



# **Understanding the Political Economy of Structural Reform: The Case of Argentina\***

Carlos H. Acuña  
Sebastián Galiani  
Mariano Tommasi

Universidad de San Andrés

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Departamento de Economía  
&  
Departamento de Humanidades

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## I. Introduction

Throughout the 1990's Argentina underwent a very intense process of transformation of some of its policies and economic institutions, constituting until fairly recently "the poster child" for the implementation of the so-called Washington Consensus. Yet, more than a decade later, the experiment reached an inflection point, under the effects of a dramatic economic, social and political crisis. It is nowadays common to hear critics of the so-called "pro-market reforms" refer to the Argentine case as irrefutable evidence that such reforms lead to disastrous outcomes not only in terms of inequality and exclusion, but also in terms of aggregate economic performance.

The Argentine case presents an important analytical challenge in order to distill lessons about the interactions of economics and politics, and about the interactions of internationally construed reform packages with the idiosyncrasies of domestic political institutions, political practices, and historical heritages. This paper is one attempt to deal with that challenge.<sup>1</sup>

The reform-cum-Convertibility process achieved some spectacular macroeconomic results in the early part of the 1990s. We are still watching the unfolding of the post-Convertibility economic and political dynamics. It is too early to have very set conclusions about the "final outcome" of the reform process. Our very tentative reading of the Argentine reform experience is as follows.

We conjecture that several areas of reform (such as trade liberalization and some transformations of the structure of the public sector) are likely to remain broadly in place. On the other hand, the very negative reading of the reform experience that seems dominant in public opinion and political discourse suggest the potential for (at least, partial) reversions in some areas.

Beyond the broad strokes of what was done and not done, what might stay, and what might be reversed, we believe that some aspects of the reform policies were colored and shaped by historical and permanent characteristics of the Argentine polity. A history of ill-resolved distributional conflicts and macroeconomic mismanagement, as well as some characteristics of the political system and policymaking process, cast a long shadow on the policies and outcomes of the period. Indeed, there are some examples in the Argentine reform experiences in which reforms following the standard recipe did not lead to the desired behavioral outcomes because of a lack of deeper institutions.

In the real economy, the reforms of the 1990s have left a modernized productive structure, with substantial heterogeneity. Some firms have been able to bring their operation closer to the international frontier; there has been substantial product

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<sup>1</sup> Our analysis focuses on the macroeconomic aspects of reform, not paying much attention at this point to other important questions such as the dynamics and impact of institutional changes (e.g., decentralization) or to the microeconomic side of reform.

and process innovation throughout the decade; and there was a huge increase in exports even under a severe exchange rate appreciation. Nowadays, economic and (to a lesser extent) social indicators show recovery from the crisis. Yet, many relevant economic actors are still following a wait and see strategy, and the credibility necessary for adequate intertemporal behavior is not there yet. Also, poverty and income inequality are quite high compared to Argentine historical standards.

The paper is organized as follows. Section II, “The Political Economy of Reforms in Argentina”, constitutes the core of the paper from the point of view of the comparative project. It aims at answering *why*, *by-whom* and *how reforms* were made for the Argentine case. It contains a synthesis of the historical politico-economic background that led to reforms (*why...*); an analysis of the options, motivations and understanding that lay behind the strategic decision and design of the reforms (*who...*); and an explanation of the logic that characterized the implementation of reforms, paying particular attention to: a) the way reforms were presented and legitimized vis-à-vis society and markets; b) the politico-institutional resources that made the reforms possible; and c) the political steering of the reforms through building coalitions and neutralizing the opposition within the complex realm of political and economic actors affected by the reform process (*how...*). Section III describes some of the main economic and social outcomes of the reform decade. Section IV provides some parting thoughts.

## **II. The Political Economy of Reforms in Argentina**

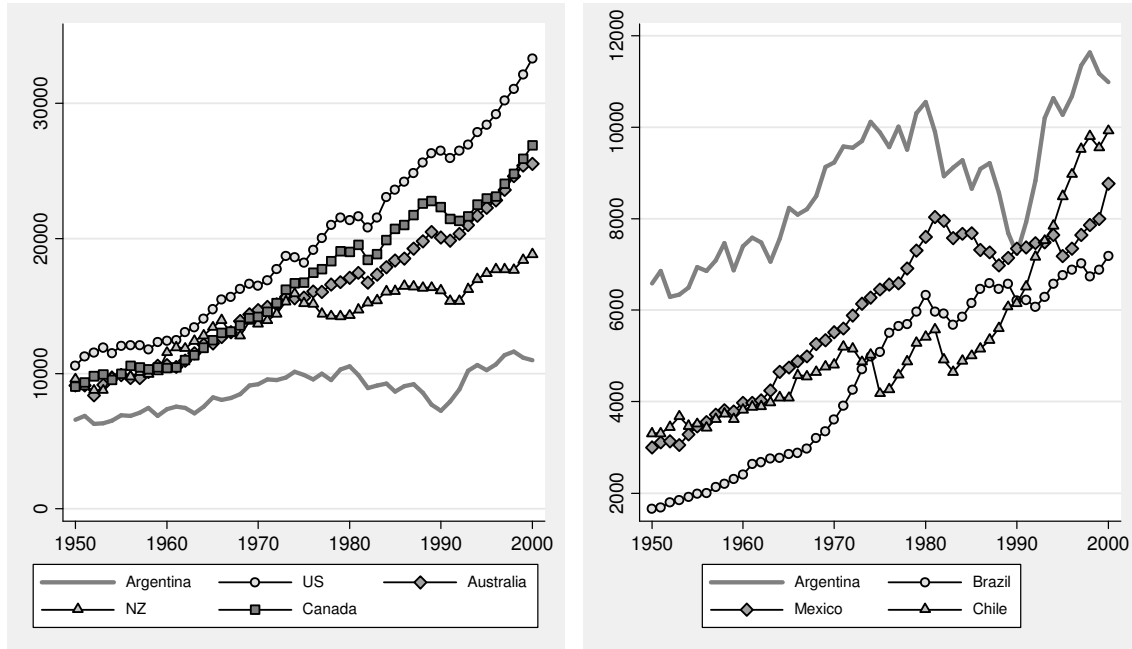
### **II. 1. Background: The Road to Structural Reforms**

Even though Argentina grew at a reasonable rate up to 1974, the overall performance of the economy during the import substitution industrialization (ISI) period was disappointing when put in comparative perspective. As predicted by notions of growth convergence, other poorer Latin American countries were catching up with Argentina. However, Argentina was diverging from more developed countries such as Australia, Canada and United States, to mention just a few (see Figure 1).

In the post-World War II period Argentina adopted an extreme version of the ISI model. Industrialization was promoted using the whole set of ISI instruments. First, the relation between internal and external prices was distorted to protect the manufacturing sector. This was achieved by building up protectionist barriers via tariff, import quotas, licenses and prohibitions, and by taxing agricultural exports. Second, a complex system of investment incentives (via subsidies and tax exemptions) was created to promote industry. There were several reimbursement regimes for nontraditional exports. Certain imports were exempted from paying tariffs, and a “buy national” regime was implemented. Third, industrialization was promoted by direct government investment in key industries. User fees for utilities

were normally set so as to favor industrialization. Finally, interest rates were regulated and credit was directed to the manufacturing sector.

**Figure 1: GDP per capita, Argentina and Selected Countries**



Source: PWT 6.1 – Series in 1996 PPP-adjusted dollars.

The Argentine public sector had a structural deficit since the 1930s. Up to the hyperinflation process at the end of the 1980s, it was financed by diverse non-traditional revenue sources. Inflation was systematically high, and the inflation tax played a significant role in financing public expenditures. Another important source of finance for the government was the pay-as-you-go pension system created during this period. Naturally, at the beginning it operated under large surpluses. But from the mid-1970s on, when the number of retired workers began to grow, the system developed a structural deficit that became more aggravated over time.

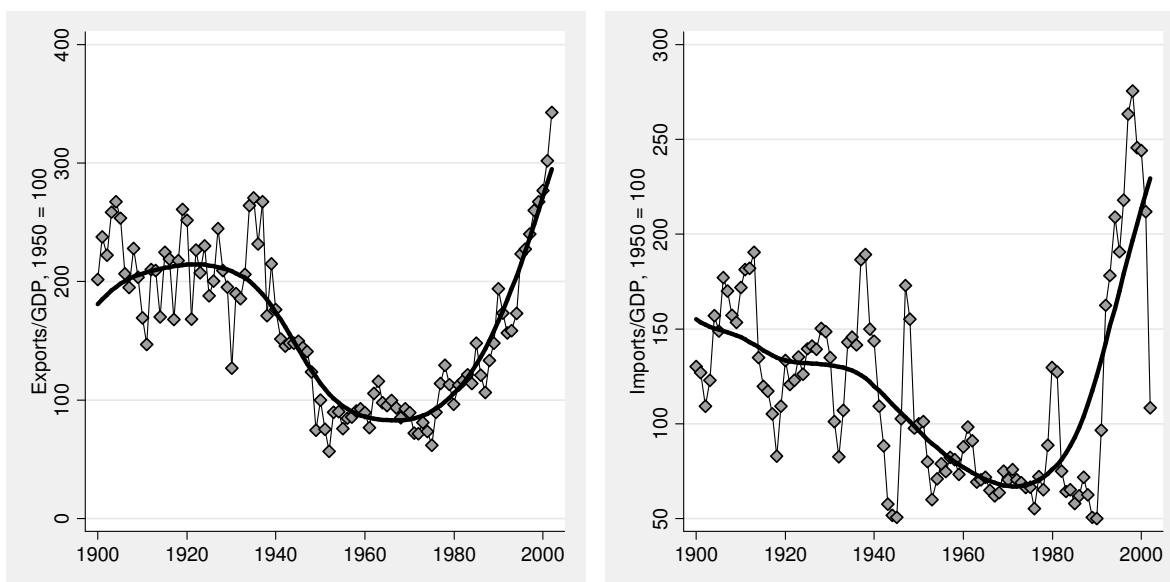
Strong oligopolies arose within the protected manufacturing sector. This development and the importance of state enterprises contributed to the development of powerful unions. During the 1940s, pro-labor governments also favored unions and established a legal system of collective and individual labor legislation. Since then, only one union per economic sector is granted the right to bargain collective agreements and these are legally extended to all workers in that sector of the economy. Later on, granting unions the right to administrate the workers' health insurance system ("*obras sociales*") provided them with a considerable and enduring amount of power (Galiani and Gerchunoff, 2003).

A permanent distributive conflict broke out—between labor and capital, among urban and rural business, and among unions. The State became the arbiter of a conflictive society. This arbitration role was initially highly discretionary. Thus, every

sector tried to establish institutional arrangements to protect their own real incomes, introducing all sorts of rigidities in the economy (Mallon and Sourrouille, 1975; O'Donnell, 1977). Over time, all these protected interests evolved into powerful interest groups that opposed any substantial change in the economic system. Even when this system led to severe economic inconsistencies, it was politically very hard to change. It took a long protracted economic decline and a number of crises, ending in a complete collapse of the currency, to generate the space for reform.

Import substitution led to rapid development of the industrial sector, but exports did not expand much, and over time this was at the core of the economic stagnation that marked the eventual collapse of that development model. The imports to GDP ratio contracted continuously over time, until a point in which further decline was not possible (see Figure 2). At this point, the country was extremely vulnerable to external shocks.

**Figure 2: Exports and Imports to GDP Ratios at Constant Prices of 1986 Indexes (1950 = 100)**



Notes: GDP, Exports and Imports at constant prices of 1986. Index ratios equal 100 in 1950.  
Source: CEPAL.

Since the dollar crisis in 1969, fundamental changes in the international context made the ISI-state-led strategy of development obsolete. In addition to the fast growth of international trade that started at the end of World War II, financial and productive globalization strengthened. However, no Latin American country showed much ability to adapt to this new reality.

A populist experiment (under President Perón and then his wife) in the early 1970s ended up in economic and political disorder. A top-down disciplinarian military experiment replaced it. The main objective of economic policy was to reduce inflation. This required eliminating the fiscal deficit (only partially accomplished)

and getting rid of wage pressures. A market-oriented program with financial and trade liberalization was implemented. The government attempted to discipline unions (collective bargaining and other union rights were suppressed) and businessmen (through trade liberalization). Over time, both inflation inertia and prevalence of fiscal deficits made the exchange rate system (of preannounced gradual devaluations) unsustainable. Between 1979 and 1981 capital flight amounted to around 20 percent of GDP, leaving the government (which had absorbed private sector external debt) with a hefty external debt that has conditioned the country's economic performance ever since.

After taking over from the military government in 1983, President Alfonsín's constitutional government faced the triple threat of coping with mounting external debt arrears, confronting military upheavals related to human rights violations and responding to demands of a population that had just achieved political freedom.<sup>2</sup>

An important attempt to stabilize the economy was implemented in 1985, the Austral plan. It was an attempt to combine an orthodox attack on the fundamentals (primarily the elimination of the budget deficit and its monetary financing) with wage, price, and exchange-rate freeze (after an up-front devaluation). All prices, except those in flexible markets, were frozen at their pre-program levels. A new currency was introduced, the austral, and the currency was pegged to the dollar. Wages were set by decree at a level that gave compensation for the previous month's inflation. Finally, to avoid large wealth redistributions due to the fall of inflation, a currency reform was announced to correct the nominal value of pre-contracted payments.

Despite its initial success, the program faced several problems. Residual inflation triggered a rapid drift in wages. Just a year after its implementation, price controls were relaxed, unions were allowed to negotiate wages, and a crawling peg on the exchange rate and public-sector prices was reintroduced. More importantly, fiscal policies were not based on solid instruments and the fiscal correction proved to be transitory.

Yet another attempt to stabilize by pegging the currency to the dollar failed at the end of Alfonsín's government. This time, a massive portfolio shift toward the dollar brought about a devastating hyperinflationary process that caused the anticipated transfer of power from Alfonsín to the Peronist president-elect.<sup>3</sup>

Throughout the 1980s the Argentine economy showed its worst performance in the post-World War II period (see Figure 3). Investment and savings collapsed. Per capita GDP decreased approximately 20 percent between 1980 and 1989. Inflation was above 100 percent every year except 1986. Both the external debt and the debt to exports ratio rose at an ominous pace (see Figure 3). The dollarization of

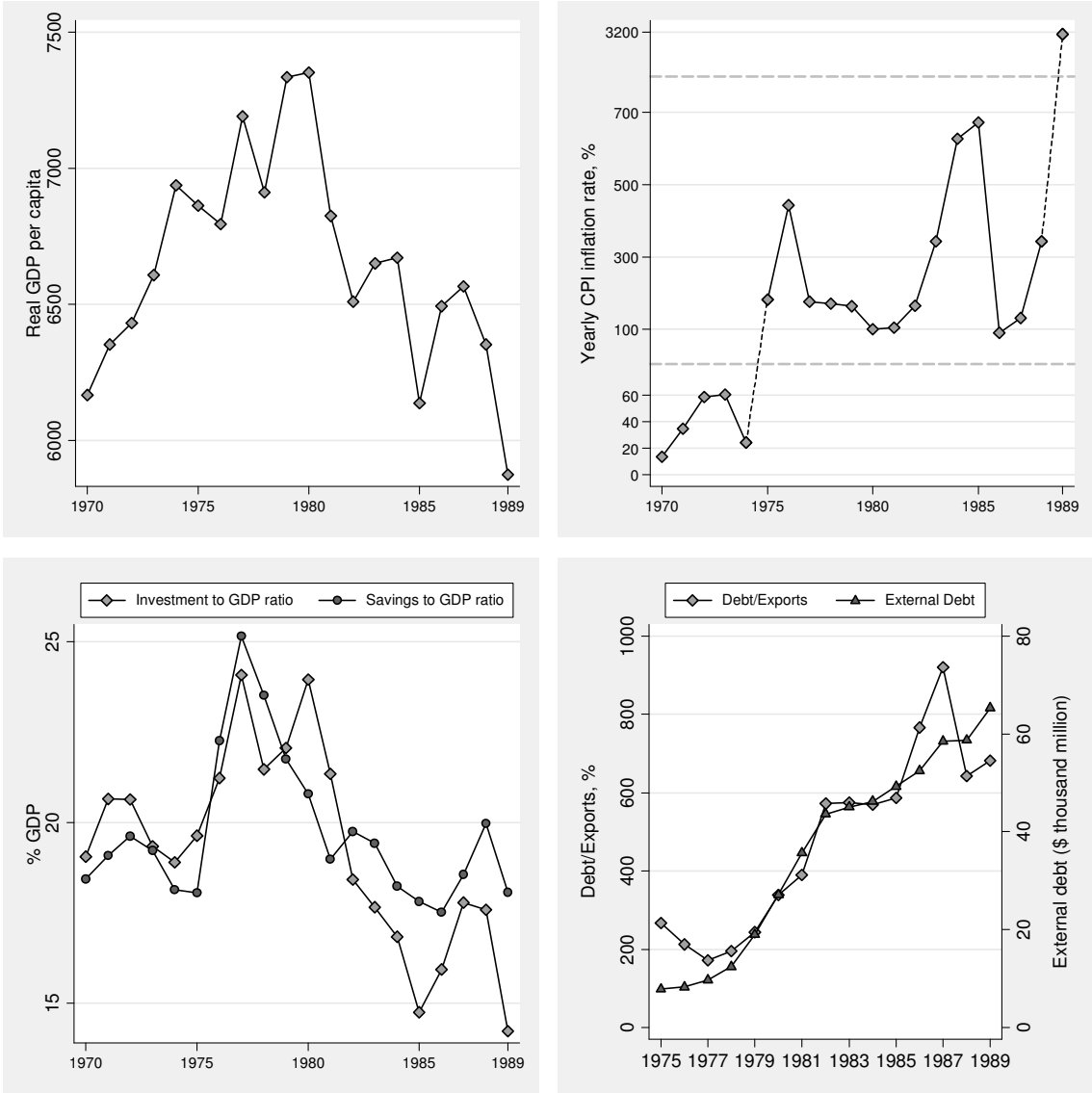
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<sup>2</sup> A good part of Alfonsín's energies were devoted to recuperating democratic politics in Argentina.

<sup>3</sup> The shared beliefs that the economic agents had about Menem's prospective populist policies seem to have been at the core of the portfolio decisions they adopted.

the economy deepened, increasing the financial fragility of the economy. Finally, with maxi-devaluations and disproportionate increases in public prices, the high inflation regime moved towards hyperinflation.

**Figure 3: The Performance of the Economy Before the Reforms of the Early 1990s**



Source: Author's elaboration based on Gerchunoff and Llach (2003) and CEPAL.

Stabilization was imperative. When a society has reached this extreme, the alternatives become stark (“stabilize or else”), although not necessarily easy to decide, let alone instrument, as the rest of the paper shows. Yet, it is true that the severity of the crises provided for a critical turning point. Contrary to the scenario faced by Alfonsín, Menem had more political breathing space but fewer degrees of freedom to define a course of action.

Thus, it was only after a brutal hyperinflation episode that a comprehensive response to the “slow agony of Peronist Argentina” was formulated. This is how hyperinflation became the inflection point of a long period of deterioration of the old order, and stabilization was the cornerstone of the process of reform design (Palermo and Novaro, 1996).

## **II. 2. Menem and the Reforms**

The Peronist government of President Menem was the one undertaking a process of market-oriented reforms whose speed and breadth of process led Argentina to become the poster child of the Washington establishment throughout the 1990's. Menem himself and his party were seen at the time as unlikely characters to undertake market-oriented reforms. In the words of Rodrik (1993, 356), “[i]t is ironic that these reforms were instituted under a Peronist president, Carlos Menem, since Peronism has been virtually synonymous with populism and protectionism. Within a year, Argentine reforms had already gone further than those adopted over a period of decades in the outward-oriented East Asian countries, which long served as the example of choice for countries like Argentina.” Menem's conversion was a surprise not only when measured against historical expectations but also when measured against his (vague but nonetheless populist) campaign statements. Stokes (2001) provides a thorough analysis of the conditions leading to such a difference between campaign statements and policies. In a nutshell, Menem and his entourage had come to recognize that market-oriented reforms were the best bet against the ongoing economic disaster, yet they thought they would lose the election if they announced this during the campaign.<sup>4</sup>

Upon entering office in 1989, the government initiated ambitious programs of privatization and trade liberalization. Structural reforms were bundled with stabilization measures, and policy decisions in several fronts were taken with an eye to their impact on short-term fiscal needs. Additionally, due to the reputation of the Peronist party, the government had to send signals of commitment to the reformist course, which was attempted by undertaking a speedy and simultaneous pattern of reform on several fronts.<sup>5</sup>

Despite those efforts, stabilization during the initial period failed, resulting in renewed inflationary episodes in 1990, and the resignation of two ministers of the economy. The Convertibility Plan of 1991 marks the beginning of the most important stage of reform, which included monetary reform, fiscal reform (simplification of the tax system and strengthening of the tax collection agency),

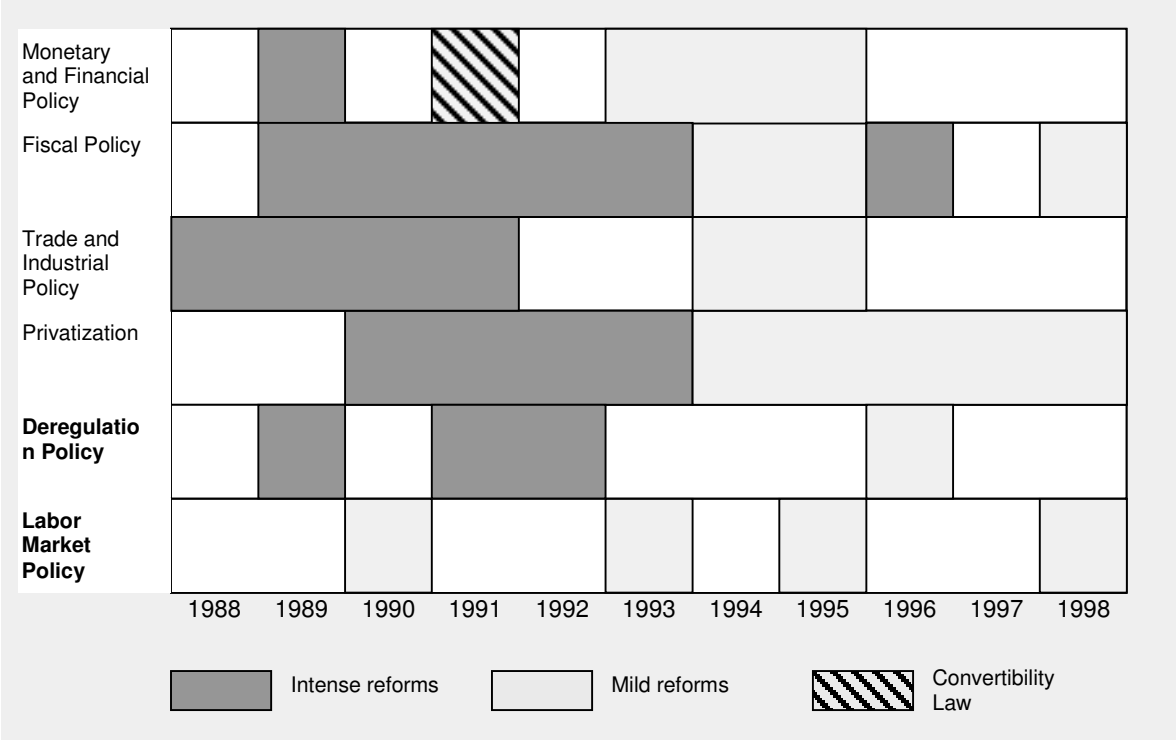
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<sup>4</sup> See also Cukierman and Tommasi (1998) and (1998b) on the “Nixon goes to China” paradox of populist presidents implementing right wing policies. See, nonetheless our further thoughts with regards to the “Nixon hypothesis” in the concluding section.

<sup>5</sup> An example of the multiple roles of some reforms is provided by privatization. They were an instrument to improve the efficiency of the economic system, yet they were also used to alleviate short term fiscal needs; and the early and quick privatization of some national symbols (airlines, telephones) helped signal the government's commitment to the new policy direction.

liberalization of domestic and external markets, and strengthening of the privatization program. The appointment of Domingo Cavallo (and his team) in the Ministry of the Economy brought renewed unity and coherence to the reform effort. Figure 4 presents our reading of the intensity of reform by area throughout 1988 to 1998.

**Figure 4: Intensity of reforms by area**



Macroeconomic stability and economic growth were the immediate results of the above measures. The hard-peg based stabilization, together with the reappearance of credit, led to a consumption boom, which was important in buying the people’s approval of the new course. At the same time that the economy began to grow, traditional public funds manipulation for electoral purposes reappeared. The fragility of the reform efforts became notorious in 1994 when the Tequila Crisis hit. At that point, a renewed sense of crisis gave room for the last bout of structural reforms of the Menem administration, which included some poorly designed attempts to increase the flexibility of the labor market, as well as the privatization of some provincial banks and companies. Interestingly, fear of economic instability helped Menem to get reelected in 1995, under the idea that the President and his team were the best pilots in stormy economic waters.<sup>6</sup>

<sup>6</sup> The Argentine Constitution did not at the time allow the re-election of the president. Menem managed to get an agreement with the main opposition party to reform the Constitution.

The second Menem administration (1995-1999), even though maintaining the reform rhetoric, did not make any substantial additional progress, as evidenced in Figure 4. We believe that this deceleration was due to the fact that “the next frontier” required going against the core of the coalition that enabled the previous set of reforms. The reforms put in place, even though implying a substantial achievement by Argentine standards, fell short of the Washington Consensus benchmark. The general picture was the co-existence of some important changes in economic incentives, together with the persistence of illiberal enclaves, scarce improvements at the provincial level, of fairly monopolistic and inefficient structures in some markets (such as health), and weak regulation of some of the privatized sectors.

### **II. 3. The Reform Decision within the Executive**

A successful reform requires the emergence of a pro-reform actor within the government, who in turn needs to mobilize support (resolving collective action problems), and to neutralize opposition. All of these steps are conditioned by historical circumstances and by the institutional framework in which they take place.

The crisis experienced by Argentina towards the end of the 1980's forced the President to embark on actions leading to economic stabilization, a collective good whose relative importance rose in this context.<sup>7</sup> As the only political actor in the Argentine institutional framework that is elected by a nationwide constituency, the National Executive is the institutional actor with more encompassing interests, and hence the most likely actor to possibly initiate such reforms. But why did Menem embark on such a reform process?

The literature on structural reforms has pointed out the relevance of socio-economic crisis to bring about the conditions that in some polities might increase the feasibility of structural reform. The Argentine case seems to confirm this assumption. The Peronist leadership, an unlikely actor to lead pro-market structural reforms, concluded just before taking office that, given the nature and intensity of the Argentine socio-economic crisis at that time (1989), it had no choice but to embark on a deep pro-market process of reform (Acuña, 1995a, Palermo and Novaro, 1996).<sup>8</sup>

Structural reforms in Argentina appeared primarily as an instrument for the stabilization of an unwieldy macroeconomic situation. Before coming back to the politics of reform in II.5, we devote the next section to discuss the economic logic

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<sup>7</sup> This is consistent with Rodrik's notion (1994) that the likelihood of a reform is a function of the ratio of net social gain to net reallocation (redistribution). In times like those of Argentina in the early 1990's, efficiency gains from halting hyperinflation were large enough to swamp many distributive considerations (see also Mondino et al, 1996).

<sup>8</sup> This does not mean that there is a one to one connection between crisis and reforms “in the right direction”, as explained in Tommasi (2004) and pointed out in section IV below.

of the decision to bundle a particular stabilization mechanism with a package of market oriented reforms.<sup>9</sup>

#### **II.4. Structural Reforms as a Stabilization Device**

At the onset of the Menem administration it was burning to restore macroeconomic stability. This required satisfying the perceived intertemporal budget constraint of the government without relying much, if at all, on the inflation tax. It was also critical to restore economic growth, which seemed to require the elimination of some of the severe inefficiencies in resource allocation. Most economists agreed that the widespread intervention of the ISI time needed to be reduced, and that the economy needed to be integrated into the world.

Stabilization was not an easy task. Given history, a complete turnaround of expectation was called for. In order to build credibility, it was necessary to introduce, in a relatively binding way, a radical change in the strategy and politics regarding current and future deficits. Stabilization also required a policy package that would force a sudden change in the forms of behavior developed during the high-inflation era.

Economic agents faced deep uncertainty. Would the government be able to stabilize the economy? Would this stabilization be sustainable? Which reforms would eventually be implemented and at what cost? What would the short-run monetary and fiscal policies be? What would they be in the medium- and long-run? More deeply, what would the new rules of the game be? Many institutional arrangements in society exist in order to reduce this type of uncertainty and to provide reliability to social and economic interactions. For a variety of reasons, Argentina did not provide those certainties at the beginning of the reform period; in a sense, the overall reform strategy (with its cornerstone in Convertibility) was an attempt to provide more certainty to economic planning.

On top of the technical complexity of the task, the new Menem administration entered government in 1989 lacking any credibility as to its ability to soundly manage the economy. In order to signal a credible shift in policy, the government adopted as its economic program a package including the entire list of first-generation reforms.

The consistency condition that the stream of revenues should finance the normal stream of spending does not dictate a particular composition of the flows. The government focused on improving tax collection, reducing subsidies and reducing the drag on fiscal accounts produced by public sector enterprises. It even used the proceeds from privatization in order to balance the budget. Public expenditures were seen as already quite low and rigid.

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<sup>9</sup> We refer the readers to Galiani et al. (2003) for a more detailed analysis of the process of convertibility, and for a critique of the naïve interpretations that see convertibility as “the mistake” in the Argentine reform process (such as Williamson, 2003).

In order to enhance economic efficiency, the government also relied on trade and financial liberalization, deregulation of markets and privatization of public enterprises. In addition, in view of the fact that the government had entered a *de facto* moratorium of the services of its external debt in 1988, a debt renegotiation was needed, to make clear what commitments the government would honor and what relief it would be able to obtain. The government made it plain that this was one of its policy priorities.

The literature on economic reforms is rich in discussions about the speed and sequencing of market liberalization (Tommasi and Velasco, 1996). Structural reforms in Argentina impressed the world because of their speed and scope. In a few years, the government substantially improved its fiscal performance, liberalized trade, opened up to foreign direct investment, reformed its pension system, privatized most state companies, liberalized the financial system and legislated a world-class bankruptcy law. All these reforms were bundled together and adopted at once. The structural reform package was also the stabilization program and *vice versa*. This was done not without haste. It is certainly not the same to privatize public firms with several objectives—i.e. to finance the government, to signal the government type and to restore efficiency and investment—than to privatize just to enhance efficiency (Galiani and Petrecolla, 2000).

Although the government attempted to stabilize the economy by changing the expectations and behavior of economic agents by means of a wide program of structural reforms, economic performance was at first disappointing. In fact, the government reached the verge of hyperinflation twice before it adopted a new stabilization program based on the convertibility law. Convertibility tried to provide a framework for contractual and investment decisions by restricting monetary policies and validating the widespread use of the dollar as a unit of denomination for domestic transactions. The common view was that such measures were necessary to induce the emergence of credit markets. This, in turn, would make it possible to take advantage of large growth possibilities left unexploited in an unfavorable macroeconomic environment.

Reliability and predictability were built upon hard rules, which consequently lacked flexibility and ultimately broke down brutally. The main institutional arrangement was the convertibility law (adopted in 1991).<sup>10</sup> Convertibility was, in the Argentina of the 1990s, much more than a monetary institution. It also shaped fiscal policies and provided the basis for an elaborate system of contracts, which clearly signified a break with the past in an economy where, say, private mortgage loans had been a rarity for decades. Over time the government became more and more committed to the fixed exchange rate in several ways. Since alternative mechanisms for gaining policy credibility did not arise, strict adherence to the existing monetary rule

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<sup>10</sup> In a nutshell, the Argentine currency was made convertible to the US dollar by law, and the Central Bank was mandated to reduce its monetary policy to the management of a currency board. Thus, the monetary base had to be backed by assets denominated in foreign currencies, mainly issued abroad.

remained identified with stability (Galiani, Heymann and Tommasi, 2003). Over time, the development of extremely high costs for exiting convertibility provided a self-sustaining system of shared beliefs about the salient way in which the game was repeatedly played.

Convertibility also served as a way of keeping political support to the structural reform process alive. One of the reasons why these reforms had usually been postponed during the 1980s was the belief that they would impose severe costs on society. However, in the favorable context for the emerging markets of the international financial markets of the 1990s, the framework created by convertibility allowed the emergence of credit, which enlarged the consumption and investment opportunities of many agents, including the government, and contributed to the growth in economic activity. Convertibility (like its predecessor the Austral Plan in 1985) rewarded the government in the legislative elections of 1991 and 1993 and led to the re-election of the president by a large margin in 1995. The consumption boom of 1992-1993 was behind the excellent legislative election made by the Peronist party in 1993 when they even won for the first time in the always-adverse Federal district. The large number of people who had contracted dollar debts, and those who feared a return of high inflation if convertibility was abandoned created a very strong constituency against devaluation. Indeed, during the financial crisis of 1995, previous to the presidential elections, the authorities used as their main electoral argument that they had ended hyperinflation and that they constituted the only political force that would maintain convertibility (Starr, 1999).

## **II. 5. Politico-Institutional Resources for Reform<sup>11</sup>**

In the Argentine case, its partisan distribution, the delegation of legislative faculties to the Executive, and its control over the Supreme Court, as well as the use of certain resources of doubtful constitutionality, enabled the Executive to concentrate political power. In this section we address the distribution of institutional power during the first (1989-1995) and second (1995-1999) Menem administrations and the delegation mechanisms present at the onset of his first mandate.

### *Distribution of institutional power:*

The electoral results throughout Menem's presidency were favorable to his party (Table 1,a), conferring Menem an ample mandate at the onset of his first administration, and further reinvigorating the reformist course later on. Favorable electoral results were mirrored in the resulting distribution of institutional power (Table 1, b, c, and d). This power composition implied that several of the pivotal political negotiations were with actors within the Peronist party (PJ), a point that we explore below.

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<sup>11</sup> Several of the arguments of this and the next subsection are drawn from Acuña (1995a) and from Bambaci, Saront and Tommasi (2002).

**Table 1. Electoral Results and Partisan Composition during Menem's Government**

**a. Electoral Results, 1989-1997**

<b>Political Party</b>	<b>1989</b>	<b>1991</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1997</b>
	% (b)	% (a)	% (a)	% (c)	% (b)	% (a)
Peronist Party (PJ)	47	40	43	39	50	36
UCR	33	29	30	20	17	7
Center-right and Provincial Parties	12	16	18	12	1	9
Center-Left Parties	7	10	3	17	31	6
Alianza (UCR+Frepasso)	-	-	-	-	-	36
Others	2	4	6	12	2	

(a) Legislative elections; (b) Legislative and presidential elections; (c) Elections for Constitutional Assembly.

**b. Partisan Composition of the Chamber of Deputies 1987-1999**

<b>Political Party</b>	<b>Deputy Periods</b>					
	<b>1987-89</b>	<b>1989-91</b>	<b>1991-93</b>	<b>1993-95</b>	<b>1995-97</b>	<b>1997-99</b>
	%	%	%	%	%	%
Peronist Party (PJ)	43	50	50	50	52	47
Unión Cívica Radical	46	37	33	33	27	26
Center-Right Provincial P.	6	7	9	9	8	11
Other Parties	5	6	5	8	12	16

**c. Partisan Composition of the Senate, 1986-1998**

<b>Political Party</b>	<b>Senate Periods</b>			
	<b>1986-89</b>	<b>1989-92</b>	<b>1992-95</b>	<b>1995-98</b>
	%	%	%	%
Peronist Party (PJ)	47	54	62	56
Unión Cívica Radical	39	30/29	23	29
Provincial Parties & Others	15	15/17	15	15

**d. Partisan Composition of Provincial Governorships, 1987-1999**

<b>Political Party</b>	<b>Gubernatorial Periods</b>		
	<b>1987-91</b>	<b>1991-95</b>	<b>1995-97</b>
	%	%	%
Peronist Party (PJ)	77	61	61
Union Cívica Radical	9	17	22
Provincial Parties	14	22	17

The favorable partisan composition at key institutional nodes was furthered by a law that increased the number Supreme Court Justices from 5 to 9. Through this device Menem was allowed to appoint four judges (with agreement of the Senate). Then, when one Justice resigned in protest, Menem was granted the opportunity for a fifth appointment. In addition, Menem resorted to the use of two types of legislative instruments of (until the 1994 Constitutional reform) dubious

constitutionality—the decrees of “necessity and urgency” (DNU’s) and the line-item veto—in a way that far exceeded the historical record.

*Delegation mechanisms:*

An additional effect of the economic crisis was to trigger a series of delegation patterns. In particular, there was a political agreement to move ahead the presidential succession in 1989, and two laws were enacted conferring on the Executive ample margins for defining the details of reform policies.

The economic crisis helped to forge a political agreement between the two major parties: the Radical party (the outgoing administration) and the Peronist party to move forward the presidential succession in order to deal with the crisis. President Alfonsín (1983-1989) resigned, Menem agreed to take office five months before originally scheduled, and in exchange the Radical party committed itself to give legislative support to the new administration.

Soon after Menem became president (in July 1989), Congress delegated to the Executive vast legislative powers through *Ley 23.696 de Emergencia Económica* (Economic Emergency Law) and *Ley 23.697 de Reforma del Estado* (State Reform Law). The intent of the first of these laws was to dismantle most of the institutions related to the state-centered, inward-looking development model—subsidies, industrial promotion regimes, etc. The second one conferred vast powers on the executive to define the details of the reform policies, including the privatization of state-owned enterprises.

In sum, the partisan distribution of institutional power coupled with these delegation patterns allowed the Executive to jump institutional hurdles for the initiation of structural reforms. Yet, this did not completely numb relevant political and institutional actors.

## **II. 6. The Political Steering of the Reforms: Dealing with the Relevant Actors**

Contrary to what much of the literature on the political economy of reforms in Argentina asserts, the reform process was not carried out by an Executive power in isolation of social, political and institutional actors. Rather, reforms were the product of a series of transactions between the Executive and some key actors at every step of the process. In this subsection we present the relevant actors with whom the Executive dealt in order to advance the reformist course.

The reformist administration was clever in manipulating both electoral and policy coalition-making throughout the reforming period. Having been elected by a coalition of traditional Peronist sources with the center left, it governed and was reelected with a coalition of traditional Peronist sources (with changed weights within that coalition) with the center right. The latter was taken into account no only

as an electoral source but, mostly, because of its ties with business and international actors whose economic support was necessary.<sup>12</sup>

Menem made clever use of its institutional and fiscal resources to obtain the support of the politically important backward provinces; it gave selective benefits to some unions and union leaders while debilitating the overall labor movement; and it was able to gain the support of important business actors through a mix of general policies and particularistic deals. In the rest of this section we describe the strategy vis a vis each of the main actors. We start with several actors whose key roles are in the electoral/governmental arena (parties, provincial governments, voters), and then we refer to other (mostly corporate) actors who operate mainly in other arenas (conflict resolution, opinion making, the economy).<sup>13</sup>

We implicitly use a theory in which an agenda-setting executive needs a given level of support for his reform package and insures it by “buying” the necessary number of “votes”. We can think of it as the Executive facing a price schedule for votes in favor of the policies that it is trying to implement. The spot price to be paid will depend, among other things, on the intertemporal political linkages between the President and each relevant actor. The cheapest votes (probably price zero, or even negative) will be those of actors who directly benefit from the reform package. From the actors who do not benefit from the package, the cheapest votes will come from those legislators with whom there are credible intertemporal reward mechanisms. These mechanisms will include future appointments in the executive or in the party. Legislators from the same party will be first in line, legislators from small independent parties will come second, and legislators from the main opposition parties will be the most expensive. The spot currency used to buy votes might include outright bribery, policy benefits to the relevant constituency, or exemptions from reforms costly to the relevant constituency.

Which votes are actually purchased out of this schedule will depend on the rules of the game (for instance, what is the required majority), and on the actual composition of the legislature and other relevant institutional positions at the time of the reform. In the Argentine case under Menem, it turns out that the pivotal votes were some in the Peronist party (from provincial blocks and from union-related actors) as well as some of the small provincial parties. We look at these actors in turn.

### *The Peronist Party*

Due to the above-mentioned partisan distribution of institutional power, the Peronist party had high leverage on the legislative process, becoming the

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<sup>12</sup> This strategy was also related to the signaling to international financial actors, who provided crucial funding and opinion-making support for the reform process.

<sup>13</sup> In previous and longer drafts of this paper we also included actors such as the military. The military, which had opposed privatization while in government, was no longer an important actor by the time of reform partly because Menem’s administration managed to subordinate this actor to constitutional rule. For a detailed account of these dynamics, see Acuña (forthcoming 2006).

fundamental veto player at the time of approving reforms (Corrales, 2000). When referring to the Peronist party as a fundamental political actor, we are basically concerned with its two major historical constituencies—provinces and trade unions, which we analyze in later subsections.

Menem's Peronist credentials allowed him, on the one hand, to achieve the acquiescence of popular sectors, a "Nixon goes to China" effect analyzed in Cukierman and Tommasi 1998 and 1998b (see discussion in the concluding section, though). On the other hand, there was a major disruption in the party since the policies Menem was propounding constituted a dramatic break with the populist policies Peronism traditionally embodied. This break produced resistance and criticism inside the party, yet both the intellectual efforts devoted to "rebuild" the Peronist identity as well as the concessions used to construct support, helped moderate these tensions.<sup>14</sup> Menem's conversion to neo-liberal policies created discrepancies between the government and official legislators that led to schisms in the Peronist block of the Deputy's Chamber. Pro-government deputies took part in arduous discussions prior to approving legislation regarding reform of the state. Eventually, under pressure from the Executive, the package was approved. Nevertheless, a dissident faction of Peronist deputies was formed, the so-called "Group of Eight."<sup>15</sup>

In contrast to the notion of an insulated all-powerful executive, between 1992 and 1994 Congress modified around 46 percent of legislative initiatives of the President. The Executive managed to tackle these discrepancies through the extensive use of "Decrees of Necessity and Urgency" and vetoes that strengthened its bargaining position in the legislature, through political transactions with provincial and small national parties, and through concessions in policy design.

Menem was also forced to engage in public arguments when other Peronist figures challenged him to return to the sources of Peronist doctrine. Menem counteracted the reaction within party ranks in several ways. He exploited the extreme crisis that prevailed when he entered office by deflecting criticism, which usually centered on the social costs of the policies adopted. He argued that alternatives did not exist, that the room for maneuver was limited. Finally, he filled party leadership with individuals close to the Executive.

Menem also displayed considerable pragmatism in choosing candidates for elections. Whenever non-Peronists were likely to win an election or support the government's economic course, the Executive did not hesitate to incorporate them.

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<sup>14</sup> Levitsky (2003) provides an insightful analysis of the internal process of Peronist adaptation to the new policies.

<sup>15</sup> It is interesting to note that all the legislators departing the Peronist block were from the two major districts (the city and the province of Buenos Aires). Some legislators from those districts tend to be the most ideological, the most visible, and the most focused on national policy. Legislators from the vast majority of peripheral provinces tend to respond mostly to provincial governments, and in general only need to be bought with provincial spoils in order to support whatever national policies the Executive might be pushing (Jones et al., 2006). It is also interesting to notice that many of the legislators who supported pro-market reform under Menem applauded cheerfully when debt default was declared in late December 2001.

Even Peronists with little party experience were nominated as candidates. This occurred in Tucumán, Santa Fe, and the Federal Capital. Of course, the success of the economic policy strengthened this strategy. Moreover, resistance from his own party diminished with the progressive acquisition of new members, co-opted from center-right parties (especially UCD).

### *Center-right parties*

The government's resolute implementation of market-oriented reforms implied realignments within the party system. The convergence of the Peronists with the rightist UCD led to an important shift in the UCD electorate toward support for Menem's policies. Peronists and the UCD reached formal alliances in some districts, such as the Federal Capital. And UCD specialists and professionals held government positions including secretariats in the ministry of the interior, provincial offices, and management of firms being privatized. (UCD, as had happened to most of its conservative predecessors, pretty much disappeared after this experiment.)

### *The opposition: the Radical Party*

The Radical party faced the Menem administration from a weak position, resulting from the disastrous economic performance of the Alfonsín government, which led to the delegation to the Executive to take office 6 months in advance in 1989. The party agreed not to oppose any legislative initiatives originating in the Executive during the six months before the newly elected Congress was in place.

The initial success of Menem's economic and political strategy, further weakened the potential for a strong opposition. The weakness of the main opposition party was reflected in the 1993 agreement ("Pacto de Olivos") between Menem and Alfonsín to launch the process of constitutional reform giving Menem the chance to be re-elected for a second term (Acuña 1995b). In a nutshell, even though the Radical party did start reasserting itself after 1991, being ideologically divided and electorally weaker, it was a mild opposition.

### *The Provinces*

The Peronist machinery in the provinces constitutes one of the fundamental electoral pillars of the party. Argentine federalism confers a high degree of political and institutional power to the provinces, especially as veto players in the national arena (Spiller and Tommasi 2003, and references there). In this sense, it is possible to trace, throughout the reform period, a strong reformist impetus at the national level that contrasts with the scarce advances at provincial levels.

Gibson and Calvo (2001) show that the territorial organization of the electoral coalition—to the extent that poor and under-populated provinces received special treatments to generate legislative support to sustain the reformist agenda—was an important element in the successful implementation of reforms. Peronism

historically encompassed two distinctive and regionally based coalitions: a “metropolitan” coalition, which gave support to the party’s development strategies, and a “peripheral” coalition, which carried the burden of generating electoral majorities. The metropolitan coalition is of very high economic importance, but carries less political weight in Congress given the notable mal-apportionment of seats. Under the Gibson and Calvo hypothesis, Menem decided to have the metropolitan coalition shoulder the full blow of adjustment costs, while he spared the peripheral coalition through several concessions in tax benefits and by allowing the subsidizing of interventionist and populist enclaves. Tommasi (2006) provides empirical evidence on the details of this strategy, supporting the Gibson-Calvo hypothesis. We provide below a very brief synthesis.

National legislators in Argentina tend to act as agents of provincial governments, rather than national policymakers.<sup>16</sup> Small peripheral provinces have had special importance in general, and especially within the Peronist coalition. The general importance of small provinces is the result of their overrepresentation in the National Congress.<sup>17</sup> These provinces have an institutional representation that far exceeds their population (and their economic importance).<sup>18</sup> In the period of market-oriented reforms, the peripheral regions held 83 percent of Senate seats and 52 percent of seats in the Chamber of Deputies.<sup>19</sup>

Independent provincial parties have also played an important role in lending presidents the support needed to pass legislation in Congress, as shown in Palanza and Sin (1997). In particular, during the Menem reform years the Peronist party (PJ) had the majority of seats in the Senate, but not in the Lower Chamber. (The President chose to present his bills through the Senate.) Despite the general agreement attained with the main opposition party UCR—which guaranteed the PJ would always have the required quorum in Congress, Menem faced several obstacles when he tried to pass his reform projects. The way out of the gridlock was to buy in provincial party support. Palanza and Sin (1996) have documented the denial of support made by provincial party legislators during first rounds of negotiation, and how their positions changed to be aligned with the PJ when voting.<sup>20</sup>

This institutional overrepresentation, together with the “subnational drag” on legislators’ incentives, meant that no national legislative coalition could be put

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<sup>16</sup> This is primarily a consequence of the electoral system (provinces are the electoral districts where party lists are drawn). See the details of the provincial nature of legislators’ careers in Jones et al (2002) and (2006).

<sup>17</sup> Stepan (1999) utilizes three indicators of malapportionment across twelve modern federal democracies, and in all the indicators Argentina is the worst case.

<sup>18</sup> The bulk of the Argentine economy is concentrated in a few districts: the city and the province of Buenos Aires, plus the provinces of Santa Fe, Cordoba, and Mendoza contain almost 80% of economic activity and 70% of the population.

<sup>19</sup> Party politics do not seem to temper this influence: peripheral provinces have always been a central part of the Peronist coalition (Sawers, 1996, p. 199, and references there).

<sup>20</sup> Examples of legislation sanctioned thanks to the aid provided by provincial parties are, among others, law 23809 (Privatization of Altos Hornos Zapla), law 23871 (Fiscal Reform), law 23897 (Payment of Oil Royalties), 24154 (Transformation of YPF—the later privatized oil company).

together without the support of the regional structures of power in the periphery. The need to buy this support affected the eventual outcome of the reform process in several ways. The burden of the costs of reform was shouldered predominantly by the metropolitan constituency. The reforms were timed and instrumented in a fashion that implied earlier and heavier hits on the central provinces, as well as differential benefits in favor of peripheral provinces.<sup>21</sup>

All provinces benefited from improved tax collection due to low inflation and from overall gains in tax bases, but there was a redistributive component favoring the provinces that are net recipients in the common pool of *coparticipación*. The main impact on provincial tax revenues in the reform process came from the increase in tax revenues due to the Olivera-Tanzi effect from the substantial drop in inflation, from tax reforms increasing and generalizing the Value Added Tax, and from the consumption boom in the early years after Convertibility. A very simple simulation of these effects (treating private sector and public sector as a unit) shows that the central provinces of Buenos Aires, Córdoba and Santa Fe (and the Capital City of Buenos Aires) were net losers, the province of Mendoza was about equal, and all the other (peripheral) provinces were net winners (Tommasi, 2006).

Similarly, the estimated 37 percent reduction in public employment (both in the central administration and in privatized public enterprises) was concentrated on the metropolitan region. We do not have the exact figures of the territorial distribution of the reduction of national public employment, but even under the assumption that the reduction was uniform across the territory, 74 percent would have taken place in the metropolitan region (Buenos Aires, Córdoba, Mendoza, Santa Fe, and the city of Buenos Aires), and 26 percent in the periphery. However, the actual distribution of labor shedding was even more concentrated in the center. Even beyond labor shedding, other reform measures were also concentrated on national rather than subnational regulations.

In addition, peripheral provinces were given distortionary “hand-outs”, the most salient of which were:

- the subsidizing and increase of distortionary, expensive industrial promotion schemes that mainly benefit poorer provinces (Sawers and Massacane, 2001)
- the 1992 “Fondo de Desequilibrios Regionales” (Fund for Regional Imbalances), where money was distributed 2 percent for metropolitan provinces and 98 percent for peripheral provinces
- the asymmetric reduction of labor taxes with special provisions for provinces farther from the capital: these rates in 1995, after the reduction, were 27 percent in the city of Buenos Aires, 26 percent in the province of Buenos Aires, 23 percent in Cordoba, 22 percent in Santa

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<sup>21</sup> It is worth noting that even though many peripheral provinces did suffer some economic costs from trade liberalization (and from some of the privatizations), provincial governors did not oppose those measures as long as there were some compensations in the form of resources that they themselves could distribute through their political machines (Spiller and Tommasi, forthcoming 2006 and Jones, Sanguinetti and Tommasi, 2002).

Fe, and they were less than 20 percent for almost all the peripheral provinces, reaching as low as 14 percent for Chaco, Formosa, Santa Cruz and Santiago del Estero.

- the distribution of Contributions from the National Treasury (ATNs). This fund, 1 percent of Coparticipation revenues, has traditionally been distributed independently of the fiscal situation of the province. In 1994, for instance, 20 percent of ATN money went to the small province of La Rioja, followed by 2.4 percent to San Luis and 2.3 percent to Santiago del Estero.

### *The Electorate*

The way the electorate was handled in the strategy of the reformist government could be divided in two groups, following the Gibson-Calvo logic described above.

With regards to the electorate in the peripheral provinces, Menem built alliances with the (almost feudal) leaders of those provinces, through a series of handouts that they administered internally in order to maintain the traditional Peronist connection to the electorate in those provinces, in a way that was functional to the conformation of a government coalition cum electoral coalition in support of the government and of the reforms being implemented.

With regards to the metropolitan voters (irrelevant for the Senate, somewhat relevant for the Chamber of Deputies, crucial for presidential elections), the successful stabilizing effect of Convertibility rendered popular support to the center-right governing coalition, fostering a solid electoral coalition that would start dismembering itself only in the last years of the decade.

### *The Unions*

The restructuring of the populist metropolitan coalition involved picking winners and losers within the business community (see next sub-section) and the labor movement. In part the success of the reform process involved the division of the labor movement and the co-optation of certain sectors to prevent unified labor opposition to economic reform, as well as the more limited extent of reform of labor markets. Menem's credentials also proved to be an asset during the implementation of this strategy.

In 1989, Menem deepened divisions inside the unions, precipitating a fracture that diminished their bargaining power. The policy succeeded through the administration of "carrots and sticks". Unions opposing the reforms were punished; unions supporting the reforms were brought on board via "new economic businesses", and through rewards to some leaders with government positions (Murillo, 1997). The **carrot** came in a variety of forms: several cooperative union leaders were appointed to government positions; Menem treated unions supporting him favourably when it came to wage negotiations and the transfer of welfare funds from the social security agency to individual union funds; the government provided

some incentives like early retirement programs, re-training programs, and workers' ownership of stock (10 percent of total) in privatizations of large public enterprises (telephones, petroleum, gas, and electricity). In several cases, privatization opened up new lucrative business opportunities for unions, as they were allowed to set up companies managing the shares transferred to workers.

The **stick** was used to break strikes of defiant unions by invoking the new legislation, enforced by decree in 1990, regulating the right to strike. The administration adopted massive layoffs affecting employees who had participated in strikes regarded as illegal in the telephone, railway, and oil companies between 1990 and 1991. By 1992, many union leaders who had initially opposed Menem's state-shrinking policies understood that the process was irreversible and it was politically wise to jump on the President's bandwagon before it was too late.

The unions' new tolerant attitude to the reforms was evident by the decrease in their activism compared with the levels reached during the Alfonsín administration. In exchange for their non-conflictive behavior, the government allowed the unions to maintain their sources of power—the regulation of collective bargaining and "*Obras Sociales*"<sup>22</sup>—in spite of the constant decrease in the unions' representation in the legislature.<sup>23</sup> The number of general strikes decreased from 13 during the Alfonsín administration to two in the first Menem term and 5 in the second. Furthermore, there was a reduction in the average number of people participating in each strike.<sup>24</sup>

### *Business Sectors*

Business actors at the most aggregate level—i.e., as owners of capital—tend to be naturally supportive of measures that weaken trade unions, shrink the State, and privatize public services. At that level, the efforts of the government was mainly to build credibility for those policies. At a more sectoral level, there were several business actors threatened by specific measures.

In the delicate fiscal situation of the 1989 economic crisis, reactions from business leaders could determine the success or failure of economic policy. Menem's political background generated distrust among most domestic and international businessmen and investors. This forced him to overreact in sending signals to give credibility to his reformist intentions. The initial signals of commitment to the new reform path were the privatization of firms like the national airline and telecommunication companies; the invitation to influential economic groups—traditionally opposed to the Peronist party—to take part in the government; and the

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<sup>22</sup> *Obras Sociales*, union-administered welfare organizations (very important in the health market), are the main source of financing of unions. That is the reason why a profound health reform did not take place.

<sup>23</sup> The number of deputies with ties to unions decreased from 35 in 1983-85 to 10 in 1993-95 and 14 in 1997-99. (They were concentrated mostly in the labor legislation committee.)

<sup>24</sup> There was also a change in the main motivations behind strikes. During Alfonsín's presidency the protests were mainly related to wage levels and economic policy, whereas during Menem's presidency, they were related to labor policy and unemployment.

alignment of foreign policy with the US. Menem included in his first cabinet as Minister of Finance a representative from a powerful holding of the business sector. The strategy consisted in establishing a close relationship with a particular holding, Bunge & Born (in Peronist imagery, a symbol of the oligarchy with interests incompatible with those of the “people and the nation”), instead of dealing with representatives of business associations—as had been the Peronist tradition and as former Radical president Alfonsín had unsuccessfully done.

The administration faced some dilemmas in its relationship with specific business sectors. The industrial sector was reluctant to support trade liberalization policies, since such policies would generate competition from international products. Also, privatization policies implied a cost to many of the firms that were privileged suppliers of the state-owned companies, while also affecting business as a consumer of state-subsidized public services.

We could say that the government followed *vis-à-vis* different business sectors a strategy similar to the one dealing with partisan actors: ignore the weak, weaken those that you can, and buy the support of the strong.

Among “the weak and weakened” we would include traditionally protected industries, like textiles, electronics and auto-parts that even though hurt by reform, by that time had lost the capacity for collective action.<sup>25</sup> Furthermore, the government furthered their collective weaknesses by providing strong incentives to negotiate individual solutions to each particular sector.<sup>26</sup>

Intermediate cases were those industries, such as pharmaceuticals, that had more economic capacity to adapt to the new set of rules. In those cases, the government showed its determination to speed up and/or increase the opening of the economy, forcing them to acquiesce politically and adjust economically.

The (economically and politically) stronger business groups were the industrial conglomerates that were strengthened during the 1976-1983 dictatorship, which saw their interests affected by the shrinkage of the state. Even though these groups were horizontally diversified and had export capacity, they depended heavily on their profits as (over-priced) state suppliers. These groups were a real threat, since they could shape an alliance with other sectors and build upon a “nationalistic” discourse in defense of the state. The government strategy to neutralize the potential reaction of these conglomerates was to barter their loss of

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<sup>25</sup> They used to group around the once powerful CGE (a corporatist business counterpart to CGT, the central trade union), which by the early 1990s was already weak and thus had no capacity for sustaining significant opposition to the government.

<sup>26</sup> According to Viguera (1998), rather than isolating trade policy from political pressures (as was the case with monetary policy and the Central Bank) the government kept these decisions in the scope of the Ministry of Economy, where each sector, in a non-cooperative manner, lobbied for favorable treatment. The “accommodating” response to these sectors is well encapsulated in a statement by the president of the Union Industrial Argentina, Israel Mahler: “The level of deterioration of the productive sector showed by the fact that the production per capita in industry is now almost 40 percent lower than in 1970, definitively influenced toward setting aside confrontational attitudes that would lead us nowhere.” (our translation, *La Nación*, September 1 1991, part 3<sup>a</sup>, page 1, quoted by Acuña, 1995a, 356-357).

earnings as state suppliers by their appropriation via privatization of the state-owned companies that were placed in monopolistic or oligopolistic positions (especially providers of public services, made even more attractive by the peso-dollar parity). This strategy was very successful.<sup>27</sup> Although not all the large former suppliers of the state attained similar benefits in the process of privatization, those that ended up suffering absolute losses in the competition for the appropriation of state-owned firms did not constitute a sufficiently powerful group for their reaction to complicate the government strategy.

Politically, the government maintained a similar strategy as the one employed with some unions, namely, exchanging “favors” accompanied by threats of sanctions in the event of not reaching a solution to the conflicts with the business sectors that were affected by the plan as producers. The overall result of the reforms was a strong consolidation of the local industrial conglomerates to the detriment of the smaller, less horizontally diversified industrial companies that had to pay the costs of the liberalization of trade and the privatization of state-owned companies.

The process of privatizations didn't only benefit these conglomerates. Banks (temporarily) and foreign firms were, as expected, important beneficiaries of the reforms. Beyond the urban sector and in the long run, agricultural producers emerge also as clear beneficiaries of trade liberalization.

To summarize, the government managed to build an alliance of the most powerful and diverse business interests, not leaving much room for the reaction of those that were to pay the costs of the reforms.

### *International Actors*

The US government was a key international actor to assure the right environment for the reforms. In order to include this government as one of the supporting actors for the reforms, Menem's strategy was to establish a close alliance with the US by radically shifting long-standing Argentine positions in the international arena. In this sense, Argentina did not condemn the US invasion of Panama, withdrew from the Non-aligned Movement, dismantled the Condor Missile project—a major interest of the US at that time (Acuña and Smith, 1994)—sent troops to the Gulf War, signed the Tlatelolco Treaty, and sustained a voting behavior almost identical to the US in different international fora.

The consistent international support from the US government, EEC, IMF, IDB, and the World Bank was instrumental in boosting the credibility of the administration's reform program at home. For instance, in July 1997, the IMF decided to enhance Argentina's credit line because of that country's “good governance” record. In

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<sup>27</sup> By way of illustration, *Pérez-Companc* participated in the privatizations of EnTel (telecommunications), SEGBA (electricity), YPF (oil), Gas del Estado (gas), and national roads; *Techint* participated in the privatizations of EnTel, YPF, SOMISA (steel), SEGBA, Gas del Estado, national railways and roads. Moreover, in the aftermath of privatizations, the energy market was concentrated in the hands of these few economic conglomerates.

addition, privatizations, for example, played a key role in Argentina's ability to enter the Brady Plan.<sup>28</sup> It was in seeking to achieve this goal that Menem pursued a foreign policy aimed closely at aligning Argentina with the US.

### **III. The Effects of the Reforms**

After a decade of market oriented reforms, what can be concluded in terms of their impact on economic outcomes? This is a very difficult, but important, question. First, it is always very hard to nail down the effect of macroeconomic policies. Confounding the impact of reforms with other secular trends and with other simultaneous interventions tend to be pervasive in these cases. Second, and in particular in the Argentine case, disentangling the aggregate effects of the "reforms" from those of the stabilization based on convertibility is simply not possible. There is no way to assess the counterfactual of what would have happened if the reforms had been implemented without adopting convertibility. Thus, we will just provide a descriptive analysis of some key aggregate economic variables, whose ups and downs nevertheless were associated by all political actors with the reforms-cum-convertibility package.

Taking a broad and long perspective, and recognizing the starting point of the Argentine economy in the late 1980's, "the reforms" seem to have been (in broad strokes) a movement in the right direction. Several overall outcomes were successful (if measured against reasonable counterfactuals).

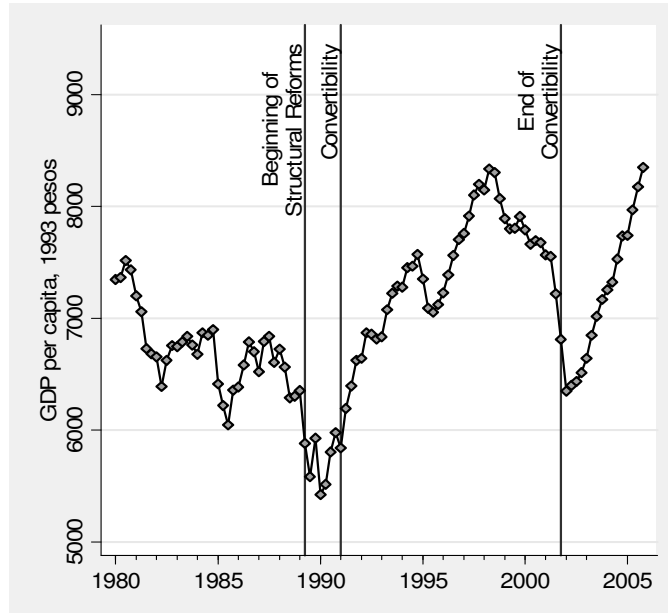
In our view, the main achievement has been on the inflation front. After decades of high inflation, Argentina's inflation has been in the single digits, with the exception of 2002 (in which the exchange rate multiplied by four after convertibility was abandoned.) This substantial and so far permanent removal of inflation has had substantial microeconomic benefits.

The aggregate performance of the economy also improved substantially reverting a long declining trend (Figure 5), although this is somewhat obscured when the collapse of convertibility is taken into account. In addition, the economy recovered faster than expected. During the 1990s, GDP per capita grew at 3 percent, twice the rate of growth of the world economy and 50 percent more than that of Latin America as a whole. However, when the crisis period is incorporated, the economy only grew at 1.88 percent per year, which is a substantially better performance than the one obtained during the 1980s, but it is similar to the one achieved in the 1970s (Table 2).

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<sup>28</sup> Argentina's entry into the Brady Plan meant that the country received a discount of 35%, or \$10 billion, on its foreign debt and a rescheduling of the remaining outstanding debt. In addition, the IMF, World Bank and IDB provided special loans exceeding \$5 billion to finance the reforms.

**Figure 5: GDP per capita, 1980-2005**



**Table 2**  
**GDP per capita growth**  
**- Annualized rate (%) -**

	Period			
	70's	80's	90's	90-05
<b>Argentina</b>	1.73	-2.24	3.13	1.88
<b>Latin America</b>	1.60	-1.02	2.09	3.04
<b>World</b>	2.35	1.60	1.61	2.89

Source: Author's elaboration based on CEPAL, CIA World Factbook, Penn World Tables, Llach and Gerchunoff (2003) and INDEC.

Trade liberalization was also very successful. Starting in the early 1980s, and partially responding the opening of the mid-1970s, exports to GDP almost tripled (Figure 2). This process continued in the aftermath of the convertibility crisis. The growth of exports was a necessary condition to reinstate economic growth in the country after the demise of the import substitution strategy adopted in the post-world war period. During the 1990s, there were also significant gains in the productive efficiency of the economy—see Galiani et al. (2005) for the privatized firms and Chudnovsky et al (2004) for the manufacturing sector.

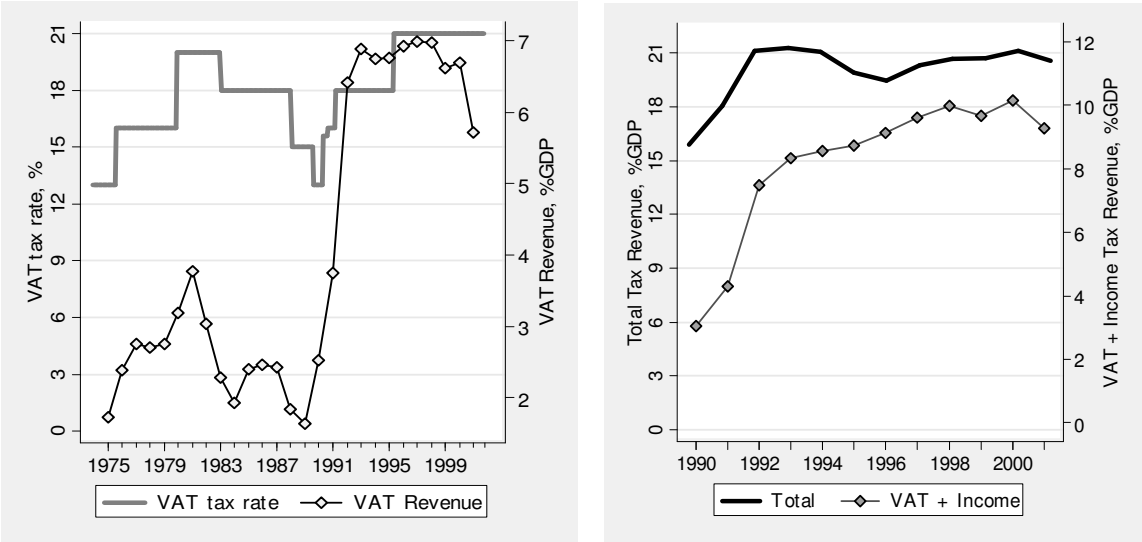
There were also substantial improvements on the fiscal front. Up until the end of the eighties, the deficit (including inflationary tax revenue but not privatization income) was around 6 percent of GDP. During the nineties, the primary budget

was balanced. Under convertibility, Argentina undeniably achieved the best fiscal results in 40 years.

At the beginning of Convertibility, government spending was quite low and increasingly inelastic. A high share of government spending was devoted to wages and social security payments. Furthermore, a large share of resources was automatically transferred to the provinces, adding to the rigidity of the fiscal accounts. This rigidity in government spending implied that most of the action in terms of fiscal adjustment had to rely on the use of tax instruments.

Tax reform largely followed the consensus on tax policies for developing countries (see, among others, Harberger, 1993). The value added tax was generalized and tax collection improved. Figure 6 shows how the effectiveness of the collection of the VAT increased substantially during the early years of the reform. A similar improvement occurred in income taxes. In all, tax collection from income taxes and the VAT increased from about 3 percent of GDP in 1990 to about 10 percent of GDP by 1998, more than accounting for the overall increase in government resources (see Figure 6). Several years later, the 2001 crisis showed that this improvement was permanent, and that efforts made during the decade to strengthen convertibility with a consistent fiscal policy are behind the stability achieved after its demise.

**Figure 6: VAT, Income, and Total Tax Revenue**



Source: Cetrángolo and Jiménez (2003).

Nevertheless, the fiscal retrenchment turned out insufficient in light of the macroeconomic requirements of a very rigid monetary regime.<sup>29</sup> Finally, the government defaulted on its debt.

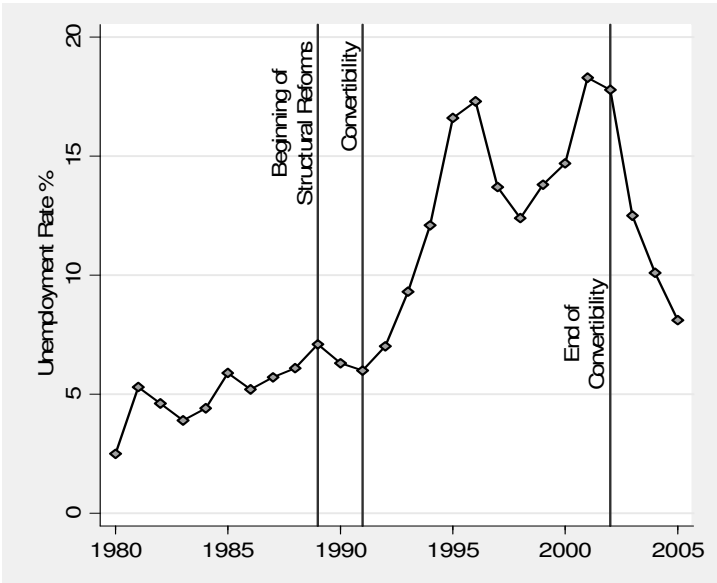
<sup>29</sup> To a large extent, the budget deficit in Menem's second term grew out of reductions in labor taxes and the privatization of social security.

Tax pressure in Argentina is still too low. It was below 22 percent of GDP by the end of the 90s, while it was above 30 percent in Brazil and Uruguay, and between 35 and 40 percent in most developed countries. Argentina still needs to broaden its tax base if she is to improve the quality of her supply of public goods.

With respect to business, the overall result of the reforms show clear benefits for the mining, oil and agricultural exporters with a strong consolidation of the local industrial conglomerates in detriment to smaller, less horizontally diversified industrial firms, which had to pay the full cost of trade liberalization and the privatization of state-owned companies. In the new context of liberalized trade and private ownership of public services, the economy in the long run also shows an increased weight of foreign capital and a novel (for Argentina) tension between the producers of tradable and the (now private) producers of non-tradable goods and services.

One of the worse outcomes of the period was the substantial increase in unemployment (see Figure 7). However, and despite the fact that many commentators had adjudicated this to the structural reforms of the 90s—privatization and trade liberalization—this trend seems in part related to a large secular increase in female labor supply, as well as to the rigidity of the monetary system adopted. Certainly, before 1995, unemployment increased substantially, reaching 12 percent. However, only approximately 4 percentage points of this jump can be directly adjudicated to the massive layoffs associated with the privatized firms and the manufacturing sector that was also shedding labor. Since 1995, there were a series of severe shocks to unemployment that kept it above 10 percent for most of the period (Figure 7). These severe shocks to employment can be blamed mostly on the rigidity of the monetary system. Indeed, after the brutal decrease in real wages as a result of the demise of convertibility and four years of fast and sustained economic growth, unemployment has returned to the levels observed at end of the 80s (Figure 7).

**Figure 7: Unemployment Rate, 1980-2005**



**Note: Since 2003, the Argentine Statistical Agency changed the way unemployment is measured. We adjusted unemployment figures since 2003 to make them comparable with the previous ones.**

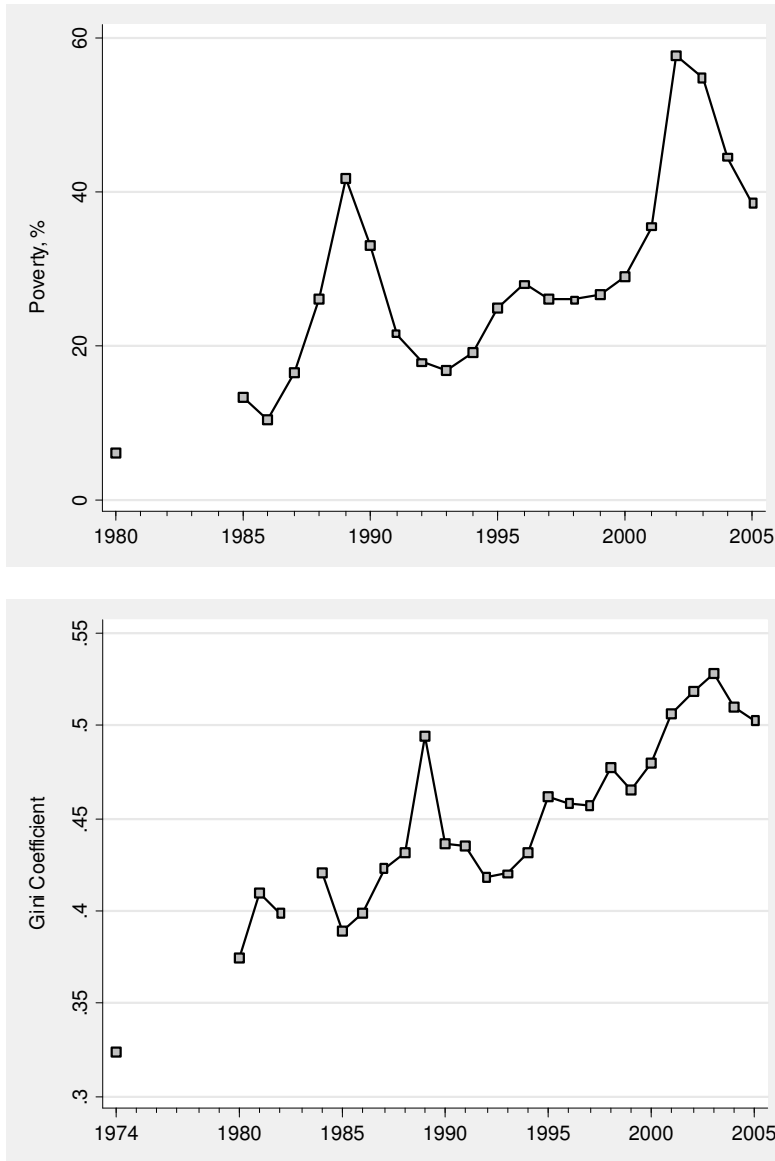
Related to the increase in unemployment, there was a substantial increase in inequality and poverty (see Figure 8), particularly since 1995. Both poverty and inequality were at the historical maximums at the time convertibility collapsed. However, both indicators were growing fast well before the 90s. Just as an example, note that the poverty index in 1998 was quite close to its value in 1988.<sup>30</sup> In any event, the worse outcome related to poverty is not whether it is higher or lower than in 1988. It is that now it has been above 20 percent for almost 20 years, which makes poverty one of the most serious problems to be faced by the Argentine society in the years to come. Income inequality has significantly increased since the 1970s. The Gini coefficient for the distribution of household income in Greater Buenos Aires climbed from 0.32 in 1974 to 0.52 in 2003. Inequality greatly increased in the second half of the 1970s, remained stable in the first half of the 1980s and substantially increased during the macroeconomic crisis of the late 1980s. After stabilization, inequality went down, although it did not reach the pre-crisis levels. The 1990s were again times of increasing inequality, as the Gini climbed 6 points from 1992 to 1998. The recent macroeconomic crisis of 2001-2002 pushed the Gini up another 4 points but this had already been partially reverted by 2005. The increase in unemployment, poverty and inequality, and the association of these events with the adopted economic model severely affected public support for the reforms.

To wrap up this section, we have a few words on public perception of the costs and benefits of the reforms. Overall, public sentiment towards the whole reform process is fairly negative. For instance, as of 2003, Argentine citizens rank among the ones least supportive of privatizations among Latin American countries (Lora, Panizza, and Quispe-Agnoli, 2003), even though privatizations have in general been welfare improving, in some cases, even for the poor (see, for example, Galiani et al., 2005). This overly negative impression is probably due to a combination of factors, including the association of some of these measures with lack of transparency and government corruption, the actual failure of some reforms (notably pensions) to meet their goals, the poor institutional capacity to regulate and control the provision of public services, as well as the political strategies in the construction of the post-Convertibility political coalitions, which have successfully managed to further conflate in the public's mind the 2001-2002 crisis with the overall reform package.

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<sup>30</sup> Certainly, GDP per capita in 1998 was at its historical peak and, hence, one would have expected poverty to be lower than in 1998 than in 1988. But the increase in unemployment and inequality prevented poverty from decreasing in the second part of the nineties.

**Figure 8: Poverty and Inequality**



Note: Top Panel, poverty headcount ratio. Source: Gasparini (2003). Bottom Panel: Gini coefficient for household income per equivalent adult, with parameter of household economies of scale set at 0.5. Authors' calculations from Permanent household survey.

#### IV. Some Parting Thoughts

In this paper we summarize the experience of market-oriented reforms in Argentina during the 1990s. In a context of economic chaos following several decades of fiscally irresponsible and inward looking economic policies, a pragmatic incoming executive decided to “follow the international wave” and embarked in a broad reform process along the lines of the Washington consensus. The Executive was able to build a governing coalition that put together economic sectors benefiting from the reforms with some of the traditional clientelistic Peronist networks.

One of the most salient features of the Argentine case was the bundling of measures such as privatization, trade liberalization and de-regulation, with a particular stabilization device, the monetary regime of Convertibility. We argue in this paper that convertibility played a key role both politically and economically, given the peculiar inflation history of Argentina, and its impact on the contractual basis of the economy.

Argentina has made clear progress on some important fronts in the last decades. In 1983 it returned to democratic rule, and it has remained there ever since, even through deep crises like the one in 2001-2002.<sup>31</sup> It also seems to be conventional wisdom even among political leaders nowadays that high inflation is not good politics, and that in order to avoid high inflation, care on the fiscal end seems necessary. The reform process also left behind a relatively modernized business sector, a more open economy, as well as some clear improvements in infrastructure.

The economy still has many unresolved problems, and the social situation has deteriorated throughout the reform decade. On the political and institutional end, Argentina is still a country that does not seem able to steer a clear direction, unlike some of its neighbors such as Chile or Brazil.<sup>32</sup> Even though not the direct focus of this paper, we believe that some of Argentina’s unresolved problems relate to the inability of the polity to produce credible policies sustained by more cooperative political behavior.<sup>33</sup> Convertibility was an institutional shortcut towards the building of more adequate “deep institutions” but in the end it did not work.

Even though in this paper we seem to provide some evidence that crisis led to reform we believe that a narrow reading of that statement is misleading. Crises do not necessarily lead to better policies or even to policies in any particular direction. If anything, the 2001/2002 crisis had the effect of pushing the discourse in the anti-reform direction. Crises are more likely to be necessary to trigger reforms in

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<sup>31</sup> According to some observers, the quality of Argentina’s democracy deteriorated crisis after crisis from an incipient liberal democracy to a dangerous delegative democracy (O’Donnell, 1994). Also, the way in which political institutions work in Argentina does not facilitate consensus building or high quality policymaking—see the next two footnotes.

<sup>32</sup> Compare for instance the volatility and quality of international policymaking in Argentina vis-a-vis its main neighbors (Spiller and Tommasi, forthcoming 2006, Chapter 4).

<sup>33</sup> Some of those issues are raised in Spiller and Tommasi (forthcoming 2006), in Tommasi (2004) and in Acuña and Tommasi (2000).

politics that have a poor capacity for (less costly) collective learning and to solve collective action problems. More importantly, a crisis does not seem the best time for the gradual and profound building of deep institutions that need time to develop, which are fundamental to deliver credible and adaptable policies over time. The type of solutions that tend to be adopted in some crisis situations, like the Convertibility regime in Argentina, do not tend to provide the most adequate starting point for the building of good adaptive institutions.

Another common maxim in the reform folklore is that *“left-wing governments are more likely to successfully implement reforms because they are more credible”*. One of the authors of this paper is one of the authors credited in the literature for the development of that hypothesis. We believe the hypothesis is theoretically relevant and practically relevant in some situations. Although some of that literature was partly motivated by examples like that of Menem in Argentina, a deeper reading of the case suggests that such was only a small portion of the story in this particular case. The ability of Menem to manoeuvre the reforms with the traditional constituencies of Peronism is more related to the management of clientelistic political machineries than on the additional credibility lent to the necessity of reform by his Peronist credentials. The disastrous pre-existing situation was a stronger source of information about the need for some change.

In this paper we looked in a rather disaggregated manner at the way winners and losers were handled politically. This implicitly states that, contrary to some naïve renderings of the political economy of reforms, the implementation (and sustainability) of market-oriented reforms does not depend on their Pareto-improving nature, but on political configurations in which losers do not have effective power to mobilize against implementation (or for reversal).

This brief paper has focused on the broad aspects of the reform package and of the underlying politics. The more disaggregated analysis behind this project suggests the presence of important actors relevant for some specific reform areas. For instance, the military used to be an obstacle for privatization, but not so much for trade liberalization. Specific structural reforms are nested games; the logic of support and opposition by specific actors depends on the interplay among multiple reforms in multiple arenas. In the specific case of Argentina, the lack of intertemporal political credibility led to the bundling of multiple simultaneous reforms as a way of allowing exchanges to take place at a relatively low risk for the potential losers of some specific components of reform.

Finally, the impact of structural reforms cannot be assessed in narrow economic terms. The Argentine case shows that the weakness of its governmental institutions to sustain intertemporal exchanges in an efficient, effective and legitimate way, is at the core of the logic of reforms and, more broadly, at the core of its problems. In this context, the original promise of the Washington Decalogue that more market and less government would bring about better politics and economics was wrong. Economies cannot be understood or reformed independently of the political conditions and institutions in which they operate.

Good governmental institutions allow bad policies to be redefined, while bad institutions cannot even assure that good policies will be maintained. Conceptually, the “Washington” notion of first and second generation reforms got the order wrong.

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ATNs:	Contributions from the National Treasury
CGE:	General Economic Confederation
CGT:	General Labour Confederation of the Argentine Republic
DNU's:	Decrees of "necessity and urgency"
EEC:	European Economic Community
EnTel:	National Telecommunications Company
GDN:	Global Development Network
GDP:	Gross Domestic Product
IDB:	Inter-American Development Bank
IMF:	International Monetary Fund
ISI:	import substitution industrialization
PJ:	Peronist party
SEGBA:	Electric Services for Great Buenos Aires
SOMISA:	Steel Mixed Society Argentina
UCD:	Democratic Center Union party
UCR:	Radical Civic Union party
VAT:	Value added tax
YPF:	Fiscal Petroleum Fields