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EMBEDDING NEOLIBERAL REFORM IN LATIN AMERICA

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THE process of global integration in recent years has presented scholars with a striking puzzle. While it was long believed that expansion of the public sector would reduce the competitiveness of national producers and distort labor markets and thus would be sharply curtailed by globalization, recent scholarship has observed instead that the size of the public sector in many cases has *grown* with the enhanced international mobility of firms and capital.[1] The precise causal link between openness and expanding state efforts remains unclear, however. One prominent approach points to the rising insecurities and dislocations attendant on globalization that are said to inspire public demands for state compensation and that lead to the expanded public sector presence. Increases in social insurance benefits, in this view, become the political glue binding together political coalitions supportive of free trade. Scholars have compared these contemporary forms of compensation to the postwar politics of "embedded liberalism," in which the liberalization of international trade was predicated on the expansion of Keynesian-style welfare state protections and countercyclical demand management.[2]

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[1] Geoffrey Garrett, *Partisan Politics in the Global Economy* (Cambridge: Cambridge University Press, 1998); Dennis Quinn, "The Correlates of Change in International Financial Regulation," *American Political Science Review* 91 (September 1997); and Dani Rodrik, "Why Is There So Much Economic Insecurity in Latin America?" (Manuscript, Kennedy School of Government, Harvard University, 1999).

[2] Alicia Adserà and Carles Boix, "Trade, Democracy, and the Size of the Public Sector: The Political Underpinnings of Openness," *International Organization* 56 (Spring 2002); Brian Burgoon, "Globalization and Welfare Compensation: Disentangling the Ties That Bind," *International Organization* 53 (Summer 2001); Jude Hays, Sean Ehrlich, and Clint Peinhardt, "Government Spending and Public Support for Trade in the OECD: An Empirical Test of the Embedded Liberalism Thesis," *International Organization* 59 (Spring 2005); Garrett (fn. 1); and John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36 (Spring 1982).

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Most of this research has focused on the advanced industrial nations; and only a few studies have found positive links between economic openness and the size of the state in the developing world.[3] The latter studies, however, run counter to an extensive stream of research arguing that economic integration has curtailed broad consumption-smoothing policies and state intervention more generally in the developing world.[4] There is, moreover, no clear sense from research on the politics of economic reform that developing country governments, pressed as they are to attract foreign investment or to lower production costs, have even *sought* a coherent alternative to the path of deep economic liberalization. Where substantial variation in the degree of economic liberalization enacted by developing countries is observed, it is typically explained either as a pernicious "partial reform" equilibrium or as the result of ad hoc concessions aimed at overcoming opposing distributional coalitions.[5] In short, emphasis on the force of global economic and political pressures has portrayed governments in the developing world, in contrast to those in the advanced countries, as possessing neither the motivation nor the ability to undertake substantial or coherent state interventions in domestic economic processes.

This article challenges this view of the developing country state on both counts. We contend that despite powerful constraints on broad consumption-smoothing policy efforts, governments in the developing world retain important leeway and motive to embed neoliberal economic reform in state interventions. Liberal economic orthodoxy is certainly the dominant policy option available to developing world governments. But a new, more statecentric development model is emerging that is also consonant with the generalized economic openness that characterizes most of the global South. The strategy of embeddedness that we identify, however, contrasts sharply not only with aspects of the orthodox neoliberal model of the minimal state but also with the

[3] Robert Bates, Phillip Brock, and Jill Tiefenthaler, "Risk and Trade Regimes: Another Exploration," *International Organization* 45 (Winter 1991), 14; Geoffrey Garrett, "Globalization and Government Spending around the World," *Studies in Comparative International Development* 35 (February 2001); and Dani Rodrik, "Why Do More Open Economies Have Bigger Governments?" *Journal of Political Economy* 106 (October 1998).

[4] Robert R. Kaufman and Alex Segura-Ubiergo, "Globalization, Domestic Politics, and Social Spending in Latin America: A Time-Series Cross-Section Analysis, 1973–97," *World Politics* 53 (July 2001); Nita Rudra, "Globalization and the Decline of the Welfare State in Less-Developed Countries," *International Organization* 56 (April 2002); and Erik Wibbels, "Dependency Revisited: International Markets, Business Cycles, and Social Spending in the Developing World," *International Organization* 60 (April 2006).

[5] See, for example, Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (January 1998); and Hector E. Schamis, "Distributional Coalitions and the Politics of Economic Reform in Latin America," *World Politics* 51 (January 1999).

egalitarian ambitions of the European model of "embedded liberalism," as well as closed-economy postwar developmentalism. In this strategy, which we call "embedded neoliberalism," the state becomes a promoter of economic production through active *supply-side* interventions, including export promotion and public employment, but it does so while retaining commitments to openness on the trade and capital accounts.

We examine the political foundations of this alternative developmental strategy in the Latin American region, for it is here that key early innovators are to be found. It is also a region in which movements toward economic openness are all but universal. Naturally, not every Latin American government has sought to embed economic openness in this way, and thus after theorizing why such a strategy is possible, we seek to explain how, why, and where embedded neoliberalism, in contrast to neoliberal orthodoxy, has emerged since the mid-1980s. We contend that the *legacies* of postwar closed-economy industrialization, combined with contemporary *partisan politics*, shape the adoption of an embedded neoliberal path to economic integration. Embedded neoliberalism, we find, has its roots in advanced, developmentalist import-substituting industrialization (ISI), which generated both the political coalitions and the human capital to permit mature domestic industries, faced with the inevitability of economic opening after the debt crisis, to pressure governments for support in becoming competitive exporters. This choice will also be conditioned, though not directly, by partisan dynamics. Because the political beneficiaries are relatively privileged sectors (producers and the middle sectors), we argue that in general embedded neoliberalism will be the province of the political right. But this expectation depends on the absence of a powerful labor movement. Such a movement, which would also benefit from embedded neoliberal policies, would be a principal opponent of conservative governments. Where labor remains strong, conservative politicians would be far less inclined toward embedded neoliberalism (as it also benefits their union opponents, while the orthodox neoliberal alternative weakens them), while left executives would be faced with pressure from a politically critical ally to adopt embedded neoliberal strategies to protect educated, formal (and especially public) sector labor, even though this implies comparatively regressive economic priorities.

Economic Openness and the State in Latin America

Although state intervention and protection were the cornerstones of Latin America's economic development model between the 1930s and the 1980s, the process of import-substitution industrialization effectively collapsed in the region after the 1982 debt crisis.[6] Spiraling inflation, capital flight, and recession, which followed in the wake of government defaults, were largely blamed on this statist development model. With the support of Washington-based multilaterals, governments throughout the region responded by embracing an array of orthodox neoliberal economic reforms such as trade liberalization, privatization, and deregulation. As market-oriented reform efforts progressed, interventionist policies such as price and capital controls, credit subsidies, and comprehensive social insurance programs came to be viewed as undesirable—and maybe not even feasible—in the open-economy era. By the early 1990s economic openness had become almost universal in the region—both as the preferences of most political elites and as empirical policy outcomes.

Within the striking trend toward the expansion of market forces, however, significant variation is evident within and across different policy areas and countries. As Figures 1 and 2 illustrate, convergence around the "Washington Consensus" model of economic orthodoxy seems far truer of some policy arenas than others. For example, while we observe that almost all of Latin America has converged upon open trade, considerable dispersion remains in areas such as financial reform and privatization. The political economy of liberalization has thus not entailed a uniform march toward markets across policy sectors.

But is it only a matter of time? Many have suggested that at least for the less developed countries, ever greater reliance on deregulated markets is all but inevitable. In this view, globalization severely constrains and may even proscribe active state intervention in the economy, particularly in the form of consumption-smoothing social welfare transfers. In one strand of this research, the curtailing of broad social welfare policies is deeply indebted to pressures from international financial institutions (IFIs) that are said to condition development loans and assistance on the adoption of orthodox, market-oriented reform, including in the social policy realm.[7] Consequently, the very option of expanding broadly redistributive forms of social insurance is removed from the political agenda by financial commitments to and dependence on IFIs.

[6] Sebastian Edwards, *Crisis and Reform in Latin America: From Despair to Hope* (Oxford: Oxford University Press, 1995).

[7] For example, Barbara Stallings, "International Influence on Economic Policy: Debt, Stabilization, and Structural Reform," in Stephan Haggard and Robert Kaufman, eds., *The Politics of Economic Adjustment* (Princeton University Press, 1992); and Evelyne Huber and John Stephens, "The Political Economy of Pension Reform: Latin America in Comparative Perspective," Occasional Paper 7 (Geneva: United Nations Research Institute for Social Development, 2000).

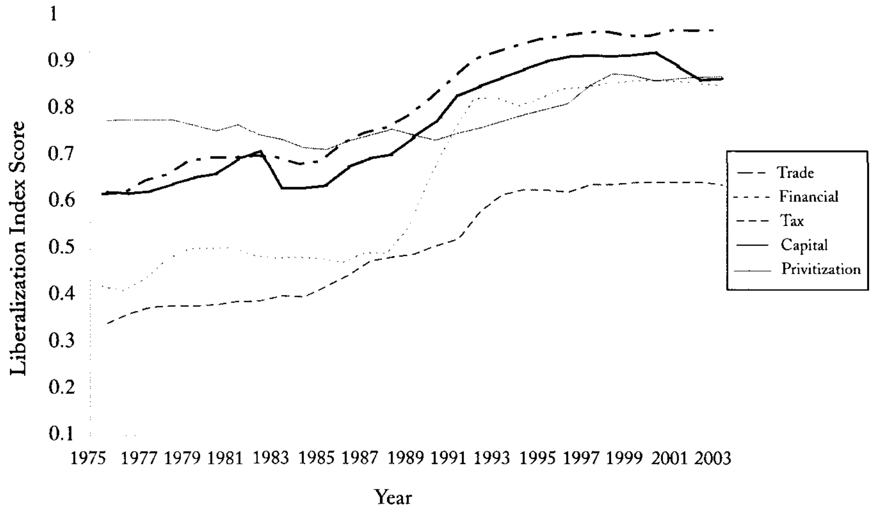


FIGURE 1
MEAN SCORES ON ECONOMIC LIBERALIZATION INDICES IN LATIN AMERICA (1975–2003)

For other scholars, much stronger market-based pressures from trade and capital flows constrain public sector interventions. With regard to trade, competition from low-cost manufacturers is said to limit state efforts to finance broad social protections through payroll taxes, while unskilled workers lack the bargaining power to demand the preservation or expansion of social benefits.[8] Capital mobility, too, has been shown to exert powerful constraints on the ability of developing country governments to intervene in ways that allay the costs and risks of economic openness for workers. Indeed, not only are fiscal policies in the developing world highly procyclical—expanding government spending in good times and slashing it during economic downturns—but this trend has also been causally linked to exposure to international capital flows, which tend to be supplied generously in good times and rationed in bad times.[9] Income shocks associated with volatile capital flows, moreover, have recently been shown to undercut the capacity of developing country governments to smooth consumption through

[8] Kaufman and Segura-Ubiergo (fn. 4); and Rudra (fn. 4).

[9] Graciela Kaminsky, Carmen M. Reinhart, and Carlos A. Vegh, "When It Rains, It Pours: Procyclical Capital Flows and Macroeconomic Policies," NBER Working Paper no. W10780 (Washington, D.C.: National Bureau of Economic Research, September 2004).

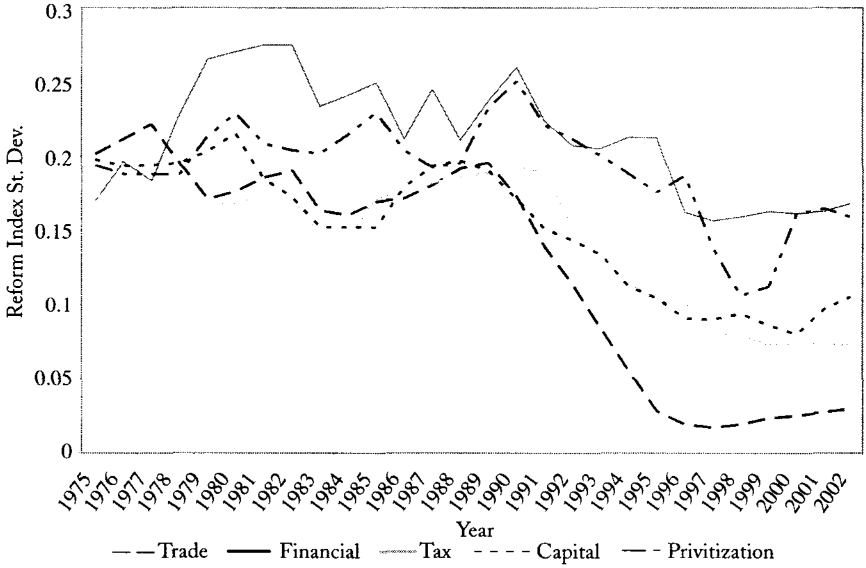


FIGURE 2
STANDARD DEVIATION OF ECONOMIC LIBERALIZATION SCORES IN LATIN AMERICA (1975–2003)

countercyclical policies such as social insurance spending.[10] To the extent that developing countries rely on foreign savings to finance their economic development, significant countercyclical policy interventions of the European mold have thus been largely proscribed.

The view that governments have few realistic alternatives to the enactment of free-market economic reforms is echoed in scholarly research on the politics of economic reform that has considered liberalization as part of a singular effort by governments to move toward greater market orientation across policy areas.[11] Where variations emerge along the continuum of a greater to lesser role for markets in the economy, these differences are said to result largely from institutional and/or economic conditions that influence the efforts by reform-seeking politicians to overcome the distributional pressures of special interests.[12] In

[10] Wibbels (fn. 4).

[11] See Ben Ross Schneider, "Organizing Interests and Coalitions in the Politics of Market Reform in Latin America," *World Politics* 56 (April 2004).

[12] For example, Schamis (fn. 5); and Javier Corrales, "Presidents, Ruling Parties, and Party Rules: A Theory on the Politics of Economic Reform in Latin America," *Comparative Politics* 32 (January 2000).

other words, purposive decisions to maintain a broader state role in the economy have traditionally not been considered possible or even desirable in the context of strong international pressures for reform and in light of the perceived failures of the earlier inward-looking statist developmental efforts.

There are other reasons to doubt that comprehensive social protection is making a return. A different stream of research points to abundant evidence of rising insecurity and social dislocation in Latin America,[13] with the result that the most vulnerable citizens are unlikely to be able even to demand, let alone obtain, effective compensation.[14] One important barrier emerges from the atomizing effects of liberal economic reform: these exacerbate collective action problems among workers most at risk of impoverishment, particularly in rural sectors.[15] Another issues from the political party system. For Roberts, political party systems in Latin America, rather than channeling Latin America's yawning class cleavages into the political arena, have organized in recent years around more "segmented" divisions, reinforcing market discipline and the political subordination of the poorest citizens.[16] Indeed, such compensatory politics as have emerged in Latin America in the last two decades are said to be confined mainly to a form of "neoliberal populism," which is characterized by ad hoc use of discretionary budgetary outlays to win support among the popular masses and to subvert more traditional policies and state institutions.[17]

We concur that economic and political realities have precluded the expansion of broad consumption-smoothing transfers in the region. That said, we should not assume a dichotomous contraposition of liberal orthodoxy and closed-economy statism, with the latter no longer viable. For it does not follow from impediments to Keynesian countercyclical intervention that active, state-mediated developmental efforts are foreclosed. What has been largely overlooked is the possibility that developing country governments might intervene on the *supply side* of

[13] Inter-American Development Bank (IDB), *Good Jobs Wanted: Labor Markets in Latin America* (New York: IDB, 2004), 127–32; and Rodrik (fn. 1), 1–2.

[14] Kenneth Roberts, "Social Inequalities without Class Cleavages in Latin America's Neoliberal Era," *Studies in Comparative International Development* 36 (January 2002).

[15] Marcus J. Kurtz, *Free Market Democracy and the Chilean and Mexican Countryside* (Cambridge: Cambridge University Press, 2004); idem, "The Dilemmas of Democracy in the Open Economy: Lessons from Latin America," *World Politics* 56 (January 2004).

[16] Roberts (fn. 14), 4.

[17] Edward L. Gibson, "The Populist Road to Market Reform: Policy and Electoral Coalitions in Mexico and Argentina," *World Politics* 49 (April 1997); Kenneth M. Roberts, "Neoliberalism and the Transformation of Populism in Latin America: The Peruvian Case," *World Politics* 48 (October 1995); and Kurt Weyland, "Neoliberal Populism in Latin America and Eastern Europe," *Comparative Politics* 31 (July 1999), 381.

the economy. In the next section we argue that governments in the developing world may retain considerable leeway to intercede in market processes through significant supply-side policies such as industrial promotion and public employment, for these are not subject to the same international constraints as are traditional Keynesian demand-side efforts.

Embedding Neoliberalism on the Supply Side

Beyond consumption-smoothing transfers there is a wide range of public policies that correct or alter market processes, but in ways that seek to stimulate the production side of the economy, in particular, by changing the supply and cost of labor and capital. These are broadly termed supply-side policies. Their importance as a domain of significant government intervention has been highlighted in research on the advanced industrial nations that has shown that although economic integration has put pressure on Keynesian-style countercyclical fiscal and monetary policies, governments retain significant latitude to pursue partisan objectives through supply-side policy interventions.[18] These include active labor-market policies and job-training programs, along with subsidies to promote investment and help businesses adjust to changing economic conditions.

Although supply-side policies since the 1980s have been popularly associated with the curtailment of taxes and state interventions, which were said to distort investment and work decisions, supply-side measures have historically and also more recently been interpreted in much broader terms to include an array of active public efforts to shape the provision of labor and capital in the economy. In postwar England, for example, supply-side policies were highly interventionist, entailing efforts to "subsidize physical capital, to nationalize and/or not privatize, to finance prestige research projects notably in aerospace and nuclear power, to promote 'national champion' firms and to maintain a highly distortionary tax system."[19] Supply-side policies thus go well beyond support for education and technological development, to include an array of industrial-promotion measures and public service provision.

Are such policies feasible in developing countries? Recent research suggests that they are. In areas such as labor-market reform and agricul-

[18] Geoffrey Garrett and Peter Lange, "Political Responses to Interdependence: What's Left for the Left?" *International Organization* 45 (Autumn 1991), 541.

[19] Nicholas Crafts, "Supply-Side Policy and British Relative Economic Decline," *Economic Growth and Government Policy* (London: HM Treasury, 2001), 24.

tural policy, scholars have found evidence of significant trends toward the *expansion* of public regulations in the last decade.[20] Other scholars have found evidence of substantial market-correcting supply-side policy initiatives such as export promotion in Latin America. Such measures, which Schrank and Kurtz term *open-economy industrial policy*, differ markedly from those characterizing the protectionist era.[21] Rather than inhibiting competition and keeping foreign goods out of the hands of local consumers, contemporary industrial policies aim to correct market failures in the provision of skills, finance, information, and infrastructure.[22] These policies include substantial fiscal and credit incentives for exporters to advance technologically and to branch out into more diverse, high-value-added sectors or nontraditional market segments.[23] They are supply-side policies, however, as they alter both relative prices and explicitly encourage the targeted intersectoral transfers of investment.

Critically, open-economy industrial policies in the developing world rest heavily on a compensatory logic, for they seek to offset the costs for new exporters from "imperfections imposed by either ISI or a hypothetical free market alternative."[24] On the one hand, these may take the form of credit subsidies, which compensate local industry for costs associated with imperfect credit markets, such as high and volatile interest rates. Or, on the other hand, they may entail broad export subventions, such as in Costa Rica, which were designed "to compensate exporters for the inefficiencies in public services such as electricity, telecommunications and ports, as well as the high costs of financial services like insurance and banking caused by the quasi-monopolistic structures that remained in those sectors."[25]

Supply-side industrial policies also seek to fill gaps in domestic markets, whether in the provision of nontraditional investments, labor,

[20] Richard Snyder, "After Neoliberalism: The Politics of Reregulation in Mexico," *World Politics* 51 (January 1999); and M. Victoria Murillo and Andrew Schrank, "With a Little Help from My Friends: Partisan Politics, Transnational Alliances, and Labor Rights in Latin America," *Comparative Political Studies* 38 (October 2005).

[21] Andrew Schrank and Marcus J. Kurtz, "Credit Where Credit Is Due: Open Economy Industrial Policy and Export Diversification in Latin America and the Caribbean," *Politics & Society* 33 (December 2005).

[22] Sanjaya Lall, "Reinventing Industrial Strategy: The Role of Government Policy in Building Export Competitiveness," Working Paper no. 111 (Oxford: Oxford University QEH Working Paper Series, 2003), 13–15.

[23] Carla Macario, *Export Growth in Latin America: Policies and Performance*, with Regis Bonelli, Adriaan ten Kate, and Gunnar Niels (Boulder, Colo.: Lynne Rienner, 2000).

[24] Schrank and Kurtz (fn. 21), 683.

[25] Andrés Rodríguez-Clare, "Costa Rica's Development Strategy Based on Human Capital and Technology: How It Got There, the Impact of Intel, and Lessons for Other Countries," *Journal of Human Development* 2 (July 2001), 313.

infrastructure, or services. As Rodrik explains, "The nature of industrial policies is that they complement (opponents would say "distort") market forces: they reinforce or counteract the allocative effects that the existing markets would otherwise produce."[26] Thus we may expect government efforts to promote industrial investment not just by providing technical training and support for innovation but also possibly by providing infrastructure and financial services. Critically, public sector outlays on subsidies for investment and production should, like investment and production themselves, follow the economic cycle quite closely, rising in expansionary times and declining during recession. Thus active industrial policies in developing countries are consistent with the observed procyclical character of state spending.

An additional implication of government provision of services and infrastructure is that these broader public sector enterprises should provide a politically instrumental form of social protection through public employment. Indeed, research on the advanced industrial nations has found public service provision to be an important instrument of social protection,[27] while civil service employment also was an important element of postwar development efforts in many Latin American countries. Although public employment has declined significantly as a result of the divestment process in many countries, as Figure 2 illustrates, the privatization track record varies markedly across Latin America. Particularly as labor markets have become volatile in the region, civil service jobs provide a valuable source of job stability and thus have become desirable despite the lower wages they often pay relative to the private sector.[28]

Indeed, if we understand embedded neoliberalism as a strategy of state-mediated international integration, we should also expect that it is accompanied by far less extensive privatization when compared with its orthodox alternative. Industrial policies imply the purposive intervention of the state in producer-inputs markets—be they credit, energy, insurance, or the like. It is thus quite compatible with the privatization of final-goods-producing industries but should be accompanied by a continued state presence in the banking, energy, utilities, infrastructure, and corporate insurance industries because it is the cost of these inputs that the state would seek to manipulate most directly. And indeed,

[26] Dani Rodrik, "Industrial Policy for the Twenty-first Century" (Manuscript, John F. Kennedy School of Government, Harvard University, 2004), 2.

[27] Richard Clayton and Jonas Pontusson, "Welfare-State Retrenchment Revisited: Entitlement Cuts, Public Sector Restructuring, and Inegalitarian Trends in Advanced Capitalist Societies," *World Politics* 51 (October 1998), 82.

[28] Rodrik (fn. 1), 2.

where direct public ownership continues in Latin America, it is typically in precisely these sectors.

Importantly, while this strategy is interventionist, it is *not* downward redistributive. Instead, the supply-side interventions sketched above are likely to privilege the better-off, skilled workers and export-oriented business owners, rather than the poorest and most vulnerable in society. While they distort market prices, they are producer subsidies, not redistributive social programs. They therefore rest on a political foundation of business interests as well as relatively privileged educated and skilled workers. For these reasons we label this strategy embedded *neo*liberalism, to distinguish it from its more egalitarian European analogue.[29]

There are varieties of embedded neoliberalism. While we have described embedded neoliberalism as a general strategy of state-mediated international economic integration, we have not yet given a specific sense of the gamut of policies that it has empirically entailed or of the important qualitative variations or (or intermediate forms) that may exist. We turn next to this task, which is crucial on two fronts. First, in light of our argument that there exists a new policy equilibrium representing an alternative either to traditional protectionist statism or to orthodox economic liberalism, it is essential to establish its face validity through an examination of specific instances. Second, by using this comparative discussion to set out important variations in the character of the policy mixes that can constitute embedded neoliberalism, we lay the foundations for future work that can investigate their political foundations. The following section considers both the patterns of state-society relations and the concrete policies and institutions that undergird embedded neoliberalism in two notable cases: Costa Rica and Colombia, which we have chosen for two reasons. On the one hand, they represent the range of variation in concrete institutional and policy embodiment of this strategy in a pair of countries that are consistently high scorers on the aggregate measure of embedded neoliberalism developed below. On the other hand, the latter represents a case not typically thought of as "statist" in the Latin American post–debt crisis context. As such, it should be a difficult context in which to make our case.

To begin, embedded neoliberalism is typically not just a set of business-friendly and export-friendly supply-side economic policies. It also has a social side. Indeed, the term is itself derived in part from Evans, who was the first to point out that embeddedness also refers to patterns

[29] Our concept of "embedded neoliberalism" also differs from van Apeldoorn's use of the term in the European context. See Bastiaan van Apeldoorn, *Transnational Capitalism and the Struggle over European Integration* (New York: Routledge, 2002).

of state-society interaction that imply cooperation and coordination between industry and government (but not business capture or state dominance).[30] It stands in contrast to the arm's-length regulation and sectoral policy neutrality that are hallmarks of orthodox liberalism. This aspect of embedded neoliberalism, naturally, cannot be directly measured in our aggregate measure, but it should be present in the cases identified by the measure.

Colombia, ranked near the top of our index of embedded neoliberalism, has institutionalized just such a dense network of state-business relationships. At the peak level are the National Conferences on Productivity and Competitiveness, which are accompanied by a set of ten specialized public-private partnerships linking the state and business associations as they develop goals, and "export-oriented competitiveness agreements" to pursue them.[31] Indeed, in this case the emphasis has been very clearly bottom-up, focused on efforts to support and upgrade existing business sectors, rather than on the state taking the lead to define potential future areas of competitiveness and direct resources to them.[32] It seeks to enhance existing sources of comparative advantage, not create new ones.

Partnership, however, means little unless there are policies and resources to back it up. Colombia is a regional leader on this score as well—it has an extensive set of firm-oriented promotional policies in place. For example, Melo has outlined a series of fiscal incentives and credit policies that constitute the core of Latin America's activist-state economic strategies.[33] The former include, for example, a host of tax rebates, duty drawbacks, and temporary admission schemes, while the latter include subsidized export finance, working capital loans, project investment capital, and credit insurance. By this metric, Colombia has nearly the most comprehensive set of open-economy industrial policies to be found in Latin America. And as Macario has pointed out, these are linked to one of the most successful and long-established export-promotion agencies (PROEXPORT) on the continent.[34] Indeed, it was

[30] Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton: Princeton University Press, 1995).

[31] Alberto Melo and Andrés Rodríguez-Clare, "Productive Development Policies and Supporting Institutions in Latin America and the Caribbean," Working Paper no. C-106 (Washington, D.C.: Inter-American Development Bank, February 2006), 15. These partnerships run the gamut of economically vital policy areas, from science and technology, to finance, internationalization of the economy, education, labor, and infrastructure.

[32] Ibid., 16.

[33] Alberto Melo, "Industrial Policy in Latin America and the Caribbean," IADB Working Paper no. 489 (Washington, D.C.: Inter-American Development Bank, August 2001), 14–22.

[34] Carla Macario, "Why and How Do Manufacturing Firms Export: Evidence from Successful Exporting Firms in Chile, Colombia, and Mexico" (Ph.D. diss., University of Missouri-Columbia, 1998), 220.

Colombia that was the model for the widely heralded (and successful) Chilean export agency (ProChile). Macario finds that export promotion has also been widely utilized in actual practice; more than 85 percent of the export firms in her sample relied on these promotional instruments. And such promotional efforts have entailed the expenditure of large sums. In Colombia in 2004, for example, the public development bank provided credit in excess of $1.15 billion (1.4 percent of gross domestic product), despite "the chronic budgetary constraints on the public sectors in countries with low tax-to-GDP ratios—an almost universal characteristic of Latin America."[35] To this would have to be added the implicit cost, in revenue forgone, of the tax refunds, tariff drawbacks, and other fiscal incentives to producers provided by the Colombian government.

While Colombia exemplifies the promotion-and-subsidy approach to international economic integration, Costa Rica, while also applying similar policies, adds a larger role for more direct public ownership and promotion in the context of extensive international integration. While Costa Rica has long been known for its impressive set of social policies (especially given its comparatively low level of development), the public sector also plays a crucial role in a host of developmentally critical sectors from banking, to insurance, to public utilities, telecommunications, and infrastructure.

Development promotion and linkages between the state and the domestic and international private sector is mediated through PROCOMER (Promotora de Comercio Exterior, Export Promotion) and CINDE (Coalición Costarricense de Iniciativas de Desarrollo, Costa Rican Coalition of Development Initiatives), respectively. The former is explicitly headed by the minister of trade and directed by a board that includes three other representatives of the public sector, the president and vice president of the Chamber of Commerce, and one representative each from the Chamber of Industry, the Chamber of Exporters, and the small and medium-size export sector. CINDE's role has been well recognized and has been acknowledged as having played a key role in attracting massive investments, most notably from Intel corporation, that alone now account for a substantial share of Costa Rica's annual exports.

The state's role in investment and development (despite an open trade regime) does not end there. An NSF study identifies Costa Rica as a regional outlier in terms of research and development expenditure as a share of GDP, of which over 67 percent was carried out directly

[35] Melo and Rodríguez-Clare (fn. 31), 55.

by the state or via the university system.[36] The public sector's role in finance more generally is even more pronounced, with public bank assets accounting for 68.02 percent of the total in 2002 (compared with the almost complete absence of public banking in all of the rest of the Central American region).[37]

Public fiscal expenditures for development promotion were equally impressive. One single policy—the *certificado de abono tributario*, a tax credit to nontraditional exporters—was so successful that at its peak it consumed as much as 5 percent of the government expenditures, before ultimately being phased out.[38] The public development bank (Banco Nacional de Costa Rica) in Costa Rica also plays a huge role, providing a credit equivalent of 6.5 percent of GDP—an amount just short of the level of the prototypical developmental state in Korea.[39]

There are thus a wide array of specific policy mixes that can constitute an embedded neoliberal developmental strategy, though all share the characteristics of strong public intervention to enhance international competitiveness, substantial public resource commitments, and state-business linkages. We must, however, next turn to an explanation of the factors that induce this interventionist, but open-economy policy regime in an era of alleged universal market orientation, public sector neutrality, and state subsidiarity.

Explaining Embedded Neoliberalism

Why would some Latin American governments choose to maintain a strong state presence in the open-economy era? Our causal expectations for the emergence of this strategy rest heavily on the political and economic legacy of import substitution in each country. Embedded neoliberalism should be more likely in countries with the most advanced, or relatively "successful" experiences of ISI—that is, where domestic industry developed in higher-skill sectors that may ultimately be able to

[36] Costa Rican R&D investment amounted to 1.2 percent of GDP in 1996, compared with 0.4 percent or less in Argentina, Mexico, and Venezuela, countries at a comparable or higher level of development. This is still smaller than the R&D investments made by the East Asian developing countries or the United States (in excess of 2 percent of GDP), but it is impressive for a poor Central American nation. See Derek Hill, "Latin America: R&D Spending Jumps in Brazil, Mexico, and Costa Rica" National Science Foundation Division of Science Resource Studies NSF 00-316 (Washington, D.C.: NSF, 2000), 3–4.

[37] Eduaro Levy Yeyati, Alejandro Micco, and Ugo Panizza, "Should Government Be in the Banking Business? The Role of State-Owned and Development Banks," Working Paper no. 517 (Washington, D.C.: Inter-American Development Bank, 2004), 34.

[38] Mary A. Clark, "Nontraditional Export Promotion in Costa Rica: Sustaining Export-Led Growth," *Journal of Interamerican Studies and World Affairs* 37 (Summer 1995), 196.

[39] Melo and Rodríguez-Clare (fn. 31), 55.

compete globally, rather than simply providing rents for a plutocratic oligarchy. We also expect government partisanship to matter, although not in the same fashion as in northern Europe. Since embedded neoliberalism is likely to benefit export-oriented firms and middle-class educated and public sector workers, we hypothesize that all else equal this strategy will be embraced by conservative governments, whereas left governments will pursue such policies only where they have the support of (and pressure from) a powerful organized labor movement. Where a powerful union movement survived economic opening, the pressure on the left is immense to channel resources to this important and often public sector–based political constituency. And only with strong union support could the left withstand the heightened pressures by international market actors to adopt more orthodox, liberal macroeconomic policies. In parallel, where conservative governments are faced with a strong labor movement, they will eschew this strategy and pursue economic orthodoxy, as this has the positive political and economic externality (for them and their business allies) of undermining their union opponents.

ISI Legacy

Although import-substitution industrialization (ISI) in most Latin American countries came to an end with the debt crisis, important social and economic legacies endured. By most accounts, its long-term consequences are decidedly mixed. On the positive side, the industrialization process in Latin America saw sharp increases in growth after 1950, while investment rose in every country but Argentina.[40] Life expectancy at birth also rose substantially in this period, while infant mortality fell. Literacy rates and living standards increased dramatically across the region as ISI governments invested in the creation of a skilled industrial workforce.[41] Infrastructure likewise improved as governments channeled resources toward the development or upgrading of roads, irrigation, and schools.[42] And, of course, manufacturing as a share of national income rose, signifying a departure from the more unstable reliance on raw materials exports as a development strategy.

There were also a number of pitfalls associated with ISI, including sharp labor-market distortions that allowed industrial wages to rise

[40] Henry Bruton, "A Reconsideration of Import Substitution," *Journal of Economic Literature* 36 (June 1998), 115–16.

[41] Pablo Astorga, Ame R. Berges, and Valpy Fitzgerald, "The Standard of Living in Latin America during the Twentieth Century," *Economic History Review* 58 (November 2005), 766.

[42] Bruton (fn. 40).

despite falling demand for labor as industries shifted to more capital-intensive production.[43] Since the costs of industrial development were typically imposed on the rural agro-exporting sectors, declining investment in agriculture and falling production led eventually to mass dislocations of rural laborers, who migrated to the cities in search of work. Given the highly segmented labor markets and the shift to more capital-intensive production as ISI matured, fewer and fewer jobs were available to absorb the excess labor capacity as ISI deepened. The dividing line between industrial, organized labor and informal work (such as construction day labor and domestic service) thus grew markedly at midcentury, aggravating the already high levels of inequality in the region.[44]

ISI was also a decidedly political project, resting on important coalitions among urban industrialists, organized industrial labor, and the urban middle class. We should thus expect such programs to have important political legacies as well. The ISI political bargains typically worked to safeguard the interests of the parties involved at the expense of other groups in society—particularly rural sectors and the unorganized, nonmanufacturing private sector laborers.[45] Urban industrial coalitions thus came to dominate the political systems in ISI countries, which only reinforced the influence of both the new industrial sectors and the government bureaucrats.[46] Organized labor typically grew in importance as industrialization progressed, becoming the mass base of what were often semiauthoritarian "populist" coalitions under charismatic leaders such as Vargas in Brazil and Perón in Argentina.

Although many scholars have noted that protectionist interests that thrived under ISI were destroyed during the 1980s debt crisis, there remain stark disparities in both the strength and the orientation of domestic manufacturing interests and organized labor across Latin America. Indeed, unionization rates in Latin America in the first half of the 1990s ranged from 4.4 percent of the workforce in Guatemala to 24.8 percent in Brazil.[47] While often an opponent of market-oriented reform, powerful union movements such as those in Argentina nevertheless negotiated support for deep restructuring programs in return

[43] Ibid., 917.

[44] John Sheahan, "Market-Oriented Economic Policies and Political Repression in Latin America," *Economic Development and Cultural Change* 28 (January 1980), 273.

[45] Jeffry Frieden, *Debt, Development, and Democracy: Modern Political Economy and Latin America* (Princeton: Princeton University Press, 1991), 49.

[46] Ibid., 47.

[47] Inter-American Development Bank, *Good Jobs Wanted: Labor Markets in Latin America* (Washington, D.C.: IDB, 2004), 233.

for rents under the new market rules.[48] On average, however, while labor has resisted many aspects of liberalization, it has focused especially on the promotion of a larger public sector role in Latin America, for example, by blocking privatization programs. Moreover, powerful labor unions in the region, as privileged minorities, are more likely to seek to reinforce their sectoral privileges rather than promoting more egalitarian or universal programs. Despite being core constituents of left parties, formal sector unionized workers are closer to the top than the bottom of the Latin American income distribution.

The interests of domestic industry also were far from consistently opposed to trade liberalization, and many business sectors in fact welcomed it.[49] In part, the existence of sectors more favorable toward trade openness may be explained by the prior shift toward export strategies in some Latin American nations. In countries such as Chile and Uruguay, for instance, the government began the process of shifting toward export orientation well before the debt crisis, spurred by exogenous shocks in terms of trade and global demand in the 1970s.[50] Other countries, such as Costa Rica, began to move in that direction in the 1980s, gathering support from coalitions in the more competitive domestic industries. Where ISI was most advanced, therefore, we expect a larger coalition of *potentially* competitive exporters to provide support for governments turning toward trade liberalization, though on the condition that they receive compensation to level the playing field with companies in nations with more efficient credit markets and more developed infrastructure. One of the lessons of trade liberalization thus is that not all ISI industries were white elephants. Many, such as EMBRAER, the Brazilian aerospace firm, have survived and flourished under subsequent international integration.[51] When combined with the political weight of existing exporters in the natural resource and agricultural sectors, these could form the base of a powerful, if conservative, political coalition. Similarly, where labor unions remained strong into the 1990s, we expect greater resistance to the privatization of state-owned enterprises and stronger pressure for state subsidies for

[48] Sebastián Etchemendy, "Constructing Reform Coalitions: The Politics of Compensations in Argentina's Economic Liberalization," *Latin American Politics and Society* 43 (Autumn 2001); and M. Victoria Murillo, *Labor Unions, Partisan Coalitions, and Market Reforms in Latin America* (New York: Cambridge University Press, 2001).

[49] Peter Kingstone, *Crafting Coalitions for Reform: Business Preferences, Political Institutions, and Neoliberalism in Brazil* (Princeton: Princeton University Press, 1999).

[50] Bela Balassa, "Policy Responses to Exogenous Shocks in Developing Countries," *American Economic Review* 76 (May 1986)

[51] Other examples range from cement (CEMEX, Mexico), to steel and metallurgy (Techint, Argentina; CVRD, Brazil), and food products (Arcor, Argentina). See Schrank and Kurtz (fn. 21).

high-skilled export industries. High labor-union density, larger manufacturing sectors, and high-skill profiles in the workforce should thus be associated with more robust strategies of embedded neoliberalism.

Partisan Politics

In the literature on advanced industrial nations, contemporary strategies of embedded liberalism are said to work best in countries with strong and centralized labor unions and powerful social democratic parties.[52] More generally, parties of the left are associated with stronger tendencies to use state instruments, rather than market forces, to raise productivity.[53] In the face of global economic pressures, moreover, left parties in the OECD tend to be more resistant to making cuts in social spending.[54]

We contend that partisanship is also an important part of the story in Latin American embedded neoliberalism, but it is not the same story found in the wealthy countries. Rather, our expectations follow from the sorts of policies entailed in embedded neoliberalism. On the one hand, producer subsidies, cheap credit, loan guarantees, tax incentives, and technical support are probusiness policies par excellence. On the other hand, the focus on public employment principally benefits the educated and skilled middle class, which is not necessarily the left's preferred partisan constituency. While left parties would likely prefer to encourage progressive redistribution and consumption smoothing, economic openness has largely constrained their ability to pursue such measures; instead, left executives have confronted powerful pressures to establish their credibility in the eyes of wary market actors.[55] And insofar as embedded neoliberal policies are market distorting, they may be more alarming to international investors when implemented by left governments. Thus we expect more conservative—right or center-right—governments to take the lead in advancing embedded neoliberal strategies, as these offer greater advantages to their business and middle-class constituents while being unlikely to induce undesirable responses by international market actors.

[52] Geoffrey Garrett, "Global Markets and National Politics: Collision Course or Virtuous Cycle?" *International Organization* 52 (Autumn 1998), 798.

[53] Carles Boix, *Political Parties, Growth and Equality* (New York: Cambridge University Press, 1998).

[54] Garrett (fn. 1); Walter Korpi and Joakim Palme, "New Politics and Class Politics in the Context of Austerity and Globalization: Welfare State Regress in eighteen Countries, 1975–95," *American Political Science Review* 97 (August 2003).

[55] Karen Remmer, "The Politics of Economic Policy and Performance in Latin America," *Journal of Public Policy* 22 (January 2002); Alex Cukierman and Mariano Tommasi, "Credibility of Policymakers and of Economic Reforms," in Federico Sturzenegger and Mariano Tommasi, eds., *The Political Economy of Reform* (Cambridge, Mass.: MIT Press, 1998); and Wibbels (fn. 4).

We cannot assume that policy outcomes will follow seamlessly from partisan preferences, however. Whether governments can realize their partisan goals depends on a number of political and contextual factors, including the strength of such social actors as organized labor.[56] Strong labor movements can disrupt reform efforts and impede governments from realizing partisan goals when these clash with the interests of labor.[57] This is particularly likely to be the case when conservative governments are in power and face strong union movements that include noncompetitive sectors opposed to liberalization. Here conservative executives face serious challenges—they must advance the orthodox side of embedded neoliberalism in the face of union opposition. But embeddedness itself expands or maintains the influence of organized labor; thus if strong unions persist, this becomes a more difficult strategy for conservative presidents to pursue—and one that is politically less desirable for them. This is unlikely to be the case when strong labor unions coincide with a left-wing government, where we expect the opposite: left executives should be able to draw upon historic ties to labor to obtain union cooperation with an array of structural reforms in exchange for concessions in other policy areas, such as the attenuation of privatization. As Remmer found, the expansionary tendencies of labor and left governments have been attenuated considerably when the two coincide, with left-labor coalitions yielding more disciplined fiscal and macroeconomic policy.[58] Thus, we expect conservative governments to be most likely to pursue embedded neoliberal policies, at least where labor is weak, while left-wing executives should be more likely to combine economic openness with this type of active state intervention when they have the backing of, or are subject to pressure from, a strong union movement.

This of course begs two critical, and linked, questions. First, since embedded neoliberalism is in many senses a probusiness measure, but one that can simultaneously benefit organized labor, why don't conservative politicians act to co-opt unions where they are strong rather than opting instead for orthodox policies? Second, as organized labor and public employees are typically privileged sectors, why are they so frequently core constituencies of the political left? The first question suggests an alternative strategic choice for politicians from nonlabor parties: using embedded neoliberalism as a means to attract the core constituents

[56] Remmer (fn. 55), 38.

[57] Garrett and Lange (fn. 18), 541; Quan Li and Dale Smith, "The Dilemma of Financial Liberalization: State Autonomy and Societal Demands," *Journal of Politics* 64 (August 2002), 781.

[58] Remmer (fn. 55).

of their opponents. The second considers why left executives would not abandon organized labor's goals where they oppose directing scarce resources to the far more numerous and truly disadvantaged citizens in the informal and rural sectors.

The problem for conservative executives in attempting to co-opt organized labor is twofold. First, any effort to do so would likely run afoul of the interests of their own core constituents in the business sectors. It is one thing for the state to use public resources to attract new constituencies to the executive's political party, but it is quite another to strengthen the labor movement and create a serious negative externality for private entrepreneurs. After all, the stronger the labor movement the greater the threat to firm flexibility and profitability; the business elites who fund and staff conservative parties are keenly aware of this. This is not an issue, of course, where labor is weakly organized, for there the strengthening of the public sector and the extensive use of industrial policy do not support an effective organized interest, and the externalities for firm owners remain positive.

The second, greater difficulty is on the labor side. Even were an executive from a nonlabor party to pursue the support of organized labor through a program of embedded neoliberalism, it would be unlikely to succeed in the Latin American context. Why? In many cases, for one, the ties between left/labor parties and the union movement are exceedingly strong and well institutionalized. Indeed, unions were very often instrumental in the formation of left parties in the first place, and the leadership and parliamentary delegation of the parties is frequently drawn in part from the ranks of labor officialdom. Burgess, for example, highlights the "stable, institutionalized alliances" between Venezuelan and Mexican labor confederations and Accíon Democrática (AD) and the Partido Revolucionario Institucional (PRI), respectively.[59] These relationships were often less than democratic, with the unions taking a subordinated role relative the parties.[60] In Brazil, the now-governing PT (Partido dos Trabalhadores) was formed directly out of the labor movement and the current president himself was a former leader of the metalworkers union.[61] These organic ties and the typical relationship of asymmetrical dependence made the probability of a successful appeal to unions by nonlabor political parties remote. And strong linkages often

[59] Katrina Burgess, "Loyalty Dilemmas and Market Reform: Party-Union Alliances under Stress in Mexico, Spain, and Venezuela," *World Politics* 52 (October 1999), 107.

[60] Burgess, for example, points out that AD in Venezuela had a role in selecting who would stand for union office, while in Mexico the PRI had solidified control of the CTM (the principal labor confederation) by the 1950s; Burgess (fn. 59), 121, 130.

[61] John Guidry, "Not Just Another Labor Party: The Workers' Party and Democracy in Brazil," *Labor Studies Journal* 28 (Spring 2003), 89.

result in even ideologically progressive parties supporting policies that privilege a relatively affluent constituency. The PT, for instance, through the 1990s opposed equity-enhancing reform of Brazil's regressive pension system, which privileges the PT's well-organized constituents in the civil service. Moreover, appeals to labor made by right-wing politicians—given the typically very problematic (and frequently violent) historical relation between conservative elites and unions in the region—would suffer from a lack of prima facie credibility for workers.

The political left will find it difficult to abandon a strong, if privileged, labor movement, even if this political ally forces comparatively regressive policy choices on it, since it typically has no viable, organized alternative base of support. After all, left parties typically relied on labor for on-the-ground organizational strength, a reservoir of votes, and the maintenance of social peace.[62] Notably, as Burgess has pointed out, organized workers were often left parties' most loyal constituents—more reliably providing votes than the poorer citizens in the informal economy.[63] And a potential shift to a strictly pro-poor policy effort by such parties would confront a crucial problem: who would then provide the material and organizational resources necessary for electoral success? If they abandoned organized labor in the effort, it is hardly likely, for example, that business elites would fill their place. More critically, the impoverished and unorganized multitudes in the informal and rural sectors are unable to fill this role almost by definition. They may at best be a reservoir of votes, though even this is far from certain. But their poverty, dispersion, and disorganization render them unstable terrain on which to build a political coalition.

The Argentine case perhaps best highlights the challenges to making nontraditional political appeals outlined above. In Argentina while the labor movement is historically very strong, it has had only weakly institutionalized ties with the Peronist Party (Partido Justicialista), which claims to represent it.[64] In the late 1980s a centrist president, Raúl Alfonsín, who was pursuing a heterodox economic policy, made an effort to reach out to the Peronist unions, in effect making an effort to co-opt at least part of this core constituency of the labor-backed Peronist Party. In this he was more credible that most nonlabor politicians would be: he did not come from a conservative party (instead, he was from the centrist/center-left Radical Party), and he had a history of opposition to the military rulers who had brutally repressed labor

[62] Steven Levitsky, "From Labor Politics to Machine Politics: The Transformation of Party-Union Linkages in Argentine Peronism, 1983–1999," *Latin American Research Review* 38 (October 2003), 7.
[63] Burgess (fn. 59), 107.
[64] Levitsky (fn. 62), 5.

during Argentina's many authoritarian interludes. The result was, however, singularly unsuccessful, as Alfonsín suffered no fewer than seven general strikes during his administration, four in 1986 alone.[65] At the same time he was roundly denounced by his chief Peronist opponent, soon-to-be-president Carlos Menem, as being, of all things, *a social democrat*; this made clear that even in this comparatively fertile soil, pursuing labor support through economic policy concessions or expansionary policies is no mean feat for a nonlabor party.

Empirical Analysis

An empirical examination of our theoretical claims must begin by first establishing that, contrary to conventional expectations, it is reasonable to understand post–debt crisis economic transformation as consolidating around two distinct open-economy strategies: economic orthodoxy and embedded neoliberalism. Our expectations are straightforward. On the one hand, the economic policy choices made by Latin American governments should all be characterized by movements toward macroeconomic opening, that is, a reduction in barriers to the movement of goods and capital across borders. But at the same time, we expect national differences over the role of industrial policy and public ownership to persist. As a first step, we use factor analysis to evaluate whether economic reform movements across six different policy arenas are in fact characterized by two such dimensions or whether they have moved together in a more consistent fashion. Finding that two very different dimensions exist in patterns of state intervention and economic reform, we use the results of this analysis to construct two indices—statism and openness—from which we generate composite measures to capture the strategies of embedded neoliberalism (where both orientations are high) and economic orthodoxy (where openness outpaces statism). In the second portion of our empirical analysis we test our theoretical explanations for the emergence of embedded liberalism developed above.

The Dimensionality of Reform

We set out to identify this alternative policy equilibrium by examining new data compiled by Morley and colleagues on market-oriented reform trends in Latin America.[66] The data quantify movements to-

[65] James McGuire, "Union Political Tactics and Democratic Consolidation in Alfonsín's Argentina, 1983–89," *Latin American Research Review* 27, no. 1 (1992), 46.

[66] Samuel Morley, Robert Machado, and Stefano Pettinato, "Indexes of Structural Reform in Latin America," Economic Reforms Series no. 12 (Santiago, Chile: ECLAC, 1999 [2006]).

ward market-oriented reform in the areas of trade, domestic financial reform, privatization, taxation, and capital account liberalization. The indices are designed to permit comparisons in the degree of reform across countries and over time and thus provide an instrument by which to assess movements toward greater or lesser market orientation in the region.[67] They are described in earlier work and are normalized for comparability.[68] In addition to the five structural reform indices, we examine final government consumption (as a share of GDP) in order to capture the broadest range of state fiscal interventions, for we expect these to go beyond social transfers to include export promotion subsidies and tax rebates as well. These data are taken from the World Bank and include all current government expenditures (including payrolls), excluding that aspect of military expenditure that is considered capital formation.[69]

Given our theoretical priors about the distinct ways in which liberal reforms and state involvement in the economy may relate, we carry out a confirmatory factor analysis to evaluate whether economic liberalization has proceeded in a unidimensional manner and, if it has not, whether the components that underlie its dimensionality comport with our expectations. Factor analysis provides a basic method to determine whether and how these policies are organized along one or more underlying, but unobservable dimensions. This technique has been widely used in political research, for example, to identify the nature of issue dimensions along which parties compete,[70] to identify the foundations of public opinion in survey research,[71] and to analyze the spatial structure of candidates' ideological positions.[72] The factors we identify in this analysis are unobserved dimensions along which policies of economic liberalization and state intervention are organized. For each dimension, we report the factor loadings, which indicate how and how strongly different variables relate to each underlying dimension.

Table 1 reports the results of the principal components analysis. It is clear that most—but not all—market-oriented reforms are enacted

[67] It should be noted that by relying on reform indices constructed on the *assumption* of a single liberal/statist continuum, we employ measures that are biased against our finding of alternative open-economy policy equilibria.

[68] Morley, Machado, and Pettinato (fn. 66).

[69] World Bank, *World Development Indicators* CD-ROM (Washington, D.C.: World Bank, 2005).

[70] For example, Herbert Kitschelt, Zdenka Mansfeldova, Radoslaw Markowski, Gábor Tóka, *Post-Communist Party Systems: Competition, Representation, and Inter-Party Cooperation* (Cambridge: Cambridge University Press, 1999).

[71] Richard Niemi, Stephen Craig, and Mattei Franco, "Measuring Internal Political Efficacy in the 1988 National Election Study," *American Political Science Review* 85 (December 1991).

[72] Stephen Ansolabehere, James Snyder, and Charles Stewart III, "Candidate Positioning in U.S. House Elections," *American Journal of Political Science* 45 (January 2001).

TABLE 1
PRINCIPAL COMPONENTS ANALYSIS OF ECONOMIC LIBERALIZATION AND THE SIZE OF THE PUBLIC SECTOR

	Factor Loadings[a]	
	Economic Liberalization	*Scope of the Public Sector*
Trade reform	**0.851**	0.184
Financial reform	**0.786**	–0.281
Tax reform	**0.774**	0.201
Capital account liberalization	**0.629**	–0.067
Privatization	0.259	**–0.675**
Government consumption	0.169	**0.740**

[a]Principal Components Factors (unrotated) with 313 observations.

with vigor when liberalization is pursued, even if the politics and the timing of reform vary across these different sectors.[73] While the liberalization of trade, domestic finance, and tax reform load powerfully on the first dimension, capital account liberalization is somewhat weaker but still a significant element in the orthodox turn toward markets. We call this the openness dimension. However, in the second column we observe a starkly contrasting tendency: some governments have maintained a larger public sector role in the economy by attenuating privatization measures and maintaining higher fiscal outlays. Greater market orientation in macroeconomic policy has thus not always meant a wholesale retreat of the state in Latin America. The question that remains is how these tendencies relate: are they two sides of the same coin, revealing a protective tendency within the broader neoliberal turn; or do they emerge in different countries, with some nations being more open across the board and others maintaining a more statist profile?

We answer this question first by scoring the two dominant factors into indices of statism and openness and assessing countries' joint scores on the two dimensions. Figure 3 shows the four possible combinations that result and how the Latin American countries have been located across them, on average, in four periods between 1975 and 2003. Governments scoring high on both dimensions may be said to pursue a strategy of embedding free-market reform in broad state protections—embedded neoliberalism—while countries scoring high on the open-

[73] For example, Schneider (fn. 11); and Marcus Kurtz, "Chile's Neo-Liberal Revolution: Incremental Decisions and Structural Transformation, 1973–89," *Journal of Latin American Studies* 31 (May 1999).

ness index but low on the statist index may be said to take the orthodox neoliberal path. Countries scoring low on openness and high on statism, by contrast, reveal the traditional statist (ISI) development strategy, while low scores on both indices we regard as the austerity condition of scant global ties and minimal state intervention. From the results presented in Figure 3, it is apparent that both traditional statism and austerity have been scarcely observed in the last decade, as most countries have shifted to high levels of openness. Where countries remain quite divided, however, is on the scope of the public sector, where we observe movement toward two unique policy equilibria: the neoliberal and the embedded neoliberal strategies. Our next task is to explain this pattern of divergence.

Empirical Model and Estimation

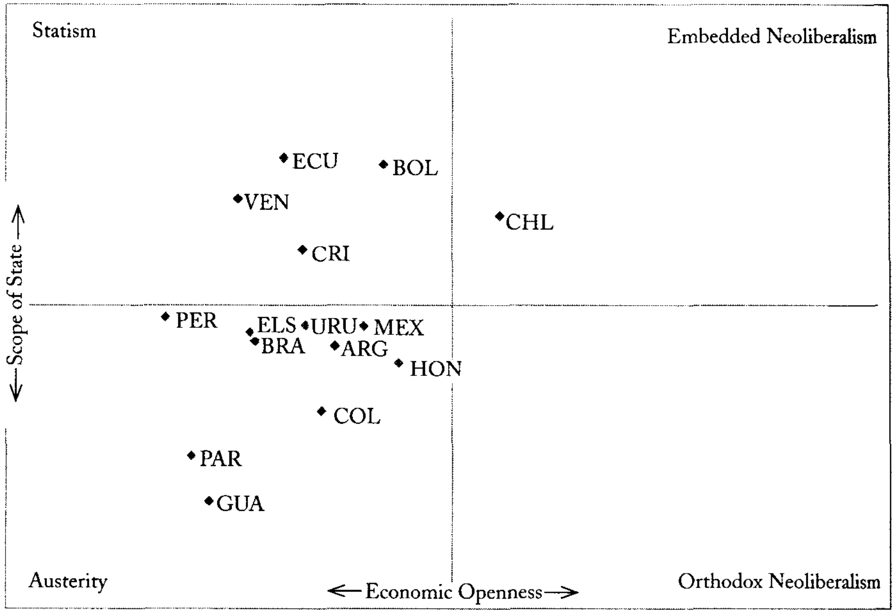
While a rich body of work has emerged in recent years to explain the move toward economic liberalization in Latin America, less attention has been paid to broader patterns of state intervention that have coincided with this trend. According to our argument, governments in Latin America that choose to pursue free markets and to maintain a significant public sector presence in the economy should be, first, those in which the process of import-substitution industrialization was most advanced prior to the debt crisis, and second, led by either conservative executives with weak union movements or left governments with strong labor allies. Where they exist, strategies of embedded neoliberalism are unlikely to be egalitarian and redistributive; they should instead be associated with interests that were privileged under ISI, that is, the better-off organized labor and domestic industry.

We test these hypotheses while controlling for an array of domestic and international factors that could otherwise account for observed patterns of economic liberalization and public sector outlays. We use time-series, cross-sectional data from seventeen Latin American countries between 1985 and 2003. We chose our starting date in order to avoid the confounding effects of the debt crisis on patterns of public sector outlays. Table 2 provides summary statistics for the data used in the analysis.

Dependent Variables

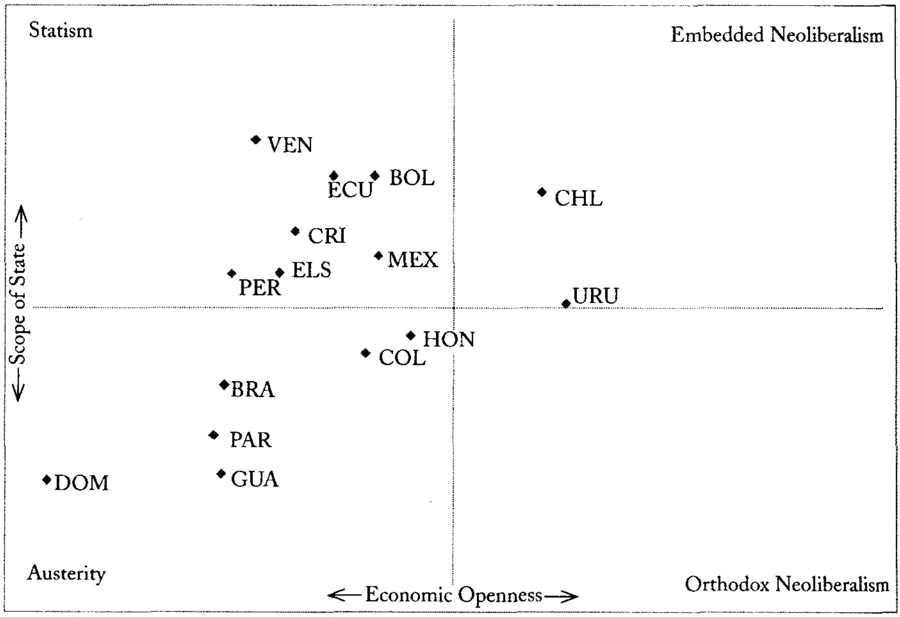
Our principal dependent variables are country scores on the two indices described above, statism and openness. We used the principal components method in the construction of these indices, which assumes that the factors are uncorrelated and that the communality of each item

FIGURE 3
ECONOMIC STRATEGY IN LATIN AMERICA
(1975–2003)



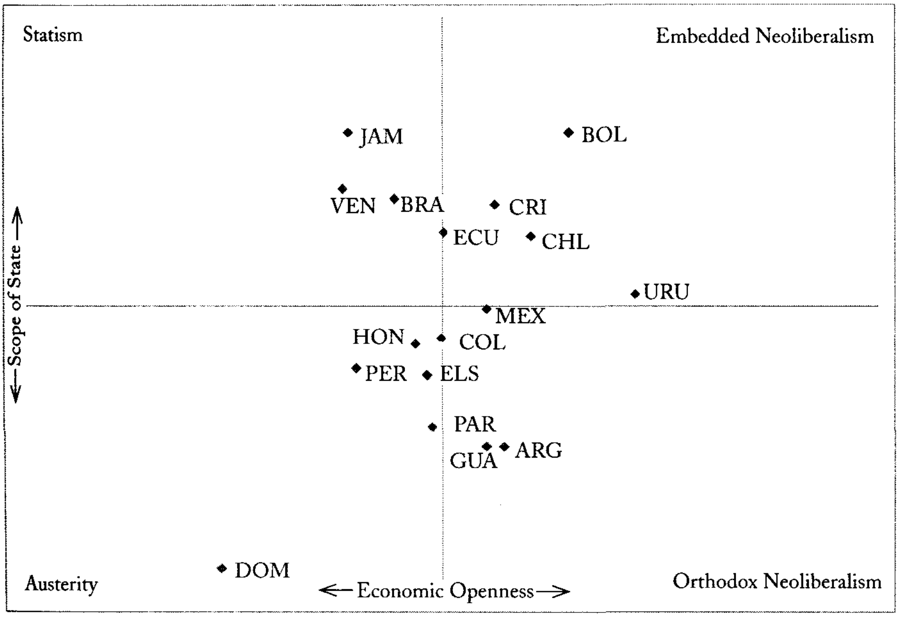
(a)

Average for 1975–79



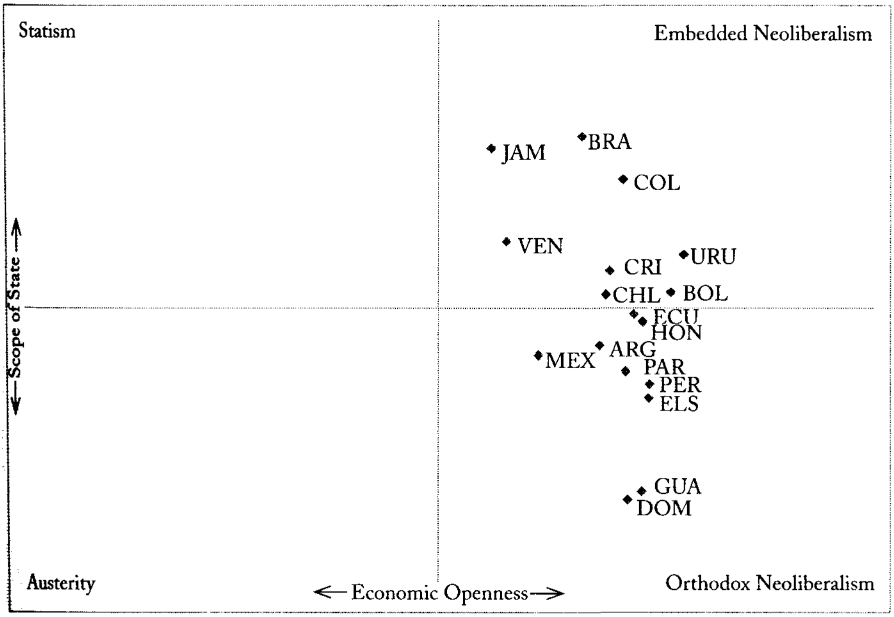
(b)

Average for 1980–84



(c)

Average for 1985–94



(d)

Average for 1995–2003

TABLE 2
SUMMARY STATISTICS

Variable	Obs.	Mean	Std. Dev.	Min	Max
Political Actors and Institutions					
Executive Partisanship[a]	310	1.326	0.836	0	2
Unions	266	15.956	4.902	4.4	24.8
Majority	317	0.566	0.176	0.108	1
PR	317	0.896	0.306	0	1
Social and Economic Legacies					
Manufacturing 1980	323	20.228	5.295	14.447	33.485
Human Capital	323	4.771	1.296	2.720	7.030
Inequality 1980	323	47.930	5.159	39.420	57.780
Growth 1980s	323	–0.427	1.492	–2.431	2.669
Controls					
Democracy	305	6.866	3.374	–8	10
Trade	323	53.588	23.418	13.24	121.56
IMF	323	0.021	0.035	0	0.330
World Bank	323	0.053	0.050	7E-05	0.226
Inflation(1n)[b]	323	2.924	1.460	0	9.372
Current Account	323	–2.787	3.977	–14.7	17.04
Unemployment	275	8.803	4.657	1.4	23.7
Age Dependency	323	0.705	0.112	0.490	0.972
GDP per capita	323	5.543	2.351	2.05	13
LnGDP	323	3.395	1.477	1.311	6.432
Time Trend	323	9	5.486	0	18

[a] Missing data for the Venezuelan case were corrected; the Chávez administration was coded as a left government. In addition, an obvious pair of errors for the Chilean case was corrected. The posttransition Christian Democratic administrations of Aylwin and Frei were coded as centrist, while the socialist administrations that followed them were coded as left. Finally, the scoring of the post–1982 Mexican PRI governments was changed to centrist (from left), following the corrections released by the authors of the database of political institutions themselves, but inadvertently omitted from the data file.

[b] Inflation rates less than 1 percent were recoded to 1 percent before natural logarithmic transformation to avoid the introduction of artificially large negative numbers, or leaving cases of deflation undefined.

sums to 1 over all factors (each variable has zero unique variance). The sum of the two factors should thus produce a wholly new variable on account of the orthogonality of the factors. Thus, countries scoring high on the sum of the two indices are said to employ an embedded neoliberal strategy, producing our first dependent variable, *Embedded Neoliberalism.* Countries scoring high on the economic openness and low on the statism index are said to pursue a mainstream neoliberal strategy. Thus, our second dependent variable, *Orthodox Neoliberalism*, is the difference between the score on the openness index and statist index for each country year. As this gap widens, countries pursue more extensive free-market policies with fewer state interventions. It is crucial for us to analyze these compound variables, for our theoretical claims are about the *conjunction* of openness and statism. To examine either factor separately (or even its constituent inputs), even controlling for the other, would not fully test the hypotheses we have developed. For example, we are interested in the relationship between partisanship and embedded neoliberalism, which would not be the same as investigating the relationship between partisanship and statism, even controlling for the level of openness.

INDEPENDENT VARIABLES

Our two central hypotheses relate to the legacy of import substitution in a country and to the partisan identity of the executive. We operationalize the ISI legacy using several variables to capture the nature and maturity of import substitution programs in Latin America. The first is the manufacturing value added as a percentage of GDP in 1980 (*Manufacturing 1980*).[74] Where manufacturing accounted for a higher share of national income in 1980, ISI may be said to be most advanced. Deeper ISI should also be consistent with a higher level of inequality by the end of this era. Thus we also include a measure of income inequality in 1980, measured as the GINI index for each country in that year or the closest year available (*Inequality 1980*).[75] An additional implication of advanced ISI that we should observe is a higher level of human capital investment.[76] We measure this legacy as the average years of schooling in the labor force in a given country in 1980 (*Human Capital*).[77]

We test our partisan hypothesis using a three-point measure of executive partisanship that codes left-wing government leaders as 0, centrist governments as 1, and conservatives as 2 (*Partisanship*). This variable is taken from the Database of Political Institutions (DPI), 2004 update.[78]

[74] World Bank (fn. 69).

[75] Klaus Deininger and Lyn Squire, "A New Data Set Measuring Income Inequality," *World Bank Economic Review* 10 (September 1996).

[76] Astorga, Berges, and Fitzgerald (fn. 41), 772.

[77] Robert Barro and Jon Wha Lee, "International Measures of Schooling Years and Schooling Quality," *American Economic Review* 82 (May 1996).

[78] An alternative analysis, relying on a dichotomous coding of left versus nonleft executives, produced very similar results. We incorporate the updates to the data set indicated by Philip Keefer, "DPI2004 Database of Political Institutions: Changes and Variable Definitions" (Manuscript, World Bank, 2005); we also corrected an error in the coding of the Chilean case, so that it now properly

This measure of partisanship begins with the categorization of the political party of the executive, but in cases where actual behavior deviates from party orientation, the former was used.[79] We expect partisan effects to be mediated by labor strength. Although we would ideally want time-series data on labor unionization, such data are not available. Accordingly, we capture labor strength as the average unionization rate from 1991 to 1995 (*Unions*), roughly the midpoint of the time period under analysis. These data are published by the Inter-American Development Bank.[80]

CONTROL VARIABLES

We include an array of controls for political and economic variables that are likely to shape the adoption of more liberal and/or statist economic policies. First, we include a measure of whether legislatures are elected using proportional representation (PR) systems. Scholars have long associated PR systems with economic openness, while plurality systems have been shown to promote behavior oriented toward protection, including stronger constituency service and support for geographically defined interests.[81] We thus include a variable indicating whether legislators are elected using a plurality rule, coded 0, or proportional representation, coded 1 (*PR*).[82] Previous research has also found that divided government— where the executive party lacks majority control of the legislature—is an important hindrance to economic liberalization.[83] We thus include a measure of the size of the governing majority (*Majority*),[84] which also allows us to address the hypothesis that minimum winning coalitions provide more stable legislative foundations for free trade policies.[85] While de-

considers the two posttransition Christian Democratic governments centrist, while the two socialist executives are recoded as left wing. Inexplicably, all posttransition Chilean governments had been coded as right wing in the database. The data set is described in Thorsten Beck, George Clarke, Alberto Groff, Philip Keefer, and Patrick Walsh, "New Tools in Comparative Political Economy: The Database of Political Institutions," *World Bank Economic Review* 15 (January 2001).

[79] For details, see Keefer (fn. 78), available at http://siteresources.worldbank.org/INTRES/Resources/DPI2004_variable-definitions.pdf (accessed September 24, 2007).

[80] IDB (fn. 13), 223.

[81] Ronald Rogowski, "Trade and the Variety of Democratic Institutions," *International Organization* 41 (Spring 1987); and Thomas Stratmann and Martin Baur, "Plurality Rule, Proportional Representation, and the German Bundestag: How Incentives to Pork-Barrel Differ across Electoral Systems," *American Journal of Political Science* 46 (July 2002).

[82] Beck et al. (fn. 78).

[83] Gregg Johnson and Brian Crisp, "Mandates, Powers, and Policies," *American Journal of Political Science* 47 (January 2003); Helen Milner and Peter Rosendorff, "Trade Negotiations, Information, and Domestic Politics: The Role of Domestic Groups," *Economics & Politics* 8 (July 1996); and Susan Stokes, *Mandates and Democracy: Neoliberalism by Surprise in Latin America* (Cambridge: Cambridge University Press, 2001).

[84] Beck et al. (fn. 78).

[85] Rogowski (fn. 81).

mocratization has been associated with the move toward free trade,[86] authoritarian governments have been found to be more capable of imposing liberalization without compensating domestic constituents.[87] We thus include the Polity IV index score of democratic freedom for each country and year (*Democracy*).[88]

In order to control for external pressures on governments to adopt free-market reform or to curb spending, we include measures of the use of IMF credit for each country-year (*IMF*) and World Bank loans and credit, both as a percentage of GDP (*World Bank*).[89] In addition, countries in which international trade constitutes a larger share of the economy should be those more likely to employ more generous state interventions in the context of free trade. Although increasing exposure to trade has been associated with cuts in social spending in the developing world,[90] trade has been found to be compatible with broader human capital spending in Latin America;[91] and we would expect it to be a key component of the embedded neoliberal strategy. We control for trade exposure by including the annual level of imports plus exports as a percentage of GDP (*Trade*). To capture each country's vulnerability to capital flow reversals and thus of the strength of global market constraints, we include the current account balance as a share of GDP (*Current Account*) and the natural log of inflation (*Inflation*). We also expect smaller economies to opt for the embedded neoliberal strategy, as opposed to the orthodox neoliberal one, since these economies, which are typically less diversified and more trade dependent, should feel more heavily the effects of terms of trade volatility. We thus include the natural log of gross domestic product (*lnGDP*) to measure the size of the domestic economy.[92]

In order to distinguish whether the broader fiscal outlays in the embedded neoliberal countries emerge from demands of the more vulnerable populations, we include measures of the unemployment rate[93] (*Unemployment*) and the age dependency ratio, which is the ratio of children under age fifteen and adults over age sixty-five to the active

[86] For example, Helen Milner and Keiko Kubota, "Why the Move to Free Trade: Democracy and Trade Policy in the Developing Countries," *International Organization* 59 (January 2005).

[87] Adserà and Boix (fn. 2).

[88] Monty Marshall and Keith Jaggers, *Polity IV Project: Political Regimes and Transitions, 1800–2002* Data Users Manual (Manuscript, Center for International Development and Conflict Management, 2002).

[89] World Bank (fn. 69).

[90] Garrett (fn. 52); and Kaufman and Segura-Ubeirgo (fn. 4).

[91] Wibbels (fn. 4), 459.

[92] All four variables are from World Bank (fn. 69).

[93] International Labour Organization (ILO), *Key Indicators of the Labor Market*, 4th ed, CD-ROM (Geneva: ILO, 2006).

working-age population (*Age Dependency*).[94] Higher levels of country wealth have been closely associated with a broader state presence in the economy, so we include as well a measure of per capita gross domestic product (*GDP per capita*) at purchasing power parity in constant dollars of 2000. We include the average annual GDP growth between 1980 and 1990 (inclusive) to proxy for the intensity of economic crisis in the 1980s (*Growth 1980s*).[95]

EMPIRICAL MODEL

Our approach to estimation begins with a cross-sectional, time-series estimation of data spanning seventeen countries over the period 1985–2003. Since a lagrange multiplier test indicated the presence of first-order autocorrelation, temporal dependence in the errors is modeled as an AR-1 process. Cross-sectional correlation of the disturbances is controlled through the use of panel-corrected standard errors, with pairwise selection in the computation of the Σ matrix. We include a linear time variable (*Year*) in each model to control for spurious correlation among trended variables. We do not initially employ a fixed-effects specification, as many of the theoretically important variables reflect historical legacies and are thus not time varying; instead we endeavor to model relevant national differences directly. We then proceed to evaluate whether omitted country-effects or potential nonstationarity are affecting the principal results in a meaningful way.

Results

Table 3 reports the results of the initial statistical analysis. The analysis provides support for our expectations that the embedded neoliberal development strategy grew out of a legacy of advanced import-substituting industrialization, that it has emerged in small economies, and that it has generally been promoted by more conservative governments. We find support also for the expectation that this partisan effect is mediated by labor strength, such that the left has pursued embedded neoliberalism only where it has the support of, or been subjected to pressure from, powerful unions. The orthodox neoliberal model, by contrast, has emerged where postwar industrial development was more attenuated and is not subject to similar political dynamics.[96]

[94] World Bank (fn. 69).

[95] Ibid.

[96] Indeed, partisanship appears to have little direct relationship to orthodox neoliberalism, most likely because both conservative and left governments have pursued it in the region, albeit typically for

ISI LEGACY

Our three proxies for the ISI legacy are all (with one exception) statistically significant and their coefficients are in the expected direction. Where import substitution was most advanced, we have argued, a powerful industrial sector should be both more likely to mature into competitive exporters and more capable of pressuring the government for subsidies and compensations in this process. As we see in Table 3, column 1, in countries where domestic manufacturing claimed a larger share of GDP in 1980, governments have moved further along toward a strategy of embedding economic openness in a more substantial public sector presence in the economy. The opposite is true in the neoliberal countries, as we see in the next column. Countries with a smaller manufacturing sector at the end of the ISI era tend to pursue free-market reform with minimal state intervention. The higher premium paid for skilled labor under ISI has also been associated with the exacerbation of the already wide income disparities in Latin America.[97] The signs of the coefficients on the 1980 GINI index are consistent with expectations (though insignificant in one case), as countries that were more unequal in 1980 have on average moved further in the direction of the embedded neoliberal strategy. By contrast, countries with a relatively flatter income distribution in 1980 have clearly pursued the more orthodox neoliberal development strategy since the debt crisis. Significantly, this result directly contradicts the conventional view that inequality would not only fuel social instability but also cause delays in orthodox adjustment, overly expansive macroeconomic policies, and inflation.[98] Such a perspective assumes both that it is the poorest citizens who will effectively pressure governments for favorable budgetary outlays and that those expenditures will favor inflation-generating consumption. Our results, by contrast, are consistent with the view that the more powerful sectors are the beneficiaries of public outlays in the open economy,

different reasons. See Sarah Brooks and Marcus Kurtz, "Capital, Trade, and the Political Economies of Reform," *American Journal of Political Science* 51 (October 2007). It is likely that other factors may condition the relationship (if any) between partisanship and aspects of orthodox neoliberal reform; at least this has been suggested in recent literature. See M. Victoria Murillo and Cecilia Martínez-Gallardo, "Political Competition and Policy Adoption: Market Reforms in Latin American Public Utilities," *American Journal of Political Science* 51 (January 2007); and Daniel Nielson, "Supplying Trade Reform: Political Institutions and Liberalization in Middle-Income Presidential Democracies," *American Journal of Political Science* 47 (July 2003). While we consider this a fruitful line of research, further analysis of the question is beyond the scope of this paper.

[97] Sheahan (fn. 44), 273.

[98] Jeffrey Sachs, "Social Conflict and Populist Policies in Latin America," NBER Working Paper no. 2897 (Cambridge, Mass.: National Bureau of Economic Research, 1989), 4.

TABLE 3
EXPLAINING ECONOMIC POLICY OUTCOMES IN LATIN AMERICA[a]
(1985–2003)

Dependent Variable	*Embedded Neoliberalism*	*Orthodox Neoliberalism*	*Embedded Neoliberalism*	*Orthodox Neoliberalism*
Political Actors and Institutions	*1*	*2*	*3*	*4*
Partisanship	0.7277*	0.4827	0.7202*	0.4876
	(0.3890)	(0.3281)	(0.3843)	(0.3278)
Partisanship * Unionization	−0.0509**	−0.0144	−0.0500**	−0.0150
	(0.0243)	(0.0194)	(0.0241)	(0.0194)
Unionization	0.1894***	−0.0121	0.2047***	−0.0236
	(0.0532)	(0.0472)	(0.0555)	(0.0475)
Majority	0.6820**	−1.0242***	0.5771*	−0.9381***
	(0.3415)	(0.3592)	(0.3337)	(0.3645)
PR			−0.6871	0.4572
			(0.3859)	(0.3172)
Social and Economic Legacies				
Manufacturing 1980	0.1593***	−0.0994***	0.1697***	−0.1064***
	(0.0344)	(0.0328)	(0.0357)	(0.0322)
Human Capital	0.3855***	−0.1466	0.3493***	−0.1212
	(0.1142)	(0.0914)	(0.1033)	(0.0905)
Inequality	0.0492**	−0.1004***	0.0307	−0.0868***
	(0.0250)	(0.0251)	(0.0282)	(0.0269)
Growth 1980s	0.1860***	0.0642	0.1291*	0.09815
	(0.0622)	(0.0763)	(0.0712)	(0.0819)
Controls				
Democracy	0.0116	−0.1079***	0.0063	−0.1035***
	(0.0260)	(0.0306)	(0.0251)	(0.0307)
Trade	0.0041	−0.0168***	0.0023	−0.0154***
	(0.0058)	(0.0057)	(0.0058)	(0.0057)
IMF	1.2747	−5.6314**	0.8682	−5.3438**
	(1.8534)	(2.2210)	(1.8017)	(2.1721)
World Bank	−4.9922*	1.5814	−5.7323**	2.1541
	(2.6993)	(2.9728)	(2.7393)	(2.9986)
Inflation (ln)	−0.1229**	0.0786	−0.1133*	0.0717
	(0.0584)	(0.0486)	(0.0587)	(0.0490)
Current Account	−0.0180	0.0256*	−0.0191	0.0267*
	(0.0134)	(0.0156)	(0.0127)	(0.0154)
Unemployment	−0.0231	−0.0426**	−0.0293	−0.0374**
	(0.0173)	(0.0167)	(0.0187)	(0.0172)
Age Dependency	0.8259	−1.4118	1.1797	−1.6434
	(1.7665)	(1.6853)	(1.8128)	(1.6351)
GDP per capita	−0.1931***	0.1055	−0.2142***	0.1209*
	(0.0589)	(0.0674)	(0.0617)	(0.0692)

TABLE 3, *cont.*

Dependent Variable	*Embedded Neoliberalism*	*Orthodox Neoliberalism*	*Embedded Neoliberalism*	*Orthodox Neoliberalism*
Controls	*1*	*2*	*3*	*4*
lnGDP	−0.6423***	−0.0891	−0.6671***	−0.0671
	(0.0947)	0.1100	(0.0928)	(0.1054)
Time Trend	0.1274***	0.1658***	0.1377***	0.1583***
	(0.0196)	(0.0210)	(0.0214)	(0.0214)
Constant	−8.7324***	9.3187***	−7.4388***	8.3488***
	(3.0781)	(2.7217)	(2.8310)	(2.8469)
N	193	193	193	193

***p<0.01; **p<0.05; *p<0.10

[a] Prais-Winsten regression with panel-corrected standard errors and correction for AR-1 autocorrelation.

while concessions take the form of subsidies for export production and employment for middle-income workers. Indeed, we see across model specifications that embedded neoliberalism is a noninflationary development strategy.

Consistent with expectations, we also find that higher stocks of human capital in the labor force are associated with the pursuit of embedded neoliberalism. The opposite is true under orthodox neoliberalism. Since vigorous ISI strategies brought dramatic increases in public investment in human capital in Latin America,[99] higher levels of education should signal the capacity for more mature ISI firms to move into higher value-added markets. And it is skilled labor in these industries, along with business owners, that we expect to constitute the backbone of the embedded neoliberal coalition. Indeed, firms in middle-income countries that have been able to survive in the increasingly competitive global economy are those that produce either at very low cost or in higher-quality segments of the market where they may have a greater price advantage.[100] An example of such a strategy is Costa Rica's high-tech manufacturing export strategy, which drew upon the strong human capital investments of the ISI era.[101]

Consistent with our view of embedded neoliberalism as a development strategy oriented toward more privileged, rather than more vulnerable populations, the statistical analysis reveals that high levels of

[99] Astorga, Berges, and Fitzgerald (fn. 41); Bruton (fn. 40), 916.

[100] Sanjay Lall, "Competing with Labor: Skills and Competitiveness in Developing Countries," Issues in Development Discussion Paper no. 31 (Geneva: ILO, 1999).

[101] Rodríguez-Clare (fn. 25), 313.

unemployment or dependent populations are not sources of expanded public sector outlays in embedded neoliberalism. The coefficient on unemployment rates is *negative* and insignificant in the embedded neoliberal estimates. Nor have fiscal outlays supported pensions and child care for large dependent populations, as the age dependency ratio has no statistically significant relationship to embedded neoliberalism. In the neoliberal countries we find a significant and negative coefficient on unemployment rates, suggesting that it may be politically easier to impose neoliberal reforms when unemployment is low, and thus when the labor market is capable of absorbing workers that may be dislocated in the adjustment process.

Partisanship

Our expectation that Latin American embedded neoliberal strategies would be markedly different from the European model of embedded liberalism extends as well to the partisan foundations of this development strategy. We expected that this strategy would *not* be embraced principally by the left-wing government leaders, unless labor unions were very strong. The statistical analysis confirms this hypothesis, as conservative parties are associated with more embedded neoliberal strategies where rates of unionization are low, but as labor strength increases, conservative governments are powerfully constrained by union opposition. The interaction between the partisanship and union variables reveals further that at high levels of unionization, left executives have taken the lead in joining economic openness with expanded state interventions in Latin America. It is at unionization rates around 15 percent of the workforce that labor becomes powerful enough to overwhelm conservative governments' capacities to pursue the embedded neoliberal approach. To render the marginal effects interpretable, Figure 4 shows graphically (1) the effects of partisanship on economic strategy as unionization changes and (2) its associated 95 percent confidence intervals for all models.[102] Future research may investigate whether left-governed embedded neoliberalism has entailed a more progressive public spending profile by disaggregating government outlays across left and right governments in such contexts.

The conditional effect of partisanship can be seen in qualitative comparisons as well. Our earlier example, Colombia, is emblematic of

[102] We are grateful to Matthew Golder for publishing the stata code from which we developed these figures. For the article on which the code is based, see Thomas Brambor, William Roberts Clark, and Matt Golder, "Understanding Interaction Models: Improving Empirical Analysis," *Political Analysis* 14 (Winter 2006). The code is found at http://homepages.nyu.edu/~mrg217/interaction.html#code.

right-wing governments pursuing a substantial open economy alongside a statist industrial strategy. Our hypothesis was that conservative governments would be most likely to do this where a more pronounced state role and expanded public sector would not simultaneously have the effect of strengthening the labor movement. And of course, in the Colombian case they need have no such fear. Not only is Colombia among the least-unionized countries in the region, having a union density of only 7 percent in 1996 (and declining thereafter), but there need be no fear of a reversal of this trend. As the U.S. Department of State notes, "labor leaders throughout the country [have] continued to be targets of attacks by the military, police, paramilitary groups, guerrillas, narcotics traffickers, and their own union rivals."[103]

By contrast, countries more consistently governed by left and center-left leaders have pursued embedded neoliberalism only when they were also home to comparatively strong labor movements. In Brazil and Costa Rica, for example, unionization is quite high. The former has the highest rate of unionization in the region (24.8 percent), while the latter's 15 percent unionization rate is exceptional for such a poor, comparatively agrarian country. In both cases extensive public sector presences have remained, not only in industrial promotion but also in banking, utilities, and other key inputs to the private sector.

Orthodox neoliberal strategies, by contrast, do not reveal a clear partisan foundation in our analysis, nor is this effect conditioned by labor power. This result is consistent with a broad literature on the politics of economic liberalization in Latin America that has found that free-market reforms are not consistently pursued either by governments of the right or by governments of the left.[104] Our results, taken as a whole, begin to shed some light on why there is so much dissensus over whether partisanship conditions economic policy reform in Latin America. It suggests that partisanship does indeed matter—but only with respect to some kinds of outcomes and typically in a conditional fashion.

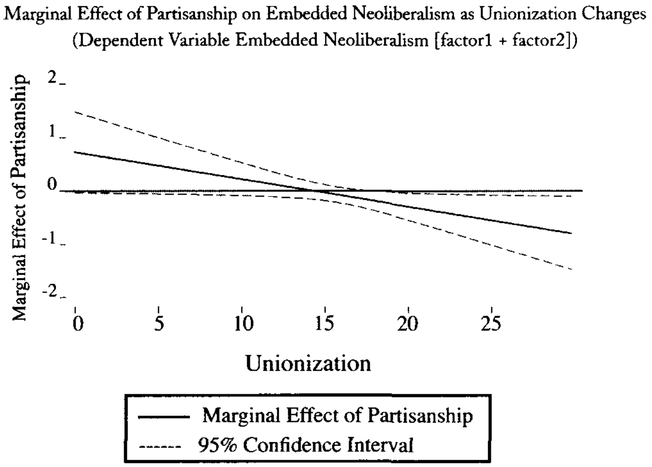
Political Institutions

The third and fourth columns of Table 3 explore whether the structure of political institutions, and specifically the difference between plurality and proportional representation (PR) systems, have shaped the tendency to adopt the more embedded openness strategies. The analysis

[103] U. S. Department of State, "Colombia: Country Reports on Human Rights Practices, 1999" (Washington, D.C.: U. S. Department of State, 2000). Available at http://www.state.gov/g/drl/rls/hrrpt/1999/380.htm (last accessed January 31, 2008).

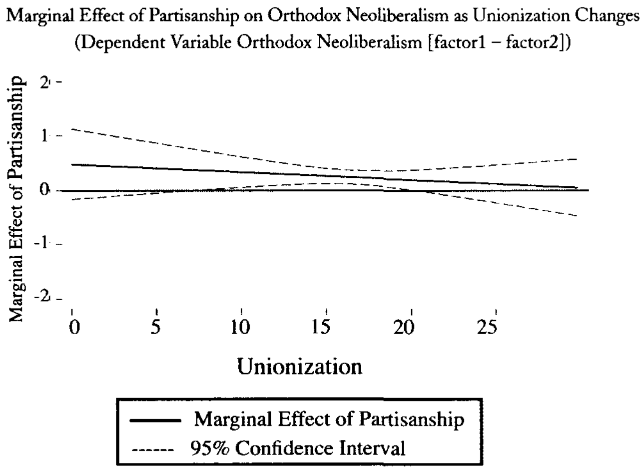
[104] Johnson and Crisp (fn. 83); and Stokes (fn. 83).

Figure 4
Marginal Effects of Partisanship by Unionization
(graphical representation of interaction terms in table 3)



(a)

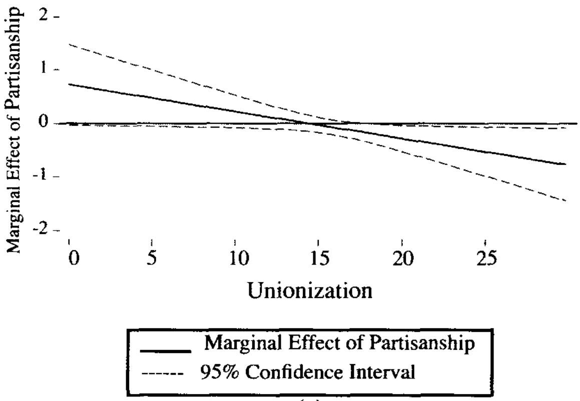
Model 1



(b)

Model 2

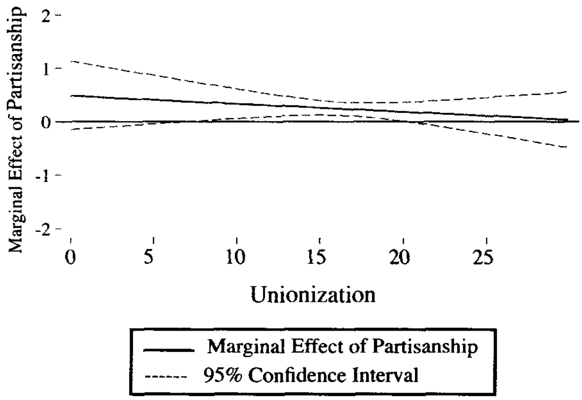
Marginal Effect of Partisanship on Embedded Neoliberalism as Unionization Changes
(Dependent Variable Embedded Neoliberalism [factor1 + factor2])



(c)

Model 3

Marginal Effect of Partisanship on Orthodox Neoliberalism as Unionization Changes
(Dependent Variable Orthodox Neoliberalism [factor1 – factor2])



(d)

Model 4

provides modest support for the view that PR systems promote legislative behavior that is more resistant to demands for state protections. We see this in the embedded neoliberal case, where countries with PR systems in Latin America have on average been more inclined toward this strategy.

The size of the governing majority appears to have some positive relationship to the disposition to embed free-market reforms in broader state interventions. In the case of the orthodox neoliberal strategy, the coefficient on the governing majority variable is negative and significant in both cases. This offers support for the claim that minimal winning coalitions provide a more stable foundation for liberal economic approaches. Democratic freedoms have not predicted the embrace of embedded neoliberal strategies, although we find support for the view that in more authoritarian contexts, orthodoxy may be more easily pursued without compensatory protections.[105]

Controls

The analysis provides no support for the view that orthodox neoliberalism was promoted by more extreme experiences of economic crisis in the 1980s, which debilitated the ISI political coalitions. The crisis variable does not predict the move toward embedded neoliberal strategies, because higher growth rates (not decline) are instead positively linked to the choice of this strategy. Embedded neoliberal strategies in Latin America have been pursued most energetically in smaller economies, however, which are typically less diversified and thus are subject to more severe terms of trade risks. Here we find the greatest parallel with the European patterns of expanded state protections in the open economy; these were typically more robust in small, open economies.[106] This result also confirms the general findings of earlier research linking state protections to enhanced exposure to terms of trade volatility in the open economy.[107]

International pressures and constraints have at best an inconsistent influence on the emergence of the embedded neoliberal strategy. We see this first on the IMF and World Bank variables, with the former unrelated to embedded neoliberalism and the latter negatively associated with it. By contrast, it is the IMF variable that is significant in the orthodox neoliberal equations, but it suggests paradoxically that

[105] Adserà and Boix (fn. 2).

[106] Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca, N.Y.: Cornell University Press, 1985).

[107] Adserà and Boix (fn. 2); and Bates, Brock, and Tiefenthaler (fn. 3).

the use of IMF credit is negatively associated with an orthodox strategy. This may, however, be an artifact of the tendency of countries to seek IMF finance as a precursor to reform, when their macroeconomic fundamentals are out of balance. A country's vulnerability to reversals in capital flows, as measured in the current account balance, has not been a significant predictor of the pursuit of embedded neoliberal or orthodox strategies in Latin America. However, trade exposure as a percentage of GDP is a negative and statistically significant predictor of the orthodox neoliberal model, suggesting that a large import/export sector itself does not drive this type of reform (though a desire to create one may well). Trade exposure is uncorrelated with outcomes in the embedded neoliberal countries, suggesting that globalization so measured does not in itself preclude state intervention (of this type) in open developing economies. The control for country wealth reveals that embedded neoliberal strategies have been pursued where per capita GDP is lower, net of other factors, contrary to expectations, while it is relatively wealthier Latin American countries that on average seem to have opted for the orthodox neoliberal approach. At a minimum, this suggests that embedded neoliberal policies, while costly, are not prohibitively so for less-wealthy countries.

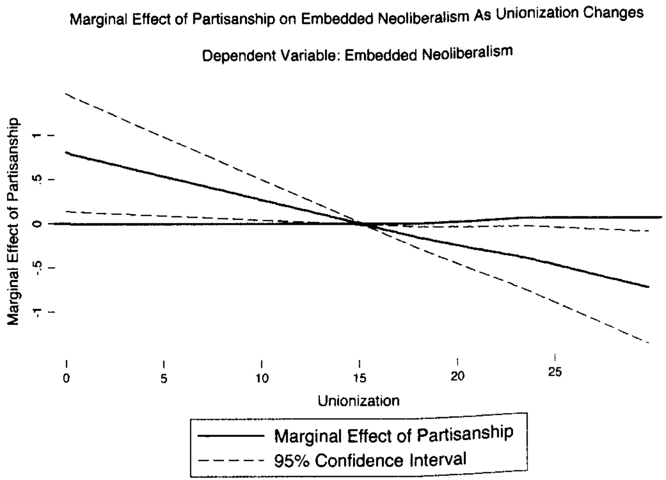
While the models in Table 3 comport well with our principal hypotheses, we must be cautious in accepting them until their robustness can be established. The most obvious problem that we must deal with is the fact that some of our theoretically relevant independent variables are time invariant (or only slow moving). Since the models in Table 3 do not include controls for country fixed effects, we cannot know whether the included time-invariant variables are correlated with the omitted unit fixed effects, inducing bias. The customary alternative—estimating a typical fixed-effects model—will not help us here, however, since it would require that we omit from the analysis many of the theoretically crucial variables.

Fortunately, recent work by Plümper and Troeger has provided an alternative multistage estimation procedure that parcels out the effects of time-invariant and slow-moving independent variables from the unobserved cross-unit heterogeneity.[108] This is doubly critical, as, in cross-national analyses, the potential that there are unmeasured country-level differences of importance is quite high. In Table 4 we report the results of a replication of the full models for both embedded neoliberalism and

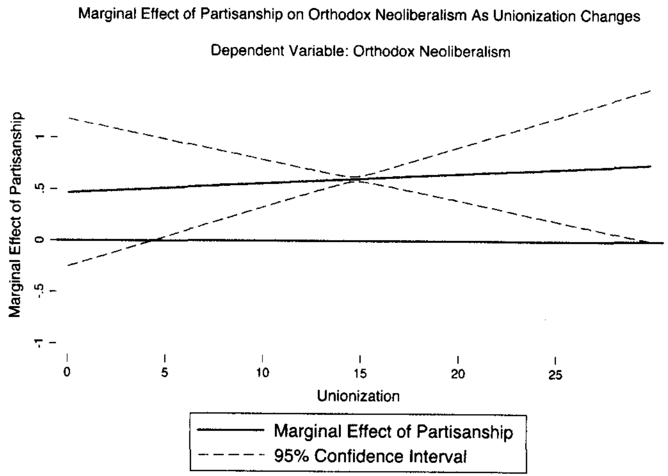
[108] Thomas Plümper and Vera E. Troeger, "Efficient Estimation of Time-Invariant and Rarely Changing Variables in Finite Sample Panel Analyses with Unit Fixed Effects," *Political Analysis* 15 (Spring 2007).

Table 4
Accounting for Country Effects and Time-Invariant Regressors
(fixed-effects vector decomposition models)[a]

Dependent Variable:	*Embedded Neoliberalism*	*Orthodox Neoliberalism*
Political Actors and Institutions	*1*	*2*
Partisanship	0.8071 **	0.4657
	(0.3397)	(0.3655)
Partisanship * Unionization	–0.0536**	0.0093
	(0.0223)	(0.0249)
Unionization	0.2012***	–0.0426
	(0.0423)	(0.0385)
Majority	0.0161	–0.0181
	(0.0350)	(0.1774)
PR	–0.7574***	0.6164***
	(0.0277)	(0.0440)
Social and Economic Legacies		
Manufacturing 1980	0.1208***	–0.1351 ***
	(0.0023)	(0.0024)
Human Capital	0.2187***	0.1020***
	(0.0164)	(0.0391)
Inequality	0.0657***	–0.1079***
	(0.0138)	(0.0147)
Growth 1980s	0.0364	–0.0971
	(0.0378)	(0.0650)



Dependent Variable:	Embedded Neoliberalism	Orthodox Neoliberalism
Controls		
Democracy	0.0550***	–0.1039***
	(0.0068)	(0.0399)
Trade	–0.0072	0.0061**
	(0.0044)	(0.0027)
IMF	–2.1850***	–5.4773***
	(0.1208)	(0.9544)
World Bank	–0.6329	–2.4619
	(1.9127)	(2.5889)
Inflation(In)	0.0338	0.0158
	(0.0243)	(0.0522)
Current Account	–0.0246***	0.0131
	(0.0024)	(0.0166)
Unemployment	–0.0048	–0.0435
	(0.0276)	(0.0565)
Age Dependency	–3.5108	–7.6472*
	(3.1038)	(4.3998)
GDP per capita	–0.0968	–0.2836
	(0.3722)	(0.4694)
InGDP	–0.8702	0.5152
	(3.7361)	(4.3715)
Time Trend	0.1350**	0.0593
	(0.0573)	(0.0619)
Constant	–4.6167***	12.6939***
	(0.0953)	(0.2656)
N	137	137



***p<0.01; **p<0.05; *p<0.10

[a] Fixed-efects vector decomposition regression with robust standard errors and correction for AR-1 autocorrelation.
Model esimated using Stata 9, and the xtfevd estimator developed by Plümper and Troeger (2007).

orthodox neoliberalism from Table 3 (that is, models 3 and 4) using the Plümper-Troeger fixed-effects vector decomposition estimator.[109] A graphical representation of the marginal effects of partisanship (as it interacts with unionization) accompanies each model.

The results are encouraging. The marginal effects of partisanship on the level of embedded neoliberalism continue as before—at low levels of unionization, ENL is a product of conservative executives (is positive), while this effect reverses itself when unionization reaches higher levels, where it is associated with left governments (becomes negative). Indeed, the confidence intervals are even somewhat tighter. Moreover, the magnitude of the estimated effects of partisanship and unionization are very similar across the models in Table 3 and 4, collectively suggesting that omitted fixed effects were not driving the results for the political variables in the initial estimation.

The results with respect to the legacies of the ISI era are also consistent with our initial estimates. The size of the manufacturing sector, the level of human capital, and inequality are all positively associated with embedded neoliberal policy approaches. This does not imply that the omission of country fixed effects had no impact on the original analysis, for the results for some of the coefficients on the control variables changed somewhat. While in the models in Table 3, the level of development and the aggregate size of the economy were negatively associated with ENL, in the models in Table 4, these variables are statistically indistinguishable from zero in their effect, though their signs are in the same direction. Finally, the alternative estimation approach also notes the expected negative effect of proportional representation systems, just as in the original model.

The replication with respect to orthodox neoliberalism (Table 4, model 2) is similarly reassuring. With respect to the theoretically interesting variables, partisanship shows a weak conditional and positive relationship with orthodoxy, but with confidence only at moderate to high levels of unionization. Two of the three measures of the depth of ISI-era development (manufacturing and inequality) are also, as expected, negatively related to orthodox neoliberalism, while human capital formation (in contrast to the model in Table 3) is positively signed. With

[109] In both these estimations we corrected for the first-order autocorrelation indicated by a lagrange multiplier test, and we employed robust standard errors. The invariant and slow-moving variables were manufacturing share of GDP in 1980, human capital in 1980, and inequality in 1980, growth over the 1980s, electoral system, partisanship, unionization rates, and their interaction. Using standard errors that assume clustering by country produced nearly identical results, including the size, sign, and statistical significance of the variables of interest. Reestimations of the slightly more parsimonious models (1 and 2) indicated that the results are robust to the inclusion or omission of electoral system (PR).

respect to the controls, it is here that control for country fixed effects has the most interesting results, eliminating the relationship between the level of development and orthodox neoliberalism. Not surprisingly, the age dependency ratio and trade openness are now negatively and positively, respectively, related to orthodoxy. The former is likely the case because high dependency ratios imply large constituencies that would oppose the fiscal austerity inherent in neoliberal retrenchment. While in Table 3 this variable had the same sign, it is only after removing unit effects that it is statistically discernible from zero. Trade as a share of GDP has changed sign and become positive, though it is not obvious whether this reflects the power of trade-based interests or the tendency of economies to become more trade oriented as orthodoxy is pursued.

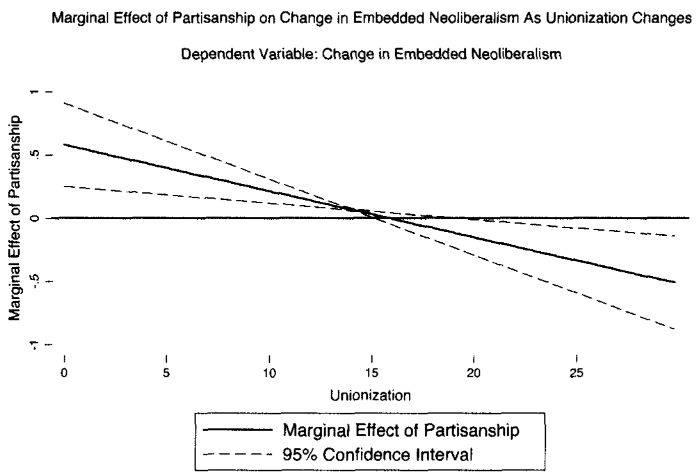
We proceed to consider one final threat to the robustness of our findings. It is possible that nonstationarity in the dependent variable could be inducing bias that is driving our results. As a final check on the robustness of our results, we replicate our models using as the dependent variable the first difference of our measures of embedded and orthodox neoliberalism, respectively (see Table 5).[110] Here again we employ the fixed-effects vector decomposition estimator to ensure that unmeasured cross-sectional heterogeneity in the units is not driving our results.

The differenced models also reinforce our theoretical contentions. Once again moves in the direction of embedded neoliberalism are the province of conservative executives, except where unionization levels are high, in which case left executives are their principal proponents (see the graphic representation of marginal effects in Table 5). All the indicators of the ISI legacy are significantly related to ENL, as also expected . As in the models of Table 4, but unlike the original estimations (Table 3), the size of the economy and the level of development are unrelated to ENL. This suggests that the initial relationship may have been caused by correlation with unmeasured country fixed effects in the initial estimation, and it reinforces the importance of—at least with respect to the controls—accounting for them. Similarly, and unsurprisingly, the level of IMF credit relative to GDP was negatively related to the level (Table 4, model 1) and the change (Table 5, model 1) in embedded neoliberalism.

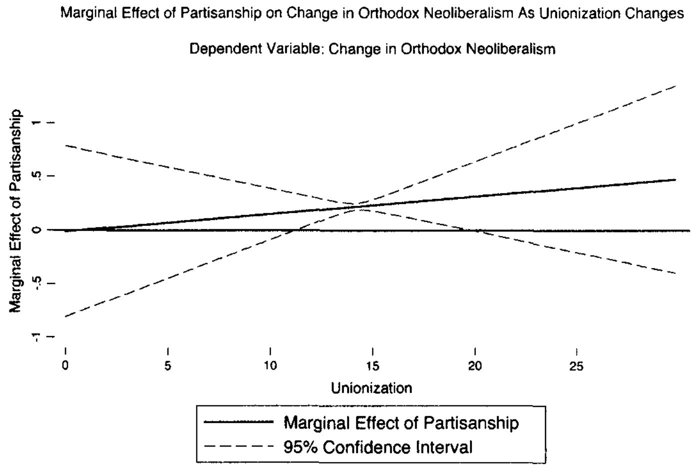
[110] Each of these differenced models naturally includes as a control the lagged level of the dependent variable as the change score is very likely in part dependent upon the antecedent level (that is, at high levels further increases are likely to be smaller). No correction for autocorrelation is made as lagrange multiplier tests indicate its absence. The time trend variable was omitted as the multivariate augmented Dickey-Fuller test indicated stationarity.

TABLE 5
ALTERNATIVE SPECIFICATIONS: DIFFERENCED MODELS[a]
(FIXED-EFFECTS VECTOR DECOMPOSITION MODELS)

Dependent Variable:	*Change in Embedded Neoliberalism*	*Change in Orthodox Neoliberalism*
Political Actors and Institutions	*1*	*2*
Partisanship	0.5804***	–0.0134
	(0.1683)	(0.4073)
Partisanship * Unionization	–0.0366***	0.0164
	(0.0120)	(0.0286)
Unionization	0.1240***	–0.0888
	(0.0280)	(0.0678)
Majority	0.2547	–0.1695
	(0.2216)	(0.5026)
PR	0.0121	–0.0075
	(0.0191)	(0.0532)
Social and Economic Legacies		
Manufacturing 1980	0.0848***	–0.1500***
	(0.0026)	(0.0119)
Human Capital	0.0558***	–0.0860***
	(0.0041)	(0.0055)
Inequality	0.0652***	–0.0988***
	(0.0054)	(0.0128)
Growth 1980s	–0.0252***	–0.0578***
	(0.0023)	(.0132)



Dependent Variable:	Change in Embedded Neoliberalism	Change in Orthodox Neoliberalism
Controls		
Lagged Level of DV	−0.1777***	−0.3301***
	(0.0141)	(0.0656)
Democracy	−0.0056	−0.0233*
	(0.0090)	(0.0136)
Trade	−0.0012	−0.0006
	(0.0040)	(0.0066)
IMF	−1.8406***	−4.0556***
	(0.5959)	(0.4854)
World Bank	−1.4352	1.2339
	(1.2955)	(2.6588)
Inflation (1n)	0.0059	0.0776
	(0.0429)	(0.0618)
Current Account	−0.0358***	0.0164***
	(0.0082)	(0.0060)
Unemployment	0.0030	−0.0029
	(0.0174)	(0.0319)
Age Dependency	−3.6759	−2.0323
	(3.5607)	(8.8153
GDP per capita	0.0401	−0.1677
	(0.2165)	(0.5075)
lnGDP	−0.8445	0.9170
	(1.9878)	(4.4271)
Constant	−1.9772***	9.0149***
	(0.1588)	(0.3207)
N	192	192



***p<0.01; **p<0.05; *p<0.10

[a] Fixed-efects vector decomposition regression with robust standard errors; a lagrange multiplier test indicated the absence of autocorrelation.

The models considering the orthodox neoliberal outcome also reinforce our general conclusions. The principal difference among the political variables is that the rate of unionization is statistically unrelated (though negatively signed) to change in the degree of orthodox neoliberalism. Nor is partisanship clearly at issue here either (see the marginal effects presented in Table 5). While the trend suggests that conservative executives are more likely to increase the pursuit of orthodox economic policies as unionization increases (and even at zero unionization, are not much less likely to pursue it than less conservative presidents), little can be said with confidence. All three indicators of the ISI legacy (manufacturing, human capital, and inequality) are negatively related to orthodoxy, as expected.

CONCLUSION

Much of the research on the politics of globalization and economic reform in the developing world has portrayed the contemporary movements toward economic liberalization as a single-dimensional process, wherein governments have progressively shed the vestiges of old, inward-oriented development strategies—particularly the reliance on state promotion of industry—and have moved consistently toward neoliberal, free-market policies. Our analysis challenges this stylized view, beginning with the demonstration that there are two coherent dimensions along which contemporary policy-making has been organized. The first is movement toward greater economic openness (especially in trade and capital flows), while the second is movement toward expanded state interventions in the economy. They are far from being strict antinomies, however. We have shown that in some Latin American countries, expanded state interventions have been preserved within the context of deep economic liberalization. Governments in the developing world thus have much more space for maneuver than previously thought, although such interventions may take a form that differs considerably from what conventional emphasis on consumption-smoothing transfers has anticipated. And indeed, this comports with findings that globalization may restrict specifically *social* spending. But it does not follow that economic openness has thus wholly proscribed state activism in Latin America. Rather, it is likely to have channeled such interventions, where they exist, into supply-side efforts to promote more diverse and higher value-added exports both through producer subsidies and through public employment and service provision.

Indeed, two distinct policy equilibria have emerged within the generalized movement toward economic integration in the region. The first, orthodox neoliberalism, combines free-market reform with a minimal public sector presence in the economy, while the second, embedded neoliberalism, combines economic openness with higher fiscal outlays and the preservation of some substantial state ownership. Our two principal hypotheses to explain how countries have divided across these two equilibria were broadly confirmed by the empirical analysis. The first suggested that embedded neoliberalism grows out of the legacy of advanced import substitution industrialization. This argument challenges two conventional stories about ISI: first, that the political interests associated with it were rendered irrelevant by economic crisis and reform in the 1980s, and second, that the legacy of import substitution in Latin America created only obstacles that had to be overcome in efforts to move toward more open, export-oriented growth. Instead, we have found that advanced ISI left an indelible imprint on the social, economic, and political landscape of Latin American countries, laying the foundation for contemporary patterns of state-supported but nevertheless open economic strategies. Nevertheless, inequalities in income, educational access, and skills that were born of advanced ISI have lingered well into the neoliberal era, allowing the more privileged social actors to provide the political foundations for the state interventions that we call embedded neoliberalism. Unlike populist responses to economic reform, which have emphasized ad hoc consumption-based spending that is targeted mainly toward the poor (or to political clients), embedded neoliberalism is likely to benefit the middle and upper classes in Latin America. In this way it also differs starkly from the more redistributive and egalitarian forms of compensation found in Europe. Indeed, embedded neoliberalism emerges in countries that had achieved higher levels of industrial development prior to the debt crisis, that were more unequal, and that are characterized by higher stocks of human capital.

Our second major hypothesis addressed the partisan foundations of embedded neoliberalism. Although there has been a long search for the partisan correlates of economic liberalization in Latin America, this research has been largely inconclusive, if not contradictory. Our analysis suggests that much of this dilemma may owe to the problem that the dependent variable of analysis has been misspecified to the extent that only one policy dimension is examined—either economic liberalization or state interventions in the economy. By joining these two dimensions in our dependent variable, we have found significant partisan differences in the tendency to combine economic openness with a more extensive public sector role. Moreover, we find that partisan effects are mediated by the strength of the labor movement. Future research could also examine the specific components of public spending in the embedded neoliberal cases to determine how, if at all, these interventions have varied across left and right governments.