Mercosur: Integration and Industrial Policy

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1. INTRODUCTION

COMPRISING the majority of Latin America's population, land and economic output, the Southern Cone Common Market (Mercosur) represents the deepest attempt to date at economic integration in that region. Initiated by the Treaty of Asunción in 1991, Mercosur aims to eliminate all internal tariff and non-tariff barriers on the flow of goods and factors of production, implement a common external tariff, and harmonise numerous macroeconomic and sectoral policies among Argentina, Brazil, Paraguay and Uruguay. If it is successful, Mercosur members will gain from greater production rationalisation, more efficient resource allocation and expanded consumption opportunities.

More broadly, Mercosur is evolving into a core unit with which other countries and regional trading blocs can negotiate trade arrangements. Already agreements have been signed admitting Chile and Bolivia as associate members, and negotiations are taking place with the *Pacto Andino* countries and the European Union. Thus, Mercosur is engaged in simultaneous efforts to widen its membership and to deepen integration among its members.

The immensity and difficulty of this task is demonstrated by the fact that despite more than two dozen attempts at regional integration in the world over the past four decades, only the European Union has successfully forged the path from free trade area, to customs union, to common market, and now towards imminent monetary union.[1] The EU's experience has shown that the predicted welfare gains

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[1] A free trade agreement (FTA) is one which removes all barriers to trade in goods among member countries while each member maintains its individual tariffs *vis-à-vis* non-member countries. A

from integration do not result automatically from tariff reduction alone, but rather depend on the removal of other barriers to competition.[2]

Indeed, one of the principal objectives of Mercosur is precisely to exploit potential welfare benefits from an economy-wide programme of reform and market liberalisation. By broadening the scope of liberalisation to an economy-wide free-trade area for goods and services, embedded in a lowering of common external tariffs, Mercosur explicitly seeks to deliver greater competition and efficiency through ‘open regionalisation.’ Closely tied to efforts to maximise welfare and promote open regionalism is the issue of industrial policy. Broadly defined, industrial policies encompass the combined effect of government policies designed to affect the allocation of resources among economic activities and produce an outcome different from what otherwise would have occurred in the market.[3]

Two tentative conclusions emerge from an analysis of Mercosur and its industrial policy: (i) the short-run welfare effects of Mercosur are likely to be small but positive, and (ii) industrial policy to date has not been very large but its future application must be judicious if Mercosur’s goals are to be met.

This paper has two goals: to present the objectives and effects of Mercosur, as well as to discuss and analyse the Mercosur countries’ industrial policies in the general framework of Mercosur. Section 2 sets out the objectives and the present status of Mercosur. Section 3 discusses some of the theoretical, policy, and empirical issues regarding Mercosur. Section 4 takes up the issue of when it is theoretically justifiable to use industrial policy, what the EC (now EU) experience has been, and what some major complementarities and conflicts of industrial policy are in Mercosur. Section 5 provides conclusions and recommendations.

2. MERCOSUR’S OBJECTIVES

Mercosur’s main objectives are to establish a free-trade area with a common external tariff, and coordinated labour, monetary, tax, trade, R&D, regional development, and industrial policies. The Tariff Structure of Mercosur is shown in Table 1. To evaluate Mercosur’s progress toward achieving these objectives, it

customs union is an FTA in which member countries adopt a common external tariff towards non-member countries. A common market provides for the free flow of goods and services, institutes a common external tariff and allows the free flow of factors of production such as capital and labour.

[2] In some cases these predicted gains can be quite large. Estimated static gains from the creation of the European Union range from two to six per cent of GDP. See Boltho (1982) and Molle (1990).

[3] Such policies could include tax exemptions or reductions for specific industries, selective credit schemes, concessional loans or administered trade protection measures such as anti-dumping measures and countervailing duties. See Leipziger and Petri (1993) for a review of industrial policies.

TABLE 1
Tariff Structure of Mercosur

Country	*Avg. Unweighted Tariff Rates (%)*	*Tariff Range (%)*	*MERCOSUR CET Avg. Rate (Unweighted)*	*CET Range*
Argentina[a]	12.3	0–20	12	0–20
Brazil[a]	12.6	0–35	12	0–20
Paraguay[b]	8.0	0–32	12	0–20
Uruguay[b]	14.7	0–20	12	0–20

[a] Source: World Bank, Brazil data 1996. Argentine data 1995.
[b] Source: Garay and Estevadeordal (1995).

is instructive to use the European Union as a gauge. Table 2 shows the objectives of Mercosur in comparison with the objectives of the European Union. To the extent that the European Union offers an example of a more ‘evolved’ union, it would provide a clear contrast which could be used to evaluate the progress and future design of Mercosur.[4]

Progress toward the first objective concerning the trade of goods has been steady. This is hardly surprising considering that the Mercosur treaty is the culmination of more than a decade of effort by Argentina and Brazil at pursuing difficult trade liberalisation. Major reorganisations in their trade regimes took place around the same time, with Brazil’s 1988 tariff rationalisation (which was followed by a comprehensive trade reform) and Argentina’s radical trade regime reorganisation in 1987. Principal reforms shared by both countries include the removal of most import barriers as well as a reduction in the level and dispersion of tariffs (shown in Table 1). In Brazil tariffs fell from 55 per cent in 1987 to 12.6 per cent in 1996 and in Argentina from 42 per cent in 1987 to 12.3 per cent in 1995 (in unweighted terms). The evidence points to the fact that the average tariff rate in Argentina is below that of Brazil when one deducts the three per cent temporary statistical tax imposed on most important categories. In any case, the actual unweighted averages are fairly close, both to one another and to the CET norm. In 1995, the common external tariff (CET) became effective bringing the tariff on most products between the range of 12 and 18 per cent.

It should be noted, however, that the CET currently covers only 85 per cent of harmonised tariff lines. The remaining 15 per cent of tariff lines (which cover almost half of all intra-Mercosur trade) are exempted temporarily to facilitate

[4] A caveat for this comparison is that Mercosur countries today differ considerably from the original EC members in 1960 in terms of level of development, industrial structure and regional disparities (all of which affect the nature of integration, the speed of implementation and the difficulty of policy harmonisation). The economies of the member states are more heterogeneous and not as interrelated as the European states. In terms of intra-regional integration, only 18 per cent of exports from Mercosur countries were sold within the bloc in 1994 (compared to an intra-regional export level of 33 per cent in the EC-6 at its inception in 1960), but up dramatically from 1990.

TABLE 2
Principle Provisions of Mercosur and the European Union

Policy Area	*Mercosur Objective*	*Status*	*European Union Objective*	*Status*
Trade of goods	100 per cent elimination of tariff and non-tariff barriers; implementation of common external tariff (CET); harmonisation of customs administration; establishment of rules of origin criteria.	■	100 per cent elimination of tariff and non-tariff barriers; harmonisation of customs administration; implementation of CET.	●
Capital mobility	Free movement of capital.	■	Free movement of capital; establishment of 'national treatment' laws for investment.	●
Labour mobility	Coordination of policies on labour relations, migration, training and safety.	❍	Free movement of labour among member countries.	●
Monetary/ exchange rate policy	Coordination of monetary policies in order to reduce real exchange rate fluctuations and resulting disruptions in trade flows.	❍	Coordination of economic policy and efforts to promote price and exchange rate stability.	■ ▼
Tax policy	Harmonisation of tax policies.	❍	Harmonisation of sales, corporate and excise duty.	▼
Unfair trade practices	Establishment of common norms for administering anti-dumping measures and countervailing duties.	❍	Establishment of judicial body to administer CVDs and anti-dumping measures	●
Dispute resolution	Establishment of dispute resolution mechanism and procedures to resolve trade controversies among Member countries.	❍	Establishment of Court of Justice to resolve disputes among EU members; adoption of enforcement mechanism to ensure compliance	●
Decision-making body	Establishment of Common Market Group, Common Market Council and inter-governmental working groups in several policy areas.	●	Establishment of supra-national European Commision and European Parliament to consider legislation.	●
Research and development	Coordination of science and technology policies.	❍	Promotion of EU-wide R&D initiatives in areas such as aerospace and electronics through specific budget budget outlays	●
Regional development	Harmonisation of regional development programmes.	❍	Creation of funds (European Regional Development Fund and the European Cohesion Fund) to reduce regional development disparities.	●
Industrial policy	Harmonisation of industrial development policies.	❍	Harmonisation/elimination of industrial promotion policies.	▼

Notes:
● Fully implemented ■ Partially implemented, but on shedule ▼ Partially implemented but delayed ❍ Still under discussion

Source: Treaty of Asunción (1991); *General Report on the Activities of the European Communities*, EU Commission, various years.

adjustment but are all scheduled to converge to the CET within specified time limits (2001 for capital goods and 2006 for telecommunications and informatics, for example). The temporary exemption of these sectors implies that industrial policies are in place during the interim. Further, in terms of the other objectives, with the exception of capital mobility, one should notice that most of the objectives have only begun to be addressed. This implies that the major adjustment is yet to come.

3. MERCOSUR ISSUES AND PROGRESS

a. Trade Theory and Policy Issues

Economic theory provides strong underpinnings for the proposition that unilateral and multilateral liberalisation are the best policies for an individual or group of countries to follow, at least in terms of static economic comparative advantage. Unfortunately, theory is much less clear about the impact of regional trade arrangements (RTAs), in part because of the typically ambiguous results of second-best welfare economics, and in part because proponents of regional trade agreements in particular often point to dynamic effects which are difficult to capture.

From a static perspective, the impact of Regional Trade Agreements (RTAs) is usually analyzed by considering the effects of trade creation and trade diversion. Typically, it is argued that if trade creation dominates trade diversion, then the welfare of the *members* of an RTA may rise. However, it is inevitably the case that the welfare of *third-party* countries will fall. The crucial issue, then, is under what conditions will trade creation most likely outweigh trade diversion? Theory points to two factors. First, the higher the initial trade between two countries, the less likely it is that there will be sizable diversion due to regional preferences. It is presumed that initial trade already indicates global comparative advantage and so regional preferences do not result in switching purchases to less efficient producers. Second, the lower the external tariffs, the lower the likelihood of trade diversion.

In the case of Mercosur, these two effects do not yield clear-cut results. The initial trade between the two largest countries (Brazil and Argentina) was small. Common external tariffs, while significantly lower than in the past, remain at average levels of around 12 per cent (not negligible by global standards). As a further complication, a variety of sectoral exceptions, selected administrative interventions restricting internal free trade, and variable external tariffs add to the potential distortionary effects. Michaely (1996) is pessimistic. Looking at indicators of trade compatibility among countries, which rise with the level of development, the degree of industrial production, and the diversification of exports, he concludes that there is little potential for trade creation gains from any regional trade schemes within Latin America. Yeats (1996) is even more negative, concluding that much of Mercosur's export growth has been in subsectors which remain the most protected from the rest of the world. In a similar vein, Garriga and Sanguinetti (1995) argue that most of the rapid trade growth within Mercosur is a consequence of aggregate trade liberalisation and should not be attributed to regional preferences. Their logic is that transport costs become more meaningful as tariffs and other trade barriers decline, and consequently neighbourhood trade should be expected to grow.

Nevertheless, most analysts conclude that trade creation effects have dominated trade diversion effects. Losada (1994) uses a partial equilibrium model of a variety of major sub-sectors and concludes that trade creation outweighs trade diversion for all countries except, possibly, Paraguay. One rough-and-ready rule of thumb which has been proposed for evaluating the impact on non-members is to compare the volume of imports into the region today with the volume before the Mercosur agreement went into effect. By this measure, it is clear that the joint process of multilateral and regional liberalisation that has occurred has been globally welfare enhancing. But even though the growth in intra-Mercosur trade has been rapid over recent years, the aggregate volume of intra-group trade remains below the level of what is considered a 'natural' trading bloc (Frankel, Wei and Stein, 1995). The implication of this market shallowness, combined with the inconclusiveness of opinion about the welfare effects of Mercosur suggest that while the welfare effects of Mercosur are probably positive, they are not very large at present.

While some analysts give much weight to the trade efficiency effects, others advance dynamic and political economy effects. The dynamic effects range from (i) a desire to exploit economies of scale that are not present in a single economy, (ii) the ability of a larger regional market to attract foreign direct investment, and (iii) a modified 'infant industry' suggestion that domestic corporations first need to be toughened through exposure to limited regional competition before facing the full force of global competition. In general, these arguments would have greater applicability to small countries. Mercosur, however, is driven by the two giants of Latin America — Argentina and Brazil — and consequently there is little reason to give much credibility to the dynamic arguments.

The political economy effects, perhaps more pertinent at this early phase of Mercosur's development, might affect these purely economic considerations.[5] The first is the issue of distributing costs and benefits. Economic differences, while not mitigating the potential economic benefits of integration, will determine the distribution costs and benefits and may engender political rivalries

[5] It is worth recalling that Mercosur issues largely fall under the Ministries of Foreign Affairs, and presenting common political objectives is expressly stated as a goal.

which work to frustrate integration attempts. Regional disparities among Mercosur countries (and for that matter, within countries) raise the likelihood that integration will aggravate regional income disparities in the same way that the accession of Portugal, Spain and Greece to the EU heightened the need for coordinating redistributional policies. Differences in the extent of economic liberalisation suggest that responsibility for policy harmonisation may fall disproportionately on some countries. A country like Argentina with relatively few industrial support programmes may find that harmonisation implies either forcing a faster pace of liberalisation on Brazil or ‘ratcheting up’ support to a level higher than the present. To what extent policy convergence will entail reversing the trend of liberalisation over the past five years is a critical issue for Argentine policymakers, who have to date been the fastest liberalisers.

The second issue is that of membership. The widening of group membership bolsters the objective of providing a coordinated body for negotiating with the other groups. Rapid expansion, therefore, can have its benefits. On the other hand, the larger the number of countries, the harder it becomes to harmonise rapid liberalisations. The tendency will be to move at a pace which all members can easily accommodate. However, provided that Mercosur continues to be associated with lower external barriers, the elimination of sectoral exemptions, membership expansion, and rapid growth of internal and external trade, it will be welfare enhancing and a stepping stone to greater openness in the region.

The third issue is how to specifically implement the treaty. Mercosur does not define any financing mechanism for regional development, industrial restructuring or reconversion initiatives, or joint research and development projects. Further, Mercosur’s institutional arrangements are far weaker than those in the EU, which coordinate and enforce policy through supranational entities such as the European Parliament and the Court of Justice. Mercosur’s inter-governmental working groups do not enjoy such legal autonomy or budgetary powers. Finally, the Treaty of Asunción’s provisions for the harmonisation of monetary, tax and industrial policies do not specify either timetables or implementation mechanisms for achieving these goals. This ambiguity is neither unintentional nor necessarily undesirable at this stage; the range of policies to be harmonised and the number of constituencies involved is sufficiently broad and complex that member interests may be better served by specifying only the broadest objectives and allowing Mercosur’s intergovernmental working groups to negotiate the terms of eventual policy harmonisation. However, Mercosur runs the risk of ambiguity, creating deadlocks due to disagreement, or derailment due to intransigence — dangers to Mercosur’s objectives. In any case, the clear conclusion remains that much work still needs to be done.

The fourth issue is the extent to which adjustment will stimulate backpeddling. Already, Brazil introduced some non-tariff barriers and Argentina reinstated the 'statistical tax' which was really a three per cent tariff. Indeed, both Brazil and Argentina have found it increasingly difficult to grow rapidly without balance of payments pressures emerging. Both countries, although to different degrees, have eschewed the use of exchange rate policy to improve external competitiveness. Instead, they have attempted to bolster export growth by stressing the importance of reducing other costs to tradable goods producers through infrastructure development, financial system changes, and the alleviation of regulatory burdens. The result is that improvements in aggregate GDP growth can worsen trade deficits. While these pressures have been manageable to date, thanks to sizeable capital inflows, there is concern that such policies cannot be sustained over the medium-term. Once two key determinants of external capital flows (high domestic interest rates and significant privatisation opportunities) return to normal levels, the issue of trade deficits will become more critical. Both Brazil and Argentina have shown, in the recent past, a tendency to use trade interventions with the rest of the world and even with Mercosur partners as an instrument for managing balance of payments problems. But such solutions will become more and more problematic as Mercosur matures.

A final issue is how to deal with sectoral interests in the context of a customs union or common market. Many programmes that are important for national purposes, such as regional, sectoral, and small and medium enterprise development, social security and government procurement, have important implications for the location of foreign and local investment and trade. Recently, Brazil's decision to offer tax incentives for automobile production in its northeast region has been challenged by Argentina as an unfair trade practice, even though the decision was taken largely in response to the domestic issue of diverging regional development within Brazil. This example illustrates the hard choices that have yet to be made within Mercosur. As region-wide protection levels come down, the flexibility of the government to deal explicitly with hard domestic issues will also be reduced. Developing a new set of understandings as to how to handle these choices will be critical. Yet their unique problems, varying economic and political systems, and weak common institutional structures will likely complicate any mutually agreeable technical solutions. In this environment, political commitment to maintain the momentum of Mercosur will become even more important as a basis on which compromise solutions can be found.

b. The Results to Date

The contribution of general trade liberalisation and deeper liberalisation within Mercosur has led to rapid trade expansion. In 1988, all the Mercosur countries were relatively closed, with total trade/GDP averaging only 15.1 per cent. By 1995, this ratio had fallen slightly to 14.9 per cent despite trade expansion at a

TABLE 3
Mercosur Trade from 1988 to 1995

	1988			*1995*		
	*Intra-Mercosur**	*ROW*	*Total*	*Intra-Mercosur**	*ROW*	*Total*
Value (US$b):						
Exports	3.02	41.5	44.5	14.5	56.2	70.7
Imports	3.1	20.0	23.0	14.4	62.7	77.0
Total	6.1	61.5	67.6	28.8	118.9	147.7
Share of total (%):						
Exports	6.8	93.2	100.0	20.4	79.6	100.0
Imports	13.2	86.2	100.0	18.7	81.4	100.0
Total	9.0	91.0	100.0	19.5	80.5	100.0
Average Annual Growth (%):						
Exports	–	–	–	25.1	4.4	6.8
Imports	–	–	–	24.8	17.7	18.8
Total	–	–	–	24.9	9.9	11.8
Share of Mercosur GDP (%):						
Exports	0.7	9.3	9.9	1.5	5.7	7.2
Imports	0.7	4.5	5.1	1.5	6.3	7.8
Total	1.4	13.7	15.1	2.9	12.0	14.9

Notes:
* Totals for Intra-Mercosur exports and imports differ due to differences in reporting standards among trading partners. ROW refers to the rest of the world.

Sources: Trade data from IMF *Direction of Trade Statistics and Mercosur Journal.* Aggregate Mercosur GDP was obtained by summing the IMF's *International Financial Statistics* line 99b converted at the year's average exchange rate (IFS, line rf).

rate of 13.3 per cent per year.[6] Trade within Mercosur grew at 25 per cent, more than double the rate of trade with the rest of the world (10 per cent), but even in 1995 intra-Mercosur trade amounted to only one-fifth of the total trade of the bloc (Table 3).

In fact, the low level of total trade in Mercosur is still one of the principal characteristics of the region. Total imports of Mercosur countries are less than 8 per cent of GDP and total imports from other Mercosur countries are only 1.4 per cent of GDP. This compares with 4.5 per cent of GDP for intra-NAFTA imports and 14 per cent for intra-EU imports. Even if intra-Mercosur imports were to continue growing at 25 per cent until the end of the century, the regional imports would only reach 3 per cent of GDP. Thus, it must be understood that much of the expansion of trade and potential for future

[6] The 'openness' indicator of trade/GDP did not grow, as dollar GDP in Brazil and Argentina rose rapidly in keeping with significant real exchange rate appreciations following stabilisation programmes.

growth, both of intra-regional trade and trade with the rest of the world, will simply be 'catching-up' to international levels of openness for at least the next decade.

Trade volumes and values are at best indirect measures of the efficiency consequences of trade reform. Tybout (1992) and Rodrik (1993) suggest that three questions need to be asked at the microeconomic level: (i) has trade liberalisation reduced price-cost margins in the tradable sectors? (ii) has it resulted in scale economies or in other intra-industry rationalisation? and (iii) has it been associated with total factor productivity growth? Partial evidence is available on each of these questions.

There is little doubt that price-cost margins have come down in Brazil and Argentina since 1988. In Brazil, trade liberalisation was an explicit element of the stabilisation programme and tariff reductions beyond the original schedule were introduced in November 1994. In the ensuing two years, price increases for tradables have been consistently below those for non-tradables. For the period July 1994–June 1995, retail prices were 9.8 per cent higher than the average price index, industrial wages were 15.4 per cent higher, prices of industrial inputs were 16 per cent lower but prices of imported inputs were 29.2 per cent lower. This trend continues into June 1996, with machinery, cars and equipment prices 5 per cent lower than consumer goods prices, while health, construction and labour cost indices (as examples of nontradables) outpaced consumer prices by 36, 23 and 51 per cent, respectively. In Argentina, after the Convertibility Plan, the rate of growth of consumer prices far outstripped the growth rate of wholesale prices (by a cumulative 33 per cent between December 1991 to December 1994), before rising faster by 3 percentage points in 1995. And while costs did not necessarily increase to the full extent of general prices, being partly offset by tax reductions, export incentives and other reforms, most micro studies suggest that margins have been reduced.

Evidence on industry rationalisation is more anecdotal and sector specific. Nevertheless, there is some support for the thesis that intra-sectoral trade has been expanded, especially in the autoparts sector, and in some food processing sub-sectors. In Paraguay, substantial modernisation of the processed-meat sub-sector has taken place, with production becoming more oriented towards Brazilian markets. Argentina has found its exports of processed tomatoes and canned peaches falling substantially and being replaced by Brazilian producers able to access the same Argentine raw materials imports. These examples suggest some industry rationalisation. However, the interpretation is not clear-cut. The various exceptions to the Mercosur agreement permit substantial levels of effective protection to downstream industries, and have resulted in large intersectoral variations. Assessing industry rationalisation in this environment is fraught with pitfalls.

The evidence is more clear-cut with regard to total factor productivity growth. Among a group of Argentine sub-sectors studied by the World Bank (1996), strong TFP improvements were observed in dairy products, cellulose paste and plastics. Further, tradable goods, such as food and steel, had higher absolute competitiveness (relative to the United States) than non-tradable goods like banking and telecommunications. Also in Brazil, rapid productivity increases have been posted by industrial firms (approximately 40 per cent over the last five years) and surveys suggest much of this is attributable to TFP gains rather than to capital investment or increased use of intermediaries.

The evidence above addresses the broad question of the effects of regional and multilateral trade liberalisation. The more focused question about the impact of narrower liberalisation within Mercosur is harder to address and the evidence appears mixed. One point, however, seems clear: any welfare effects, whether positive or negative, are likely to be small in the short-run.

4. INDUSTRIAL POLICIES IN MERCOSUR

a. Conceptual and Historical Aspects of Industrial Policy

For several reasons industrial policy constitutes an obvious area for Mercosur's attention both during these early phases of trade liberalisation and throughout the entire integration process. First, selective industrial assistance programmes which distort relative prices will lead to resource misallocation and a loss of economic efficiency. Second, industrial policies introduce an additional complex political element since they provide a popular remedy for import-competing firms reluctant to adjust to trade liberalisation. Finally, integration may inspire competition among governments to outspend one another in order to confer a competitive advantage on domestic industries. Any positive benefit conferred by state aid in one country may be cancelled out by countervailing measures in another, leading to a squandering of resources. These reasons illustrate the fact that industrial policy is a powerful tool which could significantly affect the welfare outcomes of Mercosur. Thus, a common approach to industrial policy is necessary in order to (i) maximise potential gains from integration, (ii) provide clear rules of the game for governments in dealing with inevitable pressures for state aid in one form or another, and (iii) prevent actions, and reactions, which in the end may jeopardise Mercosur's success.

Broadly defined, industrial policies encompass any state acts or policies designed to affect the allocation of resources among economic activities and alter what would otherwise have been the market outcome. This definition is quite broad and can include sector-specific interventions, industry-specific interventions, or those applicable to all industries i.e., functional interventions.

Regardless of their national particularities, industrial policy instruments can be grouped under the rubric of trade, tax and credit policies.[7]

A number of reasons are cited for the use of industrial policy: to assist resource reallocation from declining to rising sectors, to correct externalities associated with specific industries, and to use 'strategic trade policy' (helping firms to capture an international pool of profits in globally oligopolistic markets). However, even though in theory these reasons might warrant intervention, faulty intervention often costs more than neutrality since poor targeting diverts resources from economically beneficial activities and distorts the allocation of inputs by warping price signals. It also protects poor industry decisions from suffering the full costs of their folly. Governments which follow a 'hunch' to support a particularly prestigious industry without clear evidence of a market failure, or those which identify favoured sectors based on political rather than economic criteria, will impose a high fiscal cost on the government and generally fail.[8]

The European experience is illustrative because it shows several trends which Mercosur might expect to emulate. First, the coordination of industrial policies with the goal of reducing state assistance to industry and minimising distortions in the common market has often been subordinated to political objectives. During the 1970s, the economic downturns induced by successive oil shocks encouraged member countries to grant increasing subsidies to industry in an attempt to preserve employment. Second, state aid to manufacturing in the EC from 1986 to 1990 fell by 16 per cent in constant terms. However, the overall aid level of $43b in 1990 still represented a sizable sum. While distortions should not be equated with the volume of assistance to manufacturing, its size and unsteady path of reduction should give Mercosur policy makers pause. Third, with the exception of Belgium, the poorer countries are heavier subsidisers. Spain, Italy and Ireland provided more than six per cent of manufacturing value-added in aid, which is 1.5 times the EC average. In Mercosur, one might expect Uruguay and Paraguay to subsidise their industry more heavily. Fourth, grants and tax reductions were the most popular industrial policy tools (possibly because they are more easily administered in terms of parliamentary procedures than other instruments).

These trends suggest a number of lessons to be learned from the European experience. Taking stock of the extent and nature of industrial policies on a

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[7] Some examples of trade policies include selective duty rebates and non-uniform tariffs, non-tariff barriers ranging from outright QRs to more subtle protection such as product labelling and packaging requirements, safety standards, administered protection such as anti-dumping measures and countervailing duties, and differential rules of origin or domestic content requirements. Examples of tax policies include tax credits, allowances, exemptions or deferrals for particular firms, sectors, or regions. Some credit policies include below-market interest rate loans, government-backed loan guarantees, equity participation by the government and direct grants from the state budget.

[8] See Leipziger and Thomas (1993).

regional level is the first step in harmonising industrial policies. Second, it is necessary to establish strict guidelines for state assistance specifying the type of aid, absolute spending ceilings, and phase-out periods. Related to this rules-oriented approach to policy harmonisation, the EU experience emphasises the necessity of a credible institutional framework to monitor industrial subsidy programmes and enforce mutually agreed upon rules for industrial policy. Lastly, it is important to reconcile national policies and establish a supra-national policy framework. The first concerns the reconciliation of national policies to support domestic industry. This was the goal of the EC survey of state assistance programmes to industry initiated in 1989, the challenges of which have been noted. The second task involves the debate over the appropriate role for supra-national industrial policies to support bloc-wide industrial initiatives such as regional development programmes or downsizing of declining industries. Similarly, regional integration provides opportunities for collaboration on joint initiatives such as research and development in areas which were prohibitively expensive for a single country before integration. If national industrial policies in Mercosur are reduced only to be replaced by equally expensive regional initiatives, then the gains from more efficient resource allocation will be seriously compromised.

b. Some Industrial Policies[9]

To put Mercosur industrial policy in perspective, a review of industrial policies in Brazil and Argentina yields the overall conclusion that industrial policy interventions are on the whole relatively modest in both countries. Concerted industrial promotion efforts, as practiced in countries pursuing activist IPs (see Leipziger and Thomas, 1993, for a review) are largely absent, and industry-specific interventions, although they do exist, are limited in number. This is good news in terms of Mercosur harmonisation. Three examples of industrial policy in Mercosur are export promotion policies, regional development policies, and automotive policies.

Both Brazil and Argentina have been pursuing export promotion programmes which should boost long-run Mercosur-wide exports. The Brazilian export promotion programme consists of two key mechanisms: fiscal incentives (in the form of tax exemptions) and finance. Fiscal incentives come in five forms: tax exemptions, tax credits on domestic inputs for export-oriented production, a duty draw-back regime, tax concessions, and tax-exempt export processing zones. Direct finance for exports is available from the PROEX programme for a restricted positive list of goods and services (basically focused on capital goods

[9] More details on all these industrial trade programmes can be found in Frischtak, Leipziger and Normand (1996).

and engineering services). However, it should be noted that Brazil's export promotion policies do not seem to have been very effective. Between 1988 and 1993, the country's export-GDP ratio decreased from 10.4 per cent to 8.7 per cent, a little over a third of South Korea's. Brazilian exports as a percentage of world exports contracted in the same period from 1.2 to 1.0 per cent. The reason is because the domestic market is generally more profitable than export markets. Exports remain, for the most part, a countercyclical activity. Moreover, the relatively high cost of doing business in the country has become an effective impediment to the sustainable growth of exports.

In 1992, Argentina extended preferential duties to any industry group which agreed to set export targets. This plan, called the Industrial Specialisation Regime, was aimed at facilitating the productive restructuring of companies producing manufactured goods. Under the programme participating companies are required to increase their exports over those made the previous year in exchange for tariff preferences. The programme, although intended to meet the laudable goal of expanding exports, engenders several economic costs: foregone fiscal revenue which is estimated at $46 million through 1996, it subsidises an activity which may have occurred even in the absence of a government programme, it subsidises firms which should be willing to undertake the necessary restructuring and retooling in order to enter those export markets anyway, imposes a complex balancing requirement on imports and exports within a given sector in order for firms to qualify for special tariff exemptions, and embodies an implied discretionality in approving industries for participation in the regime and penalising firms which do not comply with their previously committed export quotas.

Both Brazil and Argentina have also been pursuing programmes which target the development of certain regions. In Brazil, federal tax incentives are only available for investments located in the Northeast and Amazon regions, and most states and many municipalities compete quite fiercely for new investments, through a mixture of explicit (sales and property) tax reductions and rebates, state banks' loans (although these are increasingly scarce), as well as through the supply of infrastructure services on a preferential basis. Although the fiscal cost of state and municipalities subsidies has not been precisely estimated, the amount of revenue foregone is a source of concern to the federal government in view of the fiscal condition of many states. In Argentina, legislation authorises provincial governments to provide incentives for regional economic development in the country's poorest provinces. Most programmes operate in San Luis, La Rioja, San Juan and Catamarca and offer one or a combination of the following incentives: exemption, reduction, suspension or deferment of national level taxes, accelerated depreciation, and duty free capital goods imports. In 1993 the fiscal cost of such programmes was estimated at approximately $1.54 billion. The establishment of free trade zones (with Tierra del Fuego being an important one) also seeks to promote regional development. The Ministry of Interior estimated the value of these fiscal concessions at $226 million in 1994. However, these programmes have been criticised on the grounds that they have failed to achieve their stated goals of employment generation and industrial development, in addition to imposing a high annual fiscal cost. FIEL (1994), for example, notes that many projects approved for regional development would have proven unprofitable had they not received tax exemptions. Further, tax exemptions on capital goods have lowered the relative price of capital to labour and encouraged more capital intensive production, clearly against the goal of employment generation.

We have seen two examples of industrial policy in Mercosur, export promotion and regional development. The third example is that of one of Mercosur's most important industries, the automotive industry. The liberalisation of automobile imports in March 1990 had multiple impacts: it led to a fall in prices and the rapid expansion of domestic production, it brought about higher quality models allowed by more flexible domestic content rules, it stimulated competitive behaviour in an industry accustomed to quasi-cartelised conduct, and it attracted new entrants (including Renault, Mercedes-Benz, as well as Kia Motors and Asian Motors, among other South Korean automakers). Both assemblers and autopart producers are also directing their investments with a view of the common market, and setting up complementary production lines, in order to reap the considerable economies of scale (and product differentiation) which characterises the industry. Subsectoral trade is growing considerably, and reached US$ 1.14 billion in 1994 (including autoparts) — with Brazilian exports to the Mercosur reaching US$765.4b and Brazilian imports US$375.4b. In particular, the industry has been the major factor in the rising proportion of intra-industry trade between Argentina and Brazil. The intra-industry trade coefficient for the two countries reached 39 per cent of total trade for 1993, 51.3 per cent for manufacturing trade and 77.3 per cent in the case of the automotive industry.[10]

However, every silver lining has a cloud. Brazil's March 1990 trade reform led to an upsurge in imports at a rate the government felt would be unsustainable from a balance of payments perspective and highly damaging to domestic industry. So in June 1995, the government raised tariffs to 70 per cent and imposed quotas to deal with balance of payments pressures. As for Argentina, the automobile industry still heavily leans on the benefits conferred by the export-promoting 'industrial specialisation regime'. Without a doubt, the automobile

[10] See Lucangeli (1994). The intra-industry trade coefficient reflects the proportion of intra-industry trade within a particular segment relative to total trade volume in that segment. Thus, when the value of exports and imports within the industry are equal, the coefficient is 100 per cent. When positive exports (imports) correspond to no imports (exports) from within the industry, the coefficient is zero. Or algebraically, the intra-industry trade coefficient $\Pi = [1-([\text{abs.}\ (X-M)]/[X+M])]$ times 100 per cent.

sector is one which will continue to be fractious for Brazil and Argentina to handle in an advancing Mercosur.

The first-order estimate of the annual cost of industrial policies in Argentina, provided in Table 4, is about equal to one per cent of GNP, a modest amount. Initial estimates, which need to be refined, place Brazilian support for industry at around the same magnitude. At the national or federal level, therefore, the use of tax and credit policies to support industry in general, or certain portions thereof, such as the SME sector or exports, is small and generally visible. Temporary, and sometimes selective, tariff protection either in the guise of anti-dumping responses or reactions to balance of payments problems, has at times been used. However, the basic tendency has been to maintain openness.

While the scale of Mercosur industrial policy is still relatively modest, much work still needs to be done to rationalise Mercosur's industrial policies. To

TABLE 4
Argentina's and Brazil's Industrial Programmes and their Estimated Annual Cost in 1994

Argentina		*Brazil*	
Incentives	*US$(m)*	*Incentives*	*US$(m)*
Sector-specific		*Sector-specific*	
Quotas and special tariff concessions for auto sector	300	Automobiles	n.a.
Other sectors under Industrial Specialisation Regime	46	Informatics	297
Regional		*Regional*	
Tax concessions for regional economic development	1,500	Other	3,663
Tax concessions for investment in Tierra del Fuego	226		
Functional		*Functional*	
Concessionary tariff rates on capital goods imports	n.a.	Tax concessions for the technology development	350
Tax concessions for purchase of new capital goods	260	Tax concessions for purchase of new capital goods	646
Subsidised credit for SMEs and home mortgages	122	Subsidised credit for SMEs and home mortgages	534
Total	2,454		5,490

compare Mercosur policy with other regions of the world, the review of EC experience shows a very pronounced level of state assistance to manufacturing. While federal support of this magnitude in the Mercosur context should not be expected, there may be a concern that states in Brazil and provinces in Argentina will begin to vie for and subsidise industries in order to gain local employment. Some of this has already begun in Brazil with respect to large automobile plant investments. Experience from the EU shows that the problem of state-aid to industry is a pervasive one, and some early attention by Mercosur planners is warranted.

5. SUMMARY AND CONCLUSIONS

The two general conclusions of this paper are that the welfare effects of Mercosur, while not large in the short-run, are positive and that industrial policy interventions have been modest but still bear watching. The implication of these conclusions is that Mercosur will have to continue to evolve and progress in order to maximise its welfare-enhancing effects in the same way a dieter should redouble his efforts once the first pounds begin to melt so as to keep the momentum and not invalidate past efforts. Just like the European Union, Mercosur will have to face up to inevitable economic adjustment in certain sectors. This adjustment will be exacerbated by the fact that the member and associate countries are not as homogeneous as the EU was during the first legs of its union enterprise. Initial trade between its largest economies, Brazil and Argentina, is still small and at a level below what might qualify it as a 'natural' trading bloc. Further, while average tariffs in Argentina and Brazil have fallen from about 49 per cent to about 13 per cent (not negligible by international standards) and many economy-wide reforms have been taking place, several liberalisation measures will not take place until the end of the decade, and many specific policies still await agreement. Nevertheless, Mercosur has come a long way so far. It has in some measure created trade, lowered consumer prices, rationalised production, and promoted competitiveness *vis-à-vis* the rest of the world.

Because the range of gains from the Mercosur endeavour is both uncertain and highly dependent on dynamic effects, the role of industrial policy becomes crucial. If the major participants are prone to use IP interventions to protect declining industries and if national interests continue to prevail, then the road ahead will be a narrow one. Policy cooperation, concern for the consistency of policy, smooth sailing within the WTO, and resistance to ad hoc responses to deal with economic dislocations are of paramount importance. The reason for this is that so far policy interventions, while not always being optimal, have not been extremely large. Therefore, Mercosur could lose the fruits of its previous efforts or stymie future rewards if it is not diligent with regard to its industrial policy oversight. Keeping this in mind, the following guidelines may be useful for Mercosur countries:

- *Transparency of industrial policy activities.* The failure to do this has often resulted in overlapping or competing incentives within the country, and a system which frustrates the comprehensive quantification of the costs and benefits of such policies.
- *Rapid phase-out of subsidy programmes.* Mercosur countries should set binding timelines for eliminating programmes which lack economic justification. Failure to do so for the EU has resulted in facilitating community-wide subsidisation rather than liberalisation, and in turn exacted a heavy resource cost.
- *Limit admissible types of intervention.* If some form of assistance to industry can be justified on sound economic grounds, governments should work towards adopting uniform policy instruments in order to promote greater transparency and reduce collateral distortions in other markets. Moving towards uniform instruments in this way can serve as a precursor to subsidy phase-out.
- *Consider only functional interventions.* Both theory and practice confirm the positive economic benefits of government assistance to industry in the case of market failures. Functional interventions, i.e., state aid directed at a general objective such as R&D without favouring a particular sector, can be welfare improving. However, government support of specific enterprises is generally recognised as costly for governments and seldom produces returns to justify its expense.
- *Anticipate requests for assistance from declining (sunset) industries.* If Mercosur is to work, resources will have to be reallocated and some industries will have to fold. Assistance programmes to facilitate adjustment should be temporary and conditional upon restructuring efforts such as reducing excess capacity.

There is considerable optimism for the future prospects of Mercosur. Mercosur 2000, the political programme designed to carry Mercosur into the 21st century, as well as discussions for a SAFTA (South American Free Trade Agreement) are underway. The Rose Garden Agreement signed in 1991 (setting up a forum for consultation between the US and Mercosur), and the Inter-Regional Agreement for Economic and Trade Co-operation between Mercosur and the European Union (which was signed by the Heads of Government in Madrid in December 1995) represent a growing recognition of the importance of the regional market in South America. As Mercosur finds itself involved in more multilateral and bilateral negotiations, momentum for Mercosur should be expected to build. If this is matched by caution in the area of industrial policy, Mercosur's potential can more easily be achieved.

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