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How and when a unilateral trade reform could be a political equilibrium

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Resumen:

El modelo de política comercial endógena sigue la tradición de Grossman and Helpman (1994 y 1995). La estructura de la economía esta caracterizada por un modelo de comercio de factores específicos y las preferencias de los consumidores son cuasi-lineales. Los propietarios de los factores específicos están todos organizados en grupos de presión (grupos de "lobby") y la propiedad está muy concentrada en pocos consumidores. Las opciones de política que tiene el gobierno son mantener el "status quo" de la política comercial o implementar una reforma comercial aperturista. Los grupos de lobby influencian al gobierno con contribuciones de ingreso considerando para ello su propia función objetivo. El equilibrio del juego es estudiado en dos situaciones distintas: sin excepciones en la liberalización comercial; con listas de excepciones. Se demuestra que una apertura comercial que no es un equilibrio político (no es incentivos compatible) cuando el gobierno la trata de realizar en general (sin excepción de sectores), sin embargo puede ser un equilibrio si el gobierno puede aislar a ciertos sectores de la competencia internacional, a través de largo períodos de ajustes (empleando políticas graduales o utilizando listas de excepciones). Los resultados son ilustrados aplicando el modelo al caso de una reforma comercial en un país en desarrollo (Uruguay).

Abstract:

In the paper the endogenous trade model follows the Grosman and Helpman (1994 y 1995) tradition. The structure of the economy is characterised by a specific factor trade model and consumers' preferences are quasilinears. Owners of specific factors all are organised in lobby groups and the ownership are very concentrated.The available options to the government are mantain the trade policy status quo or implement an opening trade reform. Lobbys group influence this discretional government with income contribution taking into account its own objective function. The equilibrium of the game is studied in two differents situations: without exceptions in the trade liberalisation; with the presence of sector exception list. It is shown that a commercial opening that is not a political equilibrium (it is not incentives compatible) when the government wants to make it in general, however can be so if the government is able to isolate certain sectors from the international competition, through long periods of adjustment (given by gradual policies or the existence of exceptions list). The results are illustrated applying the model to the case of a trade reform in a developing country (Uruguay).

1. Introduction

The literature on endogenous trade policy is oriented to analyse how a certain pattern of protection could be explained by a model of interaction between the private sector and the government. The main objective is to explain the particular level that the tariff rate will have in a game equilibrium given the basic parameters of the model (preferences, technology, property of the production factors). Sometimes in reality things are different, there are many restrictions (institutional, informational, etc) that imply that this kind of model does not work very well.

The government's decision which is relevant to endogenise is if the trade reform is undertaken or not. In fact, in many developing countries the interesting question to answer is how and when a unilateral reform could be a political equilibrium. It is realistic to see this problem as a binary choice. This problem is different from the one that has generally been studied in the literature on endogenous trade policy. This perspective seems more realistic. The necessary requirements of information to achieve a fine tuned definition of the tariff structure, as the output of a political equilibrium, seem to be hardly completed in reality. On the other hand, the historical observation of the process allows us to conclude that the decision on the trade policy was frecuently centered on the decision whether to open the economy unilaterally or not.

Grossman and Helpman(1995) developed a useful model which could be adapted to the previous problem. They analyse the decision of being part of a free trade agreement while considering two options: to make the agreement or not to make it. The authors endogenise the decision within a model of political contribution. This model seems especially pertinent to the case of the unilateral trade liberalisation. A government has to decide if it plays unilateral trade opening or not. It is shown that a commercial opening that is not a political equilibrium (it is not incentives compatible) when the government wants to make it in general, could be so if the government is able to isolate certain sectors from the international competition, through long periods of adjustment (given by gradual policies or the existence of exceptions list). These two characteristics seem to have been present in a notorious way in many developing countries.

The topic of the administrative protection in the context of a model of political economy with contributions admits at least two approaches. The first one consists on being able to explain why certain types of instruments are preferred to give protection in relation to others (see for example the article of Maggi and Rodriguez-Clare, 1998). A different perspective, is to not analyse the decision on the particular instruments itself but rather the decision to isolate (to except)

certain sectors from the effects of the commercial opening using government's discretionary power. This second perspective will be the one adopted in this paper. In the case of many developing countries, can be verified that the trade reform was characterised to isolate (using certain instruments that were changing along the process) a group of sectors (relatively stable along the trade reform) of the trade liberalisation process. The relevant phenomenon to explain is the fact that the trade reform implied liberalisation but also isolation with granted protection to a subset of sectors.

The paper has three other sections. In the second one the structure of the economy and the contribution game is presented. The third section discusses the equilibrium outcome in two basic environments: without exception in the trade reform (benchmark case); and with exceptions. Finally, the last section develops a brief history of the trade reform in a particular country (Uruguay) using the theoretical results of the previous sections.

2. Basic assumptions: structure of the economy and the contribution game

The economy is supposed to have individuals with identical preferences that are only different in their factors endowments. Consumers preferences are quasi-linear and can be represented by the following utility function:

$$u^i = c_0^i + \sum_s u_s(c_s^i) \tag{2.1}$$

where: $i = 1, ..., I$- consumers index; functions u_s have the usual properties (increasing and concave functions); c_z- consumption of good z, with $z = 0, s$ and $s = 1, .., S$..

Consumers want to maximise equation (4.1) subject to their budget constraint:

$$y^i \geq c_0^i + \sum_s p_s c_s^i \tag{2.2}$$

where: y^i- income of consumer i; p_s- price of good s. The price of the good 0 is taken as numeraire.

The indirect utility function is represented by:

$$\omega(p, y^i) = y^i + cs(p) \tag{2.3}$$

where: $cs(p) = \sum_s u_s(d_s(p_s)) - \sum_s p_s.d_s(p_s)$, is the consumer surplus of the sum of sector $s = 1$ to $s = S$.

The general economic production framework is specified as in a specific factor trade model. There exist $S+1$ sectors in the economy: one sector (labelled with a sub index 0) that only uses the mobile factor labour; and other sectors (labelled with a sub index s) that use a specific factor (v_s) as well the mobile factor. The specific factors are not mobiles between sectors and are fixed in a given amount. Thus, the assignment decisions is made only in the labour factor.

The supply side of the economy is characterised by those $S+1$ constant returns to scale sectors:

$$x_0 = L_0 \tag{2.4}$$

$$x_s = F^s(L_s, v_s) \tag{2.5}$$

where: L_z- is the amount of mobile factor in the z sector (with $z = 0, s$); v_s- is the amount of specific factor in sector s (with $s = 1, .., S$) ; x_z - is the quantity produced by sector z.

It is assumed that in equilibrium x_0 is greater than zero. As p_0 is equal to one, then the mobile factor price will also be one (assuming a competitive framework). The profits' functions in the specific factor sectors are:

$$\pi^s(p_s) = \left\{ \max_{x_s} \left(p_s.x_s - L_s\right) : F^s(L_s, v_s) = x_s \right\} \tag{2.6}$$

$$\pi^s_{p_s} = x_s(p_s)$$

where the subscript indicates a derivative and $x_s(p_s)$- is the supply function of good s.

The economy is small thus the international prices are given. The trade policy is a set of instruments that can directly affect the domestic prices of export and import goods, as shown in the following equation:

$$p_s = p^*_s(1 + t_s) \tag{2.7}$$

where: p^*_s- is the international price of good s; t_s- is a tax or a subsidy (in ad-valorem terms).

The trade functions are:

$$m_s = Id_s(p_s) - x_s(p_s) \tag{2.8}$$

The tariff revenue is defined in per capita terms as follows:

$$\tau(p) = \sum_s \left(p_s - p^*_s\right).\left\{ d_s(p_s) - \frac{x_s(p_s)}{I} \right\} \tag{2.9}$$

where:τ- is tariff revenue.

The tariff revenue is given as a lump sum to the consumers. As each consumer has a different factor production endowment, they have different levels of income. This specification of the model does not allow for a consumer having overlapping ownership of different specific factors. Each consumer is provided with a labour endowment of one unit, thus the population is equal to the supply of labour ($I = L$).

$$\overline{y}^i = 1 + \xi_s^i . \pi^s(p_s) + \tau(p) \tag{2.10}$$

Where: $\overline{y}^i$- is gross income consumer i; $\xi_s^i = \frac{v_s^i}{v_s}$- is the participation that consumer i has in the ownership of specific factor s.

The disposable income used in the consumer's budget constraint (4.2) is the gross income net of the contributions that each consumer makes in order to participate in the lobby.

$$y^i = \overline{y}^i - c^i(p) \tag{2.11}$$

Where: $c^i(p)$-consumer i's contribution to the political game.

In this model, consumers can be organised in groups as a way to influence on the government's actions. This will occur if they perceive that organising is beneficial for them. Only those consumers who are organised in lobbies make political contributions. The indirect utility function of this kind of consumers can be written in the following way:

$$\omega(p, y^i) = \omega^i(p) = \overline{\omega}^i(p) - c^i(p) = 1 + \xi_s^i \pi^s(p_s) + \tau(p) + cs(p) - c^i(p) \tag{2.12}$$

The natural members of a lobby group are the owners of a specific factor and they have the same interests related to the domestic prices and the trade policy. The lobby's objective function is the aggregate welfare of the members of the group, as shown in the following equation:

$$\begin{aligned} \Omega_s(p) &= \sum_{i \in \mathcal{I}^s} \omega^i(p) = \sum_{i \in \mathcal{I}^s} \overline{\omega}^i(p) - \sum_{i \in \mathcal{I}^s} c^i(p) = \overline{\Omega}_s(p) - C_s(p) = \\ & I\theta_s \left[1 + \tau(p) + cs(p)\right] + \pi^s(p_s) - C_s(p) \end{aligned} \tag{2.13}$$

where: I^s- is the subset of consumers owners of the specific factor s; $\theta_s = \frac{I_s}{I}$.

Given that each owner of a specific factor is organised into a lobby group (see Vaillant, 1998 proposition 5) and it is assumed that specific factor ownership is highly concentrated (θ_s is near to zero for all s), then the lobby's objective function comes from the following relationship:

$$\Omega_s(p) = \pi_s(p) - C_s(p) \tag{2.14}$$

where: π_s- profit function sector s; C_s- contributions from sector s.

The government has an objective function with two components: first of all, it is interested in receiving direct contributions that allow him to keep himself in power; and secondly, the government is benevolent in the sense that it maximises the aggregate well-being of all the consumers (owners and not owners). The objective function of the government is the standard one already presented in Vaillant, 1998:

$$G = aW + C \tag{2.15}$$

where: $C = \sum_s C_s$; $W = \sum_i \overline{\omega}^i(p)$ aggregate welfare (gross from contributions).

Note that the aggregate welfare could be expresed as:

$$W = \sum_s W_s \tag{2.16}$$

where: $W_s = L_s + \pi_s + cs_s + p_s^* t_s m_s = \sum_i \overline{\omega}_s^i(p)$- portion of aggregate welfare that is originated in sector s, which is different from the objective function of the lobby group (see equation 4.14); note that $\sum_s \overline{\omega}_s^i(p) = \overline{\omega}^i(p)$.

The government's choices are whether to maintain the protectionism status quo or to change it to an open oriented trade policy. In this version of the model, the definition of an opening trade policy is not explicit, but it could be thought as a mix of measures that implies : import tariff decreases; elimination of quantitative restrictions and other kinds of trade measures; and introduction of subsidies to the export oriented sectors to diminish the anti export bias that is embodied in the protectionist policy structure. The trade policy regime is defined in the following relationship:

$$r = \{q, o\} \tag{2.17}$$

where: q- is protectionist trade policy status quo; o- is opening trade policy.

The structure of the game is that of a common agency problem. Each lobby maximises its objetive function by selecting a contribution scheme, that is an incentive table relating trade policy regime and lobby's income contribution. Note as follows:

$$\{C_{sq}, C_{so}\} \tag{2.18}$$

Taking into account these lobby's contribution schemes the government selects the trade policy regime which maximises its objective function in equation (4.15). This problem will be dealt with using two cases: the first one deals with the trade policy regime without exceptions and the second case with sectoral exception list.

3. Isolated protections sector and political equilibrium

3.1. Trade policy equilibrium without exceptions

A trade policy regime $r \in \{q, o\}$ is an equilibrium of this game [1] if there exists a set of contributions $\{C_{sq}, C_{so}\}$ for each lobby s such that:

- a) contributions are feasible-

$$C_{sk} \geq 0 \text{ with } k = q, o$$

- b) contributions schedules-

$$C_{sk} \leq \max(0, \pi_{sk} - \pi_{sj})$$

  where: $j = q, o$; $k = q, o$; $j \neq k$.

- c) incentive constraints-

$$\sum_s C_{sr} + aW_r \geq \sum_s C_{sk} + aW_k$$

  where: $k = q, o$.

- d) No deviation pay- $\forall s \nexists \widehat{C}_{sq} \geq 0$ and $\widehat{C}_{so} \geq 0$, and other regime $\widehat{r}_s \in \{q, o\}$ such that,

$$\text{i) } \widehat{C}_{s\widehat{r}_s} + \sum_{j \neq s} C_{j\widehat{r}_s} + aW_{\widehat{r}_s} \geq \widehat{C}_{sk} + \sum_{j \neq s} C_{sk} + aW_k$$

$$\text{ii) } \pi_{s\widehat{r}_s} - \widehat{C}_{s\widehat{r}_s} \geq \pi_{sr} - C_{sr}$$

The first condition shows that contributions must be positive in order to be feasible. The second one says that each lobby can not contribute more than they gain with this particular trade policy regime; thus this condition is also saying that if there is a loss for the lobby, then the contribution will be zero. The third condition is the incentive restriction that shows that the goverment must be maximising its objective function. The fourth one is the no deviation pay condition, which implies that the outcome is an equilibrium of best response (Nash equilibrium).

In this game, it is posible to identify two kinds of equilibrium. The first one is the trade policy equilibrium without pressure, where there is no contribution

[1] The definition and typology of equilibrium follows those in Grossman and Helpman (1995).

from the private sector (lobbies groups) to influence the government's trade policy option. The second one is called the trade policy pressure equilibrium (TPPE); in this case the government's selection is influenced by the lobby groups' contributions.

A necessary and sufficient condition in order to have a trade policy unpressured equilibrium (TPUE) is the following:

$$a(W_r - W_{\widehat{r}}) \geq \max(0, \max_s (\pi_{s\widehat{r}} - \pi_{sr})) \tag{3.1}$$

where $\widehat{r}$ is the alternative regime to r (see result 1 in Grossman and Helpman, 1995).

As it is known for a small economy, always $W_o \geq W_q$ then a TPUE could be done only with $r = o$, then the following expression holds:

$$a(W_o - W_q) \geq \max(0, \max_s (\pi_{sq} - \pi_{so})) \tag{3.2}$$

A TPUE with $r = o$ could only exist if condition 4.20 is fulfilled. This means that no lobby s alone losses sufficient income to compensate the aggregated gain that the opening trade policy implies. In other words, with the opening trade policy no sector alone with its own contributions could be able to change the regime selected by the government. Though this is an equilibrium it is not robust because it does not resist a coalition proof test. In such a refinement of the equilibrium, a Nash equilibrium is rejected if there exist a set of actions for a subset of actors (coalition) that could increase (or not decrease) the payoff for each of its members taken as given the non- members' actions. It is not necessary to make any monitoring because the proposed action is a best response with respect to the actions proposed or those taken by the others. The TPUE does not pass this test at any time when a trade policy regime different from the TPPE is chosen.

In the TPPE the contributions are positive for at least one group.

$$C_{sr} > 0$$

The government must be indifferent between the alternative regimes:

$$\sum_s C_{sr} + aW_r = \sum_s C_{s\widehat{r}} + aW_{\widehat{r}} \tag{3.3}$$

Suppose now that the previous condition is not fulfilled, then the followings expression condition holds:

$$\sum_s C_{sr} + aW_r > \sum_s C_{s\widehat{r}} + aW_{\widehat{r}}$$

In this case, one lobby group could reduce the contributions without influencing the government's desicions and improving its own welfare. Then in equilibrium, it could not happened that $G_r > G_{\widehat{r}}$, then the government must be indifferent $G_r = G_{\widehat{r}}$. Every lobby in the losing side (the ones that prefers $\widehat{r}$ to r, $\pi_{s\widehat{r}} - \pi_{sr} > 0$) must be contributing for $\widehat{r}$ the total amount that each one gains if this regime is selected (or the amount that each lobby losses if r is selected). On the contrary, it would be profitable for this lobby group to increase the amount of contribution that each of them makes to influence and change the government's trade policy decisions. From the winning side, no lobby will pay more than what each one gains with the selected regime r. As it is already known, no lobby will contribute a positive amount if the government selects a trade policy that goes against its own interest. As Grossman and Helpman (1995) point out: "...it is never optimal for a lobby to promise positive gifts for both policy outcomes, because then it could cut back equally on both of its offers without affecting government's decision".

Accordingly contributions from the losing groups are:

$$C_{s\widehat{r}} = \pi_{s\widehat{r}} - \pi_{sr}, \tag{3.4}$$

$$C_{sr} = 0 \ , \forall s \ \in \ \mathcal{S}_{\widehat{r}} \tag{3.5}$$

where: $\mathrm{S}_{\widehat{r}}$ is the set of sectors s such that $\pi_{s\widehat{r}} - \pi_{sr} > 0$.

Contributions from the winnning groups are:

$$C_{sr} \leq \pi_{sr} - \pi_{s\widehat{r}}, \tag{3.6}$$

$$C_{s\widehat{r}} = 0 \ , \forall s \ \in \ \mathcal{S}_{r} \tag{3.7}$$

where: S_r is the set of sectors s such that $\pi_{sr} - \pi_{s\widehat{r}} > 0$.

Combining the previous relations and using the definition of the contributions' schedule of the winnning lobbies (4.24), the next expression is derived:

$$\sum_{s\in\mathcal{S}_r} (\pi_{sr} - \pi_{s\widehat{r}}) + aW_r \geq \sum_{s\in\mathcal{S}_r} C_{sr} + aW_r \tag{3.8}$$

As the following relation is fulfilled (see equation 4.21):

$$\sum_{s\in\mathcal{S}_r} C_{sr} + aW_r = \sum_{s\in\mathcal{S}_{\widehat{r}}} (\pi_{s\widehat{r}} - \pi_{sr}) + aW_{\widehat{r}} \tag{3.9}$$

then,

$$\sum_{s} \pi_{sr} + aW_r \geq \sum_{s} \pi_{s\widehat{r}} + aW_{\widehat{r}} \tag{3.10}$$

If a TPPE for a regime r exists then condition 4.28 must be fulfilled. Additionally, TPPE's existence requires that the following inequality holds:

$$aW_r < \sum_{s \in \mathcal{S}_{\hat{r}}} (\pi_{s\hat{r}} - \pi_{sr}) + aW_{\hat{r}} \tag{3.11}$$

It is neccesary that $C_{sr} > 0$ to sustain the regime r (Result 2 in Grossman and Helpman, 1995).

To sum up, it has been demonstrated that TPUE and TPPE could both exist. It was shown that the TPUE when exists, the government selects a regime $r = o$. Also the TPPE could be the other regimen q, which happens when the aggregated profits associated with the status quo are greater than the aggregate welfare losses:

$$\sum_s (\pi_{sq} - \pi_{so}) \geq a(W_o - W_q)$$

In the case that TPUE and TPPE both exist and support different regimes, it is wise to concentrate only in the TPPE. The last one is a Nash equilibrium but it is also a coalition proof equilibrium. The TPPE is an efficient equilibrium (for the set of strategic actors of the game lobbies and government, see equation 5.15) thus, applying Bernheim and Winston (1986a) result, it is an equilibrium that is also a coalition proof equilibrium.

In summary, in this game the trade policy equilibrium always exists and it is possible to be in one of the following situations presented in table 1.

Table 1
Pressure and Unpressure trade policy equilibrium

	Pressure equilibrium	Unpressure equilibrium
One equilibria	$o = \arg\max_r G_r + \sum_s C_{sr}$	$o = \arg\max_r W_r$
Two equilibrium	$q = \arg\max_r G_r + \sum_s C_{sr}$	$o = \arg\max_r W_r$

Source: author's author's own elaboration using Grossman and Helpman (1995).

3.2. Trade policy equilibrium with exceptions

A trade policy equilibrium with exceptions $E(T)$ exists when there are a set of contributions $\{\overline{C}_{sq}, \overline{C}_{so}\}$[2] $\forall s \in$S that satisfies the following conditions:

[2] An exception is a sector where trade reform is not chosen and the status quo is mantained. The overline in the variable C_i is to make a difference in the notation of the contributions schedule when there are exceptions and when there are none, as in the previous case.

- a) contributions are feasible-

$$\overline{C}_{sk} \geq 0 \text{ with } k = q, o$$

- b) contributions schedules-

$$\overline{C}_{sk} \leq \max(0, \pi_{sk} - \pi_{sj})$$

where: $j = q, o$; $k = q, o$; $j \neq k$.

- c) incentive constraints-

$$E(T) \in \arg\max_{\widetilde{E}} \left\{ \sum_{s \in \widetilde{E}} \overline{C}_{sq} + aW_q + \sum_{s \notin \widetilde{E}} \overline{C}_{so} + aW_o \right\} \tag{3.12}$$

such that $\sum_{s \in \widetilde{E}} T_s \leq T$.

- d)No deviation pay- $\forall s \nexists \widehat{\overline{C}}_{sq} \geq 0$ and $\widehat{\overline{C}}_{so} \geq 0$, and other $\widetilde{E}_s$ such that,

$$\text{i) } \widehat{\overline{C}}_{sz} + \sum_{j \neq s} \overline{C}_{j\widetilde{E}_s} + aW_{\widetilde{E}_s} \geq \widehat{\overline{C}}_{sk} + \sum_{j \neq s} \overline{C}_{sE} + aW_E$$

$$\text{ii) } \pi_{s\widetilde{E}_s} - \widehat{\overline{C}}_{sz} \geq \pi_{sE} - \overline{C}_{sk}$$

where: $z = q, o$; $k = q, o$; $z \neq k$.

Each $\widetilde{E}$ is a set of excluded sectors from the opening trade policy and it is used to denote a particular trade policy regime. If $\widetilde{E} = 0$ the government decides to select a trade opening policy without exceptions ($r = o$ in the notation of the previous sub section), alternatively if $\widetilde{E}$ =S the government mantains the status quo ($r = q$).

The government problem (see condition c) is:

$$\max_{\widetilde{E}} \left\{ \sum_{s \in \widetilde{E}} \overline{C}_{sq} + aW_q + \sum_{s \notin \widetilde{E}} \overline{C}_{so} + aW_o \right\} \tag{3.13}$$

such that $\sum_{s \in \widetilde{E}} T_s \leq T$.

Each term in the government objective function will be studied next. In the excluded sectors lobbies gain with the exclusions, so in principle they are willing

to contribute the full amount of the losses that the government caused by these exclusions:

$$\overline{C}_{sq} = a(W_{so} - W_{sq}) \text{ and } \overline{C}_{so} = 0 \ \forall s \in E \tag{3.14}$$
$$\overline{C}_{sq} + aW_{sq} \geq aW_{so}$$

But these sectors must also assure a place in the excluded list, so the question is: how much is the government lose to gain when it does not exclude the marginal sector?

$$\overline{C}_{\widetilde{s}_s q} + aW_{\widetilde{s}_s q} \geq \overline{C}_{\widetilde{s}_s o} + aW_{\widetilde{s}_s o} \tag{3.15}$$

Where $\widetilde{s}_s$ is the marginal sector, that is sector s specific where $s \in E$.

The lobby that is not excluded will pay the full amount that it looses for not being included in the list:

$$\overline{C}_{\widetilde{s}_s q} = \pi_{\widetilde{s}_s q} - \pi_{\widetilde{s}_s o} \text{ and } \overline{C}_{\widetilde{s}_s o} = 0 \tag{3.16}$$

Substituting equations 4.34 in 4.33, then the following inequality comes:

$$\pi_{\widetilde{s}_s q} + aW_{\widetilde{s}_s q} \geq \pi_{\widetilde{s}_s o} + aW_{\widetilde{s}_s o} \tag{3.17}$$

How much does the government gain if this marginal sector is included in the list of exceptions? Using 4.35, it is possible to answer this question:

$$J_s = (\pi_{\widetilde{s}_s q} - \pi_{\widetilde{s}_s o}) + a(W_{\widetilde{s}_s q} - W_{\widetilde{s}_s o}) \geq 0 \tag{3.18}$$

Then contributions from the excluded sectors must add this term to compensate the government for the loss accounted in the equation 4.32.

$$\overline{C}_{sq} = a(W_{so} - W_{sq}) + J_s \tag{3.19}$$

To determine the marginal sector it is necessary to solve the following problem:

$$\widetilde{s}_s \in \arg\max_{j \notin E} (\pi_{jq} - \pi_{jo}) + a(W_{jq} - W_{jo}) \text{ such that } T_j \leq T_s \tag{3.20}$$

There are a sub set of sectors that are not excluded but the government would be better off if those sectors were included in the list. The problem is that there are restrictions over one or more variables and that the sum over the excluded sectors on these variables are binded by the restriction T.

How is it possible to find the optimum and equilibrium list of excluded sectors? The list must maximise also the political support function ($PSF = G + \sum_s \Omega_s$):

$$E(T) \in \arg\max_{\widetilde{E}} \left\{ \sum_{s \in \widetilde{E}_{sq}} (\pi_{sq} + aW_{sq}) + \sum_{s \notin \widetilde{E}} (\pi_{so} + aW_{so}) \right\} \tag{3.21}$$

such that $\sum_{s \in \widetilde{E}} T_s \leq T$.

As an intermediate stage to find the optimum list of sectors, it is useful to define the following auxiliary variable:

$$g_s = \frac{(\pi_{so} - \pi_{sq}) + a(W_{so} - W_{sq})}{T_s} \tag{3.22}$$

where g_s is the amount of loss by unity of restriction.

The sort criteria to index the sectors is given by the next inequality:

$$(g_s - g_{s+1}) < 0 \ \forall s \ \in \ S \tag{3.23}$$

The sector where the aggregate welfare gain is equal to the sector loss is the denominated sector b, $g_b = 0$. If $g_s > 0 \ \forall s$ then $b = 0$. The sector s for which the sectoral restriction is bounded is denominated sector e:

$$\sum_{s=1 \text{ to } s=e} T_s = T \tag{3.24}$$

where: $e = \#E$.

The optimum list of exclusions consists of a set of sectors s such that:

$$s \in (0, \min(b, e)) \tag{3.25}$$

There are three general possible outcomes:

- if $b = 0$ then no sectors will be excluded $E = 0$.
- if $b < e$ then all the sectors in which $g_s < 0$ will be excluded and the restriction is not binding ($\sum_{s=1 \text{ to } s=b} T_s < T$), $E = \{s \in E : s \leq b, \, g_s < 0\}$.
- if $b > e$ then only some sectors where $g_s < 0$ will be excluded and the restriction $\sum_s T_s \leq T$ is binding. This last case is the relevant one.

The consumers' welfare will have the following pattern by construction of the trade reform policy change:

$$W_{so} > W_{sq} \ \forall s \in S \tag{3.26}$$

Using the the lobby's welfare and the definition of the lobby's problem the equilibrium conditions can be written in the following alternative way:

$$\left\{k_s, \overline{C}_{sk}\right\} \in \underset{\widetilde{k}_s, \overline{C}_{s\widetilde{k}}}{\arg\max} \left(\pi_{s\widetilde{k}_s} - \overline{C}_{s\widetilde{k}_s}\right)$$

with $k = q, o$, such that the government's incentive constraint is fulfilled,

$$\max_{\widetilde{E}} \sum_{j \in \widetilde{E}_{-s}} (\overline{C}_{jq} + aW_{jq}) + \sum_{j \notin \widetilde{E}_{-s}} (\overline{C}_{jo} + aW_{jo}) + \overline{C}_{sk_s} + aW_{sk_s} \tag{3.27}$$

with $\sum_s T_s \leq T$, and the participation constraint that says that the lobby s must guarantee to the government at least the same level of utility that the government would obtain otherwise.

$$G(\overline{C}_{-sk}, \overline{C}_{sk,} E) \geq G(\overline{C}_{-sk}, 0, E_{-s}) \tag{3.28}$$

To analyse the contributions schedule it is useful to make a classification of the lobby sectors. One subset includes those sectors that prefer the status quo rather than the opening trade policy ($\pi_{sq} > \pi_{so}, \forall s \in \mathcal{Q}$); the other subset includes those that prefer the opening trade policy ($\pi_{so} \geq \pi_{sq}, \forall s \in \mathcal{O}$). In this last sub set, the sectors' incentives are compatible with the aggregate welfare perspective, thus producers in this opening oriented sectors do not need to make any contribution to influence the government's trade policy choices.

$$\overline{C}_{sq} = \overline{C}_{so} = 0 \ , \forall s \in \mathcal{O} \tag{3.29}$$

The following are the relationships between the sub set of sectors:

$$\mathcal{Q} + \mathcal{O} = \mathcal{S} \tag{3.30}$$

$$E \subseteq B \subseteq \mathcal{Q} \tag{3.31}$$

According to this, it is possible to identify many alternative situations. Indeed, consider the case of a sector $s \in \mathcal{Q}$ and $s \notin B$. No matter what they are willing to contribute with the full amount that they gain from manteining the status quo ($\pi_{sq} - \pi_{so} > 0$), the government will choose anyway the opening policy (this

comes from the definition of the sector index and the variable g_s, see equation 4.41). This can be expressed in the following way:

$$a(W_{so} - W_{sq}) \geq (\pi_{sq} - \pi_{so}) \tag{3.32}$$

$$\overline{C}_{sq} \leq (\pi_{sq} - \pi_{so}) \text{ and } \overline{C}_{so} = 0 \tag{3.33}$$

As well, consider the sectors $s \in B$ and $s \notin E$, that contribute with the full amount of what they lose for not being in the excluded list:

$$\overline{C}_{sq} = (\pi_{sq} - \pi_{so}) \text{ and } \overline{C}_{so} = 0 \tag{3.34}$$

Finally, in the sectors identified in the excluded list ($s \in E$) the contributions schedule is the following:

$$(\pi_{sq} - \pi_{so}) \geq \overline{C}_{sq} = a(W_{so} - W_{sq}) + J_s \tag{3.35}$$

Susbtituting equation 4.36 in 4.53 and re-arranging terms the following condition must hold:

$$(\pi_{sq} - \pi_{so}) + a(W_{sq} - W_{so}) \geq (\pi_{\widetilde{s}_s q} - \pi_{\widetilde{s}_s o}) + a(W_{\widetilde{s}_s q} - W_{\widetilde{s}_s o}) \tag{3.36}$$

By definition of the index of sectors (see equation 4.42), it is known that:

$$\frac{(\pi_{so} - \pi_{sq}) + a(W_{so} - W_{sq})}{T_s} < \frac{(\pi_{s+1o} - \pi_{s+1q}) + a(W_{s+1o} - W_{s+1q})}{T_{s+1}} \tag{3.37}$$

As $s < \widetilde{s}_s$ then:

$$\frac{(\pi_{so} - \pi_{sq}) + a(W_{so} - W_{sq})}{T_s} < \frac{(\pi_{\widetilde{s}_s o} - \pi_{\widetilde{s}_s q}) + a(W_{\widetilde{s}_s o} - W_{\widetilde{s}_s q})}{T_{\widetilde{s}_s}} \tag{3.38}$$

Using the definition of the marginal sector $T_{\widetilde{s}_s} \leq T_s$ and then using equations 4.56 the inequality 4.54 is derived. Therefore, the contribution from all sectors in the exclusion list is less or equal than the gain that it is obtained from being in the exclusion list ($\overline{C}_{sq} \leq (\pi_{sq} - \pi_{so})$, $\forall s \in E$). The lobby's incentive to be in the list is the following:

$$(\pi_{sq} - \overline{C}_{sq}) \geq \pi_{so} \tag{3.39}$$

An ilustration of the profits and welfare changes in each sector induced by the alternatives trade policies is presented in figure 1.

Finally, consider which is the government's incentive to implement a trade policy reform with exceptions in comparison with the two basic previous outcomes. First of all, the comparison is made between the equilibrium outcomes from the opening trade policy (unpressured equilibrium) and the exception list regime:

$$\begin{aligned}(G^E - G^O) &= \left\{\sum_{s\in E} \overline{C}_{sq} + aW_{sq} + \sum_{s\notin E} \overline{C}_{so} + aW_{so}\right\} - \sum_{s} aW_{so} = \quad (3.40)\\ &= \sum_{s\in E} (\overline{C}_{sq} + a(W_{sq} - W_{so})) = \sum_{s\in E} J_s > 0 \quad (3.41)\end{aligned}$$

as $\overline{C}_{so} = 0\ \forall s \notin E$.

Second of all, the outcomes from the status quo regime (a coalition proof pressure equilibrium) and the exception list regime are compared:

$$\begin{aligned}G^q &= \sum_{s} C_{sq} + aW_q = \sum_{s} C_{so} + aW_o = \\ &= \sum_{s\in\mathcal{O}} (\pi_{so} - \pi_{sq}) + aW_o \quad (3.42)\end{aligned}$$

as $C_{so} = 0$, $\forall s \in S$ and $C_{so} = (\pi_{so} - \pi_{sq})$, $\forall s \in \mathcal{O}$, see also that in this case it is true that $\mathcal{Q}_r = \mathcal{Q}$ and $\mathrm{S}_{\widehat{r}} = \mathcal{O}$ (where the contribution schedule C_{sk} without an over line is the one defined in the previous sub section). Therefore, the incentive to opt for a trade reform with exceptions in this case is:

$$\begin{aligned}G^E - G^q &= \left\{\sum_{s\in E} (\overline{C}_{sq} + aW_{sq}) + \sum_{s\notin E} \overline{C}_{so} + aW_{so}\right\} - \left\{\sum_{s\in\mathcal{O}} C_{so} + aW_o\right\} = \\ &= \sum_{s\in E} \overline{C}_{sq} - \sum_{s\in\mathcal{O}} (\pi_{so} - \pi_{sq}) + a\sum_{s\in E} (W_{sq} - W_{so}) = \\ &= \sum_{s\in E} J_s + \sum_{s\in\mathcal{O}} (\pi_{sq} - \pi_{so}) = \\ &= \sum_{s\in E} \left\{(\pi_{\widetilde{s}_s q} - \pi_{\widetilde{s}_s o}) + a(W_{\widetilde{s}_s q} - W_{\widetilde{s}_s o})\right\} + \sum_{s\in\mathcal{O}} (\pi_{sq} - \pi_{so}) \quad (3.43)\end{aligned}$$

The government will have a greater incentive to play the game with exceptions rather than without when:

- the aggregated loss for the marginal sector in the government's objective function is greater,

- and the aggregated gain for sectors whose profits increase with the opening trade policy is smaller.

This apparently paradoxical result is related to the opportunity cost that the winning side lobbies must pay in both alternatives regimes, with exception (E) or in the status quo one (q).

The comparison of the results between the contribution games, without and with exceptions, should be made keeping in mind that they are different games with different restrictions. In consequence there may be different equilibrium. In fact, the game with exceptions has a set of sectors out of the reform (exception list) and simultaneously this set is restricted to some amount (the sum over this sub set can not be more than some limit T). If there is not any restriction over the sectors to be excepted, then the result will be trivial because the following holds:

$$\sum_{s\in B}(\pi_{sq}+aW_{sq})+\sum_{s\notin B}(\pi_{so}+aW_{so})\geq\sum_{s\in\mathcal{Q}}(\pi_{sk_s}+aW_{sk_s}),\forall k_s=q,o. \quad (3.44)$$

by definition of sector b and equation 4.39.

When a restriction over the exceptions is imposed, then it will constitute a trade off between the flexibility that the exception list introduces in the trade reform implementation and the fact that this exception list is restricted.

What is the rational behind having a restriction in the possibility of excluding sectors from the reform? There are multiple reasons. On the one side, an explanation could be related to international commitments and the necessity to legitimise the trade reform process vis-a-vis the rest of the world (multilateral institutions of credit and trade, etc). As well, the government could have some others objectives associated with the reform (short term macroeconomic policies, industrial policies, employ policies) that are not explicit in the game and that are introduced in an exogenous way through the restriction. In certain way, the parameter T measures the degree of discretion for the government to carry out the trade reform, and this is an exogenous element of the game structure. The second exogenous aspect is the type of trade reform. In our case, by definition the trade reform is such that for all sectors the following inequality holds:

$$W_{so}>W_{sq},\forall s\in S$$

This last assumption is reasonable but it is not always necessary to mantain this type of reform. It is obvious that in the aggregate welfare the inequality holds so the reform is evaluated as being positive from a consumer's perspective:

$$\sum_s W_{so} > \sum_s W_{sq}$$

In particular, for the import substitutive sectors (IIS), it is natural that a trade reform, with an opening orientation in a small country, affects positively the welfare for each of them:

$$W_{so} > W_{sq}, \forall s \in IIS$$

It could happen that for some export sectors (ES), the use of different type of subsidies would imply an important increment in relative prices and also the associated fiscal cost of the subsidy. Then:

$$W_{so} < W_{sq}, \text{ for some } s \in ES$$

If this would be the outcome, it could happen that this welfare cost for the government would be compensated by the income contributions of the export sectors that pressure for a reform with this particular orientation. In this case, for a sub set export sectors, favoured by the trade reform, it will be true that $\overline{C}_{so} > 0$.

Note that, given the structure of the economy, there are no general equilibrium effect over the price of the mobile factor (salary) which influence, through the protection in one sector, the outcomes in others sectors. Cadot, de Melo and Olarreaga (1998) suggest how to modify this assumption in a similar model (see Vaillant, 1999b in Vaillant, 1999a). In future research, this could be a relevant innovation to introduce in the structure of the economy in order to improve the analytical capability of the contribution game in this new framework.

Finally, it is useful to compare the aggregate welfare outcome of lobby groups and government (strategic players in the game) in both regimes: the status quo with respect to the trade reform with exceptions. The second equilibrium is preferred to the first one if the following condition holds:

$$\begin{aligned}
\sum_{s\in E}(\pi_{sq}+aW_{sq}) + \sum_{s\notin E}(\pi_{so}+aW_{so}) &\geq \sum_{s\in S}(\pi_{sq}+aW_{sq}) \Leftrightarrow \\
\sum_{s\notin E}(\pi_{so}+aW_{so}) &\geq \sum_{s\notin E}(\pi_{sq}+aW_{sq}) \Leftrightarrow \\
\sum_{s\notin Z}(\Delta\pi_s+a\Delta W_s) &\geq -\Big(\sum_{s\notin E \text{ and } s\in Z}(\Delta\pi_s+a\Delta W_s)\Big) \qquad (3.45)
\end{aligned}$$

where: $\Delta\pi_s = (\pi_{so} - \pi_{sq})$ and $\Delta W_s = (W_{so} - W_{sq})$. Note that the gain of the reform must be greater than the loss that is incurred because some sectors cannot be included in the exceptions list.

4. Trade reform in a particular developing country (Uruguay): a political economy approach.

4.1. Trade policy design

It is intended in this section to apply the model developed along the lines of the present paper. First of all, it is necessary to select and describe the phenomenon that is meant to explain. In this case, the trade reform in a particular smal economy (Uruguay) was selected. It is important to clarify that it is not a conventional analysis that describes the changes in the trade reform and which looks forward to associate them with the transformations in the productive and trade pattern that the opening process brings about. The work explicitly discards everything related to the analysis of patterns of specialisation. The thesis has a clear orientation towards the analysis of trade reform itself. Not towards its effects on the specialisation pattern, a well-known and already studied topic, but rather on the phenomenon of how decisions are taken in a collective form, given a certain strategic interaction between economic agents and the government.

Therefore, after the theoretical analyses carried out in the previous section, it is relevant to summarise which is the group of stylised facts that characterises the trade reform in a particular developing country (See Vaillant, 1999b for a detailed description). In first place, it is observed that Uruguay's trade policy in the last decades (from the 1958 until the present) has been fixed by the Executive Power through a wide set of presidential decrees and very few laws elaborated with the Parliament's participation. This fact points out that trade policy (tariff or administered) has not been too much influenced, direct or indirectly, by the democratic mechanisms of parliamentary representation, but rather that it has been established by the government in office with discretion. In the 1990s, parliamentary interventions were observed in trade policy matters, but exclusively through the ratification of regional (MERCOSUR in 1991) and multilateral trade agreements (World Trade Organisation, Agreement of Marrakesh in December of 1994). Today the government is more limited. However this is not due to the Parliament's intervention but rather to the results of international trade negotiations.

The administered protection refers to a particular set of trade policy instruments employed with the objective to favour domestic production in relation to the rest of the world's production. This kind of instruments is different from the tariff type that directly affect domestic prices. Instead, they are based on

indirect mechanisms that discriminate products from the rest of the world with other types of trade barriers. The nature of the used instrument (tariff or not tariff) is frequently associated (in implicit or explicit form) with the mechanism by means of which their juridical legitimacy is established, and in consequence with the capacity that each government has on administering the use of these protective instruments in response to particular demands.

Traditionally, trade policy instruments have been classified in tariff and non tariff measures according to the way that they influenced domestic goods prices. It is important to link them with the way that decisions are taken and their application scope. In this sense, the three central approaches that are considered are: the contingency; the covering (the generality of the application of the instrument); and government's ability to manage it with discretion without restrictions to introduce or with restrictions to withdraw.

The tariff trade policy is more transparent and less contingent in time as it is subject to a general programming that can involve one government period and even transcend it. Likewise, in general it requires mechanisms of more demanding public legitimacy. In the uruguayan case, this has been made through government decrees under the Law of Exchange and Monetary Reform of the year 1959. At the same time, Uruguay had other instruments that could be classified in the other extreme of the typology: instruments of contingent use, administered with discretion and oriented to specific sectors. The regulated prices of external trade (reference prices and minimum export prices) present these characteristics.

The instruments that were created with the aim of defending certain sectors against unfair trade practices allowed for a certain level of substitution with protection provided by tariffs. This happened mainly during the 80's and part of the 90's. These instruments provided some agricultural and manufacturing sectors (final goods producers in general) with protection, hidden under the facade of a defence against dumping practices, and this protection was available just by undertaking quick actions (sometimes at industry level and many times at firm level). It is recognised, both at a private and a public level, that most of the protection provided during the 80's and the early 90's was done through the use of these instruments (see Vaillant, 1999b).

4.2. Institutional spaces for trade policy design

4.2.1. Public institutions

In this subsection, the institutions involved in the trade policy definition are presented. In Uruguay there exists a broad group of institutions formally related to trade policy (see description in GATT, 1992). A scheme of these institutions

does not properly reveal who and how are public decisions about trade policy taken. This is so because of two main reasons.

First, the government's central administration has been going through a slow and permanent erosion and reduction process which affects different areas. This is the other side of the necessary fiscal austerity which the governments had gotten used to live with, as a way to avoid macroeconomic disequilibrium and to keep the economic stabilisation programmes. Secondly, the topics and spaces for trade negotiation have been changing in a radical way during the 90's. In this sense, institutional and human resources responses, suitable for each new circumstance, have been necessary. These have created a new real institutional framework that allowed to face the increasing claims in the trade policy level.

In this sense, analysing the real practices in trade policy design is necessary to properly describe the actual situation. As any inference, it is subject to the available information and the method used to carry it out. Nevertheless, we consider that it is more useful than a sole formal description of the places where trade policy should be conducted, according to the formal government schemes.

In the trade policy design process the two main government agencies are: the Ministry of Foreign Affairs (MFA) and the Ministry of Economy and Finance (MEF). The MEF has been the one that traditionally set the unilateral trade policy. Its branch offices more related to the definition of these topics are the Trade Policy Board, Economic and the Financial Adviser and the Tariff Advisor Commission. As it was previously described, the whole unilateral opening process and the decisions to promote exports were instrumented in legal terms through government decrees sheltered in laws from the 50's and 60's (see Vaillant, 1999b). This went on in the 90's, both for the tariff reduction in the beginning of the decade (see Vaillant, 1999b) and for the new adjustment of the export and investment promotion measures in the last years (see the following section in this paper). The latter required a new effort in legal terms (see new law analysis).

The Foreign Trade Board, belonging to the MEF, has been carrying on different tasks during its lifetime, mainly those related to the links between the public and the private sector and between different public sector agencies. The original objective of this office was related to the international integration promotion (both in the region and outside it), and this gave it a privileged relationship with the private sector. In this decade other public agencies with the same objective were created, and also trade chambers began to develop similar tasks, so its role was weakened. At the same time, the claims related to international negotiation were multiplied, and sub-regional (MERCOSUR), regional (LAIA), continental (FTA) and inter-continental (MERCOSUR-EU) forums were added to the multilateral ones. Since this board had an excellent relationship with the MFA (they

are physically in the same building), it naturally began to work on claims which arose as a result of the multiplicity of international forums taking part in trade negotiations. In general terms, it has provided technical advice to the negotiators from the MFA, and it has also been a main player in the different trade negotiations.

The Ministry of Foreign Affairs has traditionally had a more relevant role in the international trade negotiation processes. In the multilateral case, Uruguay has a long tradition which is revealed by the existence of human resources especially trained in this field. There are different offices within the MFA that deal with these affairs. Among them must be stressed the International Organisation Directory, which deals with the links between the World Trade Organisation (WTO) and the Uruguayan government. It is at this level where the different notifications to the WTO are carried out, and information from multilateral institutions and public boards related to these affairs is received. The multiplicities of coordination, information and advice tasks that are developed in this office are not related to its reduced size.

MERCOSUR negotiations were carried out in the context of a new institutional framework, which led to a much more permanent co-ordination scheme in the public sector. It went on in different stages, but the permanent and characteristic was the national representation at the Common Market Group which was integrated by members of: the Ministry of Economy and Finance, the Ministry of Foreign Affairs, the Central Bank, and the Planning and Budget Office (within the presidency). The Ministry of Economy has had a main role in the working of the group and in the general orientation of the negotiations. This was helped by the continuity of the especially trained team. On the other hand, the MFA, which in the beginning did not have a main role in the negotiations, has been getting more and more involved. This can be appreciated by the fact that in recent years an institutional change took place, and an Integration and Mercosur Direction was created at the MFA level. Strictly speaking, this is one of the few institutional spaces in the public sector specialised in the Mercosur by a formal definition. Nevertheless, one of the characteristics of the MFA which prevents it from having a much more active role, is its continuous institutional and human resources lack of continuity, consequence of the changes in the diplomatic destination of its professional personnel.

4.2.2. Lobby pressure groups

A special characteristic of the private sector organisation in Uruguay is the variety of places for the representation of the involved interests. At firm level it is

possible to distinguish many different organisations where corporate interests are represented.

First of all, it is considered the Uruguayan Chamber of Manufactures which is an old institution (this year it will be a century old) which regroup and represents the manufacturing sector. It has traditionally been associated with a defensive attitude towards the domestic market, in favour of those instruments that allow to keep the import substitution market. After twenty five years of hard announcements and not so hard practices of trade opening policies in Uruguay, its position has been slowly changing, considering the specialisation and adjustment processes of the manufacturing sector in Uruguay. Nevertheless, this Chamber still claims for government intervention in the trade atmosphere, with the aim of avoiding possible damages for local manufacturers (regional exporters or domestically oriented) from unfair practices of others. From an institutional point of view, the Chamber is strong, essentially because it has been covering issues that the public sector has been leaving (promotion, training and so on), with the aid, in many cases, of international co-operation for development. Besides, it is one of the institutions that issue certificates of origin which in fact constitute one of its main financial sources. Large manufacturing firms (private and public) and about 60 Sector Chamber are members of the Chamber of Manufactures.

In second place is the union groups of agriculture and cattle producers, which included the Rural Association and the Agriculture and Cattle Federation. Although Uruguay is abundant in natural resources for food production and raw materials, and has an export orientation, this is not entirely reflected in the opening position of these groups, which represent different interests. Those unions mainly act in fiscal topics, interacting with the government. The trade policy issues have been restricted to the historic demand of exporting agricultural and cattle goods without manufacturing (raw leather, dirty wool, live cattle, milk from the dairy, and so on), in order to be able to reduce the agroindustrial oligopsony power.

In third place we can find the commercial interests. The Mercantile Chamber of Country Goods gathers different interests from agricultural and cattle good traders, sometimes associated with a minimum transformation of the raw materials (for example wool conditioning and classification). It is also a long tradition institution. The Chamber of Trade as well is another institution that gathers trade interests. This particular chamber represents traders and importers' interests, so it is mostly in favour of trade liberalisation.

In fourth place we find the Uruguayan Exporters Union, an institution which was founded in the early 70's. Although its body of directors consists of top enterprising organisations (manufacture, mercantile, trade and so on), the organisation's support remains in the export-oriented sector (both traditional and

non traditional goods). The action of this organisation has been focused on exporters' interests, and thus has been in favour of trade policy instruments that would promote exports. Their relationship with the other chambers has been rather conflicting for many reasons, and such relationship has limited the institution's actions. Nevertheless, the institution maintains its activity and has generated its own co-ordination spaces both at the domestic and regional level. In the latter level, it is worth mentioning the creation of the MERCOEX, with other exporters' unions from the MERCOSUR.

The Entrepeneur Superior Council (COSUPEN) gathers all of the above mentioned chambers (except for the Uruguayan Exporters Union), with the exception perhaps of other very important sectorial chambers, like the Bank Association of Uruguay. This Council is the government or other social sectors's counterpart in many specific topics. In recent years, it had a more visible role, both in the representation of the entrepeneur sectors in the Social and Economic Consulting Forum of Mercosur, as in the negotiation level of the FTA.

On the other hand, workers show a higher homogeneity in their organisation and representation. There exists a single central union (PIT-CNT), formed by the different sectorial unions (both from the public and private sector). With respect to trade policy issues, there is an Integration Commission dedicated to them. Central union's participation in international negotiation forums has been taking place at the regional level (both at the MERCOSUR and at the FTA), being continuous and in many cases determinant. A proof of this fact is the creation of the Social and Economic Consulting Forum of Mercosur. The central union has been a kind supporter of the regional integration at Mercosur level, but it is more cautious with respect to continental integration (FTA) or with the WTO's multilateral negotiation. In some way this position shows that the central union is not in favour of the trade liberalisation process in a general way, or of the international negotiation processes which help its deepening. Nevertheless, it has accepted the higher trade liberalisation that the sub regional integration caused as a necessary cost which would secure the integration with the country's neighbours.

The fact that those lobby groups, which are able to organise themselves, are the ones who deal with the free riding problem is always emphasised in the traditional collective action dilemma. Small interest groups, easily organised, with a specific interest and low monitoring costs over its member's actions, will be revealed in the trade policy atmosphere by the existence of high protection levels for the defence of a specific sector. Organising similar but not identical interests requires a different level of action, the creation of lobby groups, that is the gathering of interest groups in more complex institutions, which in turn

involve many sectors.

The literature on political contributions and lobby groups states that the strategy of organising in a strategic interaction atmosphere is a dominant one for the lobby groups (when the costs of organisation do not exist or are very low). Organising and defending a particular interest is better than not doing so given that nobody has done it, because it gives an advantage in the relationship with the government (see Vaillant, 1998). If the other groups are organised into lobby groups, it is also better to do the same because this reduces the damages caused by the distortions created by the antagonist lobby groups. From the application of this logic it results that, in many societies with a great variety of specific interests, everybody is worse off than if they were not organised, reaching a prisoner's dilemma situation for the organised lobby groups.

In Uruguay it is worth stating that private interests at firm level are not easily represented by few positions in relation with trade policy issues. Positions are very different and in many cases, antagonise each other. We can state that there exist at least two different lobby levels, which imply two different ways of acting. On one hand there exist a general pressure over the rules. This level is tackled through the big organisations that are sometimes defined in relation with the functioning and management of these rules. Another lobby level is that of the application of the intervention, which takes place in a more direct and decentralised level and for that reason is more difficult to analyse.

The Chamber of Manufacturers is partly defined by the pressure around the existence of rules (group of available instruments) that allow implementing an effective defence of the domestic market from the import goods threat. On the same way, it is also impossible not to associate the Exporters Union with a group of rules specially designed to favour the exporter's activity. This would be the first lobby level, which in general is somewhat politically visible.

Another way of analysing this phenomenon is to consider the problem from a specific policy instrument's point of view. An interesting example is the MEP, which was analysed in the previous section. As a general rule, Uruguayan exporters agree with the existence of this mechanism because it gives them the possibility of using a quick instrument to solve problems in their markets. This does not imply that the Chamber as an institution seeks to influence the government's action in the specific moment of fixing the MEP, and probably this is not the case. And this happens, among other reasons, because there does not exist a common interest with respect to the specific way of applying the instrument, moreover the interests can be conflicting.

From a public policy's point of view, the possibility of being influenced by specific interests has diverse origins, and it can be different whether we are talking

about unilateral affairs not regulated by international agreements or when the issue is part of a negotiation process. In the latter case, the lack of a negotiating position to guide the decisions taken must be noted. Thus the negotiating criteria can be described by the words of an ex-negotiator from Uruguay and actual private advisor: "for the negotiators the idea of defending an Uruguayan interest prevails, hence the one who clearly identifies his place and interests can be sure that will be considered in the negotiation".

4.3. The political economy of trade reform

The revision carried out regarding the mechanisms of organisation of the private sector in pressure groups, points out that this is a mature and diffused phenomenon in the Uruguayan society. There are multiple environments of representation of interests groups. It is possible to identify basically two types of groups: the ones favourable to trade reform with a liberalisation orientation (exporters) and those against it with protective demands (the imports substitute sectors). The corporate organisation seems more kindred to the analytic pattern employed in the specific factors model (Vaillant, 1998) than to the one developed in the standard trade model (Vaillant, 1999a). The existence of permanent channels of communication with the government it is evident in all of them. It can also be observed that in this relationship, trade policy issues have had a prominent place.

In this sense, it seems reasonable to accept the assumption that trade reform as it tooks place in Uruguay lends itself to be thought of in terms of a political equilibrium in a game between the private sector and the government in office.

When trade reform began, in the middle of the seventies (see Vaillant, 1999b), one can affirm that the status quo of trade policy was clearly not a desired situation (in terms of the model it was not incentive compatible). Although at some moment there could have been a political equilibrium, clearly by the middle of the 1970s the commercial policy showed signs of generating a hardly bearable level of distortions for a small economy faceing a negative shock in its terms of trade. Surely, there was a favoured sector associated to the external trade that was able to capture some of the rents that the trade policy distortions generated. However, these minimised and concentrated interests didn't end up compensating the distortions to aggregate welfare. Without any doubt, this statement has a larger dimension in the context of a growth model (which is beyond the proposed pattern of analysis), but it is possible to accept it as an element that reinforced the need for a change in the trade policy.

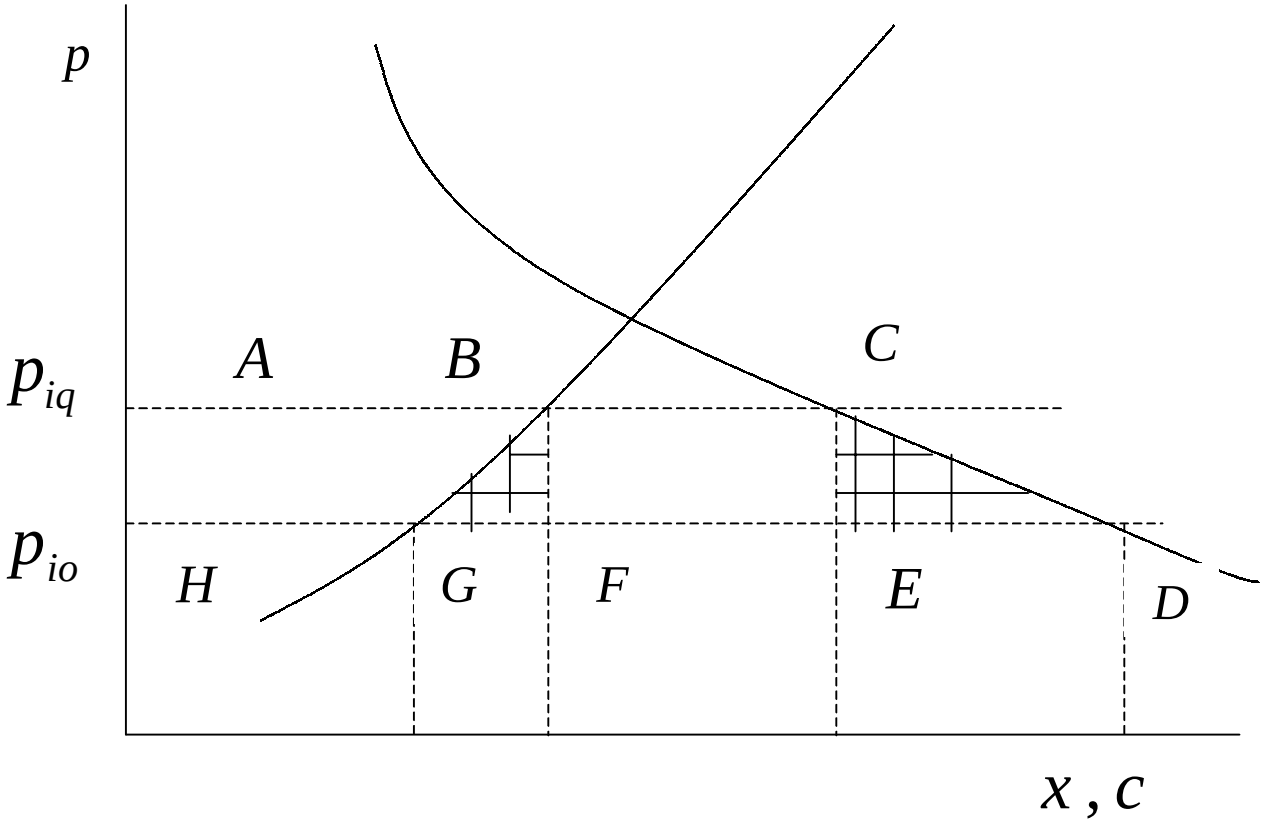
Another structural and persistent phenomenon of the trade reform process is tariff escalation (bigger protection to the goods of final use, intermediate to the

semi manufacture products, very low to raw materials). In the literature there are some articles (Cadot, De Mello y Olarreaga, 1998) that allow through smaller modifications in the structure of the economy to obtain this characteristic of tariff escalation as an endogenous phenomenon in a model of political contribution.

Surely it is also necessary to think of the trade policy political equilibrium in a dynamic context where the reassignments that the new trade policy is going to generate (in consumption as well as in production patterns) will also modify the political equilibrium. This could be a self-sustained path of unilateral commercial liberalisation. In this sense, more than to use the model to endogenise a historical trade policy status quo, it is interesting to show how this status quo could be modified in an incentive compatible way within a trade policy endogenous model. The fact that protective reversions have not taken place in the process of trade reform (those that were verified are basically founded in problems of handling the short term macroeconomic policy, and they all had a very short duration) could be showing that the path adopted in a reform process was a political equilibrium along the studied period.

In summary, the trade reform in Uruguay could be interpreted using the general framework developed in this last section. In a first stage (during the sixties) a pressure equilibrium with protection is sustained as an equilibrium of the game. There is a protection structure (the status quo) that it is not a political equilibrium in the sense of the original Grossman and Helpman (1994b) contribution game (see Vaillant, 1998), that is import tariff and export subsidies could not be controlled with no restriction in a contribution game between lobbies and the government. In the new framework the situation is different, lobby groups and the government sustain the global structure of protection that can be compared with an alternative structure such as a more open oriented trade policy. In this new game, it could happen that unpressured equilibrium with an open oriented policy exists (an this could have been the case in Uruguay) but this it is not a coalition proof equilibrium and thus the pressure equilibrium prevails (status quo). Suddenly, in the early seventies external conditions changed (terms of trade effect and changes in political institutions) and an opening trade reform with exceptions was implemented, basically because of the new external conditions of the equation 4.63 is fulfilled. See that by construction, the trade reform implies that tariff and subsidies rates are closer to the optimum rates presented in Grossman an Helpman's (1994b) article (see figure 2).

Figure 1
Welfare and profits changes



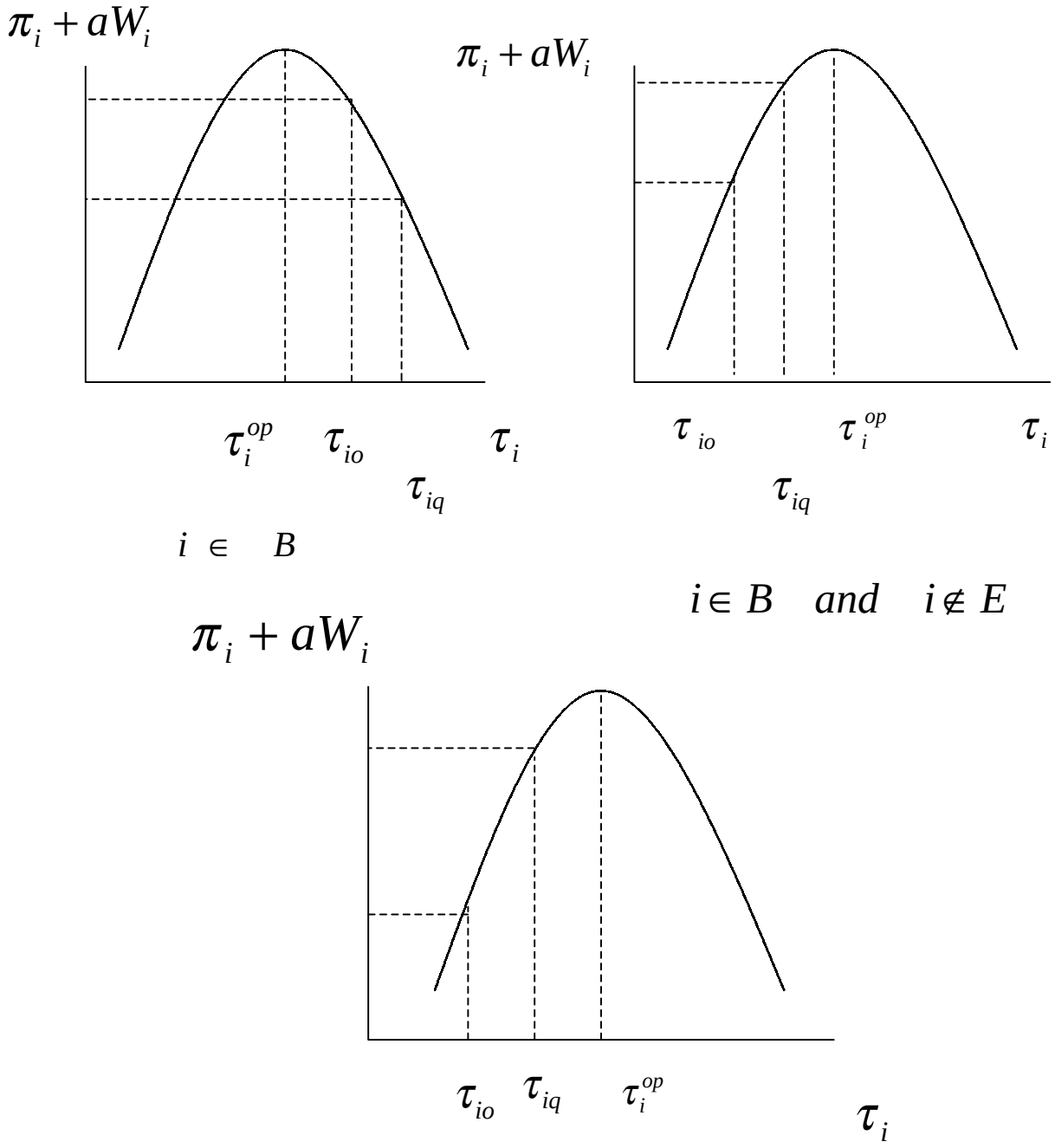
$$ABGH = \Delta\pi_i = \pi_{io} - \pi_{iq}$$

$$ACDH - BCEF - ABHG = BFG + CDE = \Delta W_i = \\ = W_{io} - W_{iq}$$

$$if \quad \Delta\pi + a\Delta W \geq 0 \quad then \quad i \notin B$$

$$if \quad \Delta\pi_i + a\Delta W_i < 0 \quad then \quad i \in B$$

Figure 2
Trade reform and optimal tariffs



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