

Book “Political Crises, Social Conflict and Economic Development in the Andean Region”.

Chapter 1. Introduction.

21/04/2004

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Economic growth and the process of development do not evolve in a political and institutional vacuum. Economic choices depend on rules, institutions and social constraints that are mediated by a political process. A governance environment characterized by stability, the rule of law, and social cooperation will foster wealth creation provided good economic opportunities are in place. However, in many societies – including the Andean countries-- the political process is often messy, institutions are far from being the ideal set of rules that minimize transactions costs and social relations are characterized by conflict and even violence. Ultimately, underdevelopment is not only a problem of lack of economic resources but it is largely associated also with volatile politics, dysfunctional institutions and highly differentiated social structures.

The subject of this book is to understand the main characteristics of political systems, institutions and social structures in the Andean region of Latin America and its interplay with economic performance. The Andean region is comprised by Bolivia, Colombia, Ecuador, Peru and Venezuela¹. These economies have a per capita income of around US\$ 2000 although they are rich in natural resources (oil, mining, forestry, biodiversity, fishery, etc). The quality of their institutions (rule of law, effectiveness of regulation, control of corruption, others) ranks in a

¹ The criterion for including the five countries in the definition of “ Andean region” is their membership to CAN (Andean Community of Nations) an economic integration and political agreement that has a governing council, a parliament and form a custom union. Chile is also an “ Andean country” in a geographical sense but it is not a member of CAN.

relatively lower place in global country ranks of quality of institutions. These countries have varying degrees of political instability, frequencies of presidential crises, turnover of authorities and frequency of change in their constitutions. Their social structure is characterized by considerable poverty, by inequality of income and wealth. In Bolivia, Ecuador and Peru a significant share of the population is of indigenous origin. Economic growth in these economies, on average, has been moderate and volatile in the last two decades. In addition, they have had their fair share of economic crises and external vulnerability associated with terms of trade shocks and changes in capital flows.

Main Questions.

This book includes comparative cross-country studies along with political economy country papers for each Andean country in the 1990s and early 2000s. The volume tries to address the following questions:

- a) What are the main characteristics of the political system in the Andean countries, both regarding presidential systems and stability of democracy?
- b) What is the frequency of episodes of *systemic breakdown* (coup d'état, authoritarian regimes, major social upheavals) or collapse of democracy in recent decades in the Andean countries?
- c) Are social contracts as embedded in constitutions stable over time? What is the frequency of constitutional change in the Andean region?
- d) How frequent are presidential crises and turnover of Ministers and other authorities in the Andean countries? How do we define and measure political instability and institutional fragility?
- e) What is the interplay between economic and political crises? Do political crises lead to economic crises? Do economic crises lead to political crises? Is there a certain degree of autonomy between both types of crises?
- f) What is the quality of institutions measured by indices of rule of law, control of corruption, effectiveness of regulations, degree of violence?

g) What are the effects of income and wealth inequality in the Andean region? Does inequality worsens governance? Does inequality hampers economic growth?

h) How the abundance of natural resources and the existence of illegal activities (e.g. drug-traffic) have affected the economy and governance conditions in the Andean region?

i) What are the main economic effects of political instability and the quality of institutions on the rate of economic growth and other indicators of economic development?

Main Findings

Main findings of this book can be summarized as follows:

Political Systems, Constitutions and Crises.

All Andean countries have a presidential system. However, formal political systems do not always guarantee strong presidencies that ensure law and order and warranty political stability in these countries. In fact, in this book we document a high incidence of presidential crises under presidential systems. In fact, several Andean countries have had presidential crises in recent years (Bolivia in 2003, Peru in 2001, Ecuador in 2001, Venezuela in 2001). Still we are not recommending here parliamentary systems for these countries. The point we want to make is that presidential systems in complex societies affected by frequent economic crises, political fragmentation and chronic social conflict may not, per se, avoid political crises. Strong presidencies may take more than having a presidential system written in the constitution.

In the 1990-2003 period, Colombia, Ecuador, Peru, Bolivia and Venezuela -- all five Andean countries-- reformed, in major ways, their constitutions as a way to solve their political and economic problems. Historically, say during the 20th century, the frequency of constitutional reform in the Andean region was high. If we interpret (major) constitutional reforms as an attempt to redraw existing social contracts, we find that social contracts are not very stable in countries that change their

constitutions with high frequency (according to international standards). Again we have to distinguish between formal social contracts -- as expressed in constitutions-- and actual (or “informal” social contracts), that embeds other considerations such as political culture, history, social norms that are more difficult to change than constitutions. The specific consequences of the last round of constitutional reforms in the Andean countries merit their own analysis but are beyond the scope of this book. Still the experiences of the last 10-15 years suggests that changing the constitution is not an overnight fix for the political, economic and social problems of these countries. In addition, new constitutions in some cases may create new problems that probably were not envisaged by the reformers of the constitution. A sensitive issue is the expansion of economic rights (and devolution of powers to sub-national levels) sanctioned by some of the new constitutions without concomitant increases in wealth and income to finance the new mandates of the reformed constitutions. This could be relevant for Colombia following the constitution of 1991 and in Venezuela after the constitutional reform of 1999-2000. Other new rules that have proved complex are provisos on the number of political parties, re-election rules, decentralization and others.

Interplay between economic and political crisis.

The Andean countries, some more than others, have been often affected by economic crises. The question arises from a political economy perspective if economic crises are always followed by political crises? In turn, do political crises have most of time have an “economic origin”? The answer is mixed. The Bolivian presidential crisis that led to the departure of former president Sanchez de Lozada came at a time when incomes of coca growers and poor peasants sharply declined following the policy of coca eradication. So although there were economic causes behind the outset of the president Sanchez de Lozada of Bolivia it did not follow a full economic crisis (defined as high inflation, continuous currency devaluation, massive decline in GDP, etc). In contrast, in Ecuador in the

last 1990s, the country indeed suffered a full blown economic crises in 1998-1999 characterized by accelerated currency depreciation, inflation, a crisis in the banking system followed by a massive deposit freeze and in 1999 a decline in gross domestic product of over 9 percent. Against this background, president Mahuad was deposed in an indigenous-military uprising in January of 2000. Of course, there were also purely political factors behind the collapse of president Mahuad administration but undoubtedly the serious economic crises of 1998-99 created a deteriorating environment conducive to a presidential crisis.

In Peru, the departure of Fujimori in 2001 was largely associated with a bribery scandal involving its chief of security Vladimiro Montesinos. In addition, the neo-authoritarian style of government of Fujimori in the 1990s certainly generated increasing levels of social resistance and international and national de-legitimization. In connection with our question of the interplay between economic and political crises, it is apparent that no open, large scale, economic crises happened to occur before or after the departure of Fujimori. In sum, we have a variety of experiences in the Andean countries that suggest that economic and political crises are not always closely related with each other; they have a degree of “autonomy”. One type of crisis (political or economic) is not necessarily preceded or followed by the other.

Stability and quality of democracy

The cross-country analysis and individual country cases show that historically, and recently, democracy has been not particularly stable in certain Andean countries. In the 1960s and 1970s, there were frequent regime changes in which military regimes alternated with democracy in Bolivia, Peru and Ecuador. Clearly, in those countries democracy was fragile. In contrast, in the last four decades democracy has been more stable in Colombia and Venezuela.

The dichotomy democracy and authoritarianism probably has to be revisited in this age of globalization of information and media outreach

that makes undemocratic acts and the violation of human rights appear more forcefully in the limelight. This brings us to the complex issue of quality of democracy, not an easy concept to define. At a broad level we may associate the quality of democracy with the efficacy by which political institutions mediate and aggregate the interests, voice and preferences of different political parties and social groups to produce results that are deemed to be socially desirable (including creating an environment conducive to economic prosperity and stability).

The demands by certain social and ethnic groups for increased voice and political representation is an important test on the quality of democracy. Exclusion and lack of representation of these groups show that democracy is incomplete. Recently we have seen the increasing demands of indigenous groups in Bolivia, Ecuador, and Peru for greater voice and representation (and eventually autonomy). Traditionally these groups have been excluded from the political system although in the 1990s that situation started to be reversed. Another issue is how democracy manages violence. There are various types of violence: criminal and political and one type of violence can breed the other. Colombia is the country with the highest incidence of political violence in the Andean group and in Latin America due to its more than four decades old armed conflict fueled later by narco-traffic. Peru also suffered from heightened violence by Sendero Luminoso in the 1980s and early 1990s. Persistent political violence reflects a failure of the democratic system that cannot impose the rule of law and maintain the monopoly of the use of force by the institutions of the state. The economic consequences of violence are bound to be severe as it often destroys human lives and valuable economic assets.

The nature and quality of institutions

Economic theories of institutions stress that they are created to minimize transaction costs and facilitate economic exchange. However, other theories envisage institutions as instruments to create and protect the economic and political interest of certain elites, although this may be

inimical to growth and prosperity. Institutions are not always socially efficient arrangements.

There is increased awareness of the importance of institutions such as regulatory agencies, the tax system, the budget process, central banks and ministries. The country studies in this volume use the set of indices of quality of institutions compiled by the World Bank and the World Economic Forum for a large sample of countries and put the Andean countries institutions in international perspective. These indices are based on surveys applied to users of these institutions such as individuals, domestic companies and foreign investors. Although there are differences within the Andean group in general these countries rate below some other Latin American countries and the OECD in terms of quality of institutions. *Natural Resources, External Vulnerability and Illegal Activities.*

Several Andean countries depend on natural resources as their main source of foreign exchange and fiscal revenues. This is the case of oil in Venezuela and Ecuador, of hydrocarbon in Bolivia, copper in Peru, etc. This dependence on natural resources make these economies vulnerable to international volatility in commodity prices that often create internal cycles of booms and bust as the financial possibilities for the smoothing of these shocks are limited given the incomplete nature of domestic and global capital markets. This dependence on natural resources creates the problem of managing the pressure on the state to spend windfalls when they occur. From a governance perspective, managing the revenues of natural resources in a transparent way is also a challenge.

Another issue, related to “natural” resources is the importance of illegal activity such as drug-traffic based in the cultivation of coca leaf. This has been especially serious in Colombia since the 1960s and 1970s in which revenues of drug-traffic has contributed with revenues for rebel groups fueling and perpetuating internal conflict. Also money from illegal activity can have a corrupting effect on institutions debilitating the democratic system and altering economic priorities away from development.

Conflict, Inequality and Ethnic Diversity

The social structure of the Andean countries comprises poverty, economic inequality and social stratification. These are societies in which the urban and rural economic elites have a disproportionate influence in society. This is contrast with the limited political and economic influence of low-income groups, the unemployed or underemployed, poor peasants and the less educated part of the middle class. To “traditional” social conflict stemming from pressures for increased distributive shares in national income by organized social groups emphasized by structural theories of inflation and growth we have to add the new demands of indigenous groups for inclusion, representation and identity. Social conflict combined with economic vulnerability

Politics, Institutions and Growth.

The combination of differentiated social structures, vulnerability to external shocks, weak institutions and unstable politics tends to deter growth and prosperity in the region. Institutions and governance conditions affect economic growth through factor accumulation, productivity growth, quality of labor-employers relations and the general business climate in the country. This book examines at country level how these mechanisms operate identifying the role of social and governance factors and shocks affect economic outcomes. The empirical growth literature has ample evidence showing the negative effects of adverse governance conditions on economic growth. The country studies included in this volume examine in rich institutional and historical detail the interactions between politics and institutions on the one hand and economic performance and growth on the other.

Organization of the Book

This book is organized in two parts besides this introduction. Part I includes two essays that consider the Andean group as a whole. Chapter 2, “Governance Crises and the Andean Region: A Political Economy Analysis” by Andrés Solimano provides a conceptual framework to study

governance patterns distinguishing between political regimes and the constitution, the quality of institutions and patterns of social conflict and cooperation. The chapter also undertakes an empirical analysis for the Andean region that combines historical and recent data on political crises, changes of constitutions along with the indices of quality of institutions published by the World Bank and the World Economic Forum. The chapter also illustrates linkages between growth performance and governance and inequality. Chapter 3, “Poverty, Inequality and Governance in the Andean Region” by Ashu Handa and Amanda Glassman analyzes the main trends in poverty and inequality in the Andean countries. The chapter explores the role of the level and volatility of economic growth, the incidence of recessions and crises, inflation, labor market dynamics and governance factors in terms of their impact on poverty and inequality. The chapter also highlights options for social policy and reform that make compatible growth with social equity and inclusion. Part II of the book is devoted to the political economy country studies written by well-known economist and political economists of each of the five Andean countries. These studies distinguish between institutional and governance factors and economic and social outcomes, exploring the interfaces between both sets of variables. The country studies provide rich institutional detail and place the country experiences in the proper historical and contemporaneous context of each country. Chapter 4, “The Political Economy of the Crisis in the Andean Region: The Case of Bolivia “ written by George Gray Molina and Gonzalo Chavez make a distinction between a “governance block” and an “economic block”. The study covers from 1982 to 2002. The governance block identifies political fragmentation, corruption, ethnic fragmentation and narco-traffic as important governance issues in Bolivia. The economic block documents the stabilization of hyperinflation in the mid 1980s and the successive economic and social reforms undertaken in the 1990s and early 2000s. The authors warn on some critical contradictions of Bolivian

society in which the modernizing reforms of the 1990s in the economy co-existed with a still high dependence on non-renewable natural resources, the revenues from drug traffic, a fragmented political system, a high level of poverty and inequality and a history of exclusion of indigenous groups. These elements are extremely relevant for understanding the crises that lived Bolivia in 2003 (and previous crises as well). Chapter 5, “The Economy, Conflict and Governance in Colombia” by Jose Antonio Ocampo examines the evolution of governance conditions and economic developments in Colombia in the 1990s and early 2000s, providing historical insights and data when relevant. The author relates the internal armed conflict of Colombia to colonization, the geographical fragmentation of power, intensified by the effects of drug-traffic and its degenerative effects on society and the rebel groups. In the economic area Ocampo analyses the impact of incomplete adjustment to trade liberalization and the vulnerability to external financial cycles on economic performance. He also notes the tensions between openness and an increased role of the state sanctioned, among other things, by the constitution of 1991. In addition, Ocampo points-out that Colombia seems to be the case of a relatively stable democracy co-existing with a violent, gang-controlled system largely related to drug-traffic activity and armed conflict.

Chapter 6 “Political Economy of Ecuador: The Quandary of Governance and Economic Development ”by Gustavo Arteta and Osvaldo Hurtado analyzes the political and economic performance of Ecuador in the 1990s and early 2000s. The authors highlight the fact that Ecuador was the first country in Latin America to begin the transition to democracy in 1977-79 after successive periods of authoritarianism. Ecuadorian democracy, however, has been characterized by political instability, a high turnover of presidents and ministers, volatility of laws and reforms, fragmented and conflictive politics, regional divides, influential corporate interests and weak executives. In the economic arena, the 1980s and 1990s

in Ecuador were decades of low and unstable growth, inflation and inflation, recurrent currency devaluations, external vulnerability to oil and commodity price shocks and volatile capital flows. The authors analyze the interactions between governance and economic conditions and reflect upon attempts of constitutional reform to improve governance in Ecuador and the changes brought by dollarization in the economy. Chapter 7 “Governance and Economic Performance in Peru in the 1990s” by Miguel Jaramillo and Jaime Saavedra examines the main politico-institutional and economic developments in Peru up to 2000. The authors document that in 1990 the country was affected by severe economic instability and by social turbulence and violence led by the Maoist group *Sendero Luminoso*. The chapter highlights the combination of neo-authoritarian political methods of the Fujimori administration along with an economic program of stabilization, liberalization, privatization and provision of social infrastructure in rural and urban areas. That contradictory political-economic mix proved ultimately explosive in 2001 when the Montesinos corruption and mafia-like scandal erupted forcing the departure from the country of president Fujimori. Chapter 8 “Venezuela: From Stability to Turmoil” by Enzo del Bufalo and German Ríos provides an interpretative political economy essay of the events that led to the government of president Hugo Chavez in the late 1990s and the economic and political situation of the early 2000s in Venezuela. The authors discuss several features of Venezuelan society during most of the 20th century: a varied “human geography” and ethnic diversity, the oil rental model, the dominance of two main political parties (ADECO and COPEI) and the influence of the international economy and global politics. This long run political economy outlook is then complemented by a look at governance indices in Venezuela also used in the other country studies. The authors also look at economic performance and discuss the interplay between governance and economics. The attempt of coup de e’tat against Chavez in

2002 and the national strike of December of 2002 are also analyzed in the context of the complex transformations underway in Venezuela.