Aaron Tornell 5

Economic Crises and Reform in Mexico

In 1979, one of the oil boom years, President Lopez Portillo announced Mexico's intention to adhere to the General Agreement on Tariffs and Trade (GATT). He then reversed this decision in 1980, having engaged in consultations with major interest groups. Under President de la Madrid (1982–88), Mexico experienced several negative shocks, namely, the collapse of the price of oil and the interruption of foreign credit influx at a time when around 5 percent of the GDP was being used to service foreign debt. To make matters worse, the country suffered one of the most severe earthquakes of the century. Even in the midst of these crises, in 1985 Mexico acceded to GATT. By 1987, it had transformed itself from an extremely closed economy into one of the most open in the world. In 1993, it signed the North American Free Trade Agreement (NAFTA) with Canada and the United States. This transformation occurred notwithstanding the fact that trade liberalization implied significant adjustment costs for the private, import-competing sector and that the state-owned sector had seen its subsidies vanish as a result. Nonetheless, the import-competing sector, which had opposed trade liberalization in 1979, did not oppose it in 1985. It is curious that it should have been President de la Madrid, typically portrayed as weak and indecisive, to initiate the change, rather than President Lopez Portillo, who was seen as a strong leader.

Following the liberalization of trade, the government implemented a far-reaching fiscal reform. The majority of state-owned companies were privatized, bringing their number down from 1,155 in 1982 to fewer than 220 in 1993; the income tax rate was reduced from 42 percent to 34 percent, and tax compliance was enforced, resulting in increased tax collection; and government subsidies were significantly reduced. These reforms changed the sign of the primary fiscal balance from negative during the period 1970–82 to positive for each year of the period 1983–93. It is worth noting that the reform took place in a context of deteriorating terms of trade. The index of the terms of trade fell around 50 percent between 1981 and 1986.

The Mexican reforms and other reforms that occur in the context described above raise the following questions: Why is it that power holders do not block such reforms, even though all or most of them result in conditions worse than the status quo? Why do such reforms happen in the aftermath of a crisis and not during good times, when the country might be able to afford the short-term costs more easily? Finally, why do power holders allow the economy to reach a state of crisis?

The objective of this chapter is to address these questions for the case of Mexico.

To facilitate this discussion, it is useful to think of the economy as being composed of two sectors: the organized elite and the rest of the population. In the unreformed status quo, organized groups extract rents from the rest of the economy. Economic reform is a set of structural changes that eliminates the power of some or all of these groups. These changes need not enhance efficiency for the economy as a whole (as would be the case with privatization or trade liberalization) but may simply consist of expropriations or a move toward protectionism.

I classify the explanations for why reform occurs into two frameworks. In one scenario, called *barbarians at the gate*, reform is imposed by forces external to the organized elite. In the second framework, termed *reform from within*, privileged groups themselves induce the reforms. A common barbarians-at-the-gate explanation is that a severe crisis leads voters to replace the current government and vote for reform. Another explanation is that during a crisis governments are forced to ask for assistance from multilateral institutions and that help comes under the condition that a reform is implemented. Although external factors are important, an explanation of reform based solely on them does not seem appropriate for cases such as the radical trade liberalizations that took place in Chile (1975) and Mexico (1985). Neither President de la Madrid nor General Augusto Pinochet faced pressure from voters or exporters to open up the economy and destroy a big part of the inefficient manufacturing sector. In these cases, reform was induced by the powerful elites.

Next, I consider the reform-from-within framework. One commonly used argument is that, during a crisis, powerful groups decide to abandon the status quo because the situation is so bad that a majority of powerful groups expect to benefit from reform. This argument, however, does little to illuminate the reforms we are trying to rationalize. These reforms do not take place in a smooth environment but rather in the midst of political turmoil, in which some or all powerful groups are displaced from power and suffer substantial economic losses.

A Reform-from-within Explanation

I present an argument in which reform serves as a tool to limit the power of political opponents. In the next section I apply the argument to Mexico. I consider an economy in which powerful groups with common access to the economy's resources find it individually rational to overappropriate resources. As a result, there is a deterioration of the economy. When the economy reaches a crisis, a conflict among powerful groups erupts, the result of which is a reform that can leave all groups worse off than before.

In my model, reform occurs if one or more groups unilaterally relinquishes its privileges. Any group that undertakes this action must reallocate its fixed assets, which entails costs for the group in question because it has to divert part of its assets to nonproductive activities during the transition. The long-term benefit is that the postreform regime will be more favorable toward this group than it would otherwise be. In equilibrium, the group (call it *i*) that introduces the change ends up worse off than in the status quo. Why, then, would *i* induce reform? It does so either to prevent other groups from introducing changes that would harm *i* even more or to neutralize the harmful effects of changes already introduced by other groups.

To illustrate this point, consider a group of protected producers who receive production subsidies and have the power to block or introduce trade liberalization. In the short run, trade liberalization is costly for these producers because their fixed assets must be reallocated. However, the institutions, such as trade agreements, that develop over the long run will weaken unions and statist groups. As a result, exporters will have the upper hand. As I discuss in the section on Chile, the protected producers in Chile and Mexico supported trade liberalization to stop expropriations by labor and statist groups, respectively. It should be clear that protected producers would have preferred the status quo. However, the alternative to trade liberalization was not the status quo but expropriation by rival groups.

When the economy is doing well, every group finds that the short-run diversion of resources to nonproductive activities is more costly than the future benefits it might gain. Therefore, every group would be better off by not introducing a change to neutralize the changes introduced by others (i.e., becoming the follower), than by introducing a change unilaterally (i.e., becoming the leader). In these circumstances any reform is unanimously blocked by all groups, and rent seeking flourishes. As the economy deteriorates, however, there is a fall in the opportunity cost of diverting productive factors to destroy the power of the rival groups. Thus, there is a point in time after which each group prefers to be the leader instead of the follower. Although every group would prefer to have a reform far in the future, a preemptive reform inevitably takes place much earlier, given each group's perspective that the other groups would stay put forever. This is when leading becomes preferred to following. That is, group i will introduce a reform to prevent other groups from introducing changes that will harm group i. The ultimate result is that all groups end up worse off than before.

Modeling this interdependence is, in principle, complicated. On the one hand, the timing of reform depends on the state of the economy. On the other hand, the state of the economy is a function of the powerful groups' past appropriative behavior, which in turn is a function of the expected reform date. In equilibrium, the appropriation policies and the reform date must be mutually consistent. A contribution of this chapter is to present a dynamic game in which this interdependence is explicitly taken into account.

We should recognize that the correct explanation for reform is a combination of the reform-from-within and barbarians-at-the-gate views. Nonetheless, the model presented in this chapter is useful because it introduces factors previously neglected in the study of reform, namely, the role of crises, the intraelite conflict, and the use of reform as a tool to limit the power of political opponents.[1]

1. A popular explanation for the Mexican reform is that it took place in the aftermath of the debt crisis because the IMF forced Mexico to open as a precondition for lending it more money. Note, however, that the same pressure was faced by Brazil and Peru, yet neither liberalized in the 1980s. Like Brazil and Peru, Mexico could have declared a moratorium and followed with inward-looking policies. Mexico chose not to pursue this path. Although there is no question that the IMF and the World Bank have played important roles, "it would be a mistake to picture the

The Mexican Experience

I address the following questions about the Mexican reforms: First, why did trade liberalization take place in the economically and politically strained environment of the 1980s instead of during the oil boom years, when Mexico could more easily have afforded such a reform? Second, why did the Salinas government pursue NAFTA so feverishly? What were the expected gains from accession, given that Mexico had already liberalized trade in manufacturing, that U.S. tariff levels were quite low, and that NAFTA entailed significant costs? Third, why didn't the government completely open trade in agriculture and services early on, given that this measure would have reduced input prices and made manufactures more competitive? More generally, hoping to derive broad lessons from the Mexican reform process, in particular, I address the questions of when trade liberalization is most likely to take place, under which conditions it is most likely to be sustainable, and what the role of a formal agreement like NAFTA is in sustaining a reform process.

I first present a brief historical overview to put the Mexican reform process in perspective. The Mexican political system centers on a president who has many formal powers but cannot be reelected and on an official party (first called PNR, then PMR, and now PRI) that, until the elections of 2000, had won every presidential election for the last sixty years. The Mexican president, however, is by no means an all-powerful autocrat. Nor is the PRI a monolithic party in which every member follows the president's instructions. The roots of this political structure can be found in the process of

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process of policy reform as one where orthodox economic policies were externally imposed on unwilling policymakers." In fact, "more often than not, reform has had a significant home-grown component exceeding World Bank expectations and stipulations" (Dany Rodrick, "Understanding Economic Policy Reform," *Journal of Economic Literature* 34 [1996]: 9–44).

Mexico's state formation. During the 1920s, Mexico was basically in a state of anarchy: several powerful local elites and armies held the control over each region. After President-elect Alvaro Obregón was assassinated in 1929, then President Calles formed the PNR as an emergency agreement with powerful groups and local bosses across the country to comply with the formalities of presidential elections.[2] In several states the existing bosses (*caciques*) and parties agreed to franchise the PNR name but did not yield any effective power to the central government. The state of Chiapas is a clear example.

The process of state formation, which paralleled the formation of the official party, consisted of transforming the independent local armies and power groups of each region into members of a national corporation. To induce them to accept this corporation, the government conferred on these groups monopoly rights over certain industries and/or geographic areas in exchange for loyalty. This consolidation process was enforced by an aggressive industrialization policy centered on import substitution and the undertaking of large infrastructure projects that generated significant rents for these groups. In addition the government granted generous tax exemptions and implemented favorable wage policies.

President Cárdenas (who served from 1934 to 1940) took this corporation process one step farther. First, he implemented an ambitious land reform through the Ejido program. This program gave the right to use land (but not ownership) to a vast number of peasants and absorbed the defeated peasant movements (Zapatistas) into the political corporation, minimizing the risk of future rebellions.[3] Second, the government gained control of the labor move-

2. See L. Meyer, "Los Inicios de la Institucionalizacion: La Politica del Maximato," in *Historia de la Revolution Mexicana*, vol. 12 (Mexico City: El Colegio de Mexico, 1978).

3. The *ejido* is a communal tenure system that prohibits the selling of land. This program limits peasants' access to credit and improvements in production and, in the long run, undermines agricultural productivity. Ultimately, the rural sector was

ment through the Confederacion de Trabajadores Mexicanos (CTM), which is still a pillar of the PRI. Lastly, the military was incorporated into the party.[4]

These policies generated social peace and high growth from the 1940s through the 1960s. A by-product was the entrenchment of powerful rent-seeking groups. By the late sixties one could distinguish two elites in the manufacturing sector: the private import-competing elite and the statist elite. In addition, the regional bosses who controlled the PRI voting machine and distributed government subsidies to the production of agricultural products comprised a rural elite. The statist elite was made up of networks associated with state-owned enterprises, such as managers, union leaders, and suppliers.

By powerful group or elite I refer to a group of people who control some fixed factors. Throughout the chapter I identify a group by the type of fixed factors it controls, not by the names of the people who comprise it. Thus, even if a group is destroyed, its members may remain powerful as part of a new group.

I turn now to the puzzle of why trade was not liberalized during the seventies, when it was considered necessary and when economic conditions could have supported it, but was instead enacted in the midst of the economic crisis of the mideighties. As discussed above, the political system in Mexico is such that no president had the autonomy to liberalize trade by decree since such liberalization implied the dismantling of a major part of the apparatus that generated rents for the strong elites. Therefore, in rationalizing trade liberalization events, we must bear in mind

polarized into two sectors, a modern and highly productive agricultural sector, with large-scale operation and access to export markets, and a backward sector formed mainly by ejido lands that remained isolated and scarcely linked to the market economy.

4. See A. Hernandez-Chavez, *La Mecanica Cárdenista. Historia de la Revoltion Mexicana*, vol. 16 (Mexico: El Colegio de Mexico, 1979).

that government actions do not reflect only the will of an all-powerful autocrat, nor are they solely determined by the will of a majority of atomistic voters. In addition to those of the president and the people, the interests of powerful elites exert a major influence over government actions. In all likelihood, all three interests influence most political events. In this chapter, however, I will emphasize the role of powerful elites. That is, I will explain the events in Mexico solely as the outcome of a game among powerful elites. I will assume that the president can take action and implement reform only if it is not blocked by powerful local elites.

As mentioned above, in the 1960s, 1970s, and 1980s, there were two strong groups within the Mexican manufacturing sector: the private import-competing elite and the statist elite. The political process guaranteed both elites almost unlimited access to fiscal revenue. They enjoyed subsidized inputs and profited from convoluted regulations and strict trade barriers, which increased the profitability of the fixed factors they owned. So why didn't these manufacturing sector elites unanimously block trade liberalization in the economically strained eighties as they had done during the seventies boom? The argument by Tornell[5] addresses this issue—the following is a summary of that argument.

To understand the process that led to trade liberalization, think of both the private import-competing elite and the statist elite as interacting in a preemption game. At every instant, each group has the opportunity to eliminate the other group's power by incurring a once-and-for-all cost. The group that incurs this cost becomes the leader and attains the power to monopolize fiscal transfers in the future. The other group becomes the follower and loses all claim to

5. Aaron Tornell, "Are Economic Crises Necessary for Trade Liberalization and Fiscal Reform? The Mexican Experience," in R. Dornbusch and S. Edwards, eds., *Reform, Recovery, and Growth* (Chicago: University of Chicago Press, 1995).

future fiscal transfers. If both groups incur the cost simultaneously (i.e., if they match), both see their power to extract fiscal revenue diminished, but neither loses relative to the other. The cohabitation equilibrium that sustains the status quo breaks down when the payoff of becoming the leader exceeds the payoff of maintaining the status quo. Moreover, if the payoff of matching is greater than the payoff of following, then each group weakens the other. In this case the government becomes relatively autonomous and is no longer beholden to elites. Therefore, it becomes free to implement a reform.

But when does the payoff of becoming the leader exceed the payoff of remaining in the status quo? To address this issue I note that all payoffs are functions of the fiscal revenue available for redistribution. As fiscal revenue declines, the marginal utility of gaining a greater share of it increases. Thus the payoff of leading increases relative to the payoff of remaining in the status quo, and the payoff of matching increases relative to following. For a sufficiently large decline in fiscal revenue, the payoff of leading becomes greater than the payoff of the status quo, and the payoff of matching becomes greater than the payoff of following. As a result each group tries to displace the other in order to get a greater share of the lower fiscal revenue. Hence, when fiscal revenue is low, the status quo collapses and the potential for reform exists.

Now let us apply this argument to the Mexican experience of the 1970s and 1980s. After the students' riot of 1968, the government of President Echeverria (president from 1970 to 1976) tried to reestablish legitimacy and assuage demands for a reduction in poverty and income inequality by expanding public investment. This expansion significantly strengthened the statist elite. Although Echeverria had a strong antibusiness rhetoric, he did not take any measure to reduce the rents received by the private import-substituting elite. For instance, in 1971 he tried to implement a tax reform to increase tax revenues, which made up 8 percent of GDP. However, he soon abandoned that move. Also, in 1973 Echeverria enacted a law that limited foreign investment, benefiting the private elite.

Echeverria's antibusiness rhetoric created a strain between the government and the private sector. President Lopez Portillo, elected in 1976, set out to relieve this strain. After the 1977 discovery of significant oil reserves, and after the price of oil had increased, the government enacted a free-for-all fiscal policy that benefited both elites. The increase in fiscal transfers showed up in the form of an increase in government expenditures from 10 percent of GDP in 1970 to 22 percent in 1982. An example of increased transfers to the private sector was the 1981 half-billion-dollar bailout of Grupo Alfa, the biggest private company in Mexico at the time. Other specific actions funded by the expansion included the acceleration of the investment program in government-owned enterprises, the subsidization of oil, gas, and electricity prices, and the establishment of an ambitious antipoverty program, the Mexican Alimentary System (SAM). SAM, which supported grain production and was intended to benefit the poorest citizens of Mexico, provided subsidies that were mostly captured by the rural elite.[6] Lopez Portillo's expansionary policies caused the fiscal deficit to jump from 10 percent of GDP in 1977 to 17 percent in 1982.

During the 1970s, fiscal revenue remained high enough to finance all this additional government spending. Government subsidies increased the probability of fixed factors owned by the statist elite and the private import-substituting elite. The elites were satisfied with the transfers they were receiving, so no powerful group had incentive to push for the structural reforms that were needed. During the boom years of the 1970s no group found that the benefit

6. J. Fox, "Political Change in Mexico's New Peasant Economy," in Cook et al., eds., *The Politics of Economic Restructuring* (San Diego: University of California Press, 1994).

of ensuring itself a large share of future fiscal revenue outweighed the short-run costs of weakening the other groups. Therefore, all powerful elites unanimously blocked reform during those years.

During the eighties, falling oil prices and an interruption in foreign lending forced cutbacks in Mexico's generous government transfer programs—fiscal revenue could no longer cover the demands of all interest groups. This reduction in the size of the pie increased the marginal utility of gaining a greater share of it, and increased the payoff of becoming the leader (recall the preemption game discussed above).

The statist elite made the first move, inducing the government to expropriate all Mexican private banks. The banks channeled much fiscal revenue to the private sector (through subsidized credit and implicit guarantees of their borrowing from foreign banks), and their owners comprised one of the strongest groups in the private elite. Lopez Portillo announced the banks' expropriation in September 1982, three months before he left office, in a dramatic address to Congress during which he cried over his failure to help the poor.[7] Alongside the expropriation of the banks, capital controls were imposed and Miguel Mancera, orthodox governor of Mexico's Central Bank, resigned. The private sector responded to these blows by announcing that a national strike would take place on September 8, but representatives canceled the strike a few days later.

The private import-competing elite matched the statist elite's first move. Aware that trade liberalization would be a mechanism by which it could destroy the power of the statist elite, the private elite did not oppose the liberalization in the 1980s as it had in the 1970s. This time, the private elite's choice was not between trade

7. It has been argued that the banks' expropriation was really a bailout. Indeed, the banking system was insolvent and the government took over all its liabilities. However, the point I want to stress in this chapter is that the bankers lost the right to operate banks and thus lost access to future bailouts, as well as the right to obtain other types of fiscal transfers.

liberalization and the protectionist status quo, but between trade liberalization and becoming the follower, which would mean being further expropriated by the statist elite. When President de la Madrid took office in December 1982, members of the private elite feared that under his tenure expropriations would continue and statism would increase. After all, he had been minister of budget and planning under Lopez Portillo and had budgeted the massive increase in investment in state-owned enterprises. Moreover, de la Madrid assumed the presidency before the Thatcher and Reagan revolutions repopularized free-market policies.

Trade liberalization has been painful for the private sector in that it has forced many firms into bankruptcy and has forced fixed factors to be reallocated, both of which have generated short-run adjustment costs. In addition, the private elite has lost the rents from protection it received before liberalization. Because of reallocation, it has also suffered from the loss of political power associated with the ownership of fixed factors in well-established industries. The extent of these reallocation costs was illustrated in the previous section.

Despite these drawbacks for the private elite, trade liberalization could drastically reduce the power of the statist elite to further expropriate the private elite and extract fiscal subsidies. This would occur through three channels. First, free trade would create new powerful groups of exporters and foreign investors with incentives to defend the new status quo. Thus, an expropriation would not only draw opposition from these new export groups but also from foreigners. Since the potential cost of confronting powerful foreign firms would be high, it is unlikely that the government would engage in further expropriation. Second, free trade abolished the complex system of import licensing and multiple tariffs, replacing it with one or two rates that apply across the board. This more transparent system quickly highlights rent-seeking behavior, allowing other groups to block such behavior right away. Third, agreements signed by a country as part of trade liberalization (such as GATT and NAFTA) impose limits on the extent of subsidization to specific industries and rent-generating regulations that a government can impose.

Ultimately, both elites became weaker and worse off after the expropriation of the banks and trade liberalization. It is important to note that there was no uncertainty beforehand that this would happen. Both groups induced this outcome because, as a result of decreased government revenue in the early 1980s, the payoff of unilaterally deviating from the status quo at that time by trying to become the leader exceeded the payoff of maintaining the status quo. (Note that the Coase Theorem does not apply in this case because there is no third party with the power to enforce an agreement between two elites.)

Once each group in the manufacturing sector had weakened the other, the de la Madrid and Salinas governments attained relative autonomy. They used this autonomy to implement a tax reform, a radical privatization program, and a deregulation program that eliminated many privileges and monopolies conferred during the consolidating years of the PRI.

The puzzling point I wish to highlight and the one I will try to rationalize is that these governments did not fully liberalize agriculture and services. From an economic standpoint, this is an incongruity. If a government's objective is to promote manufactured exports, the proper policy is to liberalize agriculture and services. Liberalizing agriculture would free unskilled labor and reduce unskilled wages. Liberalizing services would reduce interest rates, transport costs, and communication costs. Since unskilled labor and services are inputs in the manufacture of exports, the government would certainly promote exports by liberalizing agriculture and services, thereby driving down the costs of these inputs.

Why did the two governments choose not to follow such obviously advantageous policies? My next point is that the decision not to open trade in agriculture and services fully was entirely necessary to ensure that the reform process would not be derailed. Reformers needed two things to continue pursuing reform. First, they had to be reelected, which could be difficult given that initially the reform did not have much support in the population. Second, they had to avoid alienating all powerful groups simultaneously. With respect to the first requirement, reelection, the reformers depended heavily on the rural vote in the 1988 and 1994 presidential elections because reforms in the manufacturing sector had damaged the urban electoral machine and elections in urban areas had become more contested. With respect to the second requirement, delaying liberalization of agriculture and services allowed the government to avoid alienating all powerful elites simultaneously, while building new elites to support the new strategy of export promotion and private property.

Let us elaborate on the first requirement, the issue of reelection. A few months before the presidential elections of 1988, some members of the statist elite who had spun off from the PRI combined with leftist parties to form the Partido de la Revolution Democratica (PRD) and captured a third of the vote. Also, the private elite increased its involvement in politics following the 1982 expropriation of the banks. This involvement broke the private elite's implicit agreement with the government by which the private elite stayed out of politics and the government in turn ensured a profitable investment climate.[8] As a result, elections in urban areas became more contested. Therefore, the PRI has had to rely more on the rural electoral machine to win presidential elections. For instance, Salinas, who received 50.5 percent of the total vote, won only 34.0 percent of the vote in "very urban" areas, while he received 77.0

8. S. Maxfield and R. Anzaldua, eds., *Government and Private Sector in Contemporary Mexico* (San Diego: University of California Press, 1987).

percent in "very rural" areas.[9] The rural electoral machine is closely linked to the network that administers protection to the agricultural sector. Opening trade in agriculture and thus dismantling this protectionist network might have destroyed the rural machine and, with it, the presidential hopes of reformers like Salinas and Zedillo.

To expand on the second requirement above, one can view the second part of the de la Madrid administration and the Salinas administration as having been devoted to creating new elites that would support the export promotion and private property strategy. Two new elites were formed under these administrations: the private export elite and the foreign investors elite. Deregulation, privatization, and new rules for foreign direct investment (FDI) were used as instruments in promoting these elites. Deregulation eliminated the convoluted rules that allowed some groups to enjoy monopoly rents.[10] Through privatization, the government transferred to the new private elite virtually all the firms in the manufacturing sector, with the exception of the energy sector. Through less discretionary rules the government attracted a significantly greater amount of FDI than it had historically. These actions further weakened both the statist elite and the old private import-competing elite.

Several investors who had not been in the big leagues during the 1970s and 1980s were able to acquire government assets which transformed them into what one might call "new strong groups." The steel industry illustrates this point. Before privatization there was only one private integrated steel producer in Mexico—Hylsa (a subsidiary of Alfa, beneficiary of the 1981 bailout discussed above). After the privatization of the steel sector, the relative power of Alfa

9. See J. Fox, footnote 6.

10. A. Fernandez, "Deregulation as a Source of Growth in Mexico," in R. Dornbusch and S. Edwards, eds., *Reform, Recovery, and Growth* (Chicago: University of Chicago Press, 1995).

diminished drastically—now it is only one among five major steel producers. The others are GAN, a consortium of a former pharmaceutical group, a small mining group, and a Dutch steel producer; IMSA, a group of former medium-sized steel producers; ISPAT, a group from India; and Villaccro, a group of former medium-sized steel traders. It is interesting to note that as a response to the increased competition induced by privatization, Alfa recently opened a new steel plant that is internationally competitive. Before privatization, it is likely that Alfa would simply have sought more protection and received it, threatening to close down if it did not.

Today, shutdown threats from a single steel producer could not effectively induce protection because other domestic producers are available to fill the employment and production gap a shutdown would create. An example of this new regime is the recent bankruptcy of AHMSA, the largest steel producer in Mexico. In early 1999 the government refused to bail out the company when it declared that it could not meet its debt service on nearly two billion dollars.

Another indicator of the dilution of power within the private elite that Salinas's reforms have brought about is the increased number of Mexican billionaires. According to *Forbes* magazine, there was only one billionaire family in Mexico in the late 1980s—the Garza Sada family, Alfa's major shareholder. In 1994, there were twenty-four Mexican billionaires, according to *Forbes*. Outstanding examples are Roberto Gonzalez, Carlos Slim, and Salinas Pliego. Gonzalez developed the market for tortilla flour and is the biggest producer of tortillas in the United States. In the recent privatization of the banks he acquired Banorte. Slim controls Telefonos de Mexico, the telephone monopoly, in association with Southwestern Bell and France Telecom. Salinas Pliego is the top Mexican retailer of household appliances. He recently bought from the government Television Azteca, which has a joint venture with NBC, making him the only private competitor of Televisa, Mexico's other television network. It is worth noting that ten years ago none of these families were billionaires — they did not even rank among the country's richest.

I should clarify that the new elite was not totally formed by newcomers; in fact, many of its members had familial or historical links to the old elite. The important point is that the new group is defined not by the historical background of its members but by their interest in defending the new set of property rights. This common interest is in turn determined by the fact that they own and control fixed factors whose profitability depends on exports.

Summing up, the policies followed by the government during the period 1985–1994 (trade liberalization, deregulation, opening to foreign direct investment, and privatization) had the effect of weakening the statist elite and the private import-competing elite and inducing the formation of two new powerful groups: the export elite and foreign investors. Since these new elites will benefit from the new set of property rights that have been imposed, once their power is consolidated, in the near future they are likely to expend resources to ensure that these property rights are maintained.

We should emphasize that the executive has played a critical role in this process as a coalition builder, not as an authoritarian central planner. This does not mean that the administrations of de la Madrid and Salinas did not push hard for unpopular policies designed to establish the new property rights regime that would support an efficient export economy. Important examples of their efforts in this direction are the tax reform, the privatization program, and the deregulation program.

Next, I try to rationalize President Salinas's willingness to incur such high political costs in order to ensure NAFTA's approval by the U.S. Congress. Under NAFTA, trade liberalization in services and agriculture was not going to be immediate but would happen gradually over the following ten to fifteen years. This gradual liberalization would be a blow to the elite associated with traditional agriculture, who derive their power from the distribution of subsidies to inefficient producers. This is a serious concern because the PRI vote comes largely from rural voters, and to a great extent the agricultural elite controls the machine that produces this vote. Thus, trade liberalization would destroy an important part of the PRI voting machine over the next decade. This creates a good deal of uncertainty about who will gain lasting power in the future. The Chiapas uprising on January 1, 1994, the day on which NAFTA was enacted, symbolizes this uncertainty. Regardless of whether the uprising originated in the peasantry or was induced by an elite that opposed trade liberalization, it proved that there are opponents to the new regime.[11]

The uncertainty regarding who will get lasting political control once the PRI's agricultural voting machine is weakened will make it politically expedient to delay indefinitely further liberalization or derail reform altogether. My point is that NAFTA is the commitment device that will ensure that such delay will not occur and that reform will continue. This will happen in two ways. First, huge political and economic costs are associated with breaching an international agreement such as NAFTA. Second, NAFTA will consolidate the power of the new export groups that will have in their interest defending the new set of property rights.

NAFTA will benefit and strengthen the new Mexican export elite for two reasons. First, it will facilitate the establishment of links with foreign firms interested in the maintenance of policies that support free trade. Second, it will allow the Mexican export sector to grow and become a big player in the domestic arena. NAFTA will achieve this by reducing the uncertainty generated by trade disputes and by facilitating U.S. and Canadian access to Mexican goods.

11. P. Hinestrosa and A. Tornell, "Las Condiciones Economicas Como Factor de Descontento Social: El Caso de Chiapas," in Maria Luisa Armendariz, ed., *Chiapas: Una Radiografia* (Mexico: Fondo de Cultura Economica, 1994).

Also, NAFTA will reduce the cost of inputs, making Mexican exports more competitive. Liberalizing trade in agriculture will increase the supply of unskilled labor, thus reducing the real wages of unskilled workers;[12] liberalizing trade in services will reduce interest rates, transport costs, and communication costs.

By the time the reforms stipulated by NAFTA take effect, the new export groups should have already consolidated their power. Thus, they should be able to defend the new status quo, ensuring that reform is not derailed in the transition. The new groups will be able to defend the new status quo in several ways. For instance, they could finance the campaigns of politicians who favor the status quo as opposed to expropriation and inward-looking policies. Also, should the government in place try to renege on reforms, they could finance opposition groups. Regardless of what parties form and win elections in the future, they will find it costly to alter the development path established by the de la Madrid–Salinas regime. Thus, once the new groups have consolidated their power, the probability of derailment will be small.

The bailout that the Mexican government received in early 1995 after the financial panic of December 1994 exemplifies this point. Given that in early 1995 Mexico did not have enough liquidity to repay its dollar-denominated short-term debt, a default was likely. This default might have forced the government to follow inward-looking policies and increase anew the power of traditional elites, risking the derailment of reforms. The network of U.S. firms with investments in Mexico used its political clout to induce an unprecedentedly speedy response from the U.S. government and international organizations. Within a few weeks approximately fifty billion

12. Anthony Venables and Sweden Van Wijnbergen, *Location Choice, Market Structure, and Barriers to Trade: Foreign Investment and the North American Free Trade Agreement* (London: Centre for Economic Performance, London School of Economics and Political Science, 1993).

dollars in credit lines and loan guarantees was lined up. This support allowed Mexico to repay its short-term debt and even to resume borrowing in international markets by mid-1995. Moreover, the Mexican government responded to this crisis with an acceleration of the privatization program and the opening of the financial system. The fact that the U.S. network used its power to save Mexico from a reform-endangering situation suggests that Salinas was successful in inducing the creation of groups that would defend the reforms begun by de la Madrid.

The Experience of Chile

It is interesting to compare the Chilean and Mexican experiences. The conventional wisdom holds that trade reform took place in Chile because Pinochet was a tough dictator. A closer analysis reveals that causation runs in the opposite direction.[13] Before reform, the powerful groups in Chile were the unions, the import-competing elite, and the landed elite. Unlike Mexico, it was not a drastic collapse in the terms of trade that induced a breakdown of the status quo in Chile but rather a sharp increase in the number of unions. During Frei's administration new rural and urban dwellers' unions were created, and the number of strikes increased dramatically in the late sixties. This trend accelerated during Eduardo Allende's administration, during which many private firms were expropriated. The political change associated with reform was more drastic than that in Mexico. In 1973 a military coup brought Pinochet to power. From my perspective the interesting point is that the

13. See J. Frieden, *Debt, Development, and Democracy* (Princeton, N.J.: Princeton University Press, 1991); A. Valenzuela, *The Breakdown of Democratic Regimes: Chile* (Baltimore, Md.: Johns Hopkins University Press, 1978); A. Velasco, "The State and Economic Policy: Chile 1952–1992," in B. Bosworth, R. Dornbusch, and R. Laban, eds., *The Chilean Economy: Policy Lessons and Challenges* (Washington, D.C.: Brookings Institution, 1994).

trade reform introduced in 1975 destroyed a major part of the manufacturing sector but did not generate any opposition from the private elite or the replacement of Pinochet, as usually has occurred in the rest of Latin America. In fact, Chile was the only case, among the Latin American regimes of the time, that evolved into a personal dictatorship[14] because trade reform destroyed the power of the unions. In fact, unionization fell from around 40 percent in 1973 to less than 15 percent in 1990. This point is nicely put by Steppan: "The persistence of fear within the upper bourgeoisie was an important element in the bourgeoisie's willingness to accept individual policies that hurt the upper class . . . but were seen to be the necessary cost of protecting its overall interests. It is impossible to understand the passivity of the industrial faction of the bourgeoisie in Chile . . . outside of the context of fear."[15]

To summarize a bit, trade reform was an unwanted outcome in Chile and Mexico. It was the costly action undertaken by the private elite to stop the expropriations initiated by its rivals. In both countries powerful groups ended worse off than they had been under the status quo.

Conclusions

In retrospect, the sequence of reform policies adopted in Mexico is fascinating. Neither step resulted from the decree of an all-powerful autocrat, and each step both had the support of a powerful group and generated new powerful groups that would support further reforms. The first step was to liberalize trade in manufactures. The government undertook this action not when it realized its ne-

14. S. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman: University of Oklahoma Press, 1991), chap. 3.

15. A. Steppan, "State Power and the Strength of Civil Society in the Southern Cone of Latin America," in P. Evans, D. Rueschemeyer, and T. Skocpol, eds., *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985), p. 321.

cessity but only when the unanimity of the powerful groups within the manufacturing sector broke down in the 1980s. The second step was to consolidate the power of emerging elites with an interest in export promotion, an objective that the government achieved through privatization and deregulation. The third step in the sequence was the signing of NAFTA, and the fourth step will be to actually dismantle protection in the agriculture and services sectors.

The trade liberalization process was not a historically predetermined outcome but was brought about largely through the decisive contributions of Presidents de la Madrid and Salinas. De la Madrid recognized the window of opportunity created by the economic hardships of the mid-eighties and began liberalization at the start of his administration. He also recognized the limitations of this opportunity and did not try to liberalize the entire economy. Salinas consolidated the power of the new export group and, by signing NAFTA, committed Mexico to total liberalization in fifteen years.

Chances are that if all these steps had been taken at once, Mexico's powerful groups would have colluded and blocked the reform. We can see this from the Venezuelan experience, an interesting contrast to the Mexican one. In 1989–92, Venezuelan president Carlos Andres Perez tried to implement many reforms simultaneously. All the powerful groups in the population opposed him, forcing him to resign. Moreover, his successor, President Caldera, backtracked on many of Perez's reforms.

In Mexico, beginning in the late sixties, it became evident that the protectionist development strategy was no longer beneficial for the country. However, trade liberalization did not take place until 1985, and the badly needed fiscal reform did not take place until 1989. In this chapter, I offer an explanation of why these reforms were delayed and not implemented during the 1970s, when the country could afford the costs associated with these reforms. My premise is that welfare-improving reforms for the country were blocked by powerful interest groups that stand to lose from these reforms.

The interest groups that blocked the reforms during the seventies were the private import-competing elite and the parastatal elite. In the seventies, both groups were interested in keeping the status quo. Since fiscal resources were plentiful, both groups enjoyed high subsidies, which kept the profitability of their fixed assets at a high level. Under these circumstances, it was not profitable for either group to redirect its assets away from productive activities in order to reduce the power of the other group and guarantee for itself a greater share of fiscal revenue. Hence the status quo prevailed.

The equilibrium between these two powerful groups broke down when the debt crisis erupted in 1982 since the government could no longer maintain high levels of subsidies. The struggle between interest groups took place in the spheres of private bank expropriation and trade liberalization. The short-run costs of trade liberalization were the adjustment costs implied by the efficiency effects of free trade. The private elite benefited because the power of the parastatal elite to expropriate and obtain studies was reduced. This mutual weakening gave temporary autonomy to the government to implement fiscal reform.