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## **Documentos de trabajo**

### **Understanding Reform: the Uruguayan Case**

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# Understanding reform. The Uruguayan case <sup>1</sup>

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## Resumen

Este artículo analiza el proceso de reforma estructural que ha estado teniendo lugar en Uruguay desde el retorno a la democracia en 1985. Tres preguntas principales orientaron la investigación: ¿por qué la reforma? ¿qué tipo de reforma? y ¿cuál fue el desempeño de la reforma? El centro de atención principal está en las reformas pro-mercado tal como han sido resumidas en el llamado consenso de Washington, pero el artículo también trata la reforma política y la consolidación de la democracia. El objetivo general es entender la reforma en un sentido económico y político amplio. El estudio no pretende solamente evaluar las reformas implementadas, sino más bien entender por qué las reformas pro-mercado avanzaron más rápidamente en algunas áreas que en otras, quién las promovió y quién se opuso, cómo el proceso político las modeló y cuál fue su desempeño. Este artículo es parte del programa "Understanding Reform" de la *Global Development Network*, que apunta a mejorar nuestra comprensión de la experiencia de reforma reciente realizando una serie de estudios de caso-país, en profundidad, simultáneos y coordinados.

## Abstract

This paper analyzes the structural reform process that has been taking place in Uruguay since the return to democracy in 1985. Three main questions oriented the research: why reform? what kind of reform? and, how well did the reform perform? The main focus is on the pro-market reforms as they have been summarized in the so-called Washington Consensus, but the paper also deals with political reform and the consolidation of democracy. The general goal is to understand reform in a broad economic and political sense. The study is not just aimed at assessing the reforms implemented, but rather to understand why the market-friendly reforms moved faster in some areas than in others, who promoted and who opposed reform, how the political process shaped the reform, and how well the reform performed. This paper is part of the Global Development Network's research program named "Understanding Reform", which aims at improving our understanding of the recent reform experience by performing simultaneous and coordinated in-depth country-case studies.

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# 1 Introduction

Over the last few decades, the countries of Latin America have gone through a “double” transition. It has been a process similar to what happened in Eastern Europe after the collapse of “real” socialism, and also comparable to what the southern regions of the Old World had to face in the middle of the 1970s. The first dimension of these “dual” transitions has to do with the process of democratization and its chances of gaining in strength. The “second” transition has to do with the processes of reform and structural change, in politics, in the State and in the economy, and in modes of regulation and of public management. There are big changes in society on a nationwide scale, and also in international relations and in the integrated regional blocs.

We are confronted with a “change of epoch”, which is altering the structures which were established during the 20th century. This long and litigious process is still going on, and the outlines of new development patterns are emerging. This is a major historic shift, and it is happening all over the world. However, while this movement is universal it is not homogeneous. Like what happened in other periods of fundamental change, particularly since the crisis of the 1930s, this is a widespread evolution but it is not occurring in a uniform way. The map of the transitions shows diversity.

This diversity has been studied on the level of institutions and of political processes. Typologies and indicators have been constructed which seek to compare and classify the transitions to democracy, the forms and the quality of the democracies, their “weaknesses” and their degree of consolidation, government regimes, party systems, and the participation of the citizenry, of economic agents and of social actors.

There are also studies of the reforms which take into account the general orientation of these processes in a particular country, or consider one particular sector, or advance in comparative analyses which vary in scope as to the field of the comparison and the number of cases.

This paper is geared specifically to the case of Uruguay. It involves an analysis of the relation between politics and reforms – *politics and policies* – which shows the ways in which the institutions, the political processes and the games of the different power brokers impact on the “*path*” of the reforms: promoting them, limiting them or blocking them, modeling the rhythms, the initiatives and the characteristics of the solutions which have come to be adopted, their implementation and their effectiveness, and the strengths and weaknesses which have emerged through the changes which are taking place.

Much progress has been made in this line of research, but further study is needed. For a while, the debate was centered on the reforms themselves and on their suitability, principally with regard to political institutions, the economy, the state, public management and social policies. Subsequently attention turned to politics, to its rules and its specific

development, as a determinant factor in the dynamic of these reforms within the fabric of national and international conditioning factors. In our study we adopt this second perspective.

We aim to provide an answer to the three main questions posed in Fanelli and Popov (2002) for the Uruguayan case. The reform process that took place in the country in recent years has had important consequences for Uruguay, but the outcomes have not always been what was expected. This phenomenon justifies the focus of the learning model in terms of making circular use of the description and analysis scheme -Why, What and How well- put forward Fanelli and Popov (2003).

This paper focuses on a series of structural reforms implemented in recent years, mainly during the 1990s, in the areas of foreign trade, social security, public utilities, legal infrastructure and electoral and government systems. Although it is not an exhaustive list of reformist initiatives it covers the core of the process, instances where sustained political action in a specific direction can be identified. The common analytical matrix facilitated the comparison of phenomena, so similarities and differences could be identified and the factors behind successes and failures picked out. For this, the results from the literature have been integrated in the scheme mentioned above. A chronicle of the main changes in political economy in the 1990s has been brought up to date, and there is a detailed account of the positions of the different actors involved.

This study is organized in six sections, of which this introduction is the first. In section 2 we put the case of Uruguay in a regional perspective, with a review of some recent literature that measures reform efforts across countries.

Section 3 addresses the issue of why the reforms have been undertaken, focusing on goals and incentives. In section 4, the paper turns to the what-kind-of-reform question. A wide range of policies can be listed under the general heading of market-friendly reforms. The outcome of the reform process is highly sensitive to the specific mix of policies that are being pursued in each particular historical context. Hence it is crucial to identify the specific characteristics of the reform package in each country case. To this end, we try to identify the values and ideas involved in the reforms, the way they have been formulated, the decision-making process, and issues of implementation. Section 5 provides a brief account of existing evidence on the performance of the reforms. The paper contains an appendix with a general chronology of the Uruguayan reform process.

## **2 The Uruguayan reform process in a regional perspective**

Uruguay is often regarded as a reluctant reformer. This view is to some extent supported by some indexes of economic reform. Lora (2001) computes an index of pro-market structural reform in 19 Latin American and Caribbean countries. In this group, Uruguay is the country whose index of economic reform changed least between 1985 and 1999, i.e. during the period of most intense reform in the region. According to the same index, Uruguay was the fourth top reformer in 1985, surpassed only by Chile, Jamaica and Trinidad and Tobago,

but it plummeted to last position in 1999. This period coincides with the first three democratic administrations after Uruguay returned to democracy in 1985.

According to Lora (1998), it is not that Uruguay did not reform, but that it did so gradually. Using values from the structural reform index of 1985 and 1995, Lora classified Latin American and Caribbean countries in four groups: early reformers, gradual reformers, late reformers and slow reformers. Uruguay is one of the two gradual reformers (Colombia is the other). Lora and Olivera's (2003) index of "unbundling" reinforces this view. The index of reform "unbundling" registers its maximum value when reform takes place only in one area at a time, and its minimum value when it takes place simultaneously in all areas to an equal extent. Uruguay has the second highest value for unbundling in the region.

The stance of economic reform varies considerably from one area to another. According to Lora (2001), trade and finance are the areas in which Latin America and the Caribbean have reformed the most, while privatization and tax and labor policies are the areas in which there has been the least progress. By 1999 (the last year in Lora's study), Uruguay was the country in the region that had privatized the least, and was the second least flexible in terms of labor institutions. Forteza and Rama (2003) compute an index of labor rigidity and it shows that Uruguay is the most rigid country in Latin America. On the other hand, Uruguay has one of the highest values in the (free) trade index in Lora's computations, and has intermediate values for financial and tax policies.

The above mentioned studies are useful for putting the country in a regional perspective, but they inevitably leave some aspects out of the picture. First, reform is the main outcome of a political process which is only laterally addressed in the cross-country studies. Without this ingredient, it is not possible to provide a satisfactory answer to the type of questions that guided this research. Second, the cross-country approach provides some useful stylized facts, but as such they do not strictly apply in each and every country. The reform indexes are proxies used to study complex phenomena. More detailed narratives of specific experiences, such as those presented in this research program, can thus be a useful complement. To this end, we adopted an "analytic narrative" methodology (Bates et al, 1998).

### **3 Why have the reform been implemented?**

An analysis of the reasons behind the reforms answers the question of the objectives and the incentives of the actors in the process. Economic and social development is invariably a declared goal for everyone involved in processes of structural reform. More specific objectives, on the other hand, vary from one actor to another and from one reform to another. The actors in the process are subject to different conditioning factors which affect their incentives with regard to reform. Factors such as the current economic crisis, and external pressure and internal feedback which the process of reform itself can generate, are usually important incentives. In this section we propose to shed some light on the reasons

for the reforms in Uruguay by exploring the objectives and incentives of the actors involved in the process.<sup>2</sup>

### **3.1 Objectives**

The declared objectives of the reforms were ambitious and wide-ranging. They included promoting growth, increasing efficiency, strengthening social policies, and consolidating and strengthening democratic institutions. However, the specificity of the reform program which is analyzed in this paper does not lie in these general postulates but in the more specific proposals for reform which, in turn, stem from a certain diagnosis of the country's situation.

What reformers sought is to promote *economic efficiency and growth* through a collection of policies which foster the functioning of markets. Trade opening should involve a reallocation of resources towards those activities in which the country has comparative advantages, going beyond the stage of import substitution. Opening to foreign trade would also operate as a policy for promoting competition, and contribute to overcoming the monopolistic and oligopolistic structures which have dominated internal production. The experience of the import substitution periods showed that barriers to foreign trade are associated with very limited competition in the internal market, particularly in a small country like Uruguay. Opening would favor consumers because prices would fall and there would be a greater variety of products available. Productive activity with comparative advantages would also benefit from lower prices and a greater variety of inputs and capital goods, all of which would foster greater technical progress.

According to the promoters of reform, privatization and the dismantling of the monopolies formerly enjoyed by public enterprises would contribute to generating greater competition and promoting private investment and technical progress. They claimed that a number of state enterprises behaved like monopolies and were inefficient.

The reforms aimed at increasing competition in markets were based on the classic results in economics that competitive markets allow for an efficient allocation of resources, and therefore it is desirable to develop them wherever possible. Insofar as recent technological changes have modified the old conception that public service sectors should integrally constitute natural monopolies, conceptions aimed at developing competition in these markets have emerged. Greater competition should include a reduction in the costs of public services, both for the final consumer, and, just as important, for enterprises, thus contributing to increased competitiveness in the Uruguayan economy.

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<sup>2</sup> A fundamental aspect of the reform process is who takes part and who is excluded. This process of inclusion and exclusion can be partially endogenous, and some players may have the capacity to include or to exclude other players. For this reason, when we speak of the actors involved in reform we are referring both to those who are included and to those excluded. Luján (2003) has analyzed this aspect of the negotiation process in social security reform in Uruguay.

The reforms geared to strengthening capital markets were intended to give enterprises another option for financing, with additional to bank credits and new options for savers to invest. Enterprises would be able to obtain financing at lower cost and with longer repayment periods. Savers would have more options to diversify risks, greater liquidity (more flexible entry and exit) and a separation between ownership and the administration of assets. In macroeconomic terms, the reform aimed at fostering domestic savings and reducing external vulnerability. Putting aside the contentious issue of a causal link between savings and growth, there is general agreement that financial development, broadly defined, co-varies positively with GDP per capita and growth rates<sup>3</sup>.

Promoters of the reform of the social security system expected this to contribute to an improvement in both micro- and macroeconomic performance. The new system should reduce the distortions of the previous pay-as-you-go system, inducing an increase in rates of activity, greater formalization of work, a raising of the retirement age, and increases in rates of saving. The private pension funds, in turn, would contribute to the development of the local capital market. Lastly, in the long term, the reform should re-establish the financial viability of the social security system, which is threatened by the progressive ageing of the population, the generous benefits which were awarded in the early stages of the public system, and the loss of collective capitalization funds.

Other objectives that were also incorporated into the reformist platform were the strengthening of *social policies*. The ambit in which this objective can be seen in its most explicit and detailed way is the reform of the social security system. The provision of social security includes both protecting workers against the risk of income loss, that is to say an insurance service in its strict sense, and redistributive policies which seek to alleviate chronic poverty (which can be considered as insurance in a wide sense). Improvement in the provision of security had to be effected through a “diversification” of the ways in which social security services are provided, substituting the traditional system of pensions (which had a single public pillar of defined benefits and pay-as-you-go) by a system with several pillars. It involves combining three pillars in different proportions, a compulsory pay-as-you-go public pillar, a compulsory private pillar of individual capitalization, and a voluntary private pillar of individual capitalization. This was an attempt to set up formulas that would be flexible and adapted to the reality of the national situation, and which would safeguard against various risks, such as the risk of payments losing acquisitive power because of inflation, the risk that the formulas for calculating benefits and contribution rates might be modified, and the market risk in the individual capitalization area. The improvement in alleviating poverty would be effected through more focalized and transparent programs. A general diagnosis shared by the promoters of the reform is that the previous system led to a redistribution profile which often did not favor low income sectors.

Rather more tangentially, the privatization of public enterprises was linked to the possibility of developing social policies. The argument was that privatization would provide resources that would allow social policies to be strengthened.

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<sup>3</sup> See Levine-Zervos (1998), and others.

After the dictatorship, several political changes took place which involved *the consolidation of democracy*. Although the democratic transition affected virtually every area of politics, the present paper is centered specifically on an analysis of the process which led to the constitutional reform approved in 1996. According to their proponents, the new dispositions sought to foster the formation of majorities to govern, while at the same time promoting transparency in the electoral system<sup>4</sup>.

On the first point, the new constitution seeks to incorporate norms which will stimulate political agreements and negotiation, the forming of coalitions, stability in cabinets and legislative majorities. On the one hand, it was maintained that the second round in elections would stimulate the making of agreements to govern<sup>5</sup>. On the other hand, the mechanisms for replacing the directors of the public enterprises were modified so as to increase the costs of abandoning a coalition. As to the transparency of the electoral system, the intention was to give the voter greater certainty and freedom by limiting the application of the double simultaneous vote and permitting him to opt for different parties in the different sections that make up the electoral process (primary, national and local elections).

The general objectives of the reform process were relatively fixed in the period under consideration, but there was a certain evolution in the more specific or instrumental objectives. These changes were induced by the reform process itself. In the area of trade policy, a strategy which favored unilateral opening gave way to a strategy of regional integration. This change was clearly determined by the evolution of the regional integration process, and this in turn was determined basically by the big countries in the region. In the area of public enterprises, the attempt at privatization in the first half of the 1990s failed, and this caused adjustments to the reformist proposal which tended to emphasize the removal of monopolies, the possibility of public enterprises associating with private companies, and the creation of independent regulatory bodies.

### **3.2 Incentives**

The literature about the political economy of the reforms has identified factors which usually affect the incentives of agents to promote or to put a brake on reform. In this section, we analyze the incidence of three of these factors: the crisis, external pressure and internal feedback.

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<sup>4</sup> In the exposition of the reasons for the projected constitutional law, we read that, “substantial modifications to the prevailing electoral system are proposed so as to make it more transparent and suitable to the current situation...and also to make the relation between the executive power and the legislative power more fluid, thus making it easier for government agreements between the different parties with parliamentary representation to emerge and be consolidated”. (Record of the sessions of the Senate Chamber No.103, volume 376, 13 August, 1996, p. 33)

<sup>5</sup> “To create, therefore, greater political representativeness, and consequently facilitate the indispensable task of allowing agreements and political help from outside parties in order to establish stable government. This is what is embodied in the stipulation of a second round of voting in elections in cases in which no candidate has obtained more than 50% of the total votes cast in the first round.” (Record of the sessions of the Senate Chamber No. 103, volume 376, 13 August, 1996, p. 33)

### 3.2.1 The crisis of the system

There has been much debate in the literature on political economy about the role of crises in reform processes, but no consensus has been reached (Drazen, 2000, pp 444-454; Sturzenegger and Tommasi, 1998, pp 9-11). Some authors maintain that crises have been factors that triggered reform (Bresser Pereira, Maravall, and Przeworsky, 1993; Bates and Krueger, 1993; Cardoso and Galal, 2002), while others have questioned this hypothesis. Rodrik (1996) argued that this idea is a tautology, for reforms become an issue only when current policies are not working. Some models indicate that reforms might be more likely in good times than in bad (Orphanides, 1996). More recently, there has been emphasis on the idea that crises may be costly and may destroy institutions, affecting the quality of reforms and perhaps even leading to their abolition (Fanelli and Popov, 2003, p 24; Rius and van de Walle, 2003, p 5; Tommasi, 2002). The empirical evidence on crisis and reform is scarce and mixed. Drazen and Easterly (2001) found that countries that showed very high inflation and black market premiums enacted reforms that reduced inflation and black market premiums below the level of countries that did not suffer from inflation or exchange rate shocks. They did not find evidence of crises triggering reform when there were fiscal and current account deficits and low GDP growth.

The experience of reform in Uruguay does not allow firm conclusions on this question to be drawn. Crises may have been a factor in triggering reform in some areas (trade) and a brake in other areas (financial, public services). The Uruguayan experience also shows that not only the current crisis matters for reform. The perception that there may be more crises to come, and that these perceptions are the object of political action are also important aspects of the reform process (social security, the sense of urgency shown by Sanguinetti).

In 1974, the first oil crisis contributed to the termination of the import substitution model, which had been showing clear signs of exhaustion. The increase in the price of petrol (which Uruguay does not produce), the loss of markets for meat and the fall in the prices of traditional export products brought about a change of model. This episode fits in with the stylized fact, which is emphasized by Cardoso and Galal (2002), that crises characterized by falls in real income and negative rates of growth facilitate the adoption of trade reform. The subsequent move to opening, which took place at the start of the 1990s with the creation of the MERCOSUR, was not connected to any crisis with these characteristics. Quite the contrary, it was a period of significant economic growth and of rising income.

When it comes to public enterprises, it can be said in a very general way that there is no objective sign of crisis which would call for reforms. The public provision of public services in Uruguay has the not very common characteristics that they do not run with big deficits and that they provide very wide cover, especially when compared with the indicators of other developing countries. However, at the start of the 1990s, there were deficiencies in the quality of service in most of them. But the situation is not seen as critical by public opinion, nor by the political system, nor by the business sector.

It is possible that the crisis of the country may have acted as a brake on reform in some areas. In the early 1990s, the country saw the final stages of the resolution of the external debt and banking crises, which were rooted in the hard peg exchange regime collapse of 1982. The resolution of the protracted banking crisis left productive enterprises desperate for funding. It was then clear that some development of capital markets could fill the gap. More recently government spokesmen explained that the administration of the crisis which the Uruguayan economy has been going through since 1999 occupied a lot of the government's energy, thus limiting its capacity to push forward with its reform program (Búsqueda 1216, 28/08/03, p 12). There are clear signs that the government has been weakened politically by the crisis, and it has had to make concessions under pressure from different groups which resisted attempts at reform. At the moment of writing, there is a referendum process under way aimed at overturning the law for the reform of the state petrol enterprise (ANCAP). Analysts agree that one effect of the bad performance of the economy in recent years has been to turn people against this reform.

The constitutional reform that was approved in 1996 sought to resolve the problem of governability. The experience of the two previous administrations had shown that the government was finding it increasingly difficult to obtain parliamentary majorities. In particular, the plebiscite that in 1992 overturned the law of public enterprises by an overwhelming majority left the National Party government isolated politically. The rise of the left coalition in 1994 elections, which could be seen as a crisis for the traditional parties, motivated them to promote a change in the electoral rules. However, the reform was not directly triggered by a government crisis. Quite the contrary in fact, when the constitutional reform of 1996 was passed, the government had the most solid coalition in the recent history of the country.

The experience of social security reform brings to light two more facets of the complex relation between crisis and reform. First, it is not the crisis in itself but perception of the crisis which prompts action for or against reform. Second, this perception is not something exogenous which the players cannot have an influence on; the players undertook specific action geared to modifying this perception.

The reforms in social security have been strongly conditioned by the long term problems of solvency in the system. The trend towards growing expenditure in social security was reinforced in Uruguay by the increase in payments which came about after the plebiscite of 1989 which introduced a system of pension indexing into the constitution of the Republic. That plebiscite led to a big rise in pensions in the subsequent years (expenditure on retirement pensions and benefits increased by approximately 4 points of the GDP between 1990 and 1994), and prevented the government from attacking the fiscal deficit by reducing the value of retirement pensions and benefits, which had been the traditional remedy. In some sense, the plebiscite itself made a deeper reform inevitable (de Oliveira et al, 1994: 21; Filgueira et al, 1999; Saldain 1999, p 3; Rius, 2003). However, the crisis had not yet struck, at least not to the extent that the Public Pension Bank (BPS) or the government which assisted it financially were in imminent danger of not being able to make the payments. The crisis could have been anticipated insofar as different studies show that the financial accounts could only deteriorate in the subsequent years, but in any case it was the

perception of future crises more than the reality of a present crisis that triggered action leading to reform.

The perception of crisis is also an arena of political competition. Luján (2003) shows how the promoters of reform try to transmit a sense of emergency to the population, while those who oppose it resist, "One of President Julio María Sanguinetti's successes was to generate the perception that financial crisis was inevitable in the middle term if reform of the social security system was not undertaken". Against this, an opposition Senator said, "Although there is a problem in the social security system, it is not as serious nor is it at the level of crisis which the Presidency claims." (Senator Alberto Couriel. *Búsqueda*, No. 804, 10/08/95, pp. 8 – 9)."

### **3.2.2 External factors: multilateral institutions and the reform in the region.**

Like in other developing countries, multilateral institutions have contributed to pushing forward the liberal reform process in Uruguay. The institutions contributed proposals, technical counseling and finance to carry out various reforms. But the rhythm and many specific details of the reforms were very conditioned by internal factors. The process was marked by the presence of political and social forces with conflicting visions of the reforms, and this had the effect of slowing them down and limiting their scope. At times, the action of the multilateral institutions themselves seemed somewhat uncertain and contradictory, possibly because of the need to negotiate solutions with a variety of different internal actors.

On more than one occasion, both government spokesmen and representatives of the multilateral institutions said that these institutions had played a secondary role in fostering reform. For examples, Luján (2003) cites declarations made by the Presidential secretary during the Sanguinetti administration (1995-2000) which claimed that the reform agenda had been established internally, without external influence, "According to the secretary of the President, the structuring of the reform proposal came from endogenous sources and had more to do with the national limits of the coalition than with external guidelines from international or regional credit institutions." The president of the Inter-American Development Bank (IDB) made declarations in the press to the same effect. It seems evident that with public statements such as these, the IDB and the Uruguayan government wished to convey the idea that the reform had been designed in Uruguay, without foreign influence. However, it is less obvious that such declarations might be a proof that the agenda was in fact established by parties independently of multilateral institutions, given that it was only to be expected that they would say this, bearing in mind the usual preoccupation with national political autonomy and the previous position against the multilateral credit institutions which local public opinion often has. Without prejudice to this, the content of the Uruguayan reforms themselves, and some details of the negotiation process, suggest that the institutions had to make considerable concessions.

The international institutions in their mission documents, and the country in the commitments made, for example in the letters of intention with the IMF, maintain a reformist rhetoric, but the goals set are not necessarily met in the time period agreed without this causing grave consequences for the country, or financial restrictions. There is explicit recognition of the restrictions which are imposed on the internal political process when evaluating the government's reform effort. For example, in November 2000, a report from the World Bank gave positive valuation to the government's efforts to permit greater participation from the private sector in activity traditionally undertaken by the public sector, "...given the political mandate against privatization of public enterprises" (a clear reference to the plebiscite which overturned the proposed law of public enterprises). What is more, the IDB and the World Bank (WB) financed expansion projects in some public enterprises in the 1990s without imposing, as a prior requirement, structural reforms such as privatization or the imposition of regulatory frameworks. In the social security reform, the IDB and the WB adopted positions that were very far apart. At the beginning of 1995 the WB questioned the reform proposal which the political parties were negotiating and withdrew its support.<sup>6</sup> The IDB, on the other hand, supported the reform from the beginning, and contributed funding and provided technical and political backing.

These apparent contradictions, and the margins of flexibility that are evident, seem to be explicable in a strategic context in which the multilateral institution recognizes itself to be one of many "principals" who are struggling to influence the policy implemented by the government.<sup>7</sup> In this context, the rational thing to do is concede something if in exchange the reform process can be unblocked.

The situation in trade reform is somewhat different. The multilateral credit institutions have not played an active role in the process of trade reform in Uruguay. If there was some kind of imposition of conditions, it was more global and more in the atmosphere, more on the level of ideas than anything else. But in this instance we cannot talk about a concession on the part of the multilateral institutions since, beyond certain deviations in trade policy, Uruguay is recognized in the international community as a member of the club of Latin American countries which implemented trade reform and opened (Rajapatirana, 1995).

The events which were taking place in the other countries in the region also had an influence on the agenda of internal reforms in Uruguay. There is no doubt that, apart from local idiosyncrasies, reforms like the 1992 public enterprises law, the 1995 pension systems law, and the 1997 law of the regulatory framework for electrical energy, followed general guidelines present in the reform processes which were being implemented in the region. Also the impulse to trade opening which was present in Uruguay at the start of the 1990s was favored by a change in the trade policy orientation of the countries in the region. During those years, the import substitution model was tending to be replaced by a model of trade opening and orientation to exports. The most significant change was that, from the

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<sup>6</sup> At that time, the mission of the World Bank believed that the reform was not sufficiently far-reaching (Olivera, 1999). In the following years, the WB revised this vision and saw the situation in a more favorable light.

<sup>7</sup> This hypothesis fits in with the common agency model which has been developed by Grossman and Helpman, among others. See Grossman and Helpman (2001).

late 1980s and especially at the start of the 1990s, Brazil intensified the process of opening its economy unilaterally. Brazil has about 40 times the economic weight of Uruguay, and this policy change on the part of her biggest neighbor altered the domestic equilibrium in Uruguay in favor of pro-export groups (see Krishna and Mitra, 2000)<sup>8</sup>. Clearly, in the period 1990-1994, the National Party government in Uruguay were conscious of this change. The Mercosur should be understood in the context of this change of model and paradigm because it was an instrument that supported and consolidated this strategy of unilateral opening. All the economies in the region without exception adopted this strategy, although each went at its own rhythm. In this sense, unilateralism and regionalism were not strategies that substituted trade liberalization, they were strategies that complemented it.

Even though the constitutional reform of 1996 has many autochthonous characteristics, it follows the general pattern in the region. The introduction of the majority run-off system, the limitation to one presidential candidate per party, the primary elections and the separation of the local and national elections are in line with the changes that several countries in Latin America were implementing in those years. In turn, multilateral institutions did not play an active role in the process of political reform.

The Chilean experience had an evident influence and was widely debated in Uruguay. Reform in Argentina also had an effect on Uruguay, but with changing sign. In the first half of the 1990s, the Argentine model was presented by the reformist political sectors as the road to be followed. But afterwards, to the extent that economic results in Argentina turned sour and reports of corruption spread, the experience of our closest neighbor tended more to serve the political interests of opponents of liberal reform in Uruguay.

### **3.2.3 Internal factors: public opinion, parties and social organizations**

*Public opinion* has had a decisive influence on the reform process in Uruguay, conditioning its rhythm and specific content. The opinion of the people has not only made itself felt in the national elections but also in a number of referenda and plebiscites about the reforms which took place during the period. The intense use of mechanisms of direct democracy meant that, on the question of reform, the battle for public opinion was central to the activities of the political parties and of the social organizations involved.

In general, Uruguayan public opinion has been reticent on the question of market-friendly reforms, but some reforms have had explicit or tacit support. The outstanding example here is opening to trade in the region. Although there was debate about the modality of the negotiations, the general principle that Uruguay should become integrated into the region

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<sup>8</sup> Krishna and Mitra's (2000) paper concludes with the following statement: "We find that such unilateral liberalization induces reciprocal tariff reduction by the partner country. Intuitively, unilateral liberalization by one country has the effect of increasing the incentives for the export lobby in the partner country to form and to lobby effectively against the import competing lobbies there for lower protection. These results stand in contrast to the policy arguments that suggest that closing (or threatening to close) one's market would help pry open the markets of others, and some recent results in the literature emphasize institutional reciprocity as an essential means of getting to efficient outcomes".

was widely supported by the people. In other cases, rather than support for reform, there was discontent with the prior situation which the proponents of reform were able to take advantage of. This is what happened with the social security and constitutional reforms.<sup>9</sup>

The Uruguayan political parties have internal factions which hold a relatively wide range of positions on the question of liberal reform. In the traditional parties, these positions go from radical reformists to moderate reformists. In the leftist coalition, the dominant positions are strongly against reform that has its roots in liberalism, but there are factions that have shown some disposition to negotiate moderate reforms.

The traditional parties have occupied the Presidency throughout the period under study, but the dominant factions have varied considerably. The four administrations which have been in power since the return to democracy in 1985 have included two which could be called moderate (1985-1990 and 1995-2000) and two administrations of a more radical nature (1990-1995 and 2000-2005). However, there is no simple and direct relation between the ideological position of the Presidency and the rhythm and extent of the reforms carried out. There was a first significant liberalizing push during the Lacalle administration, in the period 1990-1995, but the stiff resistance which this provoked considerably limited the extent of reform in those years. The next administration was based on a coalition of center factions, and it managed to carry out some important reforms, like the social security and constitutional reforms.

The composition of the coalition government in 1995 is the key to explaining the reforms of that period. The two previous democratic governments, which started their mandates in 1985 and in 1990, negotiated governability agreements, but neither of them managed to make an agreement with the scope and duration of the coalition in power between 1995 and 2000 (Buquet and Piñero, 2000).<sup>10</sup>

The reform of the social security system had been on the agenda of the traditional Uruguayan political parties for a number of years, and there were several unsuccessful attempts at reform before an agreement was reached which led to the passing of the reform law in 1985. Throughout this process, the political parties learned about the social security system which contributed to the design of the new system (Saldain, 1999). There was a plebiscite in 1989 through which a constitutional norm was established to the effect that retirement pensions and benefits would be adjusted in accordance with the index of average salaries, and this was an important factor in the reform. In a context of falling inflation, this index mechanism meant that the amount of the payments made by the social security system increased considerably in the subsequent years, and this aggravated the weak financial situation of the system and help to convince many people that reform was

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<sup>9</sup> Shortly before the social security reform law was passed, public opinion polls indicated that the majority of the population were not satisfied with the prevailing system and that a reform was considered to be necessary. The Ministry of Public Health cited the results of surveys which they considered “promising”. According to these, 70% of the population thought that the prevailing system was unjust or very unjust, 68% felt little or very little protected by the social security regime, and 73% thought it reasonable or very reasonable that the country should undertake reform in this area. Nevertheless, the same survey indicated that Uruguayans did not consider this matter to be a priority (Búsqueda 786, 30/03/95).

<sup>10</sup> See also the opinions of other political analysts who agree with this, cited by Buquet and Piñero.

necessary. During the National Party administration (1990-1995) these factors were already in evidence, but attempts to reform the social security system failed. What was new about the period beginning in 1995 was that the government coalition that was formed by the traditional parties was to last throughout Sanguinetti's second administration.

In the literature, it is possible to identify two hypotheses which attempt to explain why the traditional parties succeeded in maintaining a particularly solid government coalition in the period 1995-2000. Both hypotheses have to do with the 1994 elections, in which the political left grew considerably and the center factions of the traditional parties emerged dominant.

The growth of the left in the 1994 elections was a definite threat to the traditional parties, and it led them to form a more solid coalition than had been the case in the two previous administrations. Filgueira et al (1999) formulate this hypothesis in the following terms, "although the government coalition involving *Blancos* and *Colorados* had existed with greater or lesser continuity and productivity since democracy was re-established, it has been reinforced in the current period by the extent of the growth of "the discontented third party" (the left, which came very close to the other two parties in the 1994 elections), and by the threat of a probable leftist government in the subsequent administration period." Luján (2003) advances a similar idea, "Another accelerating factor in the political timing of the reform, a factor which was not present when the previous projects were presented in the Lacalle administration, was the growth of the *Frente Amplio-Encuentro Progresista* (left wing party) in the 1994 elections. Seen from the perspective of the electoral system as it was in 1995, and given the emergence of a new generation more in favor of the traditional left, the rise of *Frente Amplio-Encuentro Progresista* prompted the *Colorado* and *Blanco* parties to include the reform of the social security system on their agenda in the first phase of their mandate, the so-called "honeymoon phase". Thus, after this law was passed, there would be time for it be implemented before an eventual leftist government came to power, which was expected to happen in the year 2000. Another facet of the situation is that moderate factions in the *Frente Amplio-Encuentro Progresista* saw this as an ideal solution. The matter would be resolved before they came to power, and they would not be trapped in the radical arguments of the groups in the *Frente Amplio* more connected with social actors." Buquet and Piñeiro (2000) also emphasize that the rise of the left in the 1994 elections was an important factor behind the formation of the government coalition which, among other things, implemented the reform in social security.

Lanzaro (2000a: 173-176; 2000b: 291-292) argues that the triumph of moderate or center factions in the traditional parties in the 1994 elections contributed to making the coalition government of the 1995 - 2000 period viable. The episode is consistent with the theory of the pivot or pivotal party, according to which those who are in the center, the middle of the road, are in a better position to pursue a policy of composition and equilibrium, building consensus and reducing dissent. He cites a bibliography which contains evidence that coalitions of the center tend to be more stable and productive (Lanzaro 2000a: 125-127; 140-149).

Some authors have maintained that there is a certain trend for reforms to be initiated when new government periods begin (Haggard and Webb, 1994; Lora and Olivera, 2003).

According to declarations in the press, local politicians seem to share this idea.<sup>11</sup> Paradoxically, there is no theoretical literature which adequately explains this. Nevertheless, there can be a specific explanation for the approval of pension reform in Uruguay at the start of a government's term in office. One of the main arms which the opposition has for blocking reform in the country has been to call referenda and plebiscites on these norms. By constitutional ruling, the reform law for the social security system cannot be overturned by referendum because it is a matter exclusively for the Presidency. The only instrument of direct democracy which opponents of the reform could have recourse to is a plebiscite on constitutional reform. Through a reform of the constitution, the main dispositions of the reform law could be rendered ineffective. But plebiscites can only be called along with national elections. Therefore, by pushing a reform through at the beginning of its period of administration, a government is assured of more than four years in which to organize the new system before it can be put to the test of a plebiscite.

It should be emphasized that the promoters of the social security reform were conscious of the risk of it being overturned in a plebiscite. In previous years, there had been two successful plebiscites to modify articles in the constitution which had to do with social security. In 1989 there was one which introduced the indexing of old age pensions based on the index of mean salaries. Then, in 1994, another plebiscite established that budgetary laws cannot contain norms about social security. These had the effect of overturning dispositions about social security included in the 1991 rendering of accounts. In both cases, the plebiscite was promoted by organizations of retired people, and the effect was to protect the interests of old age pensioners or workers who would soon be retiring. The second case was a clear example of overturning a reform that had been passed in parliament by the political parties. As we will analyze in the next section, the threat of plebiscite did not only condition the timing of reform but also the content.

The positions that the Uruguayan political parties took up on the question of reform were not only conditioned by their ideological posture, but also by links with the bureaucracy. In some cases, public enterprises allow their directors to maintain a high profile in the public eye and a certain capacity to influence the communication media, and this can enable these people to set up platforms for launching political campaigns.<sup>12</sup> A leader with this kind of background is naturally inclined towards a moderate position on the question of reform. For a politician, the creation of an image of leadership and capability in management is incompatible with a process of reduction and limitation in the management of the public

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11 The President, Julio María Sanguinetti, expressed this idea in the following terms, "What is not done in the first year of government is not done in the other four." (President Julio María Sanguinetti. *Búsqueda*, No. 788, 20/04/95, p.3).

12 In the last two pre-election periods, for the elections of November 1994 and November 1999, the directorships of the big public enterprises with the greatest economic importance were platforms for the launch of preliminary candidate nominations from the *Colorado* and National (*Blanco*) Parties. For the elections of 1999, this path was taken by several members of the *Colorado* party, namely Ricardo Lombardo, president of the management board of ANTEL (the State telecommunications enterprise), Mario Carminatti, president of UTE (the state electrical power utility) (*Búsqueda*, 13/11/97), and Ronald Pais, member of the management board of UTE (*Búsqueda* 11/12/97). But the most famous and most pioneering case was Alberto Volonté, president of the UTE board in the period, who, in effect, competed in the national elections of 1994, and whose only previous political role had been as president of UTE.

enterprise which he directs, as would result from a radical reform, from privatization, or even from a significant reduction in the economic weight of the enterprise in that sector.

Various *interest groups* were intensively active in the matter of the reform process. What stands out here is the militant attitude against reforms which the unions in the public enterprises and the associations of pensioners have shown. This is the classic case of groups made up of people with relatively uniform interests, and with the capacity to resolve the problems of internal free riding, involved in collective action (Olson, 1965). They aim to win over public opinion so as to block the reforms through plebiscites and referenda. They organize campaigns to convince the public, and they set legal mechanisms in motion which lead to the exercise of direct democracy. In various instances, the changes which their activity caused, and the political situation that they created by submitting certain laws to direct popular vote, prompted some political sectors to change their position. This experience seems to indicate that obtaining backing from the left was a necessary but not sufficient condition for success in plebiscite campaigns.<sup>13</sup>

As a rule, employers' groups adopt a favorable position on the question of structural change because of the hypothesis that this will reduce both the weight of the state in the economy and charges for public services. But, in general, they have not been important actors in the reform process, probably because they were not able to overcome the problem of internal free riding because of the relatively diffuse and specific character of the advantages which they would obtain from a reduction in the costs of the state. The reform in the port is the only case in which a (smallish) group of businessmen had a keen interest in reform, and they organized themselves to exert influence in the situation.

The fact that entrepreneurial groups have been so little involved in reform could also be due to their having divergent positions and interests that do not always coincide with the reforms. Unlike the workers' unions, which had a single central organization, entrepreneurs were grouped in a number of different business associations whose positions were different if not totally opposed to each other on the question of the reforms. Banks, for example, maintained a low profile, and their position with regard to laws geared to promoting the development of the capital market was ambiguous because the capital market is a competitor to bank credit. In this ambit, only the administrators of retirement savings funds seemed to take an interest in the development of the capital market and in its legal instruments.

More generally, the reform reduced the scope for rent-seeking, an activity in which some leading Uruguayan entrepreneurs had become quite skillful. Finally, the reform involved a considerable degree of individual uncertainty, and many firms could not tell for sure whether they would be among the winners (the Fernández and Rodrik effect).

Political reform is an area in which interest groups were not seen to participate actively. Since it does not affect specific groups with well-defined interests, the debate about electoral and governmental reform remained in the specific ambit of party political activity.

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13 In that period, there were a number of interesting cases in the country of lobbying activity based on the transmission of information in a way that Grossman and Helpman (2001) analyze in part 2 of their book.

We can suppose that this non-intervention on the part of the social organizations benefited reformist sectors because the groups with the greatest capacity for organization invariably line up with the positions of the left, and the majority of the left coalition opposed to reform as it would negatively affect their chances in the elections.

In some areas the government was able to effect reforms without needing to have recourse to support in parliament. The outstanding example is trade policy, which was changed mainly by decrees and resolutions with parliamentary participation.<sup>14</sup> Besides this, the government was able to take a number of infrastructure construction works out of the state sphere through mechanisms of awarding contracts for highways, airports, and water and sewage system concessions to private enterprise.

Another instrument of trade policy was conventions and treaties, and in this area the President is relatively autonomous from parliament. In the period, there was the Mercosur treaty of Asunción (1991) and the World Trade Organization Act of Marrakech (1994). In both instances, in spite of debate about approval, the ratification laws constituted a package which was approved without being opened. These two agreements constrained the scope for government discretion in trade policy.

## **4 What kind of reform is better adapted to achieving its objectives?**

### ***4.1 Politics and policies in democratic Uruguay***

Since the return to democracy in 1985, Uruguay has shown a high degree of political inclusion, decentralization of power, and political and social participation. Intensive negotiations have taken place between political parties and social organizations, which each hold a considerable degree of power. It has not been easy to arrive at agreements in a number of important policy areas. Contrasting views and different interests have made the negotiations rigid and often harsh, and as a result the reform process in Uruguay may look sluggish and incomplete. But at the same time, and despite serious disagreements in this field, the country exhibits a remarkable degree of political and social cohesion. A general hypothesis of this research project is that the gradualism of the Uruguayan reform process and political and social inclusion go hand in hand.

The central proposition of this study is that, in Uruguay, there is not simply a “blocking” of reforms, as some have argued, but a manner of implementing reforms which permits progress to be made in a peculiar and distinctive way. What in fact comes out is gradualist and moderate political engineering, which sets the mode of the reform processes with respect to itineraries and also with respect to results.

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<sup>14</sup> Rajapatirana (1995) identifies this same pattern of trade policy in many countries.

As a basic hypothesis, we maintain that this gradualist and moderate logic is a result of political competition in a pluralist democracy like that which took over in Uruguay after the authoritarian regime ended. It sprang specifically from the characteristics of the government regime, the electoral rules, and the transformation of the party system. This gradualist and moderate “incremental” logic is the result of the political dynamic. In concrete terms, it stems from the competition between parties and factions within the parties which shapes the course the government takes, regulates innovative initiatives, and mobilizes the “veto players”, setting certain parameters as to styles of leadership and reform coalitions, building consensus and reducing dissent. What we have here is a “modal pattern”, characteristic of pluralist democracies like Uruguay, which generates a process of “muddling through” (Lindblom 1959) with continual compromises and adjustments in the implementation of public policies.

It is important to note that, generally speaking, gradualism is not necessarily the result of any determinate political will. It is rather the objective resultant that “emerges” from the conflict of interests of the forces in play, and in particular from the competition between parties and factions within parties. In this general outline, gradualism is also “the law of the game”, proposing a kind of “legality of change”, that is to say, the model to which the proponents of reform have to adjust in order for their proposals to be workable, efficient and legitimate (building consensus and reducing dissent). This is the key to how to go through the “eye of the needle” in the Uruguayan system. In fact, as we shall see in different chapters of this study, the most successful initiatives are those which mould themselves to this model and meet at least two requirements: a) Presidential leadership which is both innovative and transactional, and b) a centrist, moderate, reform coalition, which makes progress by proposals for compromise.

As Lindblom would say, it is the “science” (wisdom indeed) of “muddling through”. The reform of the social security system and the reform of the electoral system with the Constitution of 1996 provide two good cases for the discussion of these premises, and comparison with other, less successful initiatives. It is no coincidence that both these examples come from President Sanguinetti’s second administration.

Before going more deeply into this explanation, it is essential to make a preliminary distinction. Some of the reform processes in Latin America have been undertaken under authoritarian regimes. The paradigm example of this is Chile under the Pinochet dictatorship, a period when there was radical “liberalization” of the economy, changes in the structure and in the functions of the state, and also constitutional reform which, to a large extent, still holds sway. Uruguayan reform also took place under the dictatorship and under democracy. The milestones of financial, domestic and foreign liberalization, and the first steps to trade liberalization, were established during the dictatorship, but the Uruguayan dictatorship did not have the “foundational” style of that in Chile.<sup>15</sup>

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<sup>15</sup> A complete inventory has not yet been made of the measures which were adopted during the dictatorship. Some economic and political science studies have made contributions to our knowledge of this, but quite a lot remains to be researched.

This trend is of fundamental importance but it is not the whole story because not all democracies fit the same pattern. Therefore it is necessary to move up to a different level of differentiation. In fact, with all due respect to other classifications, in this area we can distinguish “majority” regimes, “populist” or “neo-populist” formulas and “pluralist” systems, and Uruguay can be considered as a “leading case” in this last category.

## **4.2 Basic knowledge: values and information**

### **4.2.1 Values and ideology**

Public opinion has been a decisive factor in shaping the reform process, and certainly politicians have to pay heed to it regardless of their constituencies. The following data on the profile of public opinion in Uruguay (*Latinobarómetro* poll series 1995-2002) illustrates some values to do with economics that are widely held.

- Uruguay’s approval of the *free market economy* is by far *the lowest in Latin America*: 35% versus a continental average of 57%. It is among the four countries that are least satisfied with this system (10% satisfaction versus the Latin America average of 24%).
- Only Argentina has a more negative view of privatization than Uruguay: the former has an approval rating of 14% and the latter of 16%.

Thus public opinion in the market versus state debate is tilted in favor of the state. Although this is harder to document, swathes of public opinion have a negative perception of the financial sector and show some distrust of financial globalization. Not surprisingly, while the general public tend to favor financial regulation and supervision, some actual and would-be market participants demand less regulation and more freedom to operate. On more technical questions, a part of the legal profession with center-left leanings have voiced concern about the private parties’ choice of jurisdictions enshrined in the new capital markets legislation.

A considerable proportion of the population does not trust private enterprise and they tend to associate it with corruption, profits taken out of the country, excessive charges and bad service. There is a perception that the big enterprises which operate public services in the world would have too much power relative to the small size of the country, and Uruguay would not be able to “defend itself”.

The idea of protecting the domestic market as a way of protecting national employment from the rest of the world is deeply rooted in Uruguay. Trade opening contradicts the common sense view derived from this idea, and is therefore potentially conflictive for this society. Another idea which goes hand in hand with this is that Uruguay is a very small country and that economic growth must be led by exports.

Social security policy tends to be strongly conditioned by values and ideology. In the debate about reform there are at least two dimensions with powerful ideological connotations, the state versus the market, and equality versus efficiency. On the one hand, the fact that public opinion in the country does not trust the market makes it unlikely that a sweeping privatization reform could be successful. Therefore, the reform should reserve a dominating role to the public pillar in that system. On the other hand, although all the political and social actors involved in the reform process agree that the social security system ought to be redistributive and efficient, while the promoters of reform see these objectives as being a political dilemma, opponents do not seem to see it the same way. The parties and technicians who support the reform maintain that the tenuous correlation between contributions and payments in the old system generated powerful incentives for evasion and informality. The goal of the reform, therefore, was to give greater financial equity to the system in the expectation that this would increase incentives towards formalization. Opponents of the reform tended to attribute the inefficiency of the system, including evasion and informality in the labor market, to poor management in the administration of social security. In any case, and going beyond the differences noted here, the shared objective to develop redistribute policies through the pension system meant that the payments pillar had to continue as the basis, and the pillar of individual savings as a complementary component.

#### **4.2.2 Information and uncertainty**

Uruguay is a relatively simple and homogenous country and it has a relatively good statistical information base by Latin American standards. However, opponents of reform and various independent analysts have argued that the lack of information, transparency and experience, particularly in regulatory matters, increase uncertainty with regard to the way some reforms could function.

In the sphere of foreign trade, there are no restrictions on the implementation of reform that stem from lack of knowledge. Many national and international studies have identified the costs of protectionism in the country. Among these a number of studies made in the framework of different World Bank projects stand out (Corbo and De Melo, 1987; Connolly and De Melo, 1994; Rajapatirana, 1995; Shatz and Tarr, 2000).

In other areas there is a lack of information and transparency which could have had an influence on the success of the reforms. There was no experience of regulating public services before the attempt at reform began, and there are no studies that evaluate the possible effects of the reforms.

Absence or poor disclosure is the landmark of domestic corporate and financial sectors, often operating under weak regulation and supervision. López-de-Silanes' (2002) databases show that the ratings of Uruguayan accounting standards are clearly below the developing countries average. Other institutions for which there is a dearth of information are the following:

1. Dominance of the banking system. By its very nature, the lack of a secondary market for loans tends to make this area opaque.
2. The old syndicate of brokers, which is the backbone of the Montevideo Exchange (BVM<sup>16</sup>), has had little interference with its own self-regulation. At the end of 2002, the Central Bank had to take steps to make externally audited accounting statements from brokers in general a compulsory requirement. The market microstructure of this exchange is such that much of the turnover in securities goes unreported, unlike its more recent rival, the electronic exchange (BEVSA<sup>17</sup>).
3. The way the bankruptcy regime currently works makes for very delayed disclosure of financial distress on the part of corporations, and this harms creditors and competitors.

There are large areas in the social security system where information is lacking. Like the other countries in the region, Uruguay did not have records of labor histories when the reforms began. This lack has a serious effect on the quality of the financial projections which were made, and generates uncertainty about the extent of evasion.

A number of politicians and social actors who resisted the reforms, or who recommended greater prudence in implementation, based their arguments on these information problems, and in particular on the state's lack of experience and capacity to regulate the private sector.

### **4.3 Policy formulation**

Like in other countries, the most liberal Uruguayan reformers argued that the market economy, if allowed to function freely, would lead to economically efficient results. On a very general level, the low rates of growth which the country had in the 20<sup>th</sup> century was attributed to strong state intervention which isolated Uruguay with trade protectionism, eliminated competition by introducing monopolies in key sectors of the economy, expanded the size of the state excessively, caused macroeconomic instability, and generated legal uncertainty when there was intervention in private contracts. In line with this diagnosis, the solutions proposed included opening the economy to foreign competition, reducing the role of the state in the economy, and adopting orthodox macroeconomic policies which would guarantee stability. However, in Uruguay, the liberal sectors have never had enough power to carry their reform program through by themselves. Consequently, the possible alternatives were rather more varied and recognized idiosyncrasies that were local and in different reform areas. Besides this, local debate fed on different contributions and to a large extent mirrored universal academic debates and proposals which were going on in the rest of the region.

There is debate on two levels about the formulation of policies of trade opening. First, there is debate about whether the best option is to open unilaterally or to follow strategies of a reciprocal kind (lowering barriers to trade as a counterpart to the lowering of barriers by trade partners). The most liberal position does not only maintain that trade opening is the

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<sup>16</sup> The Montevideo stock exchange.

<sup>17</sup> Bolsa Electrónica de Valores SA (the electronic stock exchange company).

best option, but also asserts that countries which have undertaken strategies of unilateral opening have enjoyed better economic performance (Bhagwati, 2002). The second debate has to do with selecting the best strategy for reciprocal trade liberalization, that is to say it is the debate between regionalism and multilateralism. Within the group of reciprocal strategies, a distinction can be made as to whether they are discriminatory with respect to the rest of the world (regionalist) or whether they are not (multilateralist). There was widespread debate on this, and it intensified in the 1990s. In it, the reasons for the rise of regionalism in that decade emerged. Besides, there was the question of whether regionalism would improve general welfare beyond the classic effects of trade diversion and trade creation. There was also discussion about whether regionalism is a substitute strategy for multilateralism or if it is complementary. In general terms, the predominant positions in the mainstream of the profession, and in particular in the multilateral credit institutions, changed from a posture of warning and precaution about regionalism to a more pragmatic and eclectic position on this point, and even, in certain cases, to a sympathetic view of the experiences of regional integration.

Legislative reform aimed at promoting the development of a capital market introduced elements that belong to common law into a civil law legal system. According to La Porta, López-de-Silanes, Shleifer, and Vishny (1996, 1997, 1999) and López-de-Silanes (2002), financial sector development and the legal tradition of an economy are consistently related. Common law countries generally have the best, and French civil law countries the worst, *legal* protection of investors (creditors and shareholders). Countries that have German civil law as a base come somewhere in between. Ownership concentration is negatively related to investor protection, and is very widespread all over the world. Diversified shareholding is unlikely in countries that fail to protect the rights of outside investors. Poorer investor protection, whether because of the content or rules or the quality of enforcement, is consistently associated with smaller and narrower capital markets (equity and debt). Uruguay is no exception. It is inserted in the tradition of French civil law, and it has not been able to develop a significant capital market. The legislation passed in this period was an attempt to change this state of affairs.

In the area of social security, the multi-pillar model of the World Bank (1994) is an analytic reference framework of critical importance. The recommendation of a combination of public payment pillars and private pillars of individual capitalization in variable proportions according to local history and idiosyncrasies is a plan which is able to embrace different visions and preferences about the pensions system. After a long negotiation process and various failed attempts at reform, the new government coalition finally managed to get a mixed system with a strong public payment component into law.

The demand for political reform stems from two different sources. On the one hand there is the resurgence of the old critical discussion which saw the Uruguayan electoral system as a corset that favored certain party interests<sup>18</sup> which impeded citizens' wishes from being

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<sup>18</sup> "Designed in successive stages by both the traditional parties, it was intended to simultaneously perpetuate the electoral majority of these parties against the challenge from the left, and to reduce as much as possible the very intense centrifugal forces which they have gone through since their origin." (De Sierra, 1992:14).

adequately translated into political terms.<sup>19</sup> On the other hand, a new academic model was developed, inspired in the recently publicized neo-institutionalism, which saw the reasons for a blocked and inefficient system in the different aspects of the rules of the political game.<sup>20</sup>

This academic neo-institutionalist stream oriented its criticism towards two aspects of Uruguayan institutional engineering. On the one hand, as an echo of the work of Juan Linz, it questioned the Presidency-centered organization of the government regime. In this case, the discussion lacked any particular autochthonous features. It was based on general reasoning, and maintains that a Presidential government regime favors the creation of political blocs since it does not demand that majority legislative coalitions be formed (Pérez Antón, 1987, and Pareja, 1990). Moreover, the Uruguayan electoral system can be accused of fostering excessive and increasing internal factionalism in the political parties.<sup>21</sup>

To sum up, no sooner had democracy been re-established than the general diagnosis of the prevailing institutions was sharply critical. Most of the political and academic class agreed on the pressing need to carry forward political reform to avoid a repetition of the errors of the past which had been so costly for the country. Added to this there was public opinion which, after an initial period of enchantment with democracy, also increasingly began to criticize the political system and its rules of play. In this context, different political reform initiatives proliferated and they had different degrees of success.

#### **4.4 Decision making**

In general, the traditional parties have been the promoters of reform and they have met resistance from the coalition of the left, but neither of the two sides has been a single united force. There are many factions with different visions and interests, and this led to complex negotiations in which all the players had to make big concessions. The active participation of interest groups which used referenda and plebiscites to block the reforms also had a powerful influence on the content of the proposals. Although the players lined up in a relatively uniform way in accordance with their political areas, the manner in which negotiations went, and the results achieved, varied considerably. They depended on some characteristics of the areas of activity involved, on legal instruments which could be used, and on options for reform.

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<sup>19</sup> This is the most generalized criticism, and the old civic leader Juan Vicente Chiarino summed it up most ingeniously in a well known quotation, "In Uruguay the vote is so secret that not even the voter himself knows who he is voting for." Pérez Pérez maintains that the "consequences of this regime are fatal for the integrity of suffrage; an opposition *Colorado* voter, for example, may unknowingly be voting for the continuation of the current government, or vice versa, and he will only know for certain which of these two things has happened after the votes were counted." (1970:66).

<sup>20</sup> The bulk of academic work about this original impulse was shaped in three compilations, Nohlen and Rial (1986), Franco (1986) and Cocchi (1988).

<sup>21</sup> "...the electoral legislation actively promoted the break up of the parties." (González, 1991:19).

For Uruguay, joining the Mercosur was the path of trade opening on which most progress has been made since the return to democracy. It was a choice in favor of reciprocal rather than unilateral opening, and it was regional rather than multilateral. Although the most liberal political factions frequently questioned this route, the force of circumstances prevailed in the end. First, there was the effect of geography. International trade is still mostly regional, and this is accentuated in the case of Uruguay because it is a small country which borders on two countries which together have more than fifty times its economic weight. When, at the start of the 1990s, Argentina and Brazil decided to initiate a process of regional integration which would lead to the formation of the Mercosur, it was difficult for Uruguay to go in a different direction.<sup>22</sup> Second, the option of Uruguay opening up unilaterally to the world is problematic because it is a country with a temperate climate which exports agricultural products, that is to say products against which trade protectionism in the developed countries is particularly strong. Third, the left and the union organizations were strongly opposed to unilateral opening to the world but they supported the process of regional integration. In the end, something happened which was almost unheard of in Uruguayan politics, the treaty of joining the Mercosur was almost unanimously ratified in parliament. The broad support for the Mercosur did not mean that there was no debate about specific points, but even so the position in favor of the regional integration process was absolutely dominant. In the face of this situation, the most liberal factions opted for supporting the process in the hope that it would be the first step towards wider opening (open regionalism).<sup>23</sup>

Public services is one of the areas in which reform encountered its greatest difficulties. The most liberal attempt, which was the 1992 law of public enterprises, was roundly defeated in a referendum which rejected a number of fundamental articles in that law. More than two thirds of the people declared themselves against these articles, and this was universally interpreted as a clear message from the electorate against privatization. Opportunities for this kind of policy have been very reduced since that time, and now moves towards privatization are basically limited to the concession of public works (highways, water and the sewage system). Even in this ambit there is intense opposition, and on a number of occasions this has slowed down the concession process (for example, the international airport at Carrasco). The policy of privatization reached such a low point that the “accusation” of being in favor of it became enough of a stigma to discredit a policy in the eyes of the public.

A number of factors lie behind the political failure of privatization in Uruguay. First, as was mentioned above, the people strongly distrust private and market enterprises. Second, the unions in the public services are very well organized as interest groups and they have the

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<sup>22</sup> It is interesting to observe that Uruguay took steps towards joining the Mercosur during the administration of Luis Alberto Lacalle, the leader of the most liberal faction in the National Party (*Blancos*).

<sup>23</sup> In fact, in the Mercosur there was a kind of complementarity between the strategy of unilateral liberalization and that of regional integration. First, as has been pointed out in the literature, in a natural bloc like the Mercosur, unilateral opening generates trade integration (see Garriga and Sanguinetti, 1995, and Ons and Kamil, 2003). Second, regionalism in the Mercosur countries has been associated with a policy of gradual increased opening of the region with respect to the rest of the world, and was used as an instrument to give greater credibility and commitment to this trade liberalization process. This is what happened in Brazil with the Common External Tariff in the Mercosur (cite World Bank report of integration).

capacity to mobilize. They were able to take advantage of instruments of direct democracy in legislation, and also of public opinion, which was mostly against privatization, to block the process. Third, the traditional parties showed greater internal disagreement in this than in other fields of reform. The less liberal factions in the *Blanco* and *Colorado* parties were little inclined to privatization (it was these same parties which had founded the public enterprises some decades before). The link between these parties and the bureaucracy and management of the public enterprises also weakened the privatization strategy.

With the privatization route closed, the reformist agenda in public services was re-oriented towards removing monopolies, the deregulation of competition, and association with private firms in new undertakings. But even these efforts met with stiff resistance, and this has made progress slow and perspectives are uncertain.

In 1997, the law of the regulatory framework for the electrical energy industry was passed, thus ending the legal state monopoly on generating electricity. However, in the six years since the law came into force there have not been any private projects for generating electricity, and steps have been taken towards setting up a new public plant for the supply of gas. The regulatory body in this area was only constituted some years afterwards.

In telecommunications, the government tried to bring about competition in mobile and long distance telephony, but this provoked a process of collecting signatures to authorize a referendum against the new legal dispositions. Faced with the imminent threat of going to the country, the government eventually wrote off the controversial articles. While the law was in force, a number of long distance international operators entered the field so the market changed considerably and there was a marked reduction in the price of the service. The abolition of the controversial norms is impeding the entry of new operators into this market. However, the government's interpretation is that this abolition does not mean that the licenses awarded to firms that entered the market in the short period when the norms were in force have to be revoked.

Lastly, in the area of petrol refining, the government managed to get parliament to pass a law which removes the monopoly on activity in this ambit and permits the state enterprise to associate with private firms. This law was widely negotiated, and legislators from the leftist coalition made important contributions to drawing it up. But in the end the left wing coalition did not vote for the project, and eventually they supported a campaign for collecting signatures, organized by the union in the public petrol refining enterprise, to call a referendum to remove key elements in the reform law. The campaign was successful, enough signatures to submit the law to a referendum were obtained, and this will take place in December 2003.

The government managed to implement some reforms in public services which had one or more of the following characteristics:

- A law was not needed, therefore there was no opportunity for a referendum: infrastructure sectors of highways and airports, concessions for water and the sewage system.

- The reforms affected sectors which provided services that were not on a massive scale: privatization of the gas utility (piped gas), the infrastructure of highways (the users of the highways in question are a relatively small group of agents whose profile differs from that of the average consumer, and who are surely more in favor of market reforms than he is), ports, water and the sewage system (some very limited areas and seaside resorts were involved in the concession).
- The expected gains from the reform were evident, and the beneficiaries of the gains are few and are well organized (ports).
- There is a large unsatisfied demand, or what is involved is the development of a sector in which state enterprises do not play an important role (transport and gas distribution).

The Ports Law is a special case as regards how union opposition was handled by the reform group. The workers in the port were divided into two groups, port workers, who were affiliated to the PIT-CNT union federation, and stevedores, whose union was outside the federation. The stevedores were organized in ANSE (National Administration of Packing Services) which regulated the contracting of stevedores. The stevedores blocked the entrance, and this gave them considerable negotiating power. Under the Lacalle government in the first half of the 1990s, the stevedores were encouraged to leave their jobs through economic incentives. The present Batlle government eliminated ANSE. This process was successful, and trouble with the stevedores, who were traditionally conflictive, was avoided, while the workers of the ANP (National Port Administration) did not have the capacity to oppose the reform. The rest of the private actors who use port services implicitly supported the new system because the cost of moving merchandise through the port of Montevideo decreased considerably as a result of the regulatory reform.

The model chosen for the reform of the pension system was very conditioned by the initial situation of the system (mature and with wide cover), by the negotiations between the political parties and their factions, and by the threat of possible vetoes from social actors. A mixed system was passed, with the state having majority participation. The public distribution pillar will continue to be responsible for approximately three quarters of the benefits when the system is mature (and more during the transition), the individual savings pillar is obligatory only for the income band above approximately 800 dollars of 1995, and, by disposition of the reform law, a state administrator of pension funds was set up.

The wide cover and the maturity of the system of payments made it difficult to finance a reform which incorporates a very considerable individual savings pillar. These considerations were expressly taken into account by the political sectors which promoted the reform. According to some of the main protagonists, there had been financial projections which led them to rule out more radical reforms (Saldain, 1999).

The reform in the pension system is also clearly the result of a complex process of negotiation among the three parties which cover a fairly wide range of the political spectrum, from center-left to the right. The majority factions in the government coalition, which was formed in 1995, are towards the center of the political spectrum in their

respective parties. The more liberal factions, proponents of more radical pro-market reform, were a minority in the 1994 elections. These center factions and their leaders, President Sanguinetti and the president of the directing council of the National Party, Volonté, have managed to operate as arbiters in the negotiations between the more radical positions (the liberals and the proponents of state control).

Interest groups played a secondary role in the negotiations, which took place during the early months of 1995, and which led to the passing of the social security reform law. However, they were very much taken into account in the reform, because of their history and the threat of a plebiscite which might overturn the reform. Various aspects of the reform law were directly linked to an attempt to reduce the resistance that different interest groups might offer. First, there was an attempt to neutralize pensioners by expressly establishing that their acquired rights would not be modified. Second, in order to neutralize resistance from the active sectors, the obligatory individual savings pillar was limited to the higher income bands, and workers were given the option of contributing to the individual savings pillar for lower incomes which included a considerable bonus. Third, the law laid down that a state administrator of pension funds had to be established before any private administrator could be set up. This disposition sought to offer guarantees to a population which had already clearly shown that it did not trust private enterprises, and it was an attempt to deflect “accusations” of privatization. Fourth, the reform was aimed at strengthening the Government Pension Bank (BPS), which is the public body that was traditionally in charge of the social security system in Uruguay. The strengthening of the BPS had the approval of the general population, and particularly of employees of that organization. Lastly, the reform law left outside its ambit of application a number of important groups that might have offered serious resistance, the military, the police, bank employees, public notaries and the professional class.

The multilateral credit institutions do not seem to have exerted any significant direct influence on the process of negotiating the pension system. Although it is undeniable that there is intellectual influence on reform in Uruguay from the model put forward by the World Bank, the specific content of reform packages were negotiated internally and with a high degree of autonomy. The incident involving the mission from the World Bank was significant in this. A number of declarations from the president of the IDB corroborate this thesis. Different accounts of the negotiation process show that the reform is the result of complex negotiations involving different factions from the Uruguayan political parties.

#### ***4.5 Implementation, initial conditions, the sequence of events***

In a way, the implementation phase is the moment of truth for reforms. It is the stage in which reformist forces must demonstrate their capacity to go from words to deeds. It has been pointed out that reforms often bogged down in this stage because governments lacked the capability to carry through public policies. For example, we can doubt the skill of some governments to manage a privatization process and implement efficient regulation mechanisms as they themselves were not capable of efficiently running the public enterprises which they were proposing to privatize.

The implementation of reforms can also be complicated by opposition from interest groups who find opportunities at this stage to block changes they do not agree with. Rius and van de Walle (2003) quote Grindle and others (1980) who argue that, in low-income countries, participatory pressures emerge mainly in the implementation phase. Because of the weakness of interest groups and the low administrative capacity of the government, the decision-making process tends to be closed, non-participatory and elitist. As a result, the argument goes, interest groups try to block policies they oppose at the time of implementation, bringing about a wide gap between "*de jure* or official policy and *de facto* or actual policy".

In our view, the Uruguayan case does not exactly fit this pattern. Since 1985, the reforms in Uruguay have been extensively debated, with active participation of all political parties and many social groups. Referenda and plebiscites have provided vocal groups with a powerful weapon to let their voice be heard. These tools of direct democracy have been used on a number of occasions to block reforms, but even when it did not come to this, the threat of referendum hung over the design of the reform. Its influence, then, was considerably greater than one might suppose from counting up the number of successful plebiscites. This does not mean that the interest groups opposed to reform would not have tried to block reforms which reached the implementation stage, but in any case there does not seem to be a clear bias towards blocking reforms in this final stage of the process. Be that as it may, many of the difficulties which the reform programs faced made themselves strongly felt in this stage.

Trade reform is a clear example of a policy which had a number of ups and downs caused by the changing conditions of the situation. Before the 1990s, trade reform made progress as unilateral opening. The opening process increased in the first half of the 1990s, but now it was in the framework of a process of regional integration. In 1994, the Marrakech agreement was ratified in the framework of the World Trade Organization, in what can be characterized as reciprocal multilateral opening. However, the Mercosur agreement had greater scope for Uruguay than the Marrakech agreements. The 1995 to 1999 period was a time of convergence towards both a common trade policy in the Mercosur and general rules of the World Trade Organization. Finally, from 2000 to 2003, there has been a move back towards protectionism which stems from the serious crisis which has affected the country and its main trade partners in the region.

The reform of public services has varied considerably from one area of activity to another, and has changed during the period being studied. In part, this diversity is due to different initial conditions, but more important than this is the fact that there seems to have been a lack of a clear dominant model. In Uruguay, various political sectors were competing to impose their different visions of reform, and there was no single and consistent leadership to the process as there had been in Britain under Margaret Thatcher or with Felipe González in Spain. The referendum which overturned the public enterprises law in 1992 forced the reformist sectors to reformulate their proposals, but even before that episode there were changing policies which, while contracting services to third parties, undertook new investment and developed new areas of activity in the public enterprises.

There are a number of examples of this policy of attempting to strengthen Uruguayan public enterprises just when the privatization model was at its apogee. The public electricity enterprise was restructured between 1995 and 2000 in a transition which involved considerable investment. More significant still is the case of the state petrol enterprise, which in the 1990s invested in an overhaul and an expansion of its refining capacity, bought a distribution company for petroleum products in Argentina, and shifted the distribution of petroleum products in Uruguay to a private company which traditionally distributed fuel under the trademark of the public enterprise. In this period, no progress was made in opening the sector to competition. The first government declarations about the need to deregulate the market of petrol-derived products dates from 1993. Deregulation meant that the public monopoly on imports would be overturned and new importing distributors would be allowed into the market (*Búsqueda* 25/03/93 and 20/05/93). In spite of this, from that date until 2002, there were no significant changes in the institutional or regulatory panorama in that sector. The area of mobile telephony is another example of a public enterprise which continued to extend its activities during the period. The mobile telephony service was first offered in Uruguay in 1992 by a private company, but two years later the public telecommunications enterprise came into the cellular phone market. From that time until the end of 2001, the mobile telephone market was a duopoly in which one of the two companies is a contractor for the other. This means that there was no real competition between the firms since, to a large extent, decisions about technology were taken by the state enterprise, and the private company fell into line.

At the same time, successive governments have been promoting reforms which involve privatization, the breaking up monopolies, and the design of regulatory systems. However, no significant progress was made in privatization since the 1992 law of public enterprises was overturned by referendum, which rapidly blocked that road. Then, norms were enacted which dismantled monopolies in a number of public services including electricity generating, long distance and cellular telephony, and the refining and importing of petroleum products. But there have not been big changes in competition in these areas, except for long distance international telephony. This is either because private investors have not come forward (the generation of electricity), or because the norms were later abolished or are threatened with abolition through the referendum process (telephony, petrol). Lastly, during the administration of the present government, bodies to regulate competition in a number of public service areas have been established. However, the lack of progress in privatization and dismantling monopolies has led to uncertainty as to what scope these bodies will have in practice.

In the first half of the 1990s, the government made a number of attempts to reform social security but these did not attract the necessary political backing. The few changes which were introduced into legislation, and which did not alter the basic rules of the system, were reversed in a plebiscite in 1994. But after the reform law was passed in 1995, the new dispositions have gradually been implemented, and, up until now, obstacles which might force a change of course in this policy have not emerged. The change in the pension regime is going through slowly, but this is not the result of problems in the implementation of the reform but because it is in itself a gradual process.

The reform of the Uruguayan social security system is clearly gradualist. A first sign of this can be found of the full recognition of the rights acquired by retired people in the previous system. Besides this, the new norms modify only slightly the conditions for access to benefits for those workers who had acquired the right to retire but had not yet begun the retirement procedure when the reform started. Another sign of gradualism is the introduction of the so-called “transition regime”, a reformed pay-as-you-go regime applicable to workers who were 40 years old or over when the reform began. Lastly, various changes in the parameters of the pay-as-you-go pillar were programmed for gradual implementation over a period of several years.

It does not seem possible to identify one single reason for this gradualism in the reform of the Uruguayan social security system. The first fact to point out is that President Sanguinetti in general defended a gradualist strategy rather than shock strategies, quite apart from the specific reform of social security that took place during his mandate. To this we can add that the other leading partner in the coalition government also had a clear preference for gradualism. The government coalition was in the political center, and it was gradualist.

Concern with mitigating the financial costs of the transition also contributed to the choice of a gradual strategy. The fact that when the reform began only those under 40 years old would be fully incorporated into the mixed regime considerably reduced the deficit of the transition. Statements cited above by Saldain, who was one of the architects of the reform, indicate that this effect was expressly sought by the reformers. The transition was designed to be long in order to distribute the costs of the adjustment over time. Lastly, gradualism was to some extent a by-product of the strategy of de-activating blockages caused by opponents. There was an attempt to reduce opposition by excluding different generations and some groups of workers from the reform.

The constitutional reform was implemented without much difficulty. The reglament for primary and local elections generated some political confrontation, but the reformists managed to get through. It is not an area of reform in which it seems possible that opposition blocs might form in the implementation stage. This does not mean, however, the reform can be called successful in terms of achieving its declared objectives, that is to say bestowing greater governability and transparency on the electoral system.

## **5 How well did the reform perform?**

### ***5.1 Technical and political evaluation of the reform***

The recent performance of the Uruguayan economy has been extremely disappointing. Since 1999, the country has been going through one of the longest recessions in its entire history, and a very serious fiscal and financial crisis came to a head in 2002. There is no doubt that this crisis will have far reaching negative consequences for the Uruguayan economy in the years to come. The question naturally arises as to the extent to which the market-oriented reforms may be responsible for these recent developments. Of course, the

fact that the crisis followed some attempts at reform does not mean that these policies should be blamed for the negative situation. Some analysts even claim the opposite, i.e. “that the problem was not too much reform but too little” (Cardoso and Galal, 2002). Nevertheless, even if the problem was “too little reform”, it can be argued that the failure to change traditional policies that badly needed a complete redefinition is a “reform failure” (if not in the narrow technical sense, it is indeed a failure in a broader political sense).

It is not difficult to identify external, basically regional, factors that triggered the recent crisis in Uruguay. The Uruguayan financial and fiscal crises have become prominent examples of the “contagion” and “sudden stop” effects (Calvo,...). However, this is not the end of the story. For one thing, the recession began several years before the Argentine crisis hit Uruguay, and this country showed quite limited ability to deal with the external shock. During the 1990s, Uruguay was not able to escape from the currency overvaluation that characterized the whole region. Yet exchange rate misalignment is particularly damaging in a country in which most financial intermediation is done in foreign currency (mainly American dollars). Uruguay did very little to reduce its exposure to the currency mismatch. Even though inflation fell very much in this period, this was not sufficient to reduce the extent of dollarization in the economy.

Fiscal performance looked quite good during the 1990s, but recent events proved that the Uruguayan fiscal stance was not strong enough for a country of this size located in the Southern Cone of Latin America (the "bad neighborhood" issue). To some extent, currency overvaluation disguised the actual extent of the public debt, which is mostly denominated in dollars. Finally, the financial crisis revealed some important weaknesses in bank supervision and in the management of public commercial banks.

In the 1990s, there was an important change in the structure of production and employment. Total employment grew slowly in a context of intense reallocation across sectors. There were considerable job losses in manufacturing, particularly in import substitution industries (the textile industry), and there was job creation in some exports industries (the food industry) and in the service sector. The specialization index (import ratio to demand and export to production) at industry level evolves in the expected direction.

Trade opening meant greater competition and improved efficiency in the production of tradeables (greater incorporation of technical progress in all sectors). The change in the allocation of resources from import substitution industries to exporters did occur, but it was slow. The contractive adjustment was quicker and more intense than the expansive. While domestic production was quickly substituted by imports, export projects took longer to bear fruit, perhaps because of uncertainty about conditions of access to foreign markets. There was a big increase in work productivity (Casacuberta and Vaillant, 2002). There is also evidence which indicates increases in the total productivity of factors (Fachola, Casacuberta and Galdenman, 2003). The rewards for skilled workers increased, but jobs were lost among unskilled workers. In Uruguay, the good distributive effect of trade opening did not occur, that is to say there was no repeat of the “China case”, where rewards for the unskilled worker increased.

Over the period as a whole the lobby against opening weakened, and the influence of the sectors with comparative advantages increased. Thus political economy in favor of maintaining the opening has been reinforced. However, the recent crisis has to some extent stimulated a return to the protectionist philosophy (leftist-unions, but not only them).

From a technical point of view, the structural reform process in the electricity sector has attained some of the objectives set by the promoters of reform. A regulatory body has been set up with the technical capacity to administer the implementation of the regulatory framework in this sector, and the Presidency has laid down rules which are detailed enough to try to implement application. An administrative authority has been established for this market. However, no new private actor has been incorporated into the sector, and the wholesale market is not yet in operation. From the political point of view, the implementation of structural reform in the electricity sector has also had mixed results. The coalition government was able to defeat the left in the 1998 referendum and maintain the law in force. But the processes of debating the law and establishing the regulations involved made it clear that although the *Colorado* party in the government had lined up in favor of a non-radical reform, different party factions took up different positions when it came to implementation.

It is not appropriate to make a technical evaluation of the reform in the petroleum sector because we have not yet come to the stage of implementing the main changes introduced in the period. In the political sphere, it seems that the strategy of the proponents of the reform has been successful in causing divisions in the left wing bloc that was opposed. Without prejudice to this, the fate of the reform is uncertain because, before the end of this year, there will be a referendum which was promoted by opponents, and this might lead to fundamental aspects of the reform being overturned. This process has taken place during an extremely serious economic crisis, so the proponents of the law will go into the referendum at a time when public opinion is inclined to cast a “punishment vote” against any initiative by the government coalition parties and against the President of the Republic.

In the gas industry, the government achieved some of its objectives, but problems remain. Natural gas is being brought in, private enterprises are being incorporated into this area and a regulatory body has been set up. There has only been one offer for the gas company in the capital city, and two for distribution in the rest of the country<sup>24</sup>. There is no regulatory framework. In the political sphere there was no coordinated opposition to the participation of private capital in this sector. Investment in the construction of new assets to allow for providing goods which did not exist in the country before does not have any negative connotation for public opinion which might allow opposition to be mobilized. On the other hand, the mechanism of referendum was not applied in this case since the concession was awarded by the Presidency through administrative acts, which can only be appealed against on legal grounds. However, the slow pace of the process of bringing in natural gas has been due to the difficulties that the Presidency had in getting the boards of public enterprises (ANCAP, the petroleum enterprise, and UTE, the electrical power utility) to take the

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<sup>24</sup> Furthermore, one of the private firms that entered the industry is currently in retreat.

necessary decisions to make private investment economically viable with long term purchase contracts.<sup>25</sup>

Reform in the telecommunications sector sought to open it up to competition in cellular phones, long distance international and data transmission services. The reform in mobile telephony failed since neither of the two objectives initially aimed at were attained, that is to say the entry of new firms into the market or the appropriation of the monopolistic profits which future operators would obtain (the fruit of the utilization of a scarce resource, the radio electronic spectrum). In long distance international services, companies did come into the market, but then barriers to entry were put in place. In any case, the number of entrants seems reasonable for there to be competitive pressure on the public enterprise. Nevertheless, the interconnection conditions these operators have with the fixed network are not yet functioning adequately, and this is an indispensable factor to permit competition without discrimination. The long distance national sector remains in the hands of the public enterprise. This is not ideal, but it is not a fundamental impediment to competition in other parts of the sector. The basis that would enable technologies to converge were not set up, and this is probably the area where the greatest gains in efficiency could be expected from regulatory reform in telecommunications.

As to the political evaluation of telecommunications reform, it can be said that the union was successful in blocking the reform. Practically the only message they sent to the population was a call to oppose the sale of the public mobile telephony enterprise. The extent of ideological extremism which the process of reform in public services has generated was particularly evident in this sector.

The public enterprise for water and sewage infrastructure has relatively less favorable technical indicators than the corresponding public enterprises in other areas like electricity or telephony. Unlike these other sectors, the water and sewage system enterprise did not go through a process of significant technical improvement in the 1990s. The technical and commercial indicators are not in the least satisfactory. Attempts at awarding concessions were made without any previous effort to create regulatory institutions which would have separated the process of granting concessions even a little from the problems of opportunism and capture intrinsic to the functioning of the market of public services. It is an enterprise which seems to have lower political status than the other public enterprises. It does not seem probable that the public water enterprise could become a platform for launching a presidential candidate, which the other public enterprises have been exactly this. In the process of reform, the board, or part of the board at least, took the side of the union, thus standing against the policies of their own political groups.

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25 It is interesting to look at comments by the ex-director of UTE, Mario Soto (the representative of the Jorge Battle faction on the board, so we would *a priori* expect him to adopt a position in favor of private investment in the country). "Besides, on the subject of the Southern Gas Pipeline (Gasoducto Cruz del Sur), a private undertaking with which I am completely in agreement, ANCAP and UTE have been told that between them they will have to buy two million cubic meters of gas for fifteen years to ensure the supply. We were going to subsidize the investment of a third party. In the end, UTE managed to reduce this figure to 500,000 cubic meters (the purchase) which we did not need. We would have bought them when we needed them. - Do you mean to say that with these measures of the Presidency that you mention, electricity will be more expensive? - "Without a doubt. This is not profitable for UTE". (Búsqueda, 15/11/98)

In spite of the progress made in legal infrastructure in the 1990s, recent experience shows serious weaknesses:

- The fate of the new framework was highly sensitive to the misbehavior of private market participants. Granja Moro was involved in a major fraudulent bankruptcy case which shattered the local bond market. There was the Santander affair which involved an open ended investment fund, and this revealed the possibilities of self dealing through insider trading.
- The public and financial intermediation sectors were by a very large extent the dominant issuers of fixed income securities until the twin crisis of 2002.
- The legislation on securitization (1999) was poorly prepared and presented in a rush for consideration by Congress. First, it did not include the institution of trusts, which would have fitted better in our legal system. The fact that trusts did not exist was made up for by an original “close ended credit fund”, but this never became established. Securitization was restricted to mortgages to avoid higher tax collections. Furthermore, the public mortgage bank was allowed to securitize only a small fraction of its mortgage portfolio: credit to buy used houses and foreign currency denominated loans.
- The Tax Administration took issue for the lack of explicit legal tax liability of close ended *direct* investment funds. As a result, none of them could be implemented, despite that they would have been a useful investment instrument.
- Recent experience with the banking crisis and the collapse of public finances with linkages to financial intermediaries point to the need to strengthen supervision. La Porta *et al.* (2003) present empirical evidence that legislation facilitating disclosure, and liability rules, are more clearly beneficial than outright public enforcement.
- There seems to be a lack of political will to modernize the bankruptcy regime. Politicians interests in keeping some level of discretion and the lack of clearly identifiable interest groups can primarily account for this fact.

As to social security reform, a first dimension which has received considerable attention has to do with the fiscal effects of reform. A number of analysts have said that reform would cause an initial increase and a subsequent reduction in the deficit of the Government Pension Bank (Masoller and Rial, 1997; Camacho, 1997 and 2001; Forteza, 1999; Noya and Laens, 2000; Caristo and Forteza, 2003; among others). A transitory increase in the deficit is expected. This would be due to contraction in the size of the pay-as-you-go pillar which makes for two rhythms in the reform process: income from contributions initially falls more rapidly than outflow in payments. In a number of simulations, the projected reduction of the deficit in the long term is due to the fall which is expected in payments following increased control over access to benefits (Camacho, 1997; Forteza, 1999; and Caristo and Forteza, 2003). On the other hand, these same projections suppose that there will be a reduction in the cover for pensioners. It should be said that these projections are based on indirect estimates of the degree of evasion, and on hypotheses about its future evolution.

There is evidence that the management of the social security system has improved. For one thing, there has been a considerable reduction in the time which the procedure for obtaining benefits that have been awarded takes. As well as this, in the area of contributions, a system for recording individual labor histories is being implemented. The Government Pension Bank (BPS) now has a complete data base of labor history from the reform up to the present time, and it is in the process of filling in personal histories from before this period.

In the pillar of individual saving, there has been a certain amount of concern over the high exposure of the resources of the pension funds in government bonds. Forteza (2003) argues that this composition of the portfolio of the pension funds has been induced by the government and is motivated by fiscal necessity. Thus the government's financial difficulties are putting the success of the reform at risk. In addition to this, it would be desirable to strengthen the government's regulatory capacity in the areas of pension savings funds. At the present time, this function is exercised by a department of the Central Bank.

From the political point of view, it can be said that the reform of the pension system was initially very successful and, to some extent, given the sensitivity of the subject, better than might have been expected. First, low paid workers opted massively for the individual savings pillar.<sup>26</sup> Second, Ramos (1999, p 143) says that a number of public opinion surveys between 1995 and 1999 showed an increase in satisfaction with the BPS on the part of the general public. Lastly, in 1999, various retired people's organizations and the PIT-CNT union federation failed in an attempt to initiate a plebiscite to modify substantial aspects of the new system. It is worth remembering that these same organizations had in 1989 and in 1994 overturned attempts at reform using this recourse to plebiscite. In any case the subject is not closed, and these social organizations themselves insist that their intention is to effect a big change in the system, including a return to a system which is exclusively public and basically pay-as-you-go.

The main strategic goal of the constitutional reform has been achieved insofar as the new electoral rules, specifically the majority run-off, favor the maintenance of the reformist coalition in office. But things turned out differently to what had been originally planned. The winning party was the *Colorado* and not the National (*Blanco*), and the majority factions within the parties were radicals rather than moderates. The difference between the actual outcome and what was expected stems from a number of erroneous calculations in the original plan, and some strategic mistakes made during the electoral campaigns (Buquet and Piñeiro, 2000).

All the comparative research that has been done is in agreement that the effective number of parties is systematically higher when the system of absolute majority over two rounds of voting is used in presidential elections.<sup>27</sup> Although in Uruguay there was no increase in

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26 The reform law establishes that workers with income of less than approximately 800 dollars as of May 1995 would in principle continue to be covered exclusively by the public pillar, but they were given the option of paying half of their personal contribution to the individual savings pillar. More than 90% of workers in this situation took up this option.

27 See Shugart and Carey (1992), Jones (1995), and Mainwaring and Shugart (1997) on this point.

internal party fragmentation as a result of the new majority run-off system, the results of the election can be interpreted to show that this effect did in fact occur.

One of the explicit objectives of the political reform was to increase the transparency of the electoral system and give the voters greater freedom. Presidential elections with one single candidate per party, and the elimination of the accumulation of *sublemas* in the election of representatives, has evidently given the electorate greater certainty as to the consequences of their vote than they had under the old system. The “opening” of the electoral cycle made for a notable increase in the freedom of the voters since it allowed them to opt for different parties in the different voting situations. However, it is hard to argue that the primaries are a better mechanism than the double simultaneous vote for the selection of candidates for the Presidency (Colomer 2002, and Buquet, forthcoming). Besides this, the elimination of the accumulation of *sublemas* in the election of Representatives has made for a very much simpler choice for the electorate, and this can be seen in the reduction in the number of lists presented in 1999, which amounted to only a quarter of those presented in 1994. This phenomenon, along with less uncertainty as to the consequences of particular votes, restricts the menu of options for the voter, and this reduces his freedom. On the other hand, the reduction in the legislative offer is associated with the predomination of the big national factions with respect to local political groups because the new rules enforce a rigid connection between the offer for the Senate and the offer for Representatives. Consequently, we can expect more disciplined legislative conduct from the sectoral representatives.

In spite of the reduction in the number of lists of candidates, which has enormously reduced and simplified the offer to the electorate, the internal factionalism of the political parties has not gone the same way. In this area, the reform does not seem to have had any particular impact, since the internal factionalism of the *Frente Amplio* increased, that of the National (*Blanco*) Party has been reduced, and that of the *Colorado* Party has held steady (see Yaffé, 2000).

An explicit objective of the political reform was to avoid Presidents having to govern with minority representation. However, this combination of single candidates and the majority run-off system which the electoral reform set up could contribute to worsening the parliamentary position of the elected President, and this is in fact what happened the first time it was put into practice. The old Uruguayan electoral system made for at least two absolute certainties: the party of the President would have a plurality (at least) in parliament, he would have more party representatives, and the President’s faction would have a plurality in his own party. The representatives directly supporting the President of the Republic had, up to that time, necessarily been the biggest group in the biggest party. This was because of the connection between the Presidential and the legislative elections. These certainties derived from the logic of the system. To win the Presidency it was necessary to belong to the party, and to head the faction within that party, which received most votes for the legislature. Under the current rules, the legislative representation of the party in government does not have to be the biggest in parliament because there is nothing to stop the election of the candidate of the second party, whose representation would be second in number of legislators. This happened in the last election. Along with the reduction in the legislative weight of the President’s party which can result from the majority run-off, there is no disposition in the new constitution which guarantees legislative

weight to the President's faction. The President elected is the only candidate from his party, and he can be voted for together with any of the parliamentary lists of that party. The votes which the President's faction obtains are relatively independent of the electoral potential that he has, and consequently he may be in a minority in his party. There is nothing to ensure that the President will enjoy a majority in his party because there is nothing to stop factions that are defeated in the internal party elections from emerging triumphant in the legislative election.

Lastly, a fundamental objective of the reform was to overcome political blockage. On this level, the new constitution incorporates norms which would seem to stimulate political agreements, negotiation, the formation of coalitions, stability in cabinets and legislative majorities. It was maintained that the second round run-offs would become a stimulus for the making of agreements in governments. However, there are no theoretical or comparative reasons to suppose that this new system would stimulate the making of political agreements or stable coalitions beyond possible electoral agreements before the second round (Chasquetti 2000). Furthermore, the constitution incorporated a mechanism for replacing the directors of the autonomous public enterprises which was based on the idea of increasing the political cost of abandoning a coalition.<sup>28</sup> However, this mechanism seems to be inoperative to the extent that the coalition of the Batlle government broke down in the middle of his mandate without even the threat of the removal of the *Blancos* directors from these enterprises. In general terms, the same stimulus for political cooperation which existed before is still present, and it seems that it is not profitable to continue supporting a minority government throughout the entire period of an administration if there is an intention to compete against that government in the subsequent elections.

The new constitution seeks to give the President greater power over legislative procedure by reducing the periods for handling emergency laws, and by simplifying the formation of the legislative bloc for maintaining vetoes. However, the new dispositions only constitute small changes in procedure with respect to the previous situation since the legislative position of the President continues to depend on obtaining the same percentages of political support as before: an overall majority for legislation, and two fifths for applying the veto.

To sum up, the new rules of play, while fostering more fragmented political configurations than the previous system, do not give the government effective instruments which would serve to neutralize this fragmentation. The only ambit in which the new rules could have some impact is in the legislative discipline of factions and parties, a phenomenon which, in any case, was present before the reform. All things considered, the changes which may occur in the future will depend more than anything else on election results which might (or might not) give legislative majorities to those who govern, and favor (or not favor) changes in their political orientation.

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28 "...the project tends to favor, insofar as this is possible, the formation of coalitions or subscription to agreements, through two actions: the formal presentation of the Council of Ministers before the General Assembly (article 174, clause 5), and the removal by the Executive Power of the non-elected director of public enterprises and decentralized services (article 175). (Record of the Senate Chamber No. 103, volume 376, 13 August, 1996, p. 34)

## **5.2 Feedback: adaptation or a change of model**

The model of liberal reforms is far from being consolidated in Uruguay. There is no perceptible reduction in resistance to change as the reform process goes forward.<sup>29</sup> The reformist sectors do not seem to have been able to make political capital out of the successes that reform had in certain areas like trade reform, and reform in the port and in social security. Rather, the macroeconomic crisis has dominated the national scene since 1999. Another factor is that the events in Argentina have worked strongly towards undermining the perceived legitimacy of reforms in Uruguay.

Although it is quite a number of years now since reform in Uruguay was initiated, there is still no consensus about how well it is going, nor is it possible to discard the possibility of a reversal of fundamental aspects of the model. The left wing coalition and various social organizations, like the union federation and organizations of pensioners, continue to question the basic premises of reform. Surveys indicate that the left has a very good chance of winning the national elections of 2004, and this could trigger a wide-ranging overhaul of the model. However, some analysts think that political competition in Uruguay today necessarily leads to moderation, with a move to the center, and this would limit the scope for reversing the pro-market reformist vision if the left should come to form a national government.

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<sup>29</sup> As Lora and Olivera (2003) point out, some political economy models suggest that experiences of reform can facilitate the acceptance of following reforms if they reduce general uncertainty about the distribution of the costs and benefits, and the government's uncertainty about their ability to implement the reform. Fernández and Rodrik (1991) argue that uncertainty about who will be the winners and who will be the losers generates a bias in favor of the *status quo*. Milessi-Ferretti (1991) shows that reform may be slowed down if the government has to cope with uncertainty about its own ability to carry it through at low cost. The reform process could itself have the effect of reducing such uncertainty and the resistance it generates. But, this does not seem to have been a dominant factor in the Uruguayan case.

## 6 Annex: Chronology of the reform

1985	A government elected by popular vote assumes power after 12 years of military dictatorship. Julio María Sanguinetti of the <i>Colorado</i> Party is elected President.
1989	There is a plebiscite on a reform measure that introduces the indexing of pensions in the Constitution of the Republic. The proposal is passed with an 82% majority.
1990	A new government comes to power, under Luis Alberto Lacalle of the National ( <i>Blanco</i> ) Party.
1990	The Presidency submits a project for reform of the pension system to parliament. It proposes modifications to some parameters in the system, while maintaining a pure payments regime. It is not passed by parliament.
1991	Agreement for the creation of the Mercosur (Treaty of Asunción). The Program of Trade Liberalization is created. This fixes a timetable for the dismantling of tariffs on intra-regional trade which will culminate in January 1995 with the creation of a free trade area. Procedures to eliminate non-tariff barriers to intra-regional trade are proposed. There is recognition of the need for a common external tariff.
1991	The government issues a decree which contains a program for the unilateral liberalization of tariffs with respect to third markets. In the last third of 1991, the highest tariffs are reduced. Additional reductions are programmed for 1992 and 1993, and they are effectively implemented.
1992	The Presidency presents a new pension reform project to parliament. It is proposed to maintain the pure pay-as-you-go regime but introducing “notional accounts”, similar to what was later introduced in Italy and Sweden. Parliament rejected it.
1992	The law for the rendering of accounts is passed. It includes a number of articles which modify parameters in the pension system. 30 years is fixed as the minimum period of contributions to have the right to a pension, the labor history is regulated, it is established that paid contributions will be the only valid base to receive a pension. These dispositions will be overturned in 1994 (see below).
1992	Parliament passes the public enterprises law, which opens the door to total or partial privatization of the main public enterprises.
1992	Revocation by referendum of the articles in the law of public enterprises that have to do with the privatization of the public telephony enterprise (ANTEL).
1992	IADB Technical assistance on “Investment Sector Reforms Program”. Purpose: to improve “investment climate” by identifying stumbling blocks and suggesting instruments to overcome them.
1993	Inter-party group submits for consideration by parliament a constitutional reform project which modifies the electoral regime and the relation between the executive and the legislative powers (“maxi-reform”). In 1994 it receives a negative vote.
1993	First concession of water and sewage services (Aguas de la Costa).

1993	The De-monopolization of the Securities Market Law is promulgated (Law 16426).
1993	The Presidency presents a project for the reform of the social security system to parliament (third proposal in the National Party administration). It is bogged down in a parliamentary commission.
1994	Inter-party group proposes to parliament a constitutional reform centered on questions that have to do with local government (“mini-reform”). The parliament approves this proposal by an ample majority of votes. It is then presented to the people in a plebiscite, but fails to gain the necessary majority.
1994	The Presidency submits to parliament a social security reform project “for urgent consideration” (fourth proposal in the National Party administration). It does not pass in parliament.
1994	A consortium headed by Gaz de France is awarded the concession to supply piped gas in Montevideo, privatizing the public gas enterprise, which had been nationalized in 1975.
1994	A constitutional reform is passed by plebiscite. It lays down that pension norms cannot be included in budget laws, thus nullifying the articles connected to the BPS (Banco de Previsión Social) in the law of the rendering of accounts passed in November 1992.
1994	The Uruguayan parliament ratifies the Treaty of Marrakech, signed in the framework of Uruguay’s joining the new World Trade Organization.
1994	Summit of Mercosur Presidents (Ouro Preto) redefines the objectives of the regional agreement. The Mercosur Adjustment Regime is created, which fixes the program to set up a Free Trade Area in a longer period (2000), and also agrees a common external tariff along with a trajectory to establish this. In this way the objective of creating a customs union is crystallized.
1995	A new government comes to power under Julio María Sanguinetti, of the <i>Colorado</i> Party.
1995	Parliament passes the social security reform law which introduces a mixed pensions system (Law 16713).
1996	The Presidency issues decrees with new rules for multilateral trade (anti-dumping and safeguards) in the framework of the World Trade Organization membership law.
1996	Laws are passed to foster the development of the capital market: Exchanges and Corporate Bonds Act 16749 and Investment Funds Act 16774.
1996	Parliament passed a constitutional reform law (that requires a special majority of 2/3) which modified the electoral regime and was confirmed in a plebiscite by the citizenry.
1997	Transitory increase in the Mercosur common external tariff.
1997	Law 16832 of the Electricity Industry Regulatory Framework is passed.
1998	The government awards the concession for the construction of a gas pipeline between Buenos Aires and Montevideo and the distribution of piped gas in the provinces in Uruguay to private enterprise.
1998	Second concession for water and sewage services (Uragua).
1998	Failed attempt to overturn by referendum the Electricity Industry Regulatory Framework Law.

1998	The Investment Act 16906 is passed.
1998	The Executive Power submits a General Bankruptcy Code Bill, but it never left a Congress Commission.
1999	Parliament passes the Securitization and Factoring Act 17202.
1999	Pensioners' associations collect signatures for a plebiscite on a new constitutional reform aimed at nullifying the social security reform law passed in 1995, but they fail to obtain the necessary number of signatures.
2000	A new government under Jorge Batlle, of the <i>Colorado</i> Party, assumes power.
2000	Regulatory offices for electrical energy (UREE) and communications (URSEC) are set up.
2000	Mercosur extends the period for exceptions to the common external tariff, and extends the increased common external tariff passed in 1997.
2000	Legal authorization of competition in communications (long distance international, mobile telephony and data transmission).
2000	Parliament passes the Movable Property Collateral Act 17228.
2001	The creation of the Regulatory Unit for Energy and Water Services (URSEA) is passed by law. This regulatory body inherits the role of the UREE (which disappears) for the electricity sector, and assumes control in the other energy sectors and in water and sewage services.
2001	Parliament passes the Amendment to Bankruptcy Act 17292.
2001-2002	In a situation of severe economic crisis, the Mercosur countries set up various extra- and intra-regional non-tariff barriers to trade. In particular, the Uruguayan government also changes its trade policy with respect to extra-regional third markets through a collection of protectionist instruments.
2002	Parliament passes the reform law for the notaries' pension system. It is a reform of parameters, without individual accounts being introduced.
2002	A law authorizing the public fuel enterprise (ANCAP) to associate with private companies is promulgated.
2002	The Presidency approves the regulations for the wholesale market in transport and electricity distribution.
2002	The Buenos Aires – Montevideo gas pipeline is inaugurated.
2002	The legal base which supported the liberalization of telecommunications is abolished in parliament.
2002	Failed attempt by the government to auction off mobile telephony.
2002	The Presidency submits a Trust Bill to the Congress.
2003	The Administration of the Wholesale Electricity Market (ADME) is set up.
2003	Signatures of 25% of the electorate are obtained, authorizing the holding of a referendum about the ANCAP Association Law.

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