin America and vis-à-vis developed countries.

As noted above, the literature on the political business cycle and the political economy of fiscal policy suggests that fiscal policy may be manipulated motivated by political considerations. However, it is important to keep in mind that budget institutions have important effects on fiscal choices (Buchanan 1967; Eslava 2006)[11]. After all, budgetary institutions represent the sets of rules that govern the crafting of public budgets (Alesina and Perotti 1999; Poterba 1996). In the Latin American context the effects of budgetary institutions have been examined by Alesina et al. (1999), and by Stein, Talvi and Grisanti (1999). Alesina et al classify budgetary institutions in a scale that is a function of the existence of constraints on the deficit and of legislative voting rules, and show that hierarchical and transparent procedures have been associated with more fiscal discipline in the region during the 1980s and early 1990s. Stein, Talvi and Grisant proceed differently, and examine the effects of electoral rules and budgetary procedures on different measures of economic performance; their results suggest that electoral systems based on larger degree of proportionality (and fragmentation) tend to have larger governments and a more procyclical response to the business cycle.

A recent study by Amorín-Nieto and Borsani (2004) focuses specifically on the political determinants of fiscal behavior. These results suggest

11 Seminal contributions in this field include the work by Persson and Svensson (1989), on the "conservative" bias for budget deficits, and Tabellini and Alesina (1990) on political instability and budget deficits. These results are, however, mediated by fiscal institutions and fiscal performance. On these issues, see the review in Alesina and Perotti (1999).

that presidents supported by strong parties (and more to the right on the political spectrum) have a positive impact on fiscal balance, although this is affected by the electoral cycle.

In all these results are consistent with case studies, such as those by Baldez and Carey (1999) on the effects of the political-institutional rules regarding the Chilean budgetary process, and by Pereira and Mueller (2004) on the case of Brazil[12]. At the same time, they are consistent with the important work on the politics of policy developed under the auspices of the InterAmerican Development Bank (Stein and Tommasi 2008).

In the volume by Stein and Tommasi we find a very clear articulation as to why and how "politics shapes politics". The underlying analysis presented here places great emphasis on the role of institutions as determinants of the incentive structure within which political actors interact (see, also Spiller and Tommasi 2003). The policy-making process in Latin America has provided a very interesting environment for examining these issues; the comparative experience in many countries highlights some particularities of the region. In all, in Latin America (as elsewhere) political actors will interact within the context of the rules existing in the region; these may offer greater or lesser possibilities for an opportunistic use of economic policy within the economic cycle. Therein lies the relevance of a previous remark in the sense that standard models of the political business cycle do not take into account institutional considerations; at the same time, this is also the reason why political and even electoral rules can have significant effects on fiscal outcomes (as has been suggested by Persson and Tabellini 2003).

Let us consider the case of a specific institutional feature: federalism. An ideal federalist system has been considered to limit the possibility of government to encroach on the rights of citizens (Weingast 2005); federalism as is, on the other hand, can produce inefficient outcomes (Wibbels 2000). In the case of Argentina it has been argued that federalism has proved to be an institution that offers almost no incentives for fiscal responsibility (Saiegh, Spiller and Tommasi 2007). The problem is related to the fact that government revenues are considered a common pool resource which, following what we known for these types of resources under market-like conditions, will tend to be overexploited (Velasco 1998). Jones, Sanguinetti and Tommasi (1999) also apply a model of this type

12 More generally, the recent Chilean experience in terms of a "fiscal rule" (Marcel et al. 2001) seems to represent an interesting case of a fiscal constitution. This seems to represent an exercise in "self-binding" a-la Elster (1979) that has had huge influence in the management of economic policy in the country.

and suggest that it works well in explaining the existing fiscal extravagance in Argentina.

The common-pool model as applied to the budgetary process has also been employed by Hallerberg and Marier (2004) who extend this framework of analysis to Latin America as a whole. These authors argue that the common pool resource property problem appears both at the cabinet level (where individual cabinet members compete for a larger share of the budget), as well as in the legislature; electoral systems turn out to be key in this latter respect.

While we have talked much about fiscal policy cycles and the effects of different types of budget rules, it is important to recall that monetary policy can also be employed strategically. The solution to the commitment problem that appears here has led to important research on the causes and effects of central bank independence (Cukierman 1992)[13]. The popularity of this type of institutional setup in the region is evident; however, as Gutiérrez (2003) explains, the success of this type of system is not necessarily guaranteed by a statute that grants a Central Bank its legal autonomy. In the case of Latin America, entrenching a Central Bank's independence in the constitution seems to provide the expected results in terms of monetary stability.

Our analysis so far begs the question as to why Latin American countries have the institutional setups they have. Here we will defer to our previous comment on the importance of institutional persistence and the role of history. The development of newer models that focus on the endogenous nature of institutions may offer a more complete answer to this problem. In this sense, while the selected contributions we have reviewed provide some light as to the relation between institutions and growth, and the reasons for the adoption of certain institutional designs in Latin America, there still remains much to be done in this literature. As Olson (1996) has explained, there are "big bills left on the side-walk" as to the study of the relationship between institutions and growth and, we would add, even to the origins of institutions.

CONCLUSION

Traditionally, economics has been based on the rational choice paradigm.

13 This problem can also be solved through the determination of the exchange rate policy; recall that we have commented on the political economy of exchange rate policy above.

In this paradigm individual agents interact with one another in the market in order to maximize their personal utilities subject to resource constraints. Since the seminal the works of Anthony Downs, Duncan Black, Kenneth Arrow, James Buchanan and Gordon Tullock in the 1950s and 1960s, the rational choice approach has also been used to study political competition and, more generally, the effects of politics on economic policy, giving birth to what we know today as political economy.

During its first decades, political economy evolved as a research program that mainly tried to explain the problems observed in the United States and Europe. In more recent years however, researchers in this area have started paying attention to how these theories fit political outcomes in developing countries.

In this article we have reviewed a couple of research areas in the field of positive political economy, giving special attention to the empirical application of these theories to Latin American countries. These countries are interesting subjects of study because they present unique institutional feature, which makes them the best empirical proof of the generality of the results of formal political economy. From a methodological perspective, especially in terms of maintaining a methodological consistency with economic models applied to the activities by rational agents in the marketplace, we do not believe it is appropriate to claim that Latin American's are in some way special such that different economic theories (in terms of the political economy of economic policy) or different models of human behavior are required in the region.

We have seen that, even though there exist some applications of these models in Latin American context, still much work has to be done to integrate features like political instability and weak institutional settings into formal models of political economy in order to have a consistent framework to really understand Latin American politics, electoral behavior and economic policy in developing countries. This involves taking into account the unique institutional features of Latin America, as many authors we have examined have done. Methodologically, empirical studies that take into account the peculiarities of the region may be an appropriate alternative; another possibility is in terms of the development of case studies or analytic narratives (Bates et al. 1998). Whatever the case, more research is needed on the political economy of economic policy in the region.

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