

URUGUAY

Trade Reform and Economic Efficiency:
Policies for Trade Promotion

COUNTRY SUMMARY

Background and Purpose

Uruguay has a long history of protection dating back more than one hundred years. Such long exposure to protection in such a small country has made Uruguay a clear example of the typical consequences of restrictive trade policies: distortionary costs resulting from inefficiently allocated resources, and a loss of scale economies because of limited domestic markets. High protection of manufacturing was maintained by taxing agriculture, the main activity in which Uruguay has a strong comparative advantage. The limits to this policy became clear throughout the post-World War II period when, on average, real GDP growth was less than one percent a year and per capita income remained nearly constant.

In 1974, Uruguay began a sweeping reversal in policies. Domestically controlled prices and interest rates were liberalized, quantitative restrictions were abolished, export taxes were removed, and a program of tariff reductions was adopted in 1979. Through such trade and financial reforms Uruguay hoped to benefit from the substantial gains from trade and borrowing that are available to a small country from linking its prices and interest rates more closely to international ones. In the trade reform, the maximum tariff rate fell from 300 percent in 1974 to 90 percent in 1979 and even lower by 1981, and mandatory import deposits were abolished in 1975. In the financial reform, interest rates were freed in 1974 and a system of preannounced exchange rate depreciations known as the *tablita* was adopted in 1979 to stabilize inflation.

With the opening of the economy, capital flowed in, financing a construction and investment boom that led to real growth in GDP averaging over 4 percent annually from 1973 to 1981. Realized real rates of interest, however, became unsustainably high in 1980 as agents anticipated the collapse of the *tablita* with the reduction in capital inflow. When interest rates rose further worldwide in 1981 and non-petroleum commodity prices fell, Uruguay suffered a debt crisis and economic collapse of severe proportions — real GDP fell abruptly by 9 percent.

The government's emphasis shifted toward short-term stabilization policies. At stake were the gains

from better resource allocation achieved through the 1974 reforms. Despite the considerable trade and financial expansion during the 1974-81 period, the economic collapse of 1982 provoked the suspension of a preannounced five-year trade reform program (*el Programa de Reforma Arancelaria del 1980*) of planned gradual reductions of tariffs from 49 percent (unweighted average) to a basic rate of 35 percent by 1985.

At the same time, a reference price system was implemented in 1981 and a minimum export price system in 1983. Both measures had the explicit purpose of protecting domestic production through the levying of input duties based on "trigger" prices rather than on the c.i.f. import price. Important sectors such as textiles received effective rates of protection under this system well above the nominal rates: an average true tariff of 58 percent was applied to textiles rather than the official duty of 40 percent. Another important sector, automobile assembly and auto part production, which had not been liberalized in the 1970s, continued to receive exaggerated protection at rates approaching 100 percent in 1989 through duties and an elaborate domestic content and compensatory export requirement.

Some progress has been made since the collapse of 1982, however. Financial liberalization remains successful and strong, but progress in trade liberalization has been more uneven. Five escalated tariff rates were established in January 1983, ranging from a low of 10 percent on intermediate goods to a high of 55 percent on final goods. A gradual lowering of the top tariff rates brought them down to 40 percent by May 1989. A broadening of bilateral trading agreements with Argentina (the *Convenio Argentino-Uruguayo de Cooperación Económica* of 1974) and Brazil (the *Protocolo de Expansión Comercial Uruguay-Brazil* of 1975) has expanded regional trade through lowered bilateral protection, but in a distorted manner that promotes inefficiency.

Progress on trade expansion stalled in the 1980s, however, and the economy's degree of openness has reached only 30 percent in recent years, much lower than the potential 60 percent estimated to be optimal for an economy of the size and characteristics of Uruguay. Despite further efforts at the resumption of

trade expansion since 1983, high true protection rates remain in important sectors such as textiles, automobiles, and sugar that amount to more than one-third of value added in manufacturing. In addition, high transport costs and inefficient port facilities further increase protection to domestic industries.

The macroeconomic situation of high inflation and low investment is another major obstacle to further trade expansion. With the cessation of net capital inflows, increased external debt service payments were financed through trade surpluses after 1983, at the expense of investment. Other obstacles, including the perceived precariousness of property rights following the obligatory refinancing of internal debt under the Mandatory Refinancing Law of 1985, have jeopardized lending in the domestic capital market, except for self-liquidating loans such as export credits. In addition, the economy is plagued by labor market rigidities. A Senate act is required to dismiss any civil servant who has more than six months of service, and trade union power in the economy has increased since 1985, especially in the Port of Montevideo, one of the most labor intensive and strike-prone ports in the world.

It is in this context that the Uruguay government invited the UNDP-World Bank Trade Expansion Program (TEP) mission to identify areas of trade reform that could lead to further expansion of trade. The commitment to trade reform appears genuine, and key areas are now under study, to be followed by decrees implementing the trade reform measures.

Key Findings

The report assesses the effectiveness of Uruguay's trade system and the macroeconomic and microeconomic policies that affect the efficiency of the reforms under way. The main findings are summarized below.

Macroeconomy

Uruguay's policy of pegging its currency to a basket of foreign currencies to maintain a relatively constant real exchange rate provides stability to the economy. But further tariff reductions or the dismantling of the reference and minimum price systems should be accompanied by devaluation of the real exchange rate to ensure an export supply response.

Uruguay's precarious macroeconomic stability is threatened by the recent law on social security benefits, which is projected to increase the fiscal deficit by 2 percentage points of GDP. Given the

already high rate of inflation (about 100 percent a year), it is urgent that Uruguay sustain contractionary fiscal measures to avoid financing the deficit through monetary creation, which would seriously jeopardize macroeconomic stability.

Investment levels at about 8 percent of GDP are very low, even by Uruguayan standards. These low levels are attributed to the combination of inadequate protection of property rights, an exceedingly rigid structure of negotiations with labor unions, and adverse incentives created by the debt overhang. Over a long historical period, investment levels in Uruguay appear to be determined mostly by exogenous capital inflows. Increased debt service payments have been financed almost entirely through a reduction in investment expenditures.

Openness

To determine the trade expansion effects of the trade liberalization and other reforms initiated in 1974, the degree of trade openness (the share in GDP of the sum of commodity exports and imports) of the Uruguayan economy was analyzed. Openness rose significantly after the 1974 reforms, reaching a new plateau of about 30 percent of GDP. However this ratio has not increased significantly in the 1980s despite further tariff reductions after 1983 and despite the need to transfer more resources abroad to service external debt. Comparisons with other countries of the same market size and with similar endowments establish beyond doubt that the Uruguayan economy remains relatively closed. Measuring export potential by export shares of similar economies, it is estimated that Uruguay's export potential is about *twice* that achieved in recent years.

Barriers to Trade Expansion

Despite a highly publicized tariff reduction program that reduced the maximum tariff rate on final goods to 40 percent and tariffs on raw materials and intermediate goods to 10-40 percent, many hidden forms of protection remain. Also, import tariffs directly discourage exports by bidding resources away from the export sector. This disincentive effect on exports is estimated to be about two-thirds of the value of the tariff since some of the impact falls on nontraded goods: that is, an import duty of 30 percent is equivalent to an export tax of 20 percent.

Administrative (and hidden) import deterrence. Administrative protection in the form of tariff levies based on a reference price or a minimum export price

rather than the c.i.f. import price leads to true tariffs far higher than apparent tariffs. The true tariff is 18 percent greater than the apparent tariff for goods covered by the reference price system, and 7.5 percent greater for goods covered by minimum reference prices, although this latter rate vastly underestimates the full extent of protection, as is shown below.

Reference prices were established in 1981 in response to the difficulty of implementing the anti-dumping and antisubsidy law of June 1981. Reference prices exist for 54 types of products, particularly textiles and apparel, which have 177 separate reference prices. The mechanism is a simple one: when the declared c.i.f. import price is less than the reference price, the official duty is applied to the reference price. The following example indicates the effect of this system on the true tariff rate:

Reference price example: carpets*

World price	\$3.22
Reference price	\$7.50
Duty of 40% of \$7.50	\$3.00
Tariff-inclusive price	\$6.22
Effective duty	93%

*NADI item 58020241, synthetic fibre, tufted.

The minimum export price system was created in early 1983, and now covers 75 types of imported goods (35 of which were transferred from the reference price system). The minimum export price mechanism has a "moving surcharge" whereby the importer pays customs the difference between the declared import price and the official minimum export price, plus the duty on the minimum export price, as the following example shows:

Minimum export price example: automobile tires*

World price	\$3.80
Minimum export price	\$4.30
Payment to customs	\$0.50
Duty of 40% of \$4.30	\$1.72
Tariff inclusive price	\$6.02
Effective duty	58%

*NADI item 40110200.

By declaring a price of \$4.30, the domestic importer or foreign exporter can save the \$0.50 payment to customs, so the measured effective duty might be less than 58 percent. For this reason, the "magnification effect" of minimum export prices (see table 1) under-

estimates the protection afforded by this system. Also, because the importer pays not only the duty levied on the floor price but also the difference between the floor price and the declared price when the latter is lower, there is an incentive to declare a price at or near the floor price to avoid this extra charge. The minimum export price system is substantially more protective than the reference price system when applied, despite its apparently smaller magnification effect.

The system of protection that results from these mechanisms is tailored to individual interests and induces Uruguayan producers to specialize in low-quality products. This goes against Uruguay's natural comparative advantage in high-quality products with an intensive requirement for highly skilled labor. This "distortion effect" of the administered price system is regressive in that it favors the production of cheap, low-quality goods in Uruguay while favoring the consumption of expensive high-quality goods since reference prices apply only to imports with prices below the floor price. (This distortion effect on relative prices is reported in table 1.)

Many of the changes in incentives achieved by 15 years of tariff reduction have been eroded by the introduction of reference prices and minimum export prices for imports since 1981. (This "erosion effect" of the trade liberalization program is indicated in table 1.) Overall, tariffs have been increased by about 5 percent for the entire tariff structure as a result of this system. This impact underestimates the overall degree of protection since the system also causes trade in products covered by the reference price and minimum export price system to shrink. Over one-third of value added in manufactured is protected by these mechanisms, which particularly affect the textile sector.

Another form of administrative import deterrence is achieved by the elaborate system of domestic content and compensatory export requirements in the automobile industry. Importers of fully assembled automobiles pay a 40-percent tariff and must have "compensating exports" of automobile industry products with a value added in Uruguay equal to 70 percent of the f.o.b. value of the fully assembled automobile. An importer of automobile assembly "kits" must pay a tariff rate of 10 percent, must comply with domestic content requirements (a minimum of 20 percent of the value of the product must be of national origin), and must have compensatory exports based on the f.o.b. value of the kit. With the minimum domestic content of 20 percent, compensatory exports of 60 percent are required. For each

Table 1. Protection under the Reference Price and Minimum Export Price System, 1989

Type of protection	Magnification effect			Distortion effect			Erosion effect		
	Apparent tariff (%)	Real tariff (%)	Before Difference (%)	After RP/MP (ratio)	Global RP/MP (ratio)	Global Change (%)	Apparent (%)	weighted (%)	unweighted (%)
Reference price system	38.5	56.6	18.1	1.84	1.44	21.7	39.4	46.9	44.8
Minimum export price system	36.4	43.9	7.5	2.02	1.75	13.4	36.7	38.5	40.1
Textiles	40.0	58.3	18.3	2.72	1.89	30.5			

Note: See text for explanations of the various types of protection effects. RP is reference price system and MP is minimum export price system.

percentage point increase in domestic content, compensatory exports required drop by two percentage points, so that, for example, with a 40-percent value-added content, required compensatory exports drop to 20 percent.

In addition to being a hidden form of protection, this structure has the added disadvantage of being highly adapted to the interests of those engaged, directly or indirectly, in the automobile industry. Evidence exists of extensive nonproductive rent-seeking and of possible extralegal activity in import and export declarations. The current system of protection in the automobile industry imposes an estimated annual loss of from US\$70 million to US\$80 million on Uruguayan consumers. Of this loss, a transfer of US\$32 to US\$40 million goes to domestic assembly operations and components manufacturers. The annual net welfare loss to the economy is between US\$18 million and US\$35 million. The cost to the consumer per car assembled is between \$6,000 and \$7,000, and the net social cost is between \$1,500 and \$3,000 per automobile assembled.

Additional hidden protection is provided by inefficient port facilities, largely the result of labor union power. Retail trade margins on imported goods are three to four times those for similar domestic products (according to estimates based on national accounts). Furthermore, inefficiencies and chronic delays in transport cut into exporters' profit margins while providing protection to producers competing with imported products. If the trade margins of the Port of Montevideo were brought into line with those of comparable countries, Uruguayan GDP would

increase by an estimated one percentage point or more.

Further protection and distortions are created by bilateral trading arrangements with Argentina and Brazil. While these agreements have led to preferences for Uruguayan exports, their trade-creating effects have been more than offset by the trade diversion resulting from the purchase of high-cost imports from these trading partners, especially Argentina. The bilateral trading arrangements may have substantially retarded the resource reallocation expected from tariff reductions since the principal source of export expansion in recent years has been the protected neighboring markets. And finally, the arbitrary distribution of export and import rights confers the scarcity profits to exporters and importers rather than to the government in the form of higher revenues.

Labor markets. The relatively high level of education of the Uruguayan labor force is not exploited to its full potential because of labor market imperfections and policy-caused distortions that result in overemployment in a number of sectors. Adjustment to trade expansion may now be somewhat more difficult than in the trade expansion episode of the 1970s since trade union power and social protection legislation have increased, particularly since 1985. During the 1974-81 liberalization experiment, there was no change in the real wage in manufacturing, but a slight reduction in employment (less than half a percent). A net capital inflow and increased investment may have cushioned the adjustment, however.

Explicit and implicit labor contracts are a major source of rigidity in the economy. Labor market rigidities are also a likely factor in the country's low investment rates. Requiring a Senate bill to dismiss a civil servant with six months of employment is equivalent to granting job tenure to civil servants, thus removing the risk of dismissal as a discipline on performance. For dismissal in the private sector, the employer is required to pay a severance allowance equal to one month's wages for every year of employment. For temporary layoffs, the social security administration pays wages for up to a six-month period of layoff.

Specific Recommendations

Trade-related measures

Reference price and minimum export price system. The various mechanisms of protection in Uruguay lead to a system of incentives that is extremely distorted and varies widely across activities. In such an environment, further steps toward uniform tariffs will have little or no effect, and their benefits are likely to be illusory.

Despite the harmonization of its tariff structure, Uruguay's complicated system of regulations and administrative rules impedes trade expansion. Distribution margins on imported products are three to four times the equivalent rates for similar domestic products. The reference price and minimum export price systems, although ostensibly aimed at protection against unfair trading practices as allowed under the GATT, has ended up eroding the effects of the trade liberalization measures introduced since 1986. In particular, the system has resulted in an escalation of protection in the textile and apparel sector.

Given the high cost of the reference price and minimum export price systems and their other negative side effects (difficult to administer, loss of government tariff revenue), the systems ought to be abolished. This can be achieved with little disruption by first substituting equivalent tariffs for the administered prices, and then gradually lowering and incorporating the new tariffs in the uniform tariff structure. This would improve the transparency of the system of incentives, provide government revenue by mopping up the rents now accruing to importers and foreign producers, and eliminate the incentive for regressive specialization (that is, in favor of low-quality goods).

If the reference price and minimum export price systems cannot be eliminated, then at the very least

minimum export prices should be converted into reference prices, and tighter guidelines ought to be applied to the determination of floor prices and the filing of complaints (which currently do not require proof of injury). However, this alternative suffers from many drawbacks, including the difficulty of finding appropriate price levels for each specific import good — the elusive concept of "world prices" proves difficult and costly to apply in practice. And tightening the complaint process will at most eliminate some of the price collusion effects of the two systems without reducing their distortionary effects. In sum, the threat to trade liberalization posed by the reference price and minimum export price systems can be removed only by abolishing the systems. (Firms harmed by a surge in imports of their product due to unforeseen developments or tariff concessions can apply for emergency safeguard relief under GATT Article 19.)

Transport. The second major impediment to trade expansion comes from another form of hidden deterrence, that created by the inefficient handling of trade in the Port of Montevideo. Previous studies have established the gross inefficiency of the port compared with other ports in developing countries.

Inefficient handling of imports and the distortions created by the reference price and minimum export price systems result in trade and commerce margins for imports far higher than comparable rates for domestic products. Also, tariff liberalization is eroded if goods cannot be transported without considerable cost, delay, and uncertainty. It is therefore essential that reforms of port administration be introduced to reduce delays and boost productivity. A positive first step would be to introduce the secret vote in the proceedings of the port trade union.

Automobile industry protection. The system of protection in the automobile industry must rank among the most complicated systems of regulations and requirements in the country, if not the world. Because the automobile industry purchases many imported inputs, the distortionary effects of the system of domestic content restrictions and compensatory export requirements filter through the economy. Since the industry has been protected for decades, eliminating the system overnight would lead to adjustment problems; these could be avoided, however, by gradual liberalization.

To cushion adjustment costs, tariffs and domestic content and compensatory export requirements could be lowered in stages over time, say five years, to allow gradual adjustment. The first, and immediate, step should be to eliminate the detailed provisions

specifying which components must be imported as separate items. In the progressive dismantling of existing measures, care should be taken to avoid phasing out domestic content and compensatory export requirements on kits faster than on finished automobiles to avoid temporarily increasing the costs of protection.

Bilateral trade agreements. The coupon mechanism known as the *cupo*, through which export rights to Argentina and Brazil are allocated preferentially among producers, encourages the survival of outdated production patterns since companies receive the *cupos* on an automatic, historical basis.

Given the indications that the bilateral accords serve to cushion the adjustments required to achieve a more competitive domestic structure, *cupos* should be allocated on a competitive basis. Either of two alternative approaches could be used to achieve this result: an auction system for bidding and paying for *cupos*, which would force some competition and provide government revenue; or an interim two-tier auction quota system, in which one tier of the quota allocation would depend on extraregional sales, thereby encouraging diversification of sales beyond the regional market. The other tier would depend on regional sales.

Complementary measures to support trade expansion

The success of reforms aimed at expanding trade depends on appropriate supporting macroeconomic policies and well-functioning labor markets. While macroeconomic policies in Uruguay are relatively stable, at least when viewed from a regional perspective, they would benefit from the extra constraints imposed by a more liberal and transparent trade regime. Factor markets, however, especially the labor market, are not sufficiently flexible to allow for the optimum resource allocation called for by a greater expansion of trade.

Despite some current problems with stabilization measures aimed at reducing the fiscal deficit and

inflation, trade reform could still take place for two compelling reasons. First, much of the implicit "tariff revenue" resulting from protection is collected by domestic automobile assemblers in the form of transfers or by foreign exporters under the minimum export price system. Some of it is lost entirely because of the prohibitive nature of some duties, as in textiles, or the free distribution of *cupos* to preferred exporters, as under the bilateral trade agreements. The recommended reforms would divert some of these revenues to the government rather than to rent-seeking individuals and companies. Second, the lowering of implicit tariffs on trade will expand the volume of trade. If trade is sufficiently elastic, revenues would not suffer except in the very short run.

Any of the trade expansion measures suggested above should be accompanied by a depreciation of the real exchange rate, to cushion the effects on employment in industries receiving less protection and to ensure an appropriate export response.

Trade liberalization measures should be implemented before wage bargaining rounds to facilitate the alignment of real wages to the new rates of protection. It would be desirable to establish maximum authorized wage adjustments for implementation by the national wage councils.

The disincentives to invest that result from the poorly functioning system of judicial protection of property rights should be eliminated. The current extremely low levels of investment will jeopardize the success of trade measures taken to expand trade.

Table 2 summarizes the recommendations for reform over the short, medium, and long term for each major policy area.

Table 2. Matrix of Short-, Medium-, and Long-Term Policy Recommendations for Trade Promotion in Uruguay

<i>Policy area</i>	<i>Short term (6-12 months)</i>	<i>Medium term (1-3 years)</i>	<i>Long term (3-5 years)</i>
Macroeconomic policies	Sustain fiscal and monetary restraint with support of IMF and World Bank	Maintain fiscal restraint	Continue fiscal restraint
	Devalue the real peso to compensate for trade liberalization	Maintain exchange rate competitiveness	Continue real exchange rate competitiveness
	Maintain an open capital market and market-determined interest rate	Maintain an open capital market and market-determined interest rates	Maintain open capital market and market-determined interest rates
	Set maximum wage increase target before wage-bargaining rounds	Ensure freely determined wage settlements	Ensure freely determined wage settlements
Export incentives		Restore the rebate of indirect taxes on exports	Maintain the rebate of indirect taxes on exports
	Devalue the real peso to compensate for trade liberalization	Maintain exchange rate competitiveness	Continue real exchange rate competitiveness
Import regulations	Convert reference and minimum export prices to equivalent tariffs	Reduce the highest protection levels to 40% on final goods	Reduce the highest tariffs to a maximum rate of 30%
	Eliminate compensatory export requirements for importers of automobiles and automobile kits		Lower duties on automobiles and automobile kits to 30%
	Harmonize all duties on automobiles and automobile kits at 30%		
	Adopt a uniform 30% domestic content requirement for automobile kits	Reduce the domestic content requirement for automobile kits to 20%	Reduce the domestic content requirement for automobile kits to 10% in the third year, then abolish it by the end of the fifth year
	Reform the bilateral trade agreements with Argentina and Brazil, including distribution of export rights by competitive bidding	Abandon the <i>similar nacional</i> concept, which bars tariff concessions on goods also produced domestically	Adopt uniform duties on all goods from Argentina and Brazil
	Eliminate the cupo system		

Table 2. Matrix of Short-, Medium-, and Long-Term Policy Recommendations for Trade Promotion in Uruguay (cont.)

<i>Policy area</i>	<i>Short term (6-12 months)</i>	<i>Medium term (1-3 years)</i>	<i>Long term (3-5 years)</i>
Trade infrastructure	Privatize port activities by leasing concessions		
Legal framework	Reform legal framework to support the enforcement of contracts and property rights		
Institutional export support	Establish a quasi-private trade promotion organization		

