NET AND TOTAL TRANSITION COSTS:
THE TIMING OF ADJUSTMENT

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Capitalist economies recurrently face budget deficits and increasing public debt. Thus, from time to time, policy-makers must meet the challenge of fiscal adjustment. In order to maintain or recover state solvency, it is necessary to reduce public expenditures or increase taxes. The adjustment costs involved in such actions are obvious. They are often thought of as major obstacles to economic reform. Yet, they are short-term costs that should be compared with the costs of muddling through the crisis, i.e., the costs of not adjusting. In this paper we will define as net transition costs the difference between the costs of adjustment and the costs of muddling through. We also define total transition as the cumulative costs that a country faces from the time economic distortions emerged, causing inflation and eventually an output gap, till the moment economic reforms allow the country to return to stability and growth.¹

The concept of net costs will be useful to size up the timing for adjustment policies. If the decision to adjust is taken at an early stage, as it usually occurs in the advanced societies, net costs will probably be high. As a trade-off, the economy will stabilize and recover sooner. Thus, total or medium term costs will be smaller, the over all benefit to society as a whole will be greater. On the other hand, if adjustment is delayed, as often it dramatically happens in developing economies, the costs of muddling through the crisis will increase as time goes on, until they exceed the costs of adjustment. When this happens, delaying adjustment will be irrational in collective action terms, even in the short run. Yet, for each individual and for interest groups, this may not be so, since they will face their

¹ - The concepts developed in this paper were initially developed by Bresser Pereira (1992), inspired by Przeworski's discussion of the transition costs of economic reforms (1992). Jairo Abud commented them (1992).

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own costs of adjustment and muddling through. The literature on the timing of adjustment usually emphasises the distributive conflict between groups or classes. This aspect will be also included in this paper, but we are rather dealing with a collective action problem. Our main concern will be concerned with the relations between the costs of adjusting and the costs of muddling through the crisis - costs that can be taken for the country as a whole and for each individual interest group.

In the first section of this paper we will discuss the concept of net costs of adjustment and propose two curves - the cost-of-adjustment curve and the cost-of-muddling through curve. Timing is an essential component of the concept. Society’s time preference (future discount rate) will be a major factor in selecting when to implement adjustment measures and in determining the corresponding net costs. In the second section, we will discuss three adjustment styles relating them to different country experiences: adjustment when net transitional costs are positive, when they are near zero, and when they are negative. In the third section we will define and discuss the total costs of adjustment. Finally, in the forth section we will introduce social conflict, and we will discuss the different net and total transition costs faced by interest groups.

The central question addressed here is why certain societies decide to adjust earlier than others. In theory, once fiscal unbalance is recognized, the sooner adjustment is undertaken, the higher the net transitional costs. The smaller, however, will be total or medium term costs. The evaluation of the total costs involved will depend on the definition of the relevant adjustment timing. In practice, countries whose population have a high time preference for present consumption or that are lenient with inflation, will tend to postpone adjustment. Besides, conflicting group interests may have an important role in the timing of adjustment.

1. The Net Costs of Adjustment

The net transition costs of adjustment are defined as the costs of adjustment less the costs of muddling through the crisis. When economic reforms are required, policy-makers have two options: start reforms as soon as economic problems arise or muddle through it, embracing a crisis-management policy to face the demands of the different social groups. As muddling through related economic distortions appear, the burden will be shared in different degrees by segments of society. Clearly, a muddling through policy - perhaps waiting for a social consensus on the required reforms - implies smaller costs at the outset, when compared to the short term costs involved in adjustment programs, that usually include public expenditure cuts and/or tax increases, and, eventually, temporary recession and unemployment. Thus, for society as a whole adjustment costs involve short term
loss of output, or some welfare loss. For each individual group, they represent revenue losses, that will be different for each group.

The difference of this two costs give us the net costs of adjustment. If these net costs are positive and high, society will tend to shun reform, unless it has a strong preference for future consumption, or if it is characterized by a strong sensitivity to the economic distortions. If, for instance, a given society is highly resistant to inflation, it will support adjustment more easily than if it is used to price instability.

The actual estimation of net transition costs is difficult. In a stylized way, however, it is possible to estimate it, depicting in the same figure, the costs of adjustment and the costs of postponing adjustment. Figure 1 shows two curves: the cost-of-adjustment curve and the cost-of-muddling through curve. In the horizontal axis we have time and in the vertical one, costs. Thus, as the curve rises, costs go up.

Figure 1: Adjustment and Muddling Through Costs

The $C_1$ curve represents the costs involved in postponing the solution of the crisis, as society hesitates to undertake the required fiscal adjustment and the government adopts ad-hoc policies that only increase economic distortions in resource allocation and income distribution. These costs become evident when chronic budget deficits and excess demand turns into balance of payment problems, rising inflation, reduction of the growth rates, unemployment. Muddling
through costs ultimately derive from the fact that economic agents lose confidence in government policy and in the prospects of the economy, develop negative expectations, and eventually reduce their investments. In quantitative terms, the muddling through costs could be measured by the rate of inflation, that is, by an indicator of economic disarray, by the gap between actual and potential rate of growth, and by the ensuing unemployment. This curve rises at an increasing rate. As time goes the costs per unity of time of delaying adjustment increase, assuming the form of chronic recession and lasting unemployment. In the limit, when the economy arrives to hyperinflation and economic chaos, these costs become exceedingly high: the $C_1$ curve turns increasingly vertical.

Curve $C_2$ represents the envelope curve of many possible actual cost-of-adjustment curves. This envelope curve - as well as each individual curve - has a inverted U-shape. As adjustment is undertaken, costs immediately increase, as public expenditures are reduced or taxes, increased. Yet, this cost increase is short-term. Soon the costs of adjustment will level out and start being reduced, as the economy stabilizes and growth is gradually resumed. $C_2$ is an envelope curve because it contains “n” curves, representing each one the costs of a specific adjustment program over time until the program meets its target: stabilization and growth resumption.

While there is no decision, a given country that is facing an economic crisis is in the $C_1$ curve: it is incurring in the cost of delaying adjustment and economic reform. When a real decision is taken to start reform, the country will “jump” from curve $C_1$ to curve $C_2$. Now the relevant costs are the adjustment costs, that include and initially aggravate the costs of the ongoing economic crisis.

At a given time, the distance between the two curves represents the net transition costs, $NTC(t)$:

$$NTC(t) = C_1(t) - C_2(t)$$

Initially net transition costs (and the area between $C_1$ and $C_2$, that corresponds to the net transition costs) are positive, since adjustment costs are in the short run higher than the muddling through costs. They turn negative when $C_1$ cuts $C_2$. After this point even in the short run net transition costs are negative: adjustment costs are now smaller than the costs of delaying adjustment.

The $C_1$ curve cuts the $C_2$ curve in the moment that turns quasi-vertical. When this happens, it ceases to be rational even to economic agents with a high time preference for present consumption. Since the $C_2$ curve is a hypothetical

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2: Since we are using time in the horizontal axis, to speak of a vertical perfectly inelastic curve is just a metaphorical approximation. Strictly, it is impossible to measure elasticity when one of the variables is time, on the other hand, the curve cannot be vertical, since time is always an elapsing movement. Yet, the two curves are inter-related, as the figure
envelope curve, it assumes rational behavior of economic different agents revealing different time preferences. The more short term is the time preference of the economic agent, the later he will undertake adjustment. But, after the $C_1$ curve turned quasi-vertical, it make no sense any more to delay adjustment, even for an economic agent that is only interested in the present gains, discounting future consumption at a very high rate.

Figure 2: The C$_2$ as an Envelope Curve

In Figure 2 we just depict the C$_2$ cost-of-adjustment envelope curve. And we draw three of the "n" actual possible curves, each one representing a different time preference for future consumption. $C_{2a}$ represents a situation where society adopted soon economic reforms, proving a clear preference for future consumption, while, in the extreme, $C_{2c}$, represents the opposite: a strong preference for present consumption. Notice that three curves have the same inverted U-shape, for simplification the same slope while costs are increasing, but different recovery slopes. The steeper the slope of the curve, the more efficient economic reforms are, the sooner the economy will reach stability and resume growth. In Figure 2, the more efficient adjustment is depicted in curve $C_{2b}$.

shows. When the cost curve of muddling through the crisis nearly vertical, there is no more rational justification to postpone adjustment. The correspondent envelope curve of adjustment costs is supposed to have reached its maximum point.
Curves $C_1$ and $C_2$ follow a standard path shown in Figure 1. Starting from a same point, it can easily be seen that initially $C_1 < C_2$, since the short term costs of muddling through the crisis are small or none, while the transition costs-of-adjusting, high: the economy is growing and employment, rising; to adjust means recession, temporary unemployment. In this moment, although inflation is rising and the threat of a balance of payments crisis looms in the horizon, the need for reform is not easily perceived by society, particularly if its members time preference is short termed. As a result, the required fiscal adjustment, or - more broadly - the required economic reforms will probably not achieve political support. Yet, as times goes on, economic distortions will increase, public savings will be reduced and the state will come to a fiscal crisis. On the other hand, inflation will rise, the investment rate will decline, economic activity will slow-down. In this moment, as the net transition costs turned negative, political support for economic reforms will or should increase and reform should be undertaken.

At that time there will be no more room for variations in time preference, since even in the short run it is advantageous to adjust. Yet, this change will not take place immediately, since there is a perception gap between the moment net transition costs become negative and the moment this fact is perceived by society. On the other hand, society may delay economic reform because it is not certain of the adjustment costs involved. Since economic agents are risk averse, if the economic reform implies radical measures, whose outcomes are difficult to predict, society will tend to postpone reform.
Besides, net adjustment costs may have turned negative for society as a whole, but they may remain positive to some powerful economic groups, that will continue to oppose reform. We will discuss this ahead in this paper.

While we dealt just with an hypothetical curve, as $C_2$, we could not measure the total costs involved. In the moment, however, that we turn to actual cost-of-adjustment curves, as we do in Figure 3, it is possible to measure the net transition costs and the total transition costs.

In Figure 3, the moment where reforms start to be implemented is $t_1$. In this moment the economy jumps from $C_1$ to $C_2$, that assumes the form of $C_2a$. There is an immediate and large increase in costs in this jump, since we assume that the society will have to incur in the adjustment costs that $C_2$ depicts. For some time adjustment costs will continue to increase, but as positive results began to appear, the curve changes direction and recovery starts.

The total net transitional costs (TNTC) shown in the shaded area in Figure 3, can be expressed as:

$$TNTC(t) = \sum_{t}^{t_2} [C_1(t) - C_2a(t)]$$

were $t = t_1$, time when the reforms are implemented and $t = t_2$, time when ($C_1 - C_2a = 0$)

Also, in Figure 3, the total transition costs can be expressed as the area between the horizontal axis and the cost path formed by cost-of-muddling through curve, the jump to the cost-of-adjustment curve, $C_2a$, and this curve itself. The total transitional costs will be discussed in part 3.

2. Net Transition Costs: Positive, Neutral, or Negative

The net transition costs incurred by a country may be positive, neutral or negative, depending on the moment the country undertakes adjustment. The sooner adjustment will be undertaken, the higher, or more positive will be net transition costs. As a trade-off, the smaller will be total transition costs. Conversely, if adjustment measures are adopted late, net transition costs will most likely already be negative, but, in compensation, total transition costs will be higher than in the previous alternative.
Net transition costs will be positive whenever adjustment is undertaken before the cost-of-adjustment curve, \( C_2 \), is below the cost-of-muddling through curve, \( C_1 \). Or, in other words, when economic reforms, that is in this paper we are equating to fiscal adjustment, are initiated soon after economic distortions arise. Government, responding to the crisis, implements adjustment measures by reducing public expenditures, increasing taxes, getting prices right, particularly the exchange rate, that will be usually devaluated, and public prices that will be raised, eliminating subsidies. The country, at this moment, faces normal times, and the standard IMF stabilization policy is recommended.

Figure 4: Positive, Neutral and Negative Net Transition Costs

Figure 4a (case 1) presents a case of net positive transition costs. The stabilization or adjustment program starts at time \( t_1 \). In this moment costs jump from \( C_1 \) to \( C_2 \) due to the adjustment program. The economy, that is living an artificial boom but is threatened by a balance of payments crisis, while inflation is beginning to accelerate, is suddenly constrained to adjust. As a consequence costs of muddling through, that were none or practically none, change into net positive costs of adjustment. Yet, after some time the program will show results. Depending on the efficiency of the economic reforms, the cost-of-adjustment curve will, sooner or later, turn up and, again depending on this efficiency, will
present a steeper or less steeper slope, till the curve reaches the horizontal axis, representing stability and growth. The net transition costs, or the positive
difference between $C_1$ and $C_2$, can be seen in the shaded area, which represents
the total net transition costs or the burden involved in the decision to adjust the
economy at an earlier stage of the crisis.

Case II (Figure 4b) is of a country that incurs zero or neutral net costs. In
this case society delays the adjustment process when economic distortion emerge.
It will remain in the $C_1$ curve, muddling through the crisis, adopting partial
adjustment measures, managing the demands of the different social groups in the
hope that a “consensus” to undertake reforms will be eventually achieved, or
better - a miracle, an exogenous positive factor will permit to avoid them. Yet, the
costs of muddling through the crisis continue to augment. Balance of payments
stabilization may have been achieved, but inflation is now probably high. And the
economy probably is already slowing-down. If, when they are becoming equal to
the adjustments costs, a consensus is achieved and society decides to start its
adjustment process, net costs of adjustment will be none. This case is illustrated in
Figure 3b. Reforms starts at time $t_2$, when $C_1$ crosses $C_2$ ($C_1-C_2=0$).

Finally, in Figure 4c (case III) we have a case of negative net costs of
adjustment. In this case the distortions of the economy went so far, that the
adjustment program itself will in the short run reduce costs, but total costs will be
very high, given the extraordinarily high costs of muddling through the crisis. The
economy will be, in this moment, living abnormal times. Budget deficits turned
into a fiscal crisis. Public savings are now negative, the state lost credit. Inflation
turned to hyperinflation. The economy is experiencing chaos. In this moment,
standard IMF stabilization policies, that were already doubtful in the second case,
will probably not work. It is not enough to adopt gradual fiscal and monetary
policies, nor to get prices right. Besides orthodoxy abnormal times require some
type of heterodoxy. Only a shock, with the definition of a nominal anchor, will
end inflation. The anchor may be an exchange rate, the money supply, some
strategic prices, or all prices (a freeze). Some kind of explicit political agreement
will have to be reached - an agreement that express a real compromise or,
alternatively, just the victory of a group over another. 3

In this case the decision to adjust and reform is taken at time $t_3$, after the
costs-of-muddling-through curve crossed the cost-of-adjustment curve. net
transition costs are negative. Even in the short run there are no net costs-of-
adjusting. On the contrary, once economic reforms as undertaken, the explosive
increase in the costs of postponing reforms is halted, expectations turn favorable,
and the economy starts recovery, that, depending on their efficiency, may produce
rapid positive outcomes.

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3 - In Alesina and Drasden paper (1991), only the last alternative is admitted. Economic
reforms are undertaken when one group is defeated and is constrained to take on all or
most adjustment costs.
These three cases may be illustrated by countries that fell into crisis in Latin America in the 1980s. Mexico provides an example of positive net adjustment costs. Mexico decided to start its adjustment program in 1983, just after the debt crisis broken up. There is no doubt that was a painful adjustment process. Yet the country or its government, where the role of President de la Madrid was crucial, showed a future consumption preference. The pay-off was positive. The economy stabilized in 1987 and started growing in 1990. Chile is another example. Soon after the 1982 crisis, economic deep reforms were undertaken. The fiscal crisis was completely overcome, and, since 1985, the country has been growing with price stability.

Bolivia, Argentina and Peru are examples of case III. These three countries only undertook fiscal adjustment and economic reforms after hyperinflation, when the costs of muddling through the crisis had sky-rocketed and net transition costs turned negative. Bolivia did that in 1985, Peru in 1990, Argentina in 1991. Neither Argentina nor Peru may be seen as having achieved the target line, but recovery is underway.

Finally, Brazil is an approximate illustration of case II. The country has not, yet, experienced hyperinflation and economic chaos. Thus, net transition costs have not turn negative. As a consequence, governments continue to muddle through the crisis. Several attempts to adjust and reform were undertaken but lack of political support and/or wrong diagnosis about the cause of inflation depicted a quasi-horizontal C2a curve leading to high costs without reaching the target. Stabilization has failed till the moment this paper was written (June, 1994), but some structural reforms, such as trade liberalization and privatization, were implemented, and substantial although incomplete fiscal adjustment was achieved. In the first semester of 1994 an innovative stabilization program was being implemented, justifying hope that adjustment and reform will eventually be achieved before economic chaos make it imperative.

It is difficult to say which of these countries has undertaken the highest total costs. Probably Peru and Argentina, countries that faced hyperinflation. Brazil is still an open case.

3. Total Transition Costs

Thus, the later adjustment is initiated, the smaller will be the net transition costs. When the economy reaches or nears hyperinflation, net transition costs are negative. What, however, will happen to total transition costs? Total costs are the cumulative costs of muddling through (while adjustment is not undertaken) plus

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4 - Argentina tried to adjust and reform since 1985, with the Austral Plan, but failed. In this paper we are ignoring failed adjustment attempts.

5 - See Bresser Pereira (1993).
the cumulative adjustment costs from the moment the decision to adjust is taken. In the figures where we have actual cost-curves and not a hypothetical envelope one, it corresponds to the area between the horizontal axis and the path the country undergoes when unbalance begins, first incurring in muddling through costs and second, after adjustment is initiated, in adjustment costs. Initially, while adjustment is not undertaken, this path constituted by the cost-of-muddling through curve. After it is started, by the cost-of-adjustment curve.

If net transition costs are reduced as adjustment is delayed, the opposite happens to total transition costs. The later economic reforms are undertaken, the greater total transition cost will be then. The reason is that if economic adjustment is achieved soon after economic distortions manifested themselves, the economy will (1) avoid the costs of muddling through the crisis, and (2) turn easier stabilization and the resumption of growth.

The first reason derives clearly from the above analysis. The costs involved in postponing adjustment and economic reform are increasing and may end up being very high. The second is related to what we have been referring as the efficiency of economic reforms, but this subject should now be broadened to include the increasing difficulty to stabilize and resume growth that an economy that falls into deep crisis faces. Failure in fiscal adjustment and stabilization programs are very common, but they are particularly frequent when the crisis turns extreme and the economy faces abnormal times. In normal times, conventional fiscal and monetary policies have a good chance to be effective and efficient. In abnormal times there are no easy paths to adjustment and reform. The policymaker will not be permitted to use just standard formulas. Besides or instead, he will have to resort to imagination and be sometimes audacious. Shock treatment will often be required. And he will never be sure that his policies will work, not only because they may lack sufficient political support, but also because in the abnormal times that characterize deep crises he will have to adopt innovative policies that may be the required ones for the occasion or may just be wrong or inefficient. If this is the case the economy will continue incurring in the cost-of-muddling through, notwithstanding the attempt to adjust and reform. Total or cumulative costs will continue to increase.6

Figure 5 compares the total costs involved in the three preceding cases. Since costs emerge when distortions appears and cease when the specific cost-of-adjustment curve meets the horizontal axis (target) total costs can be represented by the area between the horizontal axis and the costs path, that combine, in a succeeding way, the cost-of-muddling through and the cost-of-adjustment curve.

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6 - A failed attempt to adjust may lead to a jump to the cost of adjustment curve (or at least midways between it and the muddling through curve), but, instead of taking a path that leads to the growth path the economy just goes back to the muddling through curve. In our graphics we are not showing this case, but this could be easily done.
Although net costs may be negative, total costs are always positive and increasing as time goes on. As it can be seen in Figure 5, in case I the area representing total costs is smaller than case II, which in turn is smaller than case III. In this last case, the fact that the country was facing negative net costs when it decided to reforms does not mean that its total transitional costs are not large. On the contrary, it indicates that they have become extremely high.

4. Different Social Groups

Thus, once fiscal unbalance is defined, the sooner adjustment is undertaken, the higher the net transitional costs, but the lower the total adjustment costs. Yet, history has shown that in many occasions societies fail to provide political support to the required reforms, remaining on the C1 curve. This behavior may be irrational on a collective standpoint, but it is not irrational if, instead, we desegregate society into its constituent social groups. If society is highly heterogeneous, characterized by high income concentration, conflicts will be more acute, populist policies that aggravate the crisis will be more likely (Sachs, 1988), adjustment will tend to be delayed (Alesina and Drazen, 1992).

The assumption is that total transition costs will be shared unequally between social groups. First, because the muddling through costs may be different,
second because the burden of the adjustment may be  
be read differently, depending on the group.

Different muddling through costs imply that the crisis affects social groups in a distinct way. If, for instance, an economy experiences a fiscal crisis and high inflation, it will probably be constrained to have high real interest rates. This will damage society as a whole, but it will favor renters. As to the burden of adjustment falling on certain groups rather than on others, the examples are numerous. If it is necessary to raise taxes, whose taxes will be increased? If it is necessary to cut public expenditures, which groups, sectors or regions will suffer more? If it necessary to eliminate subsidies, which ones will be eliminated? Besides, some adjustment policies that are supposed to stabilize the economy or to improve resource allocation, in fact are just policies that favor one group against another. As mentioned in Haggard and Kaufman (1992: 307-308), if, during high inflation, sectors (or firms) are able to hold nominal wage increases below price increases having as justification the need to control inflation, that would represent a draconian cut in real wages but would only have a slow and marginal affect on inflation.

Thus, net and total costs of adjustment will vary depending on the social group and on the chosen economic reform. In theory it would be possible to draw different $C_1$ and $C_2$ curves for each social group and for each stabilization policy. For each group the cost-of-muddling through curve has a different slope. For some the intersection with $C_2$ will take longer to be achieved. Worse than that, these groups may be profiting from the economic chaos, in such a way that for them net transition costs are not negative. On the other hand, also the cost-of-adjustment curve may have a different format, as social groups lose more or less with reform. Thus, net transition costs may be already negative for society as a whole, but for several groups they may still be positive, because they are not losing with the crisis, or because they will lose more than others with adjustment.

These groups that are not losing with the crisis or that will lose more with adjustment will naturally oppose reform. In certain cases because they know that they will lose more than they will gain, at least in the short run. In other cases the losses that the group will suffer are not clear, but they will exhibit the same behavior just because their fear of losses is compounded by the uncertainty about their real size. If these groups are well organized and, so, politically powerful, they will be able to block adjustment despite the chaotic economic situation faced by the society.

While the net transition costs remain positive for most groups, they will be engaged in a "War of Attrition - Prisoner's Dilemma" game, that is, they will not cooperate in the adjustment process, hoping that the other groups do. Yet, as Armijo (1994: 15), referring to the Brazilian inflation, observed, it seems reasonable to suppose that, at some high level of inflation some groups would find their share of the costs of escalating inflation (of muddling through the crisis) prohibitive. In this moment they would play the "Chicken" game, that is, they
would unilaterally cooperate in the adjustment process. This will probably happen when, for these groups, net transition costs turned negative.

Conclusion

In this paper we described two cost curves - the cost-of-muddling through curve and the cost-of-adjustment curve. These curves plus the target line defined two costs: net transition costs and total costs.

The concept of net transition costs is relevant because it shows that after a given moment, there are no costs in adjusting or reforming. Thus, even if society has a strong preference for present consumption, it would be rational on its part to adjust. Thus, the net transition costs indicates the limit rational moment for adjustment. Yet, this may not happen and adjustment continue to be delayed, if society did not realize that it is at the limit point, or if it is risk averse and fears unexpected costs of adjustment particularly if they involve shock policies, or if powerful interest groups display different cost curves and did not yet reach the point where net transition costs are negative.

Net transition costs will be smaller, tending to be negative, the later economic reforms are undertaken. In contrast, total transition costs will be smaller, the sooner reform is undertaken. If societies have not irrationally high preferences for present consumption, they should start adjustment as soon as economic distortions arise. In this way they would minimize total transition costs.

These concepts may be applied to actual situations. We did that, shortly, in relation to the main Latin American countries that fell into crisis in the early 1980s. Chile and Mexico were given as examples of early adjustment. Net transition costs were high, but total transition costs, relatively small. High costs had been incurred in Chile before, in the 1970s. Bolivia, Peru and Argentina are examples of countries that only undertake reform when net transition costs had turned highly negative, given the fiscal crisis and hyperinflation. Finally, Brazil is an intermediate and still unresolved case. It has not fallen into economic chaos; thus net transition costs have not turned clearly negative and reforms were only partially undertaken. Fiscal adjustment and stabilization remain a main challenge.
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