Universidad de la República
Facultad de Ciencias Sociales
DEPARTAMENTO DE ECONOMIA

**Documentos de trabajo**

# The entrepreneurial response to economic liberalization and integration. The formation of hypotheses on entrepreneurial behavior: an interim report based on in-depth interviews

H. Schwartz

**Documento No. 05/92**
Diciembre, 1992

# THE ENTREPRENEURIAL RESPONSE TO ECONOMIC LIBERALIZATION AND INTEGRATION

## THE FORMATION OF HYPOTHESES ON ENTREPRENEURIAL BEHAVIOR: An Interim Report Based on In-Depth Interviews*

(Se hará la presentación oral en español)

Hugh Schwartz
Departamento de Economía
Facultad de Ciencias Sociales
Universidad de la República
Montevideo, Uruguay

* The views expressed are those of the author and do not reflect the position of the Departamento de Economía.

## I. THE BASIC THESIS

In the 1960s and in the beginning of the 1970s there was an increasing level of confidence in the contribution that economic analysis could make to the solution of the problems of economic life. From here on, the attitude seemed to be, the task is basically one of *refinement*. and the content of most of the leading economics journals still seems to reflect that conclusion.

Something happened along the way, however, as major, unexpected events took place, the predictions of economists proved less reliable, at least at turning points, and disillusionment set in among many economists and among even more non-economists who had been major consumers of the analyses provided by the economists. (One of the consequences of this was the elimination of fully half of the economics positions in the major New York banks in the mid-1980s.) Even where economic results seemed to coincide most closely with what might be expected from standard economic analysis, in East Asia, doubts began to be expressed about the adequacy of parsimonious models to explain the full measure of the results (in this case, the extraordinary economic successes) that were taking place.

The uneasiness of a small but increasing proportion of the economics profession with the rationalistic approach, or rather, with the traditional view of rationality, has been sufficient so that though few of the doubts have yet made their way into standard micro or macro texts, a number of behavioral analyses (analyses incorporating the findings or approaches of psychology or other social sciences) now turn up on a regular basis in the leading economics journals; in addition, a few rational expectations theorists have modified their original expositions about economic behavior, and key figures of neoclassical analysis such as Kenneth Arrow have expressed their forthright appreciation of a behavioral approach. This paper is an interim report of an effort to look at aspects of the process of economic liberalization and integration is

Uruguay, and to do so with a view toward generating hypotheses of behavioral decision making that may contribute to improved economic analysis and better prediction.

Standard economic analysis assumes that producers attempt to minimize costs and maximize revenues, or at least that survivor firms behave in that manner. Some economists have questioned the notion that businessmen -even successful businessmen- truly attempt such maximization but the only serious inroads to the traditional approach have come, first, from those who have noted the difficulty of characterizing maximization in the context of economic uncertainty, and, second, from those who have maintained that while there is an interest in maximizing, the attempt is constrained by considerations of cost effectiveness which lead to limited search and therefore limited efforts at optimization (with the latter efforts varying in efficiency because of factors such as information asymmetries). It is only in these contexts that some economists accept notions of bounded rationality.

Most economists assume profit maximization as an acceptable simplification. Others, along with many business administration specialists and some psychologists, have invested considerable time and resources in verifying one or another hypothesis of economic behavior -generally with surveys or in the laboratories of experimental economics- but few have paused to evaluate the decision making process in detail. This project undertakes such an effort in an attempt to generate new hypotheses about the decision making process- specifically about decision making in Uruguayan manufacturing enterprises[1]. In the course of doing this, it incorporates inputs relating to the decision making of labor unions and the way in which the latter influence the decisions of producers, and to the decision making of government in its efforts to influence

---

1 This study is a follow-up of another dealing with metalworking industries in Argentina, Mexico and the United States. See Hugh Schwartz, "Perception, Judgment and Motivation in Business Firms: Findings and Preliminary Hypotheses from In-Depth Interviews", Journal of Economic Behavior and Organization, Vol. 8, Nº 4, December 1987.

producers. What follows is more anecdotal than is planned for the final report, in part because it does not include the results of a survey that will be carried out in October-November 1992, in part because some of the material gathered prior to that date has not yet been incorporated, and in part because the information has been obtained with the understanding that enterprises and individuals would not be identified, explicitly or by implication, except with their permission, and the process of obtaining permission will not begin until November 1992.

For many years Uruguay had more going for it (more potential for further economic development) than a great many other countries. During the period from the 1920s through the early 1950s, Uruguay was a high income nation with relatively favorable natural resources, that had attracted significant financial and human resource inflows from abroad, and that had a solid educational system, providing the country with the basics for strengthening itself in new as well as existing areas. Despite a considerable range of political ideology the country had a social cohesion greater than in many countries of the world. The quality of life was good and improving. In addition, Uruguay had at least a reasonable supply of capable economists, and in recent years, the number has increased significantly; if their advice has not always been followed, the same can be said for most countries of the world. However, few nations have had such disappointing economic results over such a long period of time <u>in relation to their potential</u>. (Argentina should be included in the list of underachievers, of course.) The likelihood that the explanations for this lie entirely or even primarily in narrowly economic shortcomings seems low - which would seem to caution against the use of a narrowly economic framework to analyze the shortcomings or to prescribe for changes.

What is perhaps the most important analysis of Uruguayan economic behavior to date, Martín Rama's "El País de los Vivos"[2] depicts Uruguayans to be rational, calculating and rent seeking (la viveza criolla). Rama describes Uruguayan economic behavior (or rather some such behavior) in terms of a number of recent economic theories, though without explaining why such a "rationalistic" approach has led to results so different from those in many other countries. The replies I am obtaining in my interviews suggest that even though some secondary economic signals have fluctuated, the information on basic economic trends has been relatively clear, and yet the latter seem to be ignored by some businessmen and other economic agents. My responses also suggest that some businessmen and other economic agents delay inordinately in making decisions (to a degree no self-respecting maximizer or rent-seeker would), that they frequently do not continue the search process long enough or they do not undertake it in a sufficiently systematic manner for it to be characterized as an effort at cost minimization, that possibly important decision making options are frequently overlooked -by businessmen, labor leaders, government officials, and, indeed, even by economists advising on public policy, and that some very successful businessmen fail to exploit opportunities to obtain additional revenue as much as one might expect.

Indeed, Rama's examples of seemingly maximizing actions may not really amount to that in many cases. Robert Frank and others have argued that the economic gain of individuals is often maximized by what might appear to be unselfish acts (referred to by Frank as "shrewdly irrational" actions[3] and this certainly extends to companies whose long run interests tend to be advanced most by a reputation for quality, reliability and honesty. This is at the level of the individual enterprise. Beyond that it is well recognized that such attitudes are important to a

---

2 Martín Rama, "El país de los vivos", SUMA, 1991 (originally presented at the November 1991 Jornadas Anuales de Economía del Banco Central del Uruguay.

3 Robert Frank, "Shrewdly Irrational", Sociological Forum, Vol. 2, Nº 1, Winter 1987, pp. 21-41, and Passions Within Reason: The Strategic Role of the Emotions (W. W. Norton and Co., New York, 1988). Frank argues that moral behavior often confers material benefits on the very individuals who practice it.

successful and smoothly functioning capitalist system, one that provides a substantial proportion of its members with what they regard as satisfactory incomes or good opportunities to obtain such incomes. This is also the rationale behind the Better Business Bureaus, which do not attempt to defend consumers so much as to promote consumer confidence in the business community. The absence of Better Business Bureaus in Uruguay may reflect the failure of business groups to encourage members to do what is necessary in order to more nearly maximize their long term revenues.

A few words about the interviews prior to the more formal survey which is to be carried out in October-November 1992. (That survey will cover all of the enterprises and individuals previously interviewed, along with a new group.)

I have attempted to obtain information relevant to the project both in interviews and in informal conversations (as well as from a wide range of publicly available sources). Though I gradually developed fuller lines of questioning and indeed left 2 -3 page questionnaires with some of those interviewed, the queries varied somewhat from activity to activity and from individual to individual. I explained that I sought to understand reasoning processes and was not concerned if I did not obtain answers on all points -indeed, that I was much less interested in answers which reflected a great deal of uncertainty on the part of the respondent. No tape recordings were made, so as to reduce the likelihood of inhibiting discussions. The principal purpose was to understand the accuracy with which data used in decisions were perceived and the way in which those data were used in making judgments, this as a mean of developing hypotheses about the decision making process which subsequent testing might reveal to be more useful than those currently employed.

The chief target of my interviews were Uruguayan-owned manufacturing enterprises, especially those in industries sensitive to the economic liberalization and integration in process, though I sought out some other enterprises which seemed to represent particular phenomena, and I spoke with still others to which acquaintances led me. In all, I spoke with three dozen enterprises, in most cases, once, in several cases, two or three times, and, in one case, on eight occasions. I also conducted three dozen interviews outside of manufacturing enterprises -with union leaders, bankers, trade association officials, providers of technical assistance and others. With the possible exception of the trade association officials, the coverage was limited and may not have been entirely representative. Most interviews lasted an hour, but two dozen were two hours or more. The most serious limitation -and indeed, it is very serious for the purpose of this inquiry- was that while the interviews provided a great deal of information about the past, less information was provided on the perception of specific information and judgment processes relating to decision making problems faced by the enterprises (or others) at the time of the interview. This, more than added coverage, will be a major objective of the survey and follow-up interviews in October-November 1992[4].

---

4 Certain information relevant to the analysis of decisions can be obtained only at the time that the decisions are being considered. Decision makers often cannot recall at a later date, all of the categories of information they took into account and the values they perceived for each of these. Nor can they always recall all of the options they considered, or in any event, the reasoning that led them to choose one alternative over another -or why they did not even consider still another option. An incorrect decision may result from gauging incorrectly some piece of market or technological information or some government policy. Or, the problem may lie in the way in which that information is analyzed. Unfortunately, except for cases of extraordinary errors, we tend not to recall the way in which we perceived much information or the detail of how we analyzed all but the most important decisions. This limits the degree to which we can learn from our errors. Moreover, most businessmen (and others) would be reticent to allow an outsider to chart these problems in perception and judgment -even if it were possible to have such an outsider present at all the most important points in time. Anecdotal evidence already uncovered suggests that the phenomena of imperfect information and biased reasoning processes are important in Uruguay. The October-November survey attempts to circumvent the "invasion of privacy" aspect of the problem by employing an approach that is more nearly self-monitoring.

## II. A SUMMARY OF FINDINGS FROM THE INTERVIEW DATA

This section summarizes the findings from the interview data on the following topics: 1) plant operations in manufacturing industry, economies of scale and productivity improvement; 2) inventories; 3) marketing; 4) investment; 5) policy signals from the government; 6) the perception of market information; 7) the competitive situation; 8) behavioral assumptions; 9) judgment guidelines; 10) the implementation of judgments: specific decision making; and 11) bottlenecks to Uruguayan industrial restructuring.

### A. Plant Operations in Manufacturing Industry, Economies of Scale and Productivity Improvement

1. The View from the Government

The comments here are based on public accounts and attendance at conferences of high ranking officials as much as on interviews. The interviews were with a dozen primarily middle level officials.

With the important but nonetheless limited exceptions of the privatization of State enterprises and the reform of social security, microeconomic issues have not been among the leading concerns of the Government during the period since March 1990. The Government believes that the protection that Uruguayan industry has enjoyed has led to problems of inappropriate resource allocation, lack of attention to economies of scale and low productivity, the latter in particular, as a consequence of low rates of investment and a labor leadership more concerned with political objectives than with productivity questions (though it is recognized that that is in the process of changing). Government officials do not appear to recognize the magnitude of low productivity attributable to inefficient use of available resources (X-inefficiency), nor is there much inclination to estimate it inasmuch as it is reasoned that new policies and new signals will guide private initiative to what is necessary to improve economic efficiency. That conviction has been strengthened by the success of the Chilean economy, but may have been weakened somewhat by the continuing rise in the value of the peso with respect to the dollar (which was not expected to be more than a short term phenomenon and which has led to voices within the Government for cushioning the liberalization process). Still, the general conviction is that increased macroeconomic stability and economic liberalization will provide enough guidance for a much improved development of the private sector (and the economy as a whole). The Government is pleased by the increased exposure and achievements of LATU and also refers to lower key efforts to promote small and medium scale enterprise, but probably does not have a good notion of the proportion of the needs of Uruguayan industry that such efforts are satisfying. Despite publicized gains in a few enterprises, there seems to be little recognition that public policy measures could contribute to a wider incidence of such results, accompanied, in some cases with less adverse side effects than some fear from the process of economic reconversion and restructuring. The Asian experience with diagnostics of enterprises and other "industrial extension services" is unknown (economists have not written about it), and no consideration has been given either to that type of approach or to the use of tax deductions to spur private enterprise to purchase similar services in the market. This might seem consistent with the Government's basically market economy approach except that some key members of the Administration's 1990-92 team have had skeptical views of the sensitivity of Uruguayan manufacturers to incentives.

2. <u>The Cámara de Industrias and the Product Group Trade Associations</u>

The industrial trade associations devote proportionately much less of their efforts to disseminating information concerning best practice techniques and productivity improvement in Uruguay than in the more advanced industrial countries. This is despite the fact that the value of such assistance to the firms is undoubtedly greater here; as the manager of one product group trade association stated, "Many producers [in his group] do not even know whom to turn to for help."

But the problem is no longer so much a failure to perceive the need for attention to best practice information and productivity upgrading as the way in which recognition of the value of that information is being used in the decision making processes of the Cámaras. In 1985, the Cámara de Industrias actually denied that there was a need to be active in these areas, but this changed in the late 1980s and, in particular, in the period since 1990. There is an acknowledgment that small and medium enterprises may need help, but there is still no sense of urgency in the Cámara efforts and they remain small relative to the problems confronted. Expenditures are very small compared to those for export promotion, though the export promotion efforts include some attention to means of productivity improvement.

3. <u>The Unions</u>

Labor union attitudes toward productivity improvement -which had been rather negative until only a few years ago- are changing and this change is being recognized by management. There is acceptance of the need for productivity improvement including formerly untouchable subjects such as job flexibility and reduction of forces at the general level, though more from the Economic Adviser than from the President of the PIT/CNT or the individual member unions. More than a quarter of the unions have agreed to productivity clauses -but nearly three quarters of the contracts do not include such clauses. There is still considerable resistance at the plant level to many productivity changes that would entail changes in work requirements. Some labor leaders still maintain that productivity improvement can only come by increased investment, which Uruguayan manufactures are alleged not to make, or by pressing harder (unfairly) on labor. Some labor leaders refuse to endorse productivity improvement publicly for fear of losing reelection or ceding too much to management in negotiations, but favor it privately and accept some changes in that direction. (Note the possibly counter productive nature of this strategy though; the public statements of labor union leaders have caused some managers to seek ways to eliminate positions specifically because of apparent labor intransigence.)

One key issue that is holding back some productivity contracts is disagreement over the division of gains from productivity improvement. Another stumbling block appears to be that under Uruguayan law, payments made three consecutive times are regarded as acquired rights whether or not the basis for those payments (higher productivity or increased profits, for example) continues.

4. The Enterprises

In many cases the family enterprise tradition and the absence of training in management or industrial engineering, or the disinclination to hire (or to take full advantage of) individuals with that training leads not only to small and inefficient operations, but to a failure to realize the size of the gap between unit costs of the plant in question and of a facility employing more recent technology and using best practice techniques. Moreover, the owner/managers of many small and medium scale plants have only the vaguest notions of economies of scale of plant size in their product line, and not a much better idea of the economies of scale that can be achieved with longer production runs. This is changing, but is still a factor worth noting.

A factor that contributes to the low productivity is the low level of expenditure on in-plant training and the decline of the last 20 years or so in the level of expenditure, on and in the standards of public education. These factors and their own lack of management training make some of those considering productivity improvement programs openly skeptical about what such programs can accomplish, which probably tends to reduce the effectiveness of those programs from the outset. Another way in which older attitudes reveal themselves is that though international sourcing is becoming commonplace in the world, in Uruguay there is still considerable reticence to subcontracting (though the current emphasis on economic liberalization and integration is encouraging somewhat greater emphasis on specialization and this is encouraging more subcontracting than before).

As the economy of Uruguay becomes more open, the altered situation can be expected to lead to new problems of perception and judgment. How does a formerly highly protected firm calculate the value of international expertise, the quality of which it has not needed before, and which, in any event, may not even be known to the firm? What, moreover, is the value of advice that leads to changes which engender (short term) labor difficulties and with them, costs that the enterprise would not otherwise have had? (The problem may be somewhat easier to resolve for managers of multinationals who have received such advice formerly, even when producing for the local market.)

Finally, even in seeking cost reduction or quality improvement, Uruguayan firms are inclined to ask for advice about a particular problem or a particular area rather than a general diagnostic of the enterprise, even though the latter is what may prove most useful. Asked about their reaction to a proposal to allow special tax deductions for expenditures on such general diagnostics, executives in many enterprises responded favorably, but this was much more the case for those who had already undertaken some (even limited) effort of that type than for others who had not done so and who may be able to benefit even more from such advice -showing how difficult it is to assess the value of an good or service before it is actually used.

Questions were asked to ascertain if there was a tendency to make judgments about current options, reasoning by analogy from successful (or unsuccessful) experiences in the past (a preliminary hypothesis of the study cited in footnote 1), but almost all of the producers replied negatively, stating that the situations generally were not similar enough. (However, see an important exception to this in Section II E 2.)

**B. Inventories**

Much of the inventory of manufacturing industry is imported (particularly of import substituting industry, of course) so Government might be expected to have some concerns in that area, particularly to the extent that inventories are held for substantially longer periods than producers would prefer because of existing or potential foreign trade obstacles. The Government does not appear to have considered this problem directly, but the reduction of import barriers generally and the elimination of many procedural requirements (though some not until July 1992) should have reduced the risk of interruptions (or delays) in obtaining imported inputs that had led industrialists to accumulate inventories to cover periods two to three times as long as they would have preferred if they could have depended upon obtaining supplies without having to consider the possibility of bureaucratic delays. Nonetheless, the recent improvements in this respect, reducing the incentives for large inventories, do not appear to have had much effect in altering the inventory policy of producers. This may reflect the fact that many economic agents do not respond to small (marginal) differences -that they require some larger, Just Noticeable Difference to act[5] but the liberalization policies of the Government would appear to constitute changes of that larger magnitude. This seems to be a reflection of a less-than-truly-maximizing (less than cost minimizing) business behavior. That is true even if the relative lack of adjustment in inventory policy to date reflects no more than a lagged response to the changed incentives, with the reduction in inventories about to take place

5 On the Principle of Just Noticeable Difference, see Schwartz op. cit., p. 547.

gradually over the course of, say, the next two years.

### C. Marketing

The marketing activities of perhaps greatest interest at this time relate to export promotion. This is an area in which the Government has long been engaged, and in which the Cámara de Industrias has greatly increased its activity, particularly since mid-1991 There does not appear to have been any coordination between the two during the last few years, but major new efforts may be underway.

While the same is probably true of the export promotion programs in much of the world, it should nonetheless be noted that there do not seem to be any clear economic criteria for establishing, evaluating or redesigning individual export programs. (Moreover, most producers do not seem to be really aware of the existing programs.) The Government has notions of which activities function relatively well and which do not, but there is no effort to estimate the consequences of programs carefully so as to be able to shift resources towards the more successful, and away from the least successful programs. The same can be said for the much more ambitious efforts of the Cámara de Industrias. There are statements to the effect that the individual export promotion programs are aimed at contributing to the GDP or employment, but there is really no use of efficiency or response criteria to select or evaluate the individual programs. Most exist because they have been used in Uruguay before or because they seemed to be successful in some other country.

The reaction of producers even to the export promotion activities of the Cámara is decidedly mixed. There is a growing recognition among individual exporters that there is no substitute for direct involvement on the part of the companies themselves, with follow-ups if possible by overseas representatives. This is true not only of more distant markets, but also of closer destinations such as Brazil and Argentina. The surprising thing, though, is that the firms that are reacting in this manner still seem to be in the minority. Most have not done so, presumably because they are assessing the data in a manner different from that called for by standard economic analysis. Another indication of differences in the approach to assessment is that some firms with similar products are arriving at very different conclusions with respect to foreign marketing strategies. One long successful exporter has depended on only two foreign buyers; another recently successful exporter of smaller dimensions in the same industry finds it advisable to use 15-20 foreign buyers. One of these firms is probably mistaken in its belief that it is following a maximizing course of action.

With respect to what products to market abroad, some firms rely primarily on insight and untutored personal efforts, a few turn to their Cámaras (several of which have funded studies to identify possible products), and some firms (and some Cámaras) seek help from whatever government or private group is particularly in the public eye. Thus LATU, which has been highly publicized and is well equipped to provide advice on production processes once the products have been identified, receives some requests to help identify suitable export products, which is the speciality of other agencies. This would seem to be evidence of an inefficient search process on the part of the firms involved. Finally, it is only with the double impact of continuing economic liberalization and (the at least eventual prospect of) MERCOSUR that many producers have come to recognize that successful marketing abroad would require adjustment to basic production processes. Most enterprises did not perceive this in the more limited context of CAUCE/PEC and a five-six year old INTAL report which made this point in a telling fashion was never really communicated to Uruguayan producers.

## D. Investment

Investment in Uruguay is among the lowest in relation to GDP in all Latin America and it has barely risen despite the obvious need for new plant and equipment (particulary with the opening of the economy), the introduction of macroeconomic policies aimed at increasing the general conditions for investment, the reduction of most duties on investment goods, the debt equity swap agreements, and an inexpensive dollar that makes many imported investment goods more accessible than in a long time. What then, has gone wrong?

Perhaps the Government judged the Uruguayan private sector (or foreigners) to be more inclined to respond to generally more favorable (short term) conditions than was reasonable; perhaps the set of policies which seemed to the Government to be favorable to investment was not assessed that way by private producers. The Government set out to remedy a number of aspects which economists have assumed to discourage investment, and while the Government was correct in assuming that those factors do tend to have that effect, others also may deter investment and may not have been sufficiently alleviated. (See Section II K., Bottlenecks to the Restructuring Uruguayan Industry). One of the best examples of this is that it was long assumed that the lack of medium to long term financing was a serious drawback to investment but now that available funds have increased -and are about to increase still further- it is recognized that financing is not the key constraint (though it might be if the ratio of Investment to GDP were to rise to the order of 16-20 percent). The President of the Cámara de Industrias even went so far as to state recently that there are other things that Uruguay needs more urgently than the multisectoral loan now up for consideration in the IDB. Note, too, that the high (but lower than formerly available) rates of interest are well below the projected internal rates of return on most projects being shown to government offices. Some investments continue to be made, of course, but most producers seem relatively pessimistic and resigned, and the withdrawal of certain investment incentives may not have helped. Many producers do not believe that new investment will reduce costs enough to justify itself -which seems to conflict with the projected IRRs referred to above (to the extent that those rates refer to projects in the industrial sector).

### E. Policy Signals from the Government

#### 1. Economic Infrastructure and Technical Assistance

The Government has emitted mixed signals with regard to support for economic infrastructure and the various forms of technical assistance for industry. Certainly there has not been any trumpeting of support in this area, and the long term efforts have been more related to specific projects than to broad support (support for science and technology and for science education, for example, rather than for education generally). Medium term aid -studies related to industrial competitiveness, e.g.[6]- also has not been comprehensive and has depended, to a considerable extent on what was offered to Uruguay by others. An Italian proposal to provide a study of the textile industry and a Japanese offer to study the clothing industry were accepted, but some others were not. The Government did become involved in commissioning some project appraisals but did not set out to study a wide array of industries in depth. Shorter term aid such as diagnostics of the competitiveness at the plant level also depended in considerable measure on contributions from abroad (notably the EEC and the Government of Germany) and tended to be oriented primarily to smaller enterprises. Help in the area of technological upgrading was

---

6 Note that the most relevant concept is not the competitiveness of existing Uruguayan industry, much of which was never planned to be internationally competitive (e. g., the Domestic Resource Cost rankings of a recent year), nor the "sensitivity" of facilities to foreign competition (e. g., the studies by the EEC and by Luis Porto in Uruguay). A more useful analysis would consider what it would take to make the various Uruguayan industries competitive in price and quality, and then assess which of those restructuring efforts would be profitable. Ideally this would begin with a sectoral analysis that would take account of interdependencies. Moreover, such a sectoral analysis might well uncover probably advantageous opportunities in some product lines, which would constitute the kind of preliminary signal that many (especially smaller) producers would require before preparing a detailed project appraisal.

available from LATU, and with considerable subsidization, direct and indirect. The latter went primarily to medium-to-large size enterprises, but the number of enterprises requesting such assistance probably was small compared to those that could have benefited from such help.

2. Policy Signals Generally

The Government sought to make it clear that the widespread paternalism and interventionism of the past was going to be sharply reduced, though one or two steps at a time rather than in a shock-type effort (although rumors of the possible adoption of a Shock Policy circulated throughout the period). Government planning would be downplayed and government policy would reflect opportunity costs. There would be fiscal orthodoxy and the policy of liberalization, which had begun in the mid-1970s, would now be supported by a clear and coherent economic ideology. The productive structure would come to be represented increasingly by activities of comparative advantage. (Note that there seemed to be an assumption that comparative advantage is easy to identify, and that increased macroeconomic stability and relative prices more closely reflecting opportunity costs would be sufficient to allow comparative advantage activities to emerge without difficulties. For brief comments on recent economics literature largely critical of this view, see Schwartz, "Guidelines for Industrial Reconversion and Restructuring", prepared for the 1992 Jornadas de Economía).

The unexpected turn of events in Argentina in 1991 contributed to a Uruguayan exchange rate that appreciated considerably with respect to the dollar, and to a lesser degree with respect to some other currencies. As a consequence, the new exchange rate signals (apparently first expected by government officials to be only temporary), tended to discourage exports and some investment in plant and equipment which would enable increased exports. Tariff and other trade barriers continued to be reduced even as the peso appreciated, and in a few cases, even when neighboring countries did not reciprocate. The possible consequences of the appreciation of the peso seemed to be overlooked, perhaps because the emphasis of policy was on the short run and the valuation of the currency could be easily explained in terms of prevailing short run phenomena.

To many producers it seemed that the Government was preoccupied with the short run - and not all of that so easily explained in economic terms. The perception of producers was a Government that was much less concerned with efficient signals when it come to considerations that might affect its revenues. Thus, the Government did not seem especially interested in reducing the extraordinary taxes on petroleum products or automobiles, nor did it seem willing to take political risks to improve the efficiency of certain official services (although the efforts at demonopolization and privatization were expected to help a great deal in the activities to which they related, when and if they were approved). Finally, the political in-fighting and lack of discipline in the governing coalition led to a large and varying number of signals which proved disconcerting to many producers. At one point (in late 1990) a Social Dialogue of key leaders from differing political factions evolved to grapple with major issues, but the emphasis was on short term matters such as wage guidelines, and the discussions took place out of public view.

Neither the governing party nor any other had taken much of a stand prior to 1990, on the proposed Common Market which had the potential of substantially changing the face of the Uruguayan economy, and which soon began to require policy commitments. Although the political parties and their leading economists had tended to ignore MERCOSUR before the July 1990 decision of Brazil and Argentina to accelerate the integration process by five years, by October 1990, virtually every political group had accepted the proposal - not only without a great deal of analysis, but without insisting on many specific measures to prepare the country for what were expected to be the most dramatic changes in at least a generation. Producers were awakened to the threat (or opportunity), but while many of the larger companies began to prepare for the changes, many of the small-to-medium size enterprises took only limited steps. The ensuing economic (and then political) difficulties in Brazil and the dramatic appreciation of the Argentina peso led many businessmen to assume that there was likely to be much more time to prepare for economic integration, and perhaps MERCOSUR would never take place after all and they could continue very nearly as before.

In January-February 1992, the political situation led to increased uncertainty in the business community and this improved only moderately after that. Some of the reaction of producers reflected an accurate perception of policy uncertainty (which industries would be dropped from the MERCOSUR exceptions list in six-twelve months, what was happening in the auto industry, what was happening with respect to social security, etc.), and some of it reflected an adverse psychological reaction that served to offset incentives (or magnify disincentives) in the minds of producers. In a number of cases producers stated that this political uncertainty led to decisions to postpone some investments.

The perception of, and judgments about credit are of special note. In the second half of 1990, and in early 1991, virtually everyone perceived medium-to-long term credits to be unavailable, and this was true except for the very lowest risk borrowers. By late 1991-early 1992, medium term credits had become more available, but the perception of unavailability continued among many manufacturers. By the time more producers became aware of the increased availability of credit, the increased uncertainty about economic policies and the concern about a possibly major devaluation sometime during the course of a medium term loan, tended to reduce the demand for credit. Moreover, the interest rates of 10-11 per cent in dollars, struck prospective borrowers as high in absolute terms and relative to rates in the developed world. There was also relatively little response to the recently evolved availability of

IIC-IFC type investment funds in either private or public financial institutions. Part of the reason for this lack of response to greater access to financing appears to be that the importance of other problems was beginning to be better appreciated. Some of these factors were economic, and others were of a mixed nature. As an example of the latter, many enterprises, recalling the financial debacle of 1982-1983, maintained that just as long term financial success tended to go to firms that had avoided borrowing in the earlier period, perhaps it was a good idea to continue to avoid borrowing, all the more so given certain similarities with the 1981-82 period. Such reasoning by analogy, including by some very successful enterprises, is an example of decision making that is not consistent with the assumptions of traditional economic and financial analysis.

**F. Perception of Market Information**

Imperfect perception of market information by enterprises seems to be of consequence, although major steps of a maximizing nature are now being undertaken to alter this. The spur of competition in new export markets, the increase in competition locally as a result of the reduction of tariff and other barriers, and the threat and opportunity of increased economic integration, all have changed the appropriate calculus. It is of note, though, that several enterprises acknowledge that some of the changes they are making now would have been profitable earlier as well. It is clear that the search process of some successful enterprises was much too limited (and unsystematic) to be characterized as cost minimizing/profit maximizing. Even at this time, however, there are some rather important misperceptions or questionable lines of reasoning which are causing or could cause serious problems. An example appears to be in the dairy products industry, which is generally regarded as one of Uruguay's best hopes in MERCOSUR. It would seem that neither CONAPROLE nor its leading competitors have sensed the nature of evolving demand in Argentina or Brazil well enough to take the necessary steps to develop new production capacity for high value products such as youghurt, special cheeses and other usually brand name products. If this is true, then it represents either a problem in perceiving accurately relatively accessible information, or in reasoning about that information that is better explained by the use of some (seriously biased) judgmental heuristic than by any maximizing calculus.

### G. The Competitive Situation

Until only a few years ago, the competitive pressures of industry in Uruguay were strongly mitigated by a number of factors. First, in many product groups a single producer or a small group dominated the industry and protective barriers afforded them considerable market power. Second, the absence of consumer protection group, Better Business Bureaus or even a demanding attitude on the part of Uruguayan consumers, alleviated the pressure to compete in terms of quality and service. The first more or less significant increases in competitive pressure accompanied the process of economic liberalization that began in the 1970s and that accelerated in the last few years. The CAUCE and PEC trade agreements played a role, too, as they made more local producers aware of what was necessary to sell in the not-extraordinarily efficient, but certainly somewhat more competitive economies of Brazil and Argentina. Firms that exported beyond the neighboring countries faced keener competitive pressures, of course, but by no means were all who exported beyond the region as cost competitive as they could have been. (Note, too, that there also seems to have been a problem of lack of competition at the wholesale-retail level; in the domestic market, local prices 50-100 per cent higher for some categories of imports despite tariffs and duties of under 30 per cent.)

The perception of the competitive threat increased substantially with the move towards MERCOSUR in August-October 1990, and, in many cases, the sense of pressure increased further as more was learned about Argentine and Brazilian competitors. Even so, as late as this year, some companies were first beginning to understand the degree to which they were not in condition to compete. (Note, however, the comments above with respect to the dairy industry, which, moreover, are compounded by the fact that some of the dairy industry's competitive advantage derives from the near monopsony position enjoyed with respect to dairy farmers -which will not continue with increased economic integration.)

The substantial number of meetings of producers of the four MERCOSUR countries are proving helpful to Uruguayan producers in understanding relative strengths and weaknesses, but they also provide opportunities for collusive agreements and implicit understandings that not only are likely to inhibit the degree of competition among producers that many observers hope will result from increased integration, but even more seriously, are likely to slow down the tendencies to improve productive structures that would be expected from the exposure to an increased number of foreign competitors. The initial reaction of government officials -and of observers from outside Government of all political affiliations- was to ignore this threat or to speak very skeptically of it. Finally, in early 1992, it was decided to include competition policy on the agenda of the MERCOSUR talks. The disregard of the topic by Government and the public is an example of the imperfect perception of information, and even more, of the use of a type of a judgmental heuristic which I cannot yet characterize but definitely differs from the maximizing calculation assumed by traditional economic analysis -<u>and this, on the part of most Uruguayan economists as well as by the general public</u>. In Government and among the trade associations and individuals producers, the only concern related to competition policy was that of dumping from abroad. Other uncompetitive practices did not seem to elicit much response. Some small enterprises cited a few examples of such practices but revealed a sort of fatalistic acceptance rather than the kind of anger, rejection and concern to change things that led to the passage of state and national antitrust legislation in the U. S.

### H. Behavioral Assumptions

Government and the public in general view Uruguayan businessmen as inclined not only to expect, but to seek government intervention on their behalf. Businessmen and industrialists in particular are regarded as conservative (along with Uruguayan society in general), risk averting and not very innovating. Most producers would not dissent strongly; they recognize the conservation of their group and would only insist that government policies such as those of the breaking of the tablita in 1982 have contributed to the explanation.

This raises a point especialy worth considering. A major survey of the Southern Cone area in the period 1986-88 revealed that public appreciation of businessmen was significantly lower in Uruguay than in Chile or Argentina, and that in Uruguay, the evaluation of businessmen is actually somewhat lower among those who identify themselves as Blancos than among Colorados[7]. Current government policy would appear to rely for its success on an entrepreneurial response not too dissimilar from what has taken place in Chile despite the fact that some who hold (or have held) positions related to the design and implementation of policy regard Uruguayan industrialists as relatively conservative and not very sensitive to incentives. There would seem to be a problem here unless the Government has also been doing something to alter business behavior. The problem goes deeper, however. In Uruguay, there has been little of what the EEC, in referring to elements necessary for economic success, terms a "culture of

---

7 Carlos Filgueira, Silvana Bruera, Carmen Midaglia and Mariana González, "De la transición a la consolidación democrática: imágenes y cultura política en el Uruguay", (1989, Montevideo, CIESU).

enterprise". Until only a few years ago few newspapers and popular publications carried feature articles on manufacturing leaders, and there certainly was not the attention to those who were successful but who did not meet the image of what a cultured Uruguayan should be (possess a university degree, to begin with) that one could find in some other countries -even more elitist countries such as Colombia.

Changes have been taking place, though -among manufacturers, and perhaps even more rapidly, among the leadership of labor and its advisers. That having been said, two points should be noted. First, the top leaders of labor have been reticent to acknowledge publicly, its emerging acceptance of the need for productivity improvement. Second, many industrialists continue to regard many individual labor unions as antagonistic to changes that would enable a level of productivity necessary to compete internationally (though even they recognize that there has been some increase in labor's willingness to change). In addition, some of the most successful industrialists, while critical of labor productivity in general, tend to express satisfaction with the productivity of labor in their own establishments and to observe that the key to labor productivity lies first and foremost in better management. At the same time they also urge: 1) that the labor force in individual plants not respond automatically to the requests of national labor leadership, and /or that more non-union plants be established; and 2) that labor reduce its political stances (and focus more on job and salary issues). Even manufacturers who are generally satisfied with their own labor force refer to the local environment as reflecting "a culture of strikes". Moreover, one successful exporter states that he can document slowdowns in productivity in his own plant during periods of strikes at the Port of Montevideo.

In addition to a number of individual cases, there would seem to be at least one general type of exception to the characterization of Uruguayan industry as conservative and risk averting. One of the most important preliminary findings of this study is a modification of the

Endowment Theory developed by economists and psychologists which claims that economic agents are more averse to risk when they have a higher than a lower level of wealth and that they value the same absolute amount of gain much less than if it were a loss. A number of enterprise examples suggest that there is a range of wealth (or enterprise asset levels) for which that conclusion does not hold -and there are plausible economic reasons to expect that type of less risk averting behavior in the range in question.

**I. Judgment Guidelines**

The Government's economic decision making has been guided by a conviction that standard economic analysis provides a satisfactory basis for orienting an economy, and that it affords a strong case for relying upon a market economy with minimal interventions, except to establish the macroeconomic framework, along with such elements of micro support as are necessary to provide a "level playing field" and the generalized support that will enable the success of those economic activities that have, or are capable of developing, a comparative advantage. Detailed microeconomic intervention and the selection of activities that are "winners" for specialized treatment seems to have been considered acceptable only to the degree necessary to hold in place the political coalition committed to the basic economic policy framework.

The director of a recent trade association report indicated that his interviews led him to conclude that private enterprise decisions concerning exports were influenced first, by traditional, relatively short term considerations of financial advantage, and second, by the "actitud innovadora" of the producer, his age, his health and his contacts abroad. The latter can be translated into a cost-benefit calculus, though that is almost never done. The "actitud innovadora", which would differ from enterprise to enterprise, and is perhaps the key consideration, is much harder to characterize and may depend to a degree on asymmetries in information, differences in the evaluation of that information and differences in perceived risk; it clearly introduces the possibility of elements that differ from standard economic formulation.

A number of producers insisted that intuition and not calculations were key in their decisions. Such affirmations cannot necessarily be taken at face value, of course, but they are signs of the use of one or more judgmental heuristics (rules of thumb) that almost surely involves a degree of bias from the result that would be indicated by the calculations of standard maximizing analysis. Other producers explain their decisions in terms that suggest that while maximization would be their intent, they recognize that it is not possible because of the uncertainties. Moreover, they claim (in some cases, imply) that they have little notion of how to take the uncertainties into account (note how this differs from the facile manner with which economists deal with uncertainties in calculation) <u>and thus, they allow for uncertainties in varying ways</u>. Further undermining the notion that they even <u>intend</u> to maximize is the fact that they do not do nearly as much as might be expected to ensure the use of an efficient search process or of "best practice techniques".

One readily observable and almost universal practice that tends to support the argument that the guidelines of Uruguayan businessmen differ from those assumed by standard economic analysis is the relative absence of sharp price reductions at the end of a season or in periods of economic recession. Also a matter to think twice about is the almost universal response of those producers who seek to take advantage of export markets in MERCOSUR to the effect that they seek "nichos" abroad for products with small markets that are unlikely to be able to exploit economies of scale. In three dozen interviews, none (with only one possible exception) spoke of investing in new facilities large enough to offer the possibility of minimum economies of scale that could be taken advantage of to launch massive exports to MERCOSUR and, if necessary, beyond. Nor did anyone seem interested in even investigating that possibility -in investigating if estimates of the rate of return might be large enough offset the admittedly larger risks. When reminded that there were companies in small European countries which exported large proportions of output, the typical responses was that, well, the latter were European companies. (How different from the line of reasoning in a number of East Asian countries -a line of reasoning in the case of the Uruguayan firms which seems to go beyond a mere high aversion to risk.)

## J. The Implementation of Judgments: Specific Decision Making

Despite the pessimism of conversations in a good number of firms, and the seemingly unpromising nature of some of the judgment guidelines, nearly half of the enterprises interviewed described what seemed like sensible, sometimes imaginative reactions to challenges that had presented themselves in the last twenty years -challenges such as those presented by the energy crisis and the relative increase in fuel prices (the latter of which has lingered longer in Uruguay than in the world generally), the need for new equipment in the context of limited access to financing, and the challenges presented by the tendency toward economic liberalization in the 1970s and 1980s. In each case the answers reveal a pattern of adjustment that sought to (and usually succeeded in) reducing costs or raising revenues. That's the good news[8]. At the same time, insofar as the cases reveal significantly increased search in response to adversity, this suggests that the enterprises must have been far from an optimal position prior to the adversity (along the lines the findings of Cyert and March's 1963 study, The Behavioral Theory of the Firm, but with probably an even larger gap in operational efficiency than they showed for U S

8 The recall of unrecorded decision making information from the past is vital to this conclusion, however, and such information is not entirely reliable. See footnote 4. This study is attempting to obtain some such information for current decisions, however.

firms). Half of the situations reflect a greater approach to best practice techniques and product quality improvement, though it should be noted that in few if any of the cases does it appear that there was a serious effort to determine the optimal amount of additional search that was warranted nor the best way of going about that additional search. (In some cases, recall of what was done is too incomplete to be sure.) And that refers to the cases of successes in responding to the challenges. Somewhat more than half of the firms interviewed did not cite such cases of successful adjustment (though there may have been some such cases, even in those firms). They did indicate that they were concerned about current threats, though in some cases that had not yet done much to adjust.

Although the Government, the Cámaras and various others have spoken in general terms of what needs to be done and there are warnings of possible business failures and even some planning of a safety net to aid employees in firms involved in such failures, much less is being done to encourage industrial adjustment than one might imagine -much less than was done in Japan or Korea or Mexico- although some small actions continue to be registered. Moreover, despite the important commentaries of the economic adviser to the PIT/CNT, it is not clear that the labor unions are doing more to meet the challenge to their ranks than small-medium scale manufacturers are to theirs; international experience reveals that successful industrial reconversion often leads to a sharply reduced workforce (unless accompanied by plans for expanded production). It is my impression that organized labor is doing more to maximize short run gains rather than those of the long run, and that it is attempting to maximize gains for its membership rather than for the labor force as a whole despite the fact that the unions are the backbone of a political party that seeks to be the leading party of the country. I will attempt to obtain more information from labor sources to reevaluate this, however.

**K. Bottlenecks to Uruguayan Industrial Restructuring**

A tradition has evolved, perhaps best represented in the work of FEDESARROLLO of Colombia, of surveying businessmen to ask them what they view as the principal obstacles confronting their activities. Note is taken of the factors most mentioned and of the changes in these from one period to another. Inasmuch as respondents are not asked to explain the way in which and the degree to which the factors cited actually constitute obstacles, the compilations may not provide much guidance on what actually limits the development of the various sectors and branches of economic activity. In fact, some alleged obstacles turn out to have no major consequences, and some others, while important, actually stimulate innovative responses.

Among the factors most frequently cited in mid-to-late 1990 as bottlenecks to industrial development (especially to investment) were: Difficult labor relations and the "culture of the strike". Deficient and expensive public services; Inflation; Uncertainty abut public policy; A legal and political system that does not honor contracts to the same extent as in most foreign countries; Adverse financing conditions, particularly the lack of medium-to-long term credit or equity funding; and Businessmen who are especially conservative and risk averting. By early 1991, Overvaluation of the peso (at least with respect to the dollar) was added, along with Increased political and therefore economic uncertainty. Still other problems were mentioned -protectionism, paternalism and the lack of competition; the small size of the market- still viewed that way by most manufacturers despite the opening of the economy and the plans for increased economic integration; uneven treatment by government in its liberalization moves and in tax measures; high social benefits/costs linked to wages, etc. No one in the Government, in the enterprises nor in the labor unions, cited educational limitations as a major constraint, but almost everyone referred to them (or, in response to questioning, acknowledged them) as a significant second order consideration.

It is not easy to evaluate these contentions, but it is difficult for a government, trade association or labor union policy to be determined without knowing what the bottlenecks really are, and it is obvious that what are stated to be problems cannot be accepted at face value to constitute serious problems. The lack of medium term credits was mentioned by virtually everyone during the period from mid-1990 through mid-1991, but surprisingly few have applied for the credits and equity funding now more available (and about to become still more available) and investment does not appear to be increasing. Several factors may explain this but the point is that the importance of what admittedly was not a positive factor, was overrated. Even the fiscal deficit, inflation and the crowding out effect of higher interest rates appear to have received more emphasis as obstacles to industrial and overall economic development than now seems to have been warranted.

The "Difficult labor relations" complaint is really part of a much broader issue, that of a conflictive society on the one hand (though one not characterized by conflicts as bitter as in some countries), and of institutional arrangements which seem to accentuate economic problems -but which may not be inefficient mechanisms for permitting the degree of individual expression that seems to be an important part of Uruguayan cultural values. Similarly, despite general acceptance of such major shifts as increased economic liberalization, there are continuing, (largely non-maximizing?) struggles over the detail of when and how to liberalize or integrate that have led to considerable economic uncertainty. Though this is in part a reflection of peculiarities of Uruguay's political system for which various changes are now being proposed, it is possible that the existing political system might just reflect Uruguayan values, and the question might be one of assessing the trade-off between a system that reflects those values relatively well, and one that reflects them somewhat less well but would facilitate (or at least permit) increases economic growth. Before deciding about the nature of the tradeoffs -or before deciding about any possible need to change societal values, which admittedly are not the most congenial to efficiency and economic growth- it must be borne in mind that with all its problems and deficiencies, Uruguay is a more tranquil, relaxed, civilized and livable country than many, perhaps than most.

The allegedly highly risk averse nature of Uruguayan producers is often cited as a serious obstacle to development, but after listening to some of the particulars, I conclude that much of that apparent high risk aversion may simply reflect the lack of managerial professionalism -due in part to the family or small group nature of so much business, but due in part as well to the anti-entrepreneurial (and perhaps anti-industrial entrepreneur) bias, that has existed in Uruguayan society; that may have tended to discourage some of the most able from going into business (in particular, into manufacturing industry) and it certainly encouraged some of those that selected a business (industrial) career to take a much lower key approach than they would have assumed in other countries, and than they would have preferred to take here. A second factor that may help explain the high degree of risk aversion among businessmen (industrialists) is the somewhat fatalistic strain in Uruguayan thinking. Programs such as those of EMPRETEC may be helping to alter attitudes and reduce the importance of the second factor, at least for a group of new entrants. As for the first, the lack of managerial professionalism, several educational programs and the new challenges from economic liberalization and possibly greater integration are helping to change that.

Limitations resulting from the reduced quality of much public education in recent years are on everyone's second (back burner) list of bottlenecks to increased industrial development, but the wonder is that this factor does not seem to be on anyone's first list, especially when considering the medium-to-long run. Moreover, the deficiencies may be almost as great with respect to the lack of training in many industrial plants and/or in the many of the unions of those industries as in the usually castigated public primary, secondary and vocational school systems. Furthermore, if one considers the limited training of some managers and some of the labor leaders who negotiate with them over such matters as productivity improvement to take better advantage of both best practice techniques and emerging technologies, then educational limitations may take on an importance for the short run as great as that for the medium-to-long run. Improvement of the educational panorama may be as important for increasing productivity in the period ahead as the increased competitive pressure that comes with economic liberalization or the control of monopolistic practices. Or maybe even more important[9].

The obstacles (bottlenecks) area has a rich potential for hypotheses that need to be tested -perhaps by surveys with in-depth follow-up questions, as a sort of field equivalent of the successful laboratory economics.

## III. CONCLUSION

I believe that there are important implications of this project for economic policy in Uruguay, and also for the adequacy of the approach of traditional economic analysis to policy. As Richard Thaler, the author of important work in the area of consumer behavior (and the coordinator of the "Anomalies" section of The Journal of Economic Perspectives) has written in summarizing his studies:

> The primary lesson here is admittedly a depressing one for economic theorists. The lesson is that their job is much harder than we may have previously thought. Writing down a model of rational behavior and turning the crank may not be

9 See especially Germán W. Rama y Sara Silveira, Política de Recursos Humanos de la Industria Exportadora de Uruguay. Modernización y Desequilibrios (1991, Montevideo, Oficina de la CEPAL).

> enough, and writing down a good model of less than fully rational behavior is difficult for two reasons. First, it is not generally possible to build good descriptive models without collecting data, and many theorists claim to have a strong allergic reaction to data. Second, rational models tend to be simple and elegant with precise predictions, while behavioral models tend to be complicated, and messy, with much vaguer predictions. But look at it this way. Would you rather be elegant and precisely wrong or messy and vaguely right?[10]

If I am correct, the traditional economic paradigm does not provide a basis for understanding economic phenomena well enough to comprehend why economies like Uruguay and Argentina "lost their way" and why many others, capitalist and socialist, are having more economic problems than would have been expected. A modified, more behavioral analysis is being constructed, and I hope that this study, when completed, will contribute to that, and in the process, contribute also to the industrial restructuring of Uruguay. Despite important differences, the approach of this study and of behavioral economics has some elements in common with the development of neoclassical economic analysis, one of which is that like the work of the late nineteenth century English and Austrian economists, these, too, attempt to incorporate into economic analysis, contemporary findings from the field of psychology.

---

10 Richard H. Thaler, The Winner's Curse, Paradoxes and Anomalies of Economic Life (The Free Press, New York, 1992) p. 198.