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## Competition Policy in Transition Economies: The Role of Competition Advocacy

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# COMPETITION POLICY IN TRANSITION ECONOMIES: THE ROLE OF COMPETITION ADVOCACY<sup>†</sup>

*A.E. Rodriguez and Malcolm B. Coate\**

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# COMPETITION POLICY IN TRANSITION ECONOMIES: THE ROLE OF COMPETITION ADVOCACY

*A.E. Rodriguez and Malcolm B. Coate*

## ABSTRACT

Experts and practitioners puzzle over the seemingly modest gains of liberalization programs adopted by reforming economies around the world. Explanations for the underwhelming performance of transition economies range from adverse macro-economic effects to the insidious influence of rent-seeking practices by domestic interest groups.

Since the potential survivability of these liberalization efforts depends on the relative position of competing interest groups, several commentators have proposed that the competition agency seek to challenge interest groups. In what is generally known as competition advocacy, most already have. However, apart from attempts to provide decisionmakers with information detailing the likely reductions in consumer welfare, competition agencies have yet to carefully develop what their competition advocacy role entails.

In this paper, we provide a model that examines the determinants of rent-seeking behavior in sufficient detail to enable the competition agencies to develop a coherent and focused response to interest group challenges to the sustainability of pro-market reforms. We also provide normative implications of the model, including the prospects of compensation of interest groups as an approach to building political support.

## I. INTRODUCTION

The newly formed competition agencies of the recently liberalized economies<sup>1</sup> around the world appear to have active-

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1. Most recently liberalized economies in Latin America, Asia, Eastern Europe, the former Soviet Republics, and Africa have adopted, or are in the process

ly embraced the role of free market advocates.<sup>2</sup> An important component of their agenda has consisted of challenging the pernicious influence of rent-seeking groups which have sought to subvert liberalization gains by substituting non-tariff barriers and other forms of preferential treatment for tariffs.<sup>3</sup> In

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of adopting, competition policy legislation. For an overview of these developments see the collection of papers in CLAUDIO FRISCHTAK, *REGULATORY POLICIES AND REFORM IN INDUSTRIALIZING COUNTRIES* (1995); JOHN FINGLETON, ELEANOR FOX, DAMIEN NEVEN, & PAUL SEABRIGHT, *COMPETITION POLICY & THE TRANSFORMATION OF CENTRAL EUROPE* (1996); and also Malcolm B. Coate et al., *Antitrust in Latin America: Regulating Government and Business*, 24 U. MIAMI INTER-AM. L. REV. 37 (1992).

2. In the opening address of a recent hemispheric conference on competition policy, Beatriz Boza, the President of Peru's National Institute for the Defense of Competition and Protection of Intellectual Property (INDECOPI), highlighted the importance and the necessity of instilling a "culture of competition." Beatriz Boza, Address at the Joint Organization of American States and INDECOPI Conference on *Competition Policies and the Economic Reform Process in Latin America* at Lima, Peru (August 1996). A similar sentiment was expressed by Margarita Alarcon of the Colombian Agency, Claudia Curiel of ProCompetencia, the Venezuelan Agency, and Gesner J. Oliveira of CADE, the Brazilian Competition Agency. This concern has resulted in attempts to educate consumers, the private sector, academics and the domestic bar on the reach and limitations of the various competition legislation. The concern has also produced various publications. See, e.g., INDECOPI, *PREGUNTAS SOBRE POLITICAS DE COMPETENCIA EN EL MARCO DE UNA ECONOMIA GLOBAL* (1996). Although most competition agencies have positioned themselves as technocratic and apolitical advocates of consumer welfare, this perception does not seem to be shared by the general public, opposition parties and opponents of the liberalization. It appears that since most agencies have been constituted as part of the liberalization reforms, they are inevitably associated with the pro-market forces.

3. Rents are rewards to unproductive activities within the political process. When special-interest groups "rent-seek," they seek to benefit from public largesse, either through direct expenditures, or, indirectly, through protection from competition. William Glade claims that a *fundamental* issue which defines the success of the reform is the degree to which rent-seeking behavior is encouraged or discouraged by privatizations. See William Glade, *Privatization in Rent-Seeking Societies*, 17 *WORLD DEV.* 675, 675-78 (1989). Professor Glade correctly observe that economic readjustments have squeezed out a number of the sources of economic rent and implies that rent-seeking groups' influence has consequently been reduced. Glade concludes that sufficiently thorough economic reforms eliminate the source of rents. Glade's argument, except for his conclusion, is consistent with our thesis that, to the extent that the traditional sources of rent have been eliminated, the usual mechanisms may be disrupted and the influence of groups may diminish. However, this diminished influence is only temporary. As opportunities re-emerge, these groups will reconstitute.

Indeed, Anne Krueger's analysis of the shifting fortunes of competing interest groups is applicable here. See Anne O. Krueger, *Virtuous and Vicious Circles in Economic Development*, 83 *AM. ECON. REV. PAPERS & PROC.*, May 1993, at 351, 352-53. In fact, Professor Glade himself, in a prescient comment, supports the view, albeit indirectly, that strategic behavior does not disappear, but only shifts.

choosing to allocate resources in this manner, competition agencies have counted on the support and recommendations of numerous commentators and practitioners who acknowledge the high returns to competition advocacy in newly liberalized economies.<sup>4</sup> Thus, both by design and by practice, competition

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He writes that in Mexico the "effort to eradicate rent-seeking behavior" has: along with macroeconomic conditions, apparently fed social discontent and upset the old political equilibrium. No longer does the government possess such a plentiful arsenal of means for conciliating the multiple contending interests, though already there are signs that some in both government and the ruling party think that liberalization has gone too far and that conditions may warrant restoring some of the means of rent-conferring intervention.

Glade, *supra*, at 681. Social unrest, opposition to privatization efforts, attempts to reverse macroeconomic policies, and other similar efforts are among the interest-group activities that have been considered in this regard. For comments on how public policy may be influenced through strikes or votes see Joan M. Nelson, *Poverty, Equity, and the Politics of Adjustment*, in *THE POLITICS OF ECONOMIC ADJUSTMENT* 221, 221-22 (Stephan Haggard & Robert R. Kaufman eds., 1992).

4. Perhaps the most forceful voice in this debate has been Dr. Ana Julia Jatar, who formed and acted as the first Superintendent of the Venezuelan competition agency—ProCompetencia. In various forums, Dr. Jatar has repeatedly noted the influence of interest groups in Latin America and the importance of challenging these groups through competition agencies endowed with significantly more powers than those currently available to most agencies in Latin America. See ANA JULIA JATAR, *COMPETITION POLICY IN LATIN-AMERICA* 2-3 (1995); see also Dr. Jatar's comments in *Proceedings of the Seventh Annual Conference on Legal Aspects of Doing Business in Latin America: Adapting to a Changing Legal Environment*, 4 *FLA. J. INT'L L.* 1, 54-55 (1994) (discussing the prevalence of family-owned businesses and rent-seeking behavior as impediments to the implementation of competition policy). Dr. Jatar recently reaffirmed her views in a recent Organization for Economic Cooperation and Development (OECD) conference on Competition Policy in Latin America, held in November 1996 at Buenos Aires. Her recommendations, that competition agencies should emphasize advocacy over more traditional antitrust obligations, came under attack by European Union antitrust experts, most notably, members of DG IV. Their view, succinctly and simplistically stated, is that competition agencies should strive to become technocratic institutions and remain above the political fray limiting their portfolio to only enforcing the competition laws. Obviously, although we agree that the European experts' recommendations may be optimal in the long run or in a period of socio-political tranquility, we agree with Dr. Jatar's assessment of the more immediate problem. Our model is designed to enhance the analytical abilities of a competition authority and specifically to augment its ability to challenge interest-group practices. A politically uncommitted competition agency may find itself enforcing competition laws in a regime without competition. For example, in response to social instability and the influence of pressure groups, both Mexico and Venezuela have reverted to historical practices of setting prices of a basic "basket" of goods. It is not clear to us how one can conduct antitrust enforcement measures based on a consumer welfare standard that relies largely on prices as its signaling mechanism if prices play no role in the allocation of resources.

advocacy appears to be a significant element of what constitutes competition policy<sup>5</sup> in transition economies.<sup>6</sup>

Solely confronting interest groups, however, without a careful understanding of the underlying strengths and determinants of prevailing domestic rent-seeking practices needed to chart a more selective and effective agenda, can result in a short and frustrating life not only for anti-trusters but for all competition advocates. Lately, this has become a real and troubling concern.

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Very few antitrust commentators fail to recommend that competition agencies engage in competition advocacy. However, beyond suggesting an active participation in advisory efforts firmly grounded in economic efficiency, few provide more substantive guidance. A good preliminary attempt to characterize the objectives and methodology of competition advocacy in developing economies was made by R. Shyam Khemani, in a paper presented at the conference entitled *Emerging Market Economy Forum: Workshop on Competition Policy and Enforcement* held at Buenos Aires in October of 1996. R. Shyam Khemani, *The Role and Importance of Competition Advocacy in Promoting Competition* (unpublished paper on file with the authors). Khemani expressed the view that competition offices should *proactively* foster competition by lowering barriers to entry, promoting deregulation and trade liberalization, and by *reactively* investigating complaints and prosecuting anti-competitive business practices. See *id.* at 1-2; see also FINGLETON, FOX, NEVEN, & SEABRIGHT, *supra* note 1, at 148-73 for relevant examples from the experience of the Central European Agencies.

5. At its broadest, the term "competition policy" is used to refer to regulatory mechanisms which affect the competitive process. These include the administration and enforcement of consumer protection matters, antidumping and countervailing duties, intellectual property issues, bankruptcy, market exit procedures and anti-trust enforcement. In the United States, when it is used at all, the term competition policy appears to refer exclusively to antitrust policy. The former usage is more common in newly liberalized and transition economies since it is not uncommon to find one agency charged with administering various regulatory policies. Peru's competition agency, INDECOPI, is a veritable "regulatory holding" charged with administering the full gamut of instruments listed above. See Decreto Ley No. 25868 de Organizacion del Indecopi, Nov. 6, 1992, *reprinted in* 5 INDUSTRIAL PROPERTY LAWS AND TREATIES at Peru-Text 1-002 (World Intell. Prop. Org. No 609(E), Mar. 1995).

6. Some scholars, when referring to countries currently adopting competitive market policies, use the term "transition" to refer exclusively to former communist countries and "liberalizing" when speaking of pro-market reforms in previously non-communist countries. Such a distinction is not necessary here and the terms "reforming," "liberalizing" or "transition" economies are used synonymously. Strictly speaking, these terms all reflect the return of property rights from governments to individuals. Thus, the elimination of price controls is a reinstatement of the unencumbered right to alienate one's property. Within Douglas North's theory of institutional change, which serves as our organizing framework, a liberalization represents a "discontinuous change"—as opposed to a continuous incremental change—in the formal rules. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 89 (1990) [hereinafter NORTH, INSTITUTIONS].

With some notable exceptions, the transition to a market economy in a number of countries has been marred by difficult structural adjustments, significant social dislocation and other transition problems which have impeded the realization of expected liberalization gains.<sup>7</sup> Partly as a consequence of these difficulties, some of the political support underscoring the initial push towards a market economy has eroded, jeopardizing the prospects for further reforms, and, in some instances, threatening the gains achieved so far.<sup>8</sup>

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7. Several commentators have, in fact, expressed concern over the prospects of sustaining the achievements of pro-market programs. THE ECONOMIST recently took note of the diminishing returns of liberalization initiatives in Latin America and the growing awareness among policymakers of the need for policy shifts to avoid the erosion of gains. See *The Backlash in Latin America*, THE ECONOMIST, Nov. 30, 1996, at 19, 19. This new policy directive, which THE ECONOMIST termed "the Santiago consensus," is best described by John Williamson: "[p]olicy needs to shift from cutting back a state that had become bloated to strengthening a number of key state institutions whose efficient functioning is important for rapid and/or equitable growth." *Id.* at 21. Williamson was the father of the erstwhile policy known as the "Washington consensus," which charted the liberalization programs in Latin America. See Dani Rodrik, *The Limits of Trade Policy Reform in Developing Countries*, 6 J. ECON. PERSP. 87, 90 (1992) (arguing for "a more nuanced view of the role of trade policy" in developing economies and noting that such a "view would recognize that in most of the countries that have undertaken radical trade reforms in the 1980s, the direct efficiency consequences of trade liberalization are still uncertain and are likely to be small"). For other skeptical assessments of the gains from liberalization, see Albert Fishlow, *The Latin American State*, 4 J. ECON. PERSP. 61, 67-68 (1990) (focusing on the problem of fiscal inadequacy in Latin-American economies); Stephen Globerman, *Trade Liberalization and Competitive Behavior: A Note Assessing the Evidence and the Public Policy Implications*, 9 J. POLY ANALYSIS & MGMT., 80, 80 (1990) (discussing the uncertainty surrounding the direction and extent of the influence of liberalization on competition); and, more recently, Paul Krugman, *DUTCH TULIPS AND EMERGING MARKETS*, FOREIGN AFF. July/August 1995, at 28, 44 (discussing the inadequacy of Washington consensus in light of recent economic crises and acknowledging the absence, for the time being, of alternative policy paradigms).

8. Concern and interest over the prospects of liberalization programs has fostered what Stephen Haggard and his co-authors have called "a revival of both theoretical and empirical work" "on the political economy of adjustment." STEPHAN HAGGARD ET AL., *THE POLITICAL FEASIBILITY OF ADJUSTMENT IN DEVELOPING COUNTRIES* 19 (1995) (identifying and discussing two strands in recent adjustment literature, a strand examining "how interests and institutions affect the timing, coherence and credibility of adjustment policies," and a strand examining "the political and social consequences of the adjustment process"); see also Gene M. Grossman & Elhanan Helpman, *Protection for Sale*, 84 AM. ECON. REV. 833, 848 (1994) (setting forth a theoretical model to study the impact of campaign contributions on trade policy); Gene M. Grossman & Elhanan Helpman, *The Politics of Free-Trade Agreements*, 85 AM. ECON. REV. 667, 667-68 (1995) (analyzing the strategic interaction underlying trade agreements in two stages, an initial stage char-



But despite the universality of support for free trade,<sup>9</sup> a number of economists have recognized that free trade may not be optimal if some factors are immobile after a liberalization program has been implemented.<sup>10</sup> In an economy in which agents must specialize in their use of a factor, departures from free trade may be welfare improving. If governments can make transfers from one set of agents to another, free trade would be optimal. Thus, it is possible that the government could structure its competition policy to accomplish this result.

In this paper, we suggest a novel approach to competition advocacy for competition agencies in developing and transition economies that furthers the goals of a first best policy which would redistribute income without significant price distortions and without resorting to income taxation. Chances that liberalization programs succeed are enhanced by the extent that pro-market forces are able to vigorously resist or deflect anti-competitive challenges presented by interest groups. Our approach enables agencies to refine their understanding of rent-seeking practices and develop more focused responses.

As in the political economy literature, interest groups play a critical role in our model. Analysis of the politics of economic reform typically rely on the power of entrenched interests and strives to predict which groups and sectors will support or oppose reform. Accordingly we examine what determines the observed persistence of interest group rent-seeking behavior in transition economies. We first show that lobbying for preferen-

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acterized by interest group competition and a "subsequent stage of give-and-take that determines international equilibrium"; JEAN-DOMINIQUE LAFAY & JACQUES LECAILLON, *THE POLITICAL DIMENSION OF ECONOMIC ADJUSTMENT* 18 (1993) (highlighting the inadequacies of "a narrow economic view" of adjustment and focusing on the "interweaving of economic and political behaviors"). For varying views of the impact of democratization on economic development see *Symposium on Democracy and Development* 7 J. ECON. PERSP. 45 (1993) and *POLITICAL AND ECONOMIC INTERACTIONS IN ECONOMIC POLICY REFORM* (Robert Bates & Anne O. Krueger eds. 1993).

9. See Michael Mussa, *Making the Practical Case for Freer Trade*, 83 AM. ECON. REV. PAPERS & PROC., May 1993, at 372, 372 (observing that economists are quite confident of the benefits of an open trading system).

10. See, e.g., Jonathan Eaton & Gene M. Grossman, *Tariffs as Insurance: Optimal Commercial Policy When Domestic Markets are Incomplete*, 18 CAN. J. ECON. 258, 258 (1985). For an analysis of imperfections in political markets that impede the establishment of optimal trade policies, see Robert E. Baldwin, *The Political Economy of Protectionism*, in *IMPORT COMPETITION AND RESPONSE* 263, 263-83 (Jadish N. Bhagwati ed., 1982)

tial treatment is capable of reversing liberalization gains in two general ways: by replacing tariffs with non-tariff barriers or by supra-competitive pricing obtained by either horizontal collusion or via government sanctioned cartels.

We pay close attention to the existence of particular transition rigidities and show that their presence compounds the losses which accrue to interest groups due to increased import competition, a condition which enhances the returns to cartelization. This detailed parsing of rent-seeking motives suggests competition policy implications different from those currently in place in transition economies. For example, a competition agency typically fosters and facilitates market entry by seeking to enjoin any "anti-competitive" practices that raise costs of entry. The competition agency may choose not to challenge such a practice, however, to the extent that it understands that domestic groups have little choice but to resort to recently proscribed practices as a last measure attempt to ensure their survival. Such an avenue may be the only alternative available to some domestic groups for at least two reasons: (a) they may face onerously high exit costs due to adjustment or reallocation difficulties caused by the presence of capitalized decisions incurred during the previous regime; and (b) since liberalization programs often entail a replacement of political figures, politicians may be either unwilling or unavailable to intervene on their behalf by facilitating the erection of a non-tariff barrier or some other protective measure.

Rather than taking the opportunity to enforce the law and claim victory, a competition agency may obtain better results by informing decisionmakers of the likely social costs of forcing such firms out of the market and recommending a course of action that will minimize both social and legal costs, reduce exit costs and preserve some long run competition. Unfortunately, only too frequently do agencies choose to prosecute. This is, of course, understandable since the public relations benefit of highly publicized enforcement actions often directly affects budgetary considerations.

A second situation in which our analytical approach could alter decision-making is within the asymmetry of incentives which typically arise in transition economies between political decisionmakers and those of the competition agency. Politicians are often prone to grant highly favorable packages to foreign investors to minimize social unrest due to reforms.

Investors are more likely to commit capital if they are guaranteed an acceptable level of returns. Thus, it is common to find exclusive concessions, guaranteed by government sanctioned entry barriers being offered to prospective investors, which inevitably run afoul of the efficiency-based views of the competition office. Reviewing the issue from this perspective may enable the agency to realign its incentives with those of political decisionmakers.<sup>11</sup>

This paper is organized as follows. In the following section, we provide a general overview of the paper. This is followed, in section III, by a discussion on the emergence and consequences of regime-specific capital in a transition economy. The examples and construction of our model rely on two archetypical periods drawn largely from the composite experience of the Latin-American nations. The first period encompasses the years when the Import Substitution Initiative (ISI) was the favored development paradigm. The second period constitutes the post-liberalization years after the reforms of the late 1980s and 1990s. Despite the reliance on the particulars of the Latin-American experience, the argument may have broader applicability. For example, to the extent that there are significant parallels between the experience of the Latin-American nations

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11. To fully capture the benefits of market reforms, policymakers realize that it is crucial to increase both domestic and foreign investment. Abstracting from the normal returns to business risk, firms may choose to invest in reforming economies only if they are compensated for the added risk of policy reversal, since any likelihood of a policy change that may result in capital losses can reduce the incentive to commit irreversible capital. Accordingly, entry into reforming economies is likely to occur only if firms, *ex ante*, expect higher returns than those expected for an economy with less policy uncertainty. Thus, an antitrust challenge based on a naive focus on short run allocative efficiency may adversely affect the long run investment potential of a reforming economy. For example, the acquisition of Skoda by VW in the Czech Republic was accompanied with demands for increased levels of tariff protection and foreign investment restrictions aimed at limiting import competition and new entry. An allocatively efficient approach would result in a recommendation for the competition office to seek to enjoin or oppose the acquisition. But recognizing that the prospective supra-competitive return required by investors may reflect a premium, which must be balanced against the risk of failure, could result in the authority choosing to exercise prosecutorial discretion. For a more comprehensive exposition of the potential problems from conflicting methodological approaches, see A.E. Rodriguez & Malcolm B. Coate, *Limits to Antitrust Policy for Reforming Economies*, 18 HOUS. J. INT'L L. 311, 338-45 (1996). For a brief discussion of the Skoda case and recommendations that the agency stave off the Skoda acquisition, see Khemani, *supra* note 4, at 8; see also FINGLETON, FOX, NEVEN, & SEABRIGHT, *supra* note 1, at 27, 150.

and those of the ex-communist countries, the arguments advanced here may provide similar insights into the current transition problems besetting the former communist countries. A highly stylized model serves to represent the effects of these rigidities and shows how the lack of attention to its presence may reverse the gains from liberalization. This model appears in the third section, along with policy implications. The fourth section presents some concluding comments.

## II. OVERVIEW OF THE REFORM PROBLEM

Rigidities in human and physical capital imply adjustment difficulties which appear as a result of the unanticipated insertion of inefficient, small and inflexible economies into a world market by the government's decision to liberalize. Post-liberalization, both human and physical production inputs, which reflected the "rules of the game" of the previous "closed" regime, may have little or no value in any in use. Moreover, firms inherit labor market and other social restrictions and institutions<sup>12</sup> further lowering their profitability.<sup>13</sup> Thus, even capital which was not sunk under the previous regime may find itself obsolete under the new regime.<sup>14</sup> What is clear

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12. For our purposes, institutions are defined as social rules, conventions, and other elements of the structural framework of social interaction as used in the New Institutional Economics literature. See, e.g. DOUGLASS C. NORTH, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* 201-02 (1981) [hereinafter NORTH, *STRUCTURE AND CHANGE*]; NORTH, *INSTITUTIONS*, *supra* note 6, at 3.

13. In some cases, profitability is adversely affected by exit barriers. Exit barriers are "costs or foregone profits that a firm must bear if it leaves an industry" and depend on a firm's opportunities to move capital into alternative markets. Richard J. Gilbert, *Mobility Barriers and the Value of Incumbency*, in 1 *HANDBOOK OF INDUSTRIAL ORGANIZATION* 475, 520-23 (Richard Schmalensee & Robert D. Willig eds., 1989). These exit costs effectively impose a fixed proportions technology on firms which implies no substitution possibilities between different sectors of the economy or between the various factors of production. By contrast, a neo-classical technology suggests otherwise. The standard adjustment scenario assumes that production technology is neo-classical. Thus, a reduction in the return (the value of the marginal product) to capital and labor in the import-competing sector (say due to increased import penetration), would result in reduced input usage as both inputs of production migrate to a higher valued use elsewhere. However, if the technology is characterized by fixed-proportions, substitution possibilities are limited. We argue here that conventions, labor agreements, political circumstances and other institutional features of transition economies, render the operational choices available to firms as if they were operating under fixed-proportions, even if, strictly speaking, the technology itself is neo-classical.

14. Consider the following hypothetical example. In period one, under the old

to the owners of this capital, however, is that they can recover the value of their capital if it is possible to return to economic conditions qualitatively similar to those prevailing under the old regime. Given this expectation, agents may find it lucrative to lobby to reverse liberalization gains and to reverse the erosion of the value of their capital.<sup>15</sup>

Presumably, requests for assistance from industries which are observing losses due to the presence of transition rigidities should be examined under different criteria from those industries either lacking this peculiar condition or displaying negligible levels of it. Indeed, compensation schemes can be used to manage the costs of rapid reform and, by implication, enable the competition agency to quell potential defections from the ranks of liberalization supporters. If a reform can raise aggregate output, then an appropriate scheme for compensating losers can make the reform Hicks-Kaldor efficient.<sup>16</sup> To the extent that favored groups believe that the compensation plan

protected regime, a domestic chemical manufacturer chose to invest in a 3,000 gallon reactor at an efficient scale and optimal capital labor ratio, given prices and the size of the small closed economy. In period two, post-liberalization, the economy opens up to international competition where the minimum efficient scale demands a 10,000 gallon reactor, and where input and product prices are necessarily different. Under this scenario, since the firm is unable to obtain any more than scrap value for its reactor, the reactor has become worthless as a result of the liberalization. Clearly, if the country returns to conditions qualitatively similar to those under the protected regime, the reactor recovers its value.

15. Klein, Crawford and Alchian use the following example to explain how the presence of appropriable quasi-rents in an agreement between two parties imputes incentives to behave strategically: "Imagine a printing press owned and operated by party A. Publisher B buys printing services from party A by leasing his press at a contracted rate . . ." The quasi-rent earned by A on the installed machines is positive and equal to the difference between the contracting rate paid by publisher B minus A's operating costs and salvageable value. However, publisher B could opportunistically lower his payment and capture these quasi-rents and still have printing services available to him. See Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298-99 (1978). By extension, our argument suggests that the printing press owner A has every incentive to lobby or force publisher B to comply with the terms of the original contract where the value of the printing press was highest and owner A obtained positive quasi-rents.

16. Since there are bound to be winners and losers, the transition to a market economy is not Pareto superior. Rather, the liberalization initiative may be recommended on the grounds that it is Kaldor-Hicks efficient. In such a reallocation of resources, the gains to the winners are greater than the losses suffered by the losers. This suggests a strategy for consolidation of the reforms of bribing the losers to acquiesce in the change. See P. RICHARD G. LAYARD & ALAN A. WALTERS, *MICROECONOMIC THEORY* 32 (1978).

reduces the likelihood of severe losses in the value of their capital, they should support the reform effort.

However, since most groups are likely to demand compensation, it is difficult, *ex ante*, for the authorities to determine which group actually has a reasonable claim. The groups most able to secure compensation are not necessarily the most affected by either the crisis or efforts to adjust to it and compensation may simply reward the politically well-connected.<sup>17</sup> Still, in a broad sense, it is unnecessary to identify *all* the groups with solid claims, because to make the reform politically feasible under a democratic setting, it should only be necessary to devise a compensation scheme under which at least a majority would be better off or no worse off. By identifying mechanisms or structural features, removed (at least in the short run) from the influence of interest groups, policymakers may obtain some efficient—if not necessarily equitable—results. In a world of limited managerial and financial resources, since an independent and exogenously determined procedure may reduce the validity of the claims of a number of interest groups, it may be more efficient to develop mechanisms that will allow the identification of characteristics immune from endogenous manipulation. Is this a role for the competition agency?<sup>18</sup>

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17. See Nelson, *supra* note 3, at 226-33.

18. In developed economies, with a strong antitrust tradition, competition policies focus on the prevention of proscribed practices (including cartel formation and the creation of other forms of horizontal or vertical restraints) and competition advocacy. Prevention of specific practices designed to, or which might have the effect of, reducing competition (such as price-fixing, bid-rigging and market allocation) is a fundamental responsibility of antitrust enforcers. It is also one of the most difficult responsibilities, because cartels almost always try to hide their activities. The merger oversight function constitutes review of mergers and acquisitions under the premise that market structure affects market conduct, which in turn affects market performance. Lastly, competition agencies, primarily due to advantages in expertise developed in enforcement, frequently challenge anti-competitive regulations and provide guidance on the competitive impacts of privatizations and similar reforms. See generally ERNEST GELLHORN & WILLIAM E. KOVACIC, *ANTI-TRUST LAW AND ECONOMICS* 13-14, 15-41 (1994).

Some jurisdictions have additional objectives. For example, in the Economic Union, the rules on competition are an instrument for economic integration. See Spencer Weber Waller, *Understanding and Appreciating EC Competition Law*, 61 *ANTITRUST L.J.* 55, 66 (1992) (“[t]he Community’s principle concern in the area of vertical restraints is the continued division of the Common Market along national lines”); see also Rodriguez & Coate, *supra* note 11, at 325-26 (observing the possible pitfalls of contradictory objectives in EU antitrust enforcement); A.E. RODRI-

### III. THE LEGACY OF PROTECTIONISM AND THE FORMATION OF TRANSITION RIGIDITIES

#### A. *Historical Background*

For a good portion of its recent history, Latin-American nations based their economic policy not on market competition, but on industrial policies which involved intense state control over the economy. The ISI model, for example, was prevalent from the 1950s to the late 1970s, although earlier periods also involved burdensome anti-competitive government sponsored policies.<sup>19</sup>

Over the years, the inward-looking ISI and predecessor policies did little to foster an efficient industrial sector, but rather, adversely affected the structure, conduct and performance of the economic system. Throughout the ISI period, imports were restricted through numerous mechanisms, including tariffs, permits, import licenses, export drawbacks, foreign exchange controls, and the institution of "official prices" as a basis for setting tariffs.<sup>20</sup> Official tariff policy involved the active collaboration between the Government and domestic competitors in setting tariffs. Thus, trade policy either severely restricted or altogether eliminated the disciplining effect of

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GUEZ & MARK D. WILLIAMS, DO WE NEED COMPETITION POLICY IN AN INTEGRATED WORLD ECONOMY? (Center for Trade & Commercial Diplomacy Working Paper No.5, March 1997). An OECD directive provided that "[i]t was envisaged from the outset that [the competition rules] should provide a means to ensure that regulatory barriers be eliminated in the process of creating a common market and should not be replaced by private behavior which would have the effect of isolating and dividing national markets from another." OECD, THE OBJECTIVES OF COMPETITION POLICY, DAFPE/CLP(92)1/EEC, at 3 (distributed May 14, 1992). In practice, this directive has conferred little weight on any pro-competitive benefits of vertical restrictions. With some exceptions, regional-integration as an objective of competition policy has not been discussed much in Latin America. To some extent, this topic has been addressed by the recent competition policy working groups set up by trade agreements such as North American Free Trade Agreement and the Free Trade Area of the Americas.

19. For an examination of the Import Substitution Initiative, see DIANA HUNT, ECONOMIC THEORIES OF DEVELOPMENT 77-79, 321 (1989); JOHN SHEAHAN, PATTERNS OF DEVELOPMENT IN LATIN AMERICA 82-93 (1987). For a general discussion, see ANNE O. KRUEGER, POLITICAL ECONOMY OF POLICY REFORM IN DEVELOPING COUNTRIES 43-48 (1993); Robert E. Baldwin, *Increasing Access to Markets for Manufactured Goods: Opportunities in the Uruguay Round*, in DEVELOPMENT WITH TRADE 86, 89-91 (Anne O. Krueger ed., 1988).

20. Official or reference prices were special customs figures used as a base to calculate tariff payments on imports. These prices hardly ever reflected any real values.

imports and in combination with other interventionist policies negatively influenced both the structure and performance of domestic firms.<sup>21</sup> Not surprisingly, the expectation of continued government protection did little towards encouraging domestic firms to enhance their competitiveness. Instead, these policies forged an increasingly non-competitive and highly inefficient industrial sector.

Likewise, prices of both intermediate and final goods were frequently regulated and often explicitly set by governments. Price controls stimulated active cooperation between domestic producers and resulted in industry-wide efficiency levels established by the performance of the most inefficient producer. Industrial policies which regulated market entry and even restrained expansion of productive capacity, were instituted. Even entrants that were able to navigate bureaucratic hurdles were not assured of success in the market. Production permits still depended largely on development policy priorities of the current government. The resulting arbitrariness, linked to the lack of a clear and consistent system of granting permits, fostered intense corruption and rent-seeking behavior.<sup>22</sup>

Direct subsidies also affected the performance of Latin-American industry. Arbitrary movements in relative prices would greatly advantage one sector over another. In this manner, certain sectors grew at the expense of others.<sup>23</sup> Such arbitrary pricing schemes rarely advanced economic efficiency. On the contrary, some factors of production were over-generously rewarded while others were under rewarded, and consequently

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21. The lack of competition adversely affects not only the current allocation of resources, but may also impair the long run dynamics of the market. In particular, incentives to innovate are often reduced by the lack of international competition in state-controlled economies.

22. The simultaneous use of tariffs and licensing was often handled by different government departments. In the case of Mexico, for example, tariffs were administered by the Ministry of Finance and import permits by the Ministry of Industry and Commerce. A manufacturer seeking protection could thus turn to one or the other, depending on when he encountered less resistance. See Gerardo Bueno, *The Structure of Protection in Mexico*, in BELA A. BALASSA, *THE STRUCTURE OF PROTECTION IN DEVELOPING COUNTRIES* 169, 181 (1971); see also generally, JOSÉ I. CASAR ET AL., *LA ORGANIZACIÓN INDUSTRIAL EN MÉXICO* (1990).

23. For example, in the 1955-1970 period, Mexico's policy was characterized by an anti-export bias and price distortions that "favored the use of capital in place of abundant labor." Eliana Cardoso & Santiago Levy, *Mexico*, in *THE OPEN ECONOMY* 350 (Rudiger Dornbusch & F. Leslie C.H. Helmers eds., 1988).



some factors were over-supplied and others under-supplied.

Governments often controlled a firm's operational decisions (staffing, plant closings and reinvestment). Furthermore, if the government did not actually impose such constraints, labor unions often did, taking advantage of the peculiarly cozy character of labor relations between unions and governments to achieve restrictive work rules and protect employment. As a result, many firms operated inefficiently with excess labor or capital. These costs were often intensified by generous collective bargaining agreements.

Some exports were deliberately discouraged by requiring permits, while, simultaneously, other products were granted export credits, foreign exchange benefits for imports of raw materials and capital goods as well as favorable credit terms.<sup>24</sup> To make matters worse, this infrastructure of contradictory incentives was frequently altered, often providing exporters with no more than a couple of weeks to establish their export plans.<sup>25</sup>

Exchange rate policies also adversely affected the performance of the industrial sector. There was very little of a simple nature with respect to the exchange rate. A multi-tiered exchange rate structure subject to repeated, unpredictable and arbitrary changes was the norm. Government agencies administered the granting of preferred exchange rates for imports of raw materials without clearly established pre-defined criteria. To reduce the transactions costs of handling thousands of requests, these government agencies encouraged cartelization by recommending that required budgets of applicants be jointly filed through manufacturing associations.

Another important element in the industrial scenario of Latin-American economies was the direct participation of the

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24. See Cardoso & Levy, *supra* note 23, at 357 (observing that "[e]xport subsidies were never sufficient to counterbalance the antiexport bias of the trade regime").

25. For a discussion of the impact that institutional uncertainty has on Latin-American economic growth see SILVIO BORNER ET AL., INSTITUTIONAL OBSTACLES TO LATIN AMERICAN GROWTH 17 (Int'l Ctr. for Econ. Growth Occasional Paper No. 24, 1992) (defining institutional uncertainty as the "risks arising from a highly volatile institutional environment" and observing that "[s]ome aspects of this type of risk are regulation of prices or capital mobility, surprise inflation taxing, unpredictable exchange rate and interest rate manipulations, inconsistent enforcement of contracts, an unpredictable judiciary, discontinuities in the legal system, and finally, outright corruption").

state in the economy through parastatals, or government enterprises.<sup>26</sup> The state's enterprises typically maintained the exclusive right to domestically manufacture certain products and often limited imports of competing products. These policies resulted in highly concentrated industries which, in turn, created substantial inefficiencies: supra-competitive prices, misallocated resources, and costly production due to reliance on inefficient technology.

By the early 1980s, most Latin-American governments appeared to have realized the constraints of the ISI model and determined that the best path to achieve an optimal allocation of resources would be through the dynamics of competitive markets. To achieve this objective, in the mid-80s and early 90s, governments resorted to aggressive price liberalization policies, the elimination of currency controls, a reduction in or the elimination of tariff barriers, and vigorous privatization and deregulation programs. Necessary steps were taken to curb inflationary pressures and expectations. Import competition was often used as a key instrument to control price increases in tradable products. The government pegged the foreign exchange rate to the U.S. dollar, liberalized trade, and promoted foreign investment, which resulted in a surge of imports and foreign money. These inflows soon created such a demand for domestic currency that it became overvalued.

Faced with a growing domestic market and an appreciating real exchange rate, entrepreneurs had no incentive to sell abroad. Overvaluation stimulated imports to the point that the trade deficit soon became a critical destabilizing factor. The influx of cheaper and often better quality imports resulted in a rapid consolidation of domestic producers as the higher-cost and more inefficient firms disappeared. The remaining producers, however, found themselves at a competitive disadvantage as the flow of cheap imports continued. Not surprisingly, in search of a way to alleviate competitive pressures, domestic

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26. Nora Lustig explains the increase in the Mexican state's already significant participation in the economy as follows:

The belief at the time was that a country in which the state controlled a larger share of investment, owned more "strategic" sectors (energy, steel, and so on), and regulated more of the price-setting mechanism would be more prosperous, more equitable, and less vulnerable to the political pressures of the business sector at home and abroad.

NORA LUSTIG, MEXICO: THE REMAKING OF AN ECONOMY 18 (1992).

producers lobbied the government incessantly for a devaluation and other relief measures.<sup>27</sup> In some instances, the government relented. In others, as in the case of Mexico, the government resisted such pressures for a number of reasons including the perception by officials that a devaluation would kill the chances of the United States' ratification of the North American Free Trade Agreement,<sup>28</sup> which had been under severe scrutiny in Congress.<sup>29</sup>

### *B. The Consequences of the ISI Industrial Policy*

Economic theory predicts that legal and contractual structures and rules of third-party enforcement which are necessary for most arms-length market transactions have important implications for how economic actors interact in any type of economic system.<sup>30</sup> For example, many economic activities require one party to make a considerable initial investment with the value of that investment depending on the future actions of a second party. The investing party will not incur significant initial costs without the assurance that the subse-

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27. It is well known that large macroeconomic disequilibria will have effects on the structure of protection. Sebastian Edwards observes that as macroeconomic pressures mount, most countries will hike tariffs and impose trade, exchange and capital controls in an effort to slow down the outflow of reserves. See SEBASTIAN EDWARDS, *THE SEQUENCING OF STRUCTURAL ADJUSTMENT AND STABILIZATION* (Int'l Ctr. for Econ. Growth Occasional Paper No. 34, 1992). Similarly, episodes of high inflation distort the normal functions of relative prices. See Dennis W. Carlton, *The Disruptive Effects of Inflation on the Organization of Markets*, in *INFLATION, CAUSES AND EFFECTS* 139, 147-49 (Robert Hall ed., 1982); see also Robert Feinberg and Mieke Meurs, *Privatization and Antitrust in Eastern Europe: The Importance of Entry*, 34 *ANTITRUST BULL.* 797, 808-09 (1994) (discussing still other reasons that weaken the usefulness of prices and other traditional signals and concluding that "[r]apid changes in the structure of prices, forms of ownership, and sources of demand have made it difficult for past and present profits to operate as a signal for entry in the way they do in the established market-based economies").

28. North American Free Trade Agreement, *done* Dec. 8, 1992, Can.-Mex.-U.S., 32 *I.L.M.* 605.

29. By 1994, devaluation became less of an option in the light of the possibility that the PRI's candidate would lose an election for the first time in 65 years. In December of 1994, however, the government was forced to devalue the peso and the liberalization process suffered its dramatic setback. See Moises Naim, *Mexico's Larger Story*, in *FOREIGN POL'Y*, Summer 1995, at 112, 118-19.

30. Here we refer to "economic system" as that term is interpreted by the New Institutional Economics, which places emphasis on the deficiencies of the legal and contractual systems and on the regulatory state as blocking economic progress. See NORTH, *STRUCTURE AND CHANGE*, *supra* note 12, at 205-07 and NORTH, *INSTITUTIONS*, *supra* note 6 at 4-5.

quent rewards will be forthcoming. To offer these assurances, the second party must credibly commit to following through on the desired actions. Other things equal, the more credible (in the sense of a lower likelihood of default) the assurance, the higher the value of the investment.<sup>31</sup>

But such assurances are difficult to make credible, because once the first party invests, the second party often has an incentive to behave opportunistically and move to renegotiate the terms of the agreement. The prospect of one party behaving strategically is a function of the difficulties in foreseeing all future eventualities and the ease of entering into agreements that mandate performance. Even if it were possible to foresee all prospective contingencies, bounded rationality makes it difficult to write and enforce complete contracts. Nonetheless, numerous contractual and institutional mechanisms arise to prevent such opportunistic behavior.<sup>32</sup>

The constraints imposed by the ISI economic model necessarily required explicit and persistent relationships between the state and its client groups.<sup>33</sup> The state favored collaboration with a specific set of interest groups because this minimized the direct costs to the state of administering specific

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31. See Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 92 AM. ECON. REV. PAPERS & PROC. May 1980, at 356, 356; Benjamin Klein, & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981) (discussing the role of reputation in assuring the performance of contracts).

32. See Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV., 519, 519 (1983); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 15-42, 68-84 (1985); Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 12-24 (1985) (discussing hostage-holding, collateral, hands-tying and the development of sympathy, as methods for making covenants binding in the absence of the state); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 379-91 (1990); Richard Morrison, *Efficient Breach of International Agreements*, 23 DENV. J. INT'L L. & POL'Y 183, 194 & n.41 (1994) (observing that damaging a contractor's reputation is an extra-legal sanction which is sometimes more important than the possible legal sanctions); Steven N. Wiggins, *The Economics of the Firm and Contracts: A Selective Survey*, 147 J. INSTITUTIONAL & THEORETICAL ECON. 603, 604 (1991) (discussing the importance of commitment to general economic performance).

33. See Cardoso & Levy, *supra* note 23, at 349 (pointing out that it was "at the beginning of President Miguel Alemán's administration (1947-52) [that] the private and public sectors reached the formal and informal agreements which established the political and social structure that was to permit fast economic growth in the following decades").

program directives. Clients desired linkages to the state to increase their share of the available state resources. State-client relationships were also mutually convenient arrangements for equilibrating actual and expected conditions in order to reduce the costs of adjustment for both parties.<sup>34</sup>

Naturally, trade associations, regional interests, labor unions and other such groups became the official voice for any producer who wished to benefit from state largesse. Thus, these groups gained significant influence and prominence because of their valuable function to both the state and domestic producers. On one hand, they reduced the number of participants present in price-setting and similar negotiations with the state and, on the other, provided an effective medium for furthering their members' interests.<sup>35</sup>

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34. Consider John Coatsworth's characterization of the institutional environment of nineteenth century Mexico:

The interventionist and pervasive arbitrary nature of the institutional environment forced every enterprise, urban or rural, to operate in a highly politicized manner, using kinship networks, political influence, and family prestige to gain privileged access to subsidized credit, to aid various stratagems for recruiting labor, to collect debts or enforce contracts, to evade taxes or circumvent the courts, and to defend or assert titles to land. Success or failure in the economic arena always depended on the relationship of the producer with political authorities—local officials for arranging matters close at hand, the central government of the colony for sympathetic interpretations of the law and intervention at the local level when conditions required it.

John H. Coatsworth, *Obstacles to Economic Growth in Nineteenth Century Mexico*, 83 AM. HIST. REV. 80, 94 (1978).

35. As North observes, "[t]o the degree that there are large payoffs to influencing the rules and their enforcement, it will pay to create intermediary organizations (trade associations, lobbying groups, political action committees) between economic organizations and political bodies to realize the potential gains of political change." NORTH, INSTITUTIONS, *supra* note 6, at 87. It was incumbent on these interest groups to act not only as agents for the government but as cartel ring-leaders. For the most part, the groups' obligations were limited to carrying out two of the three well known cartel functions: monitoring the agreement and disciplining cheaters. A private cartel's function of finding and setting the monopoly price is, of course, not required of a state-sanctioned cartel where the state sets prices. Thus, the interest groups had only to concentrate on monitoring and disciplining its members. Monitoring and disciplining was facilitated by years of association and collaboration with state agencies which forged group identification for manufacturer, regional and other pressure groups. This group identification provided the cartel with a number of benefits. First, it facilitated cooperation among members, which in turn aided the cartel in the collective exercise of market power. Second, group identification combined with the special relationship with government officials aided the development of exclusionary devices to keep out new entrants. Finally, group cohesiveness facilitated the disciplining of members who

Long-term relationships between the state and interest-groups allowed firms to feel comfortable when investing in significant transactor-specific capital. State opportunism was controlled by institutions that developed through interactions between the state and the various interest groups. For example, if the government attempted to implement a policy that would lower the value of a significant set of investments, a union could threaten a national work stoppage. Alternatively, opportunism could be controlled by bribes to government decisionmakers. Over time, significant quasi-rents resulted from this collaboration as firms invested in plant, capital, product mix, product quality and other aspects of competition.

Assured of continued protection from foreign or domestic competition, the industrial structure reflected an inefficient cost structure, high concentration and a smaller minimum efficient scale and scope, due to the smaller size of the domestic (and only) market. Naturally, the value of the firm's stock depended on the continuation of the relationship between the interest groups and the state which itself depended on the economic model the state had adopted. Thus, the fortunes of a large portion of the productive infrastructure were tied to the political-economic performance of the "ancien régime."<sup>36</sup>

Liberalization occurs when the existing regime collapses under the weight of its gross inefficiency. Government decisionmakers are swept away (after an election or military coup) and replaced by reformers with no obligations to the old order. Market reforms open up the economy to competition and trade, dramatically changing the economic climate. Incumbent firms are forced to compete in the new environment.

A proportion of each firm's capital commitments made under the old "rules-of-the-game" will be adversely affected by the liberalization. The sudden opening of the economy and the

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chose to diverge from group practices. The threat of rescinding an import permit or a special subsidy often sufficed to prevent any violation of cartel discipline. A recent case brought by the Peruvian antitrust agency, INDECOPI, is an excellent example of this practice. See INDECOPI, RESOLUCION No. 001-97-INDECOPI-CLC (Jan. 15, 1997) (finding a cartel of poultry producers in violation of price-fixing prohibitions).

36. As Douglass North puts it, "[t]he larger the percentage of a society's resources influenced by government decisions (directly or via regulation), the more resources will be devoted to such offensive and defensive (to prevent being adversely affected) organizations." NORTH, INSTITUTIONS, *supra* note 6, at 87.

removal or reduction of old rent-distributing mechanisms lowers the value of these regime-specific investments. Aspects of these investments such as minimum efficient scale, existing economies of scope, state of technology, management structures, and others, were idiosyncratic to the conditions of the pre-liberalization regime and predicated on the assumption of continued protection and a regulated economy. The value of this regime-specific investment cannot be readily transferred to the new liberalized regime.

Post-liberalization, as the relationship between the state and the private sector was altered, the value of most of this capital tends to dissipate. However, owners of this capital recognize that the value of their assets is directly dependent on returning to the previous protected regime or one that closely resembled it.<sup>37</sup> In this sense, the memory embodied in the capital influences the present-day performance of producers. Intent on preserving the value of this capital or preventing its slow erosion, firms solicit "temporary" protection or other forms of preferential treatment from the government or resort to private action. This latter option often takes the form of domestic cartels.

Another important and interrelated dimension of this scenario (and equally susceptible to state strategic behavior) is the presence of specific human capital. To the extent that the pre-liberalization generation of managers, with their archaic management practices and other traits, is entrenched and unwilling to relinquish control (or perhaps competent managers are unavailable due to the unavailability of trained professionals),<sup>38</sup> the personal success of the manager class may be

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37. This is the notion of path-dependency that is, for instance, intrinsic to North's theory of institutional change: "if the process by which we arrive at today's institutions is relevant and constrains future choices, then not only does history matter but persistent poor performance and long run divergent patterns of development stem from a common source." NORTH, INSTITUTIONS, *supra* note 6, at 93. The issue of path dependence was first brought to attention in Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. PAPERS & PROC., May 1985, at 332, 332 ("A *path-dependent* sequence of economic changes is one of which important influences upon the eventual outcome can be exerted by temporally remote events, including happenings dominated by chance elements rather than systematic forces").

38. This may be an example of what has been called "demography's hidden curse." Arnold C. Harberger, *Policymaking and Economic Policy in Small Developing Countries*, in THE OPEN ECONOMY: TOOLS FOR POLICYMAKERS IN DEVELOPING

tied to the continuity of the old rules of the game. Put differently, their human capital is regime-specific. To the extent that old-school managers exert their influence and prevent management changes, their highest value, and therefore, their incentive, is to seek preferential treatment rather than face the new competitive arena. The older management establishment still embodies much of the specific capital retained from the pre-reform days when the private sector worked closely with the state regulatory institutions.<sup>39</sup>

Post-liberalization, then, domestic producers have the following somewhat non-exclusive choices: they may seek protection either from the government or by organizing a cartel, or they may re-invest and replace obsolete capital to enhance the value of their non-specific capital. It appears that firms can employ strategies designed to enhance output or increase price. Output would be enhanced by either rent-seeking to increase tariffs and subsidies or investment to lower cost. However, a reasonable case can be made that subsidies usually come with requirements that limit the firm's flexibility and thus the profitability of new investment. Thus, it would appear the relevant output-enhancing choices are tariffs and investment or tariffs and subsidies. Price tends to respond to cartelization and tariffs, but not subsidies and investment. Therefore, it would seem a firm desiring to raise price would be forced to select

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COUNTRIES 249, 249-251 (Rudiger Dornbush & F. Leslie C.H. Helmers eds., 1988) (arguing that basic demographic factors suggest that small countries, defined as those with a population of less than 20 million, will contain a "small endowment" of trained educated professionals). He points out, however, that this situation impedes the establishment of "impersonal government" and the even, fair application of state policy. The particular case of the Eastern European countries evokes similar comments. See Martin C. Spechler, *Competition and Structural Change in Eastern Europe*, 6 REV. INDUS. ORG. 189, 195 (1991) (pointing out that "[w]ith markets still rudimentary in most places and needed structural changes so many, it can be plausibly thought that economic managers are still needed, if for nothing else than dealing with international aid agencies. Talent, it is said, is scarce, and entrepreneurship and risk-taking not habitual in these place[s]").

39. Robert M. Feinberg and Mieke Meurs observe a similar situation in the Eastern European countries "[w]here a small number of potentially competing firms result, connections between managers who cooperated for years under central planning facilitate collusion." Feinberg & Meurs, *supra* note 29, at 806. Feinberg and Meurs also offer comments that generally support our thesis, to wit, that the specificity of personal relations built over years of collaboration between the state and (now private) producers facilitate rent-seeking: "[t]he same private and state firms that possess market power may also possess sufficient political influence to create barriers, formal or informal, to the entry of foreign goods." *Id.* at 809.



rent-seeking strategies. On balance, the decision on whether to seek state concessions and/or invest to replace obsolete capital turns on the likelihood that a firm's net value is higher under the new regime. An expectation of growth bolsters the relative influence of the non-specific capital components while the expectation of an economic downturn, reduces the consideration given to non-specific capital.

The relative magnitude of the regime-specific versus general capital is likely to have an important effect on the firm's decision. If the firm has little regime-specific capital, a decision to write-off the investment and commit to the new regime is likely to be profitable. On the other hand, if the firm has a significant investment in regime-specific assets, the survival of the entity may be in doubt. Thus, the business would have little choice but to lobby for some type of protection.<sup>40</sup>

An important element in choosing to seek rents, rather than to replace their capital, is the continued existence of the old industry and other interest groups. To the extent that the value of specific capital, "goodwill," etc., cultivated by years of collaboration has not fully dissipated, the value of seeking preferential treatment will be higher. Thus, it is distinctly possible that this rent-seeking alternative will be chosen by domestic industry.

As with all capital, the value of the non-specific portion of capital depends largely on the expectation of its future profitability. The value of this capital is tied to the fortune of the new regime. If the reforms appear to be succeeding (or the government has credibly committed to stand by the reforms) investment appears relatively more attractive. On the other hand, if the reforms seem doomed to failure, firms will be relatively less likely to undertake specific investments. Thus, the initial results of a policy reform may have a dramatic effect on the final outcome.

The presence of regime-specific capital is not always a deterrent to successful transition elsewhere. For example, the United States successfully reformed its telecommunications

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40. Gary Becker concludes that "workers and firms with sizable specific investments tend to have relatively large gains from lobbying for government protection against temporary and unexpected declines in demand because the dead weight cost of subsidies to them is relatively small." Gary S. Becker, *Public Policies, Pressure Groups, and Dead Weight Costs*, 28 J. PUB. ECON. 329, 339 (1985).

and natural gas industries, both of which had considerable amounts of specific capital reflecting old and protected 'rules of the game.' Indeed, analytically the situation in the United States was very similar to the one in various Latin-American countries. However, the difference between the two situations lies in the relative influence of the anticipated demand growth, combined with the influence of that portion of capital that is still profitable, established interest groups and the likelihood of a policy reversal.

As described above, the once fashionable ISI model spawned capitalized inefficiencies. To the extent that this capital has not been physically depreciated even if completely devalued, there remains a strong incentive for the owners of the capital to attempt to restore the value of their investment by rent-seeking or monopolistic activities. Reformers have a number of potential responses to rent-seeking activity. A textbook approach would be to deny all requests for special treatment, break up monopolies and wait for growth to validate the decision. While this approach is credible in certain circumstances (i.e. rapid growth is expected or the regime is not subject to instability), other circumstances exist in which the combined power of the old regime's interest groups could reverse the reforms. In this case, the denial strategy is not credible, because interest groups know the government can be pressured into reversing its course. If a credible commitment to reject all rent-seeking attempts cannot be made, some divide and conquer accommodation is necessary.

An accommodation strategy can succeed without attempting to make the reforms acceptable for all interest groups. In effect, some interest groups and industries can be left worse off, as long as they are unable to prevent the reformers from credibly committing to a reform strategy.

#### IV. TRANSITION RIGIDITIES & PROTECTIONISM

The economics profession has long expressed interest in the general topic of actions taken by agents which endogenously act to influence prospective state sanctioned activity for their benefit. The literature on intervention-seeking can be traced back to Gordon Tullock's seminal paper on the social

costs of tariffs and monopoly.<sup>41</sup> Tullock's central concern, that governments are pressured or lobbied into imposing protection, generated several interesting lines of research. In the trade literature, Anne Krueger's and Jagdish Bhagwati's coined phrases, "rent-seeking behavior" and "directly unproductive profit seeking activities" or "DUP," colorfully characterized the core of the research seeking to assess the impact of the wasteful diversion of resources into unproductive activities.<sup>42</sup>

Trade protection is designed to insulate domestic industry from international competition. Such protection establishes monopoly rents in markets where long run domestic supply elasticities are finite. Inevitably, trade protection has a domestic rent-seeking constituency prepared to fight for the creation and retention of protectionist policies. Interactions between these rent-seeking constituencies and the public interest in free trade determine the precise protectionist policy that will emerge in the political marketplace.<sup>43</sup> Thus, the first task of the analyst is to identify a variable within the choice set of both those who are demanding protection, and those who are

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41. See Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 224-32 (1967).

42. See Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291, 291-93 (1974) (arguing that rent-seeking behavior is "often competitive and resources are devoted to competing for rents" and coining the term "rent-seeking"); Jagdish Bhagwati, *Directly Unproductive, Profit-Seeking (DUP) Activities*, 90 J. POL. ECON. 988, 989-90 (1982) (referring to rent-seeking as "DUP activities").

43. How has this protectionism been re-implemented in the face of reduced operational discretion in tariff and other protectionist devices due to international agreements such as the General Agreement on Tariffs and Trade? Paradoxically, various instruments and institutions implemented as constituent components of pro-market reforms have also facilitated the solicitation of preferential treatment. Institutions such as antidumping, antitrust, consumer protection and other oversight agencies which exist in developed market economies and believed to be necessary to preserve pro-market gains, may contribute less to their ostensible role under the new regime, and more towards facilitating protectionism. See, e.g., Michael P. Leidy & Bernard M. Hoekman, *Spurious Injury as Indirect Rent Seeking: Free Trade Under the Prospect of Protection*, 3 ECON. & POL. 111, 111-16 (1991); Thomas Howell, *The Trade Remedies: A U.S. Perspective*, in U.S. TRADE STRATEGY (Geza Feketekuty ed., forthcoming 1997); A.E. Rodriguez & Mark D. Williams, *The Effectiveness of Proposed Antitrust Programs for Developing Countries*, 19 N.C. J. INT'L L. & COM. REG. 209, 209-32 (1994). To be sure, the seemingly contradictory notion of advocating liberalization while recommending the adoption of regulatory agencies is often politically necessary. Liberalization proponents often advocate antidumping remedies, selective retaliatory tariffs and antitrust measures as an alternative to across-the-board protection to counter opposition arguments.

supplying it. Ultimately, one wants to understand what determines protectionism's demand and supply elasticities, and how this in turn affects the stability of the market for protection.

The ability of organized political interests to secure protective trade barriers and other benefits has been explored in the recent literature.<sup>44</sup> At least two recent papers identify liberalization-displaced workers as the control variable which both affects, and is used, by interest-groups and by political decisionmakers. Michael Leidy and Bernard Hoekman explore interest group incentive to manipulate industry labor participation directly to indirectly influence antidumping and countervailing instruments to their advantage.<sup>45</sup> James Cassing and Arye Hillman take a different, but related, tack. These authors show how declining industries can collapse suddenly due to the political response to declining labor force levels.<sup>46</sup> Again, their argument turns on a political-equilibrium relationship between tariff levels and size of the labor force in industry.

But within this literature, although displaced workers and the social and political pressures that accompanies change is typically the preferred variable which links both the supply and demand side of the market for protection, it is certainly not the only feature that is susceptible to strategic manipulation by competing interests. The strategic trade literature, for example, focuses on the existence of imperfect competition in international trade and its implications for strategic behavior by firms as well as government.<sup>47</sup> Proponents highlight infant

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44. For a recent survey of the literature, see Dani Rodrik, *Political Economy of Trade Policy*, in 3 HANDBOOK OF INTERNATIONAL ECONOMICS (Gene Grossman & Ken Rogoff eds., 1995); see also AVINASH K. DIXIT, THE MAKING OF ECONOMIC POLICY: A TRANSACTION-COST POLITICS PERSPECTIVE 19-31 (1996) (arguing that policy-making is an ongoing process that occurs in real-time and one that blends both the private incentives of the policymakers to respond to special and general interests together with an evolution of the rules of policy that gradually may change those incentives); ARYE L. HILLMAN, THE POLITICAL ECONOMY OF PROTECTION 1-8 (1989); STEPHEN P. MAGEE ET AL., BLACK HOLE TARIFFS AND ENDOGENOUS POLICY THEORY (1989).

45. Leidy & Hoekman, *supra* note 43, at 113-35.

46. James H. Cassing & Arye L. Hillman, *Shifting Comparative Advantage and Senescent Industry Collapse*, 76 AM. ECON. REV. 516, 516-22 (1986).

47. There are several excellent surveys of Strategic Trade Models. One of the most accessible is Klaus Stegemann, *Policy Rivalry Among Industrial States: What Can We Learn From Models of Strategic Trade Policy?* 43 INT'L ORG. 73, 73-100 (1989); see also J. David Richardson, *Empirical Research on Trade Liberalization*

industry and terms-of-trade arguments to rationalize trade intervention. Similarly, Carlyle Ford Runge describes how environmental regulations which may often act as non-tariff barriers are also potentially susceptible to strategic interests.<sup>48</sup> The fear of "falling behind" in the international competitive race and environmental concerns, are the arguments which enter firms' and politicians' choice set.

In terms of policy prescriptions, these models confirm that import protection is inefficient and therefore, that the rent-seeking practices which prevents or opposes the gains from competition must be opposed. Leidy and Hoekman, for example, criticize the ease with which antidumping and countervailing duty mechanisms are abused. A.E. Rodriguez and Mark D. Williams provide similar criticism for antitrust policy.<sup>49</sup> Without a more detailed inquiry into the nature of the incentives of the appeals for protection, the possibility of increasing the prospective gains from liberalization will be lost.

The model presented here allows one to reproduce the broad results advanced by the papers discussed above. However, it is distinct in the sense that it recognizes an exogenous problem that compounds the losses which accrue to domestic sectors as a result of the liberalization. Regime-specificity is both exogenous and observable, and therefore allows the new institutions to decompose the impact of liberalization; its impact is also better understood.

Generally speaking, it is now well understood that when the incentive structure changes frequently and unpredictably, managers are reluctant or unable to repeatedly incur the sunk costs of retooling.<sup>50</sup> Similarly, when substitution possibilities exist, managers may react to uncertainty by choosing labor intensive technologies, even though more capital-intensive technologies would be less costly to operate if market conditions are stable.<sup>51</sup> Rapid and efficient adjustment in produc-

with *Imperfect Competition: A Survey*, 12 OECD ECONOMIC STUDIES 7, 7-43 (1989); W. Max Corden, STRATEGIC TRADE POLICY: HOW NEW, HOW SENSIBLE? (World Bank WPS 396, April 1990).

48. C. Ford Runge, *Trade Protectionism and Environmental Regulations: The New Nontariff Barriers*, 11 NW. J. INT'L L. & BUS. 47, 47-61 (1990).

49. See Rodriguez & Williams, *supra* note 43, at 209-32.

50. See Avinash K. Dixit, *Hysteresis, Import Penetration and Exchange Rate Pass-Through*, 104 Q.J. ECON. 205, 205-27 (1989); Avinash K. Dixit, *Entry and Exit Decisions Under Uncertainty*, 97 J. POL. ECON. 620, 620-38 (1989).

51. See Val Eugene Lambson, *Industry Evolution with Sunk Costs and Uncer-*

tive capacity are likely only when market reforms establish a credible, stable regime. As a general principle, private investors will hesitate to invest in an environment of public policy uncertainty.<sup>52</sup> To the extent that capital investment is irreversible, *any* likelihood of a policy change that may result in capital losses can reduce the incentive to commit capital. In world of risk-averse investors, an increase in uncertainty usually decreases the equilibrium level of investment and may even eliminate it altogether.<sup>53</sup>

There are a number of models, primarily in the trade literature, that recognize the specificity of inputs. Mayer-Mussa type models, for example, generally assume that the stock of capital is fixed in each of the economy's two production sectors.<sup>54</sup> The third factor, labor, is mobile between the two sectors. Under these conditions, the models generally provide results on the impact of protection on both labor and capital. Both inputs then generally stake their position on the liberalization versus protection debate. Owners of specific-capital are the ones who generally organize and seek to maximize their rents by lobbying the government for favorable trade measures.

Magee (1980), contrary to the predictions of Mayer-Mussa models as well as several orthodox trade-theory models, ob-

*tain Market Conditions*, 9 INT'L J. INDUS. ORG. 171, 171-96 (1991).

52. See Robert Pindyck, *Irreversible Investment, Capacity Choice, and the Value of the Firm*, 78 AM. ECON. REV. 969, 969 (1988) [hereinafter Pindyck, *Irreversible Investment*]; Robert Pindyck, *Irreversibility, Uncertainty and Investment*, 26 J. ECON. LITERATURE 1110, 1110 (1991); DAN RODRIK, POLICY UNCERTAINTY AND PRIVATE INVESTMENT IN DEVELOPING COUNTRIES (National Bureau of Economic Research Working Paper No. 2999, June 1989) (presenting a model linking policy uncertainty to private investment response and showing that even moderate amounts of policy uncertainty can act as a hefty tax on investment).

53. Refinements in investment behavior research has shown that when new information has the potential of making the future value of an investment less uncertain, even a risk-neutral firm has an incentive to postpone irreversible investments and gather more information. See generally Pindyck, *Irreversible Investment*, *supra* note 52 (reviewing various models of irreversible investment and their applications to investment decisions).

54. See Wolfgang Mayer, *Short-Run and Long-Run Equilibrium for a Small Open Economy*, 82 J. POL. ECON. 955, 955-67 (1974). Michael Mussa developed short run models which seemed more appropriate for the analysis of the incidence of protectionism than the long run Hecksher-Ohlin model. See Michael Mussa *Tariffs and the Distribution of Income: The Importance of Factor Specificity, Substitutability and the Intensity in the Short and the Long Run*, 82 J. POL. ECON. 1191, 1191-1203 (1974).

served that both labor and capital are typically on similar sides in each sector concerning the liberalization-versus-protection issue.<sup>55</sup> Magee points out that rather than the more orthodox models, it is Cairnes' (1874) model, which assumes that all productive factors are industry-specific, that offers a more realistic analysis.<sup>56</sup>

#### A. A Geometric Exposition

The impact of the liberalization effects on an industry can be examined with a simple partial-equilibrium model which incorporates the presence of regime-specific human and physical capital. Such a model allows one to examine the interaction between tariff reductions and domestic interest group's attempts to reduce or forestall the dissipation of their regime-specific quasi-rents.

Consider the linear supply-and-demand model illustrated in Figure 1.<sup>57</sup> From this, we find that tariffs reductions and protectionist measures are mirror images in determining the price levels. In addition, the model displays how domestic cartelization efforts are similarly capable of reversing liberalization gains.

In the model, the demand curve (D) is the price a marginal consumer is willing to pay for output and the domestic supply curve (Sc) is the marginal domestic firm's willingness to sell (and coincides with the industry marginal cost curve for domestic firms). The domestic supply curve may be affected by the liberalization due to the presence of regime specific capital held by domestic firms.<sup>58</sup> This effect is modeled by shifting the domestic supply curve up and to the left ( $S_{CL}$ ). Thus, in the short run, by reducing the value of regime-specific capital, reform leads to lower output and higher prices. Of course, a successful reform will generate investment that shifts the supply curve down and to the left, lowering price and increas-

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55. Stephen P. Magee, *Three Simple Tests of the Stolper-Samuelson Theorem*, in *ISSUES IN INTERNATIONAL ECONOMICS* 138, 138-53 (Peter Oppenheimer ed. 1980).

56. *See id.*

57. *See infra* p. 396; *see also generally* PAUL R. KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS: THEORY & POLICY* (4th. ed. 1997).

58. Some regime-specific losses may affect marginal costs and hence the supply curve. For example, a reduction in scale economies can increase the marginal costs of each unit of output.

ing quantity in the long run.

At the same time, the relaxation of tariff and non-tariff barriers is modeled by shifting the supply curve downwards from  $S_{CL}$ , (the supply curve during the period when the economy is closed to imports but after the regime specific shock is incorporated), to  $S_0$ , (the supply curve in regime two, when the economy has "opened" or liberalized). The 'tariff-equivalent' composite index,  $L(q)$ , is assumed to proxy the pro-competitive effect of liberalization trade policies.<sup>59</sup> It represents the cost savings associated with lower cost imported goods.

The overall output effect is represented in Figure 1. On the quantity ( $Q$ ) axis, we see the industry output  $Q_0$  comprised of  $Q_R$ , the output produced by the domestic industry, and  $Q_0 - Q_R$ , the output that can be attributed to imports. Note that output level  $Q_c$  (representing output under the closed regime)<sup>60</sup> falls to  $Q_L$  because of the imports and then  $Q_R$  due to the loss in regime specific capital. On the Price axis ( $P$ ), the liberalization lowers equilibrium prices from  $P_c$  to  $P_0$ .

As illustrated, the post-liberalization equilibrium price  $P_0$  is lower than the initial equilibrium price by an amount which is increasing in the volume of imports.<sup>61</sup> Inelasticity of supply or demand also tends to lead to larger price effects. In the same fashion, output and revenues of domestic firms are reduced by the trade liberalization.

When faced with liberalization, domestic interest groups can respond by expending effort to either increase non-tariff barriers (NTB), or cartelize the market. Actions on tariffs or cartelization attempt to offset some or all of the effects of lib-

59. Liberalization typically relaxed a number of policies and instruments associated with protectionism, including quantitative import restrictions, tariffs, credit subsidies, controlled interest rates, exchange rate controls, foreign exchange allocation and indirect taxes. We abstract from modeling any instrument explicitly and rely on a 'composite' tariff-equivalent of all policy instruments.

60. A sufficient condition for the loss function to cause a rightward shift in the supply curve is that foreign producers have lower marginal costs of serving the domestic market than domestic producers. The rightward shift of the supply curve, which is how liberalization is represented, indicates that foreign firms enter the domestic market because their marginal supply costs are lower than those of domestic firms.

61. Note that in the absence of price-disciplining imports, prices often increase in post-liberalization economies. Higher prices and reduced employment may be inevitable because shortages and waiting lines and artificially low cash prices were often the mechanism of choice for allocating resources in protected economies.



eralization and tend to reduce output and increase price. The erection of non-tariff barriers is represented by an initial rightward shift of the supply curve as regime-specific capital recovers its value and the leftwards shift of the supply

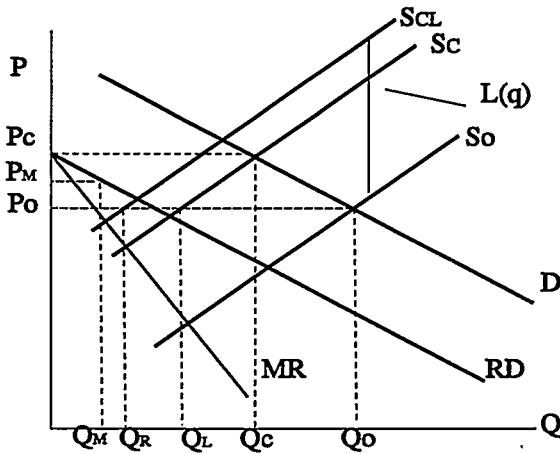


FIGURE 1  
EFFECTS OF LIBERALIZATION

curve as imports are restrained. In principle, the magnitude of the NTB can erode all the gains from liberalization, and the final price equilibrium could be at  $P_c$ , the initial setting. This could be shown in Figure 1 by equating the effects of NTB with  $L(q)$ , which implies that the final period supply curve is  $S_c$ , the original, pre-liberalization output level.

The formation of private or government sponsored cartels is modeled as a movement along the demand curve toward the position where a monopolist would operate. By expanding effort, a producer interest group can either influence government to sanction a cartel or organize a private cartel of producers. To succeed, a cartel must first control the flow of imports. For example, importers could be precluded from expanding or current import levels used to define quotas. In effect, imports could be fixed and thus netted out of the demand curve. The domestic firms could then set a monopoly price on the residual demand curve (RD).

An expenditure of cartelization effort,  $e$ , by the producer interest group shifts the new equilibrium price some fraction  $C(e)$  between the equilibrium price without cartelization,  $P_o$ , and the domestic monopoly price,  $P_M$ . By setting the residual marginal revenue curve equal to the marginal cost curve  $S_{CL}$ , one can determine that a hypothetical monopolist would charge a price  $P_M$  which depends on elasticities of supply and demand.

Note that the producer interest group acting in concert cannot raise prices above what a hypothetical monopolist would charge, so the magnitude of  $C(e)$  is non-negative but bounded. Private or public cartelization efforts are effective at raising prices, but probably with diminishing returns. Of course, importers also profit, as they are allowed to sell their fixed output at the monopoly price. Tariffs could recover these revenues for the domestic treasury.

Thus, cartelization efforts will raise the price above  $P_0$  by some fraction of the difference between the upper bound  $P_m$  and the equilibrium price under free trade. The amount of price increase is increasing in cartelization efforts, inelasticity of demand and elasticity of supply. Importantly, note that is also increasing in the impact of regime-specific capital.

Several results emerge from this characterization. First, NTB activity can reverse the impact of liberalization on imports. Second, cartelization activity may also reverse the gains from liberalization. Note also that the presence of the additional losses due to regime specificity ( $Q_L - Q_R$ ) implies incentives to seek rents. These incentives are higher the greater the reductions in domestic output. Thus, increased capital specificity increases the losses due to liberalization and, in turn, increases the returns to cartelization. Finally, some combination tariff barrier/monopoly rent-seeking strategy may be optimal for the firm.

### *B. Implications for Policy*

The best solution, from the standpoint of economic efficiency, is to eliminate barriers to competition. However, from both a private sector and political management perspective, the real problem lies in finding an alternative to the old protectionist regimes of excess private costs while minimizing social costs which may jeopardize the prospects of the transition itself. Capital equipment, and to a lesser extent, human capital, is usually durable and takes some time to be exhausted. Uneconomic practices often have constituencies that use the political process to delay abandonment or reallocation. Labor contracts normally have a fixed term and benefits which, often won, are typically not quickly forsaken by unions; indeed, to management, rescinding labor benefits may be a last recourse, because of the problems such rollbacks can cause. Furthermore, ability

to extract labor concessions will depend on the extent to which labor perceives a real threat to job security.

Maintaining revenue in the face of lower-priced imports is a problem for uneconomic firms in the new environment. After liberalization, prices in highly competitive markets come under severe pressure. Where too much capacity exists during the transition, prices under competition should tend toward the minimum short run average variable cost until excess capacity is eliminated. In these markets, contributions to overhead should be driven to zero. However, social and technological rigidities make this adjustment difficult.

These considerations alter the question of how policymakers should manage short and long run responses. The preferred avenue may be to shock the economy into becoming a world class competitor regardless of cost, which depends on political willingness and on the delicate balancing of domestic political dynamics. The mounting influence of domestic pressure groups may limit the gains from liberalization. In numerous instances pressure groups act collusively in an attempt to obtain revenue sufficient (in the short run) to avoid defaulting on payments towards the underlying capital requirements.

As a new government office, the competition agency may be able to serve as a referee for the interaction between the liberalization reformers and the interest groups. The goal would be to minimize the return to state subsidies and protection inefficiencies while at the same time maximizing the likelihood of the overall reforms remaining in place. Issues to evaluate include the relative effectiveness of each proposed state action. In effect, the competition agency (or any other government decisionmaker) would be performing industrial triage, separating those industries healthy enough to survive without assistance from those industries doomed to failure regardless of limited subsidy or protection from those industries that could benefit from some limited transitional assistance.

A number of factors would enter into the calculus. Of particular interest is the health of the industry, with evidence of actual investment or profits suggesting little if any assistance is needed and information on dramatic losses suggesting the industry should be allowed to die. Marginally unprofitable industries would be in line for some type of assistance.

A second factor is the number of jobs at risk in the reform. Labor intensive industries appear more useful subsidy targets, because their recovery would protect more jobs. On the other hand, one might expect more pressure from politically powerful unionized industries. These high wage industries may be those most in need of reform if years of state assistance has created a class of overpaid and underworked employees. Given reforms are likely to succeed, even if some workers suffer, these industries may not be good targets for assistance, unless their failure would create adverse effects in other markets.

The prospect for successful investment is a third factor. Industries likely to generate significant investment if offered short run protection would be good candidates for assistance, while declining stagnant industries would tend to be poor choices for protection. Overall, all the factors need to be balanced and an integrated recovery program devised.

Once the decision is made to aid an industry, a number of choices are possible. Crisis cartels may allow an industry to increase its revenues, although they also generate wind-fall gains to importers. Direct subsidies tend to lower prices and reduce imports at the cost of significant government expenditures. Finally, import barriers lead to price increases (and downstream misallocation of resources if applied to an intermediate good), but allow the domestic competitors to expand (especially if coupled with active antitrust enforcement to prevent cartelization).

On balance, it may be possible to rule out major use of subsidies, because reforming economies are often short of government funds. Instead, policymakers may be forced to rely on less direct means to affect competition. If the policy is designed to protect employment, some combination of tariffs (or non-tariff barriers) and active antitrust enforcement would appear optimal, with the policy designed to both increase domestic production and the market price. On the other hand, if the policy is designed to enhance the industry revenue, some pro-cartelization policy coupled with tariffs could be optimal.<sup>62</sup> Domestic firms would reduce output, but earn higher profits,

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62. Tariffs should be preferable to non-tariff barriers, because the tariff enables the government to retain the rents. Of course, importers would prefer to face quotas or voluntary import restraints, because higher profits would be retained by the foreign producers.

with the return presumably earmarked for investment in the industry.<sup>63</sup> Importers would not be significantly affected as the higher monopoly price would generate the revenues to pay the tariffs. In the long run, a reduction in tariffs and an aggressive antitrust policy could return the market to a competitive structure.

## V. CONCLUDING COMMENTS

Changes in economic policies, especially the dramatic transformation from a protected to a deregulated economy, generate substantial private transition costs. Transition costs tend to be distributed unevenly across producers. To some groups, the discounted long run gains from opening up the economy appear too small to justify the transition costs of implementing change. This asymmetry in expected cost and benefits, combined with unresponsive political authorities, may force otherwise supportive interest groups to withhold political support.

Pro-market policymakers managing the transition to a market economy, typically share the perception that interest group requests for temporary protection or assistance are not only expected but are driven solely by rent-seeking. What results is a politically naive policy disproportionately weighted by economic-efficiency considerations at the expense of competing social goals. To be sure, since interest groups will always solicit protection, and since policymakers may have difficulty distinguishing among claims *ex ante*, which groups are genuinely distressed, the best policy may be to refuse any concessions.

But the transition problem examined here is as much inherent to the industry or markets as it is a creation of past government policies. Historical alliances in devising, setting and enforcing the old rules of the game between the government and the private sector, fostered numerous actions and institutions which reflected two interrelated impulses. First, producers, workers and consumers, invested in capital and know-how which reflected the then current and expected rules of the game. Second, throughout this period, numerous institutions emerged to minimize transaction costs of private invest-

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63. Evidence of a failure to invest should lead to the reduction in tariff barriers and active antitrust enforcement.

ment and specialization. As the liberalization movements have progressed, these institutions, practices and capital stock, which emerged from legacies bequeathed by prior government policies and practices, have both prompted and facilitated various constituencies seeking some form of preferential treatment.

The legacy of regulation imposes costs and buyer/seller relationships during the transition that are very different from those that would have existed if a free-market environment had always existed. These rigidities emerge from the nature of economic regimes that dominated most developing countries for the better part of the century. The problems raised by regime-specific costs incurred in a prior regulatory regime often have been exacerbated by a legacy of uneconomic practices created during that regime. However, for transitions to succeed, policymakers must recognize that variations in the incidence of transition costs may have political repercussions. Clearly, the incidence of transition costs may affect the likelihood of success of the liberalization program itself. The ability to recognize cross-sectional differences may lead to wiser policy choices.

The competition advocacy model presented here, which highlights the influence of regime-specific capital, can serve to develop narrower policy alternatives designed to guarantee support for the liberalization process without sacrificing all the efficiency gains. Regime specific capital is observable and exogenous. Domestic productivity capacity of a scale which is substantially smaller than the minimum efficient scale required to compete in a global marketplace, a poorly trained workforce, difficulties in facilitating the flow of displaced workers from one sector to another, slow adoption rates of modern technology, and other structural features are all observable by authorities. By granting targeted short-term assistance specifically to address these identified structural parameters, the authorities recognize and accept the responsibility for erstwhile strategic actions on their part. A modest understanding of the actions of past governments and responsibilities of current ones, would help the political and public relations prospects of the liberalization. To fail to do so may allow unintended negative consequences of pro-market reforms.

