

A Manifesto for Economic Reform in Argentina

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Despite abundant evidence that the economic policies of the last several months have been highly destructive, the government has persisted with them. Argentina's economy and political system are being ground to dust. How the resulting social upheaval is resolved will determine the shape of Argentine society for a generation or more.

The basic question Argentina has been unable to resolve since the 1930s is what type of economy it should be. Should it be a business oligarchy? Mercantilist? Fascist? Socialist? Populist? These possibilities have been tried in Argentina and elsewhere and have failed. Our recommendations are based on the assumption that most Argentines will eventually conclude that they want a market economy. They may unfortunately have to suffer much more pain experimenting unsuccessfully with other systems before they reach that conclusion. Developing the social consensus in favor of a market economy is a hugely important task, but we will say no more about it because the area in which we have the most to contribute is describing what economic reforms are desirable once the consensus in favor of a market economy exists.

We describe the policy goals that we believe will provide the most economic good for Argentina. A number of intermediate steps may be necessary to reach the goals, but what those steps will be will depend heavily on the economic and political situation, which is changing fast. We have already offered [diagnoses and detailed prescriptions](#) based on the specific circumstances of late last year and earlier this year. For now, it is more worthwhile to think about what the long-term outcome should be and what course should be followed to reach that outcome. We limit our discussion to those items that we deem to be necessary for survival, stabilization and recovery. Our focus is, therefore, on the "big ticket" items because it is precisely during periods of upheaval that far-reaching changes become possible most quickly.

Overall goal

Sustained and widely diffused economic growth through the application of a market economy, the only system that has ever been successful in providing such growth.

Principles

1. Respect for private property and for contracts. In the case of Argentina, this means restoring badly damaged confidence.
2. Government limited to those tasks it can perform competently.
3. A sound and trustworthy currency.
4. A solid financial system.
5. A simple tax system with low tax rates.
6. A government budget that over the business cycle is balanced or in overall surplus.

Timetable

When the opportunity for economic reform arrives, probably not until some months from now, the most urgent task will probably be to re-establish a stable currency. That can be done almost immediately, by dollarization. Taxes and the budget will be next. The problems of the financial system will probably have been "solved" by inflation. It is likely that the financial system will have been reduced to a low base, as it was in 1991, and therefore we do not expect the financial system to be as urgent a matter as the currency. However, should the opportunity for economic reform arrive in days instead of months, the problems of the financial system will be more pressing and may be as urgent as the currency problem.

Currency (for immediate action)

A bad currency hinders trade. Nobody wants or trusts the peso; everybody wants and trusts the dollar. Dollarization is the only monetary policy that makes sense. Note that dollarization would not prevent people from using other currencies if they wish; it will simply eliminate the peso and allow Argentines to use the dollar officially, which is what they have demonstrated they wish. We propose these steps:

Officially dollarize.

- Retire from circulation all notes of the Banco Central de la República Argentina (BCRA) and all deposits at the BCRA; replace them with dollar assets. It may be possible for the BCRA to do this through administrative action, even without an official dollarization law. However, a law would make dollarization more secure.
- Allow coins in circulation or already minted to continue, if they have not already been inflated out of circulation. However, new dollar-denominated coins should only be issued by the U.S. Federal Reserve System or by banks.
- Reform the central bank to strip it of all monetary policy functions and leave it only as a superintendency of the financial system.
- Allow banks to issue notes (paper money) denominated in dollars.
- Convert peso interest rates into dollars (desagio).
- Under dollarization, there is no domestic currency that needs to be supported with exchange controls, so exchange controls can be abolished.

Taxation and government accounting (for action immediately or in the short term)

The longer the current crisis lasts, the more likely it is that the government will be financing itself mostly with inflation. Economic stabilization will present an opportunity for increasing revenue while at the same time cutting tax rates and drastically simplifying the tax system. We propose the following steps:

- Drastically simplify the tax code. The federal tax code should have at most four kinds of taxes: (1) A tax of 20 percent on gross unadjusted personal income, to replace the current income tax and social security tax. This tax should begin with the first dollar of income and have no exemptions and no deductions — in other words, a flat tax. (This tax does not include private pension contributions.) It would be desirable later to reduce the rate towards 15 percent. (2) A value-added tax of 10 percent that has no or almost no exemptions (again, a flat tax). There would be no need for a separate tax on corporate income since a comprehensive value-added tax collects money from the same stream of revenue. (3) If necessary for revenue, excise taxes on petroleum products, alcohol, and tobacco. (4) If necessary for revenue, customs duties not exceeding 10 percent. The peso has depreciated so much that Argentine producers need no "protection" from foreign competition (which, in any case, would be at the expense of consumers).
- Combine a much simpler tax code and lower tax rates with better enforcement (see below).
- Introduce a transparent fiscal framework for the federal and provincial governments, including published balance sheets and income statements using an accrual basis (not the current cash basis); annual audits by outside firms; and adherence to generally accepted accounting principles.
- Make the provinces more responsible for their own tax revenues; use the threat of provincial bankruptcy to get them to agree to changes in revenue sharing (coparticipation).
- Give priority to repaying domestic debt; repayment of foreign debt will have to wait until the economy begins growing again.

Government spending (for action in the short term)

The government budget needs to be thoroughly re-examined. Here are some initial ideas:

- The single largest item in the government budget is pensions, and the biggest potential savings are to be had by reforming the pension system (for example, preventing a minority of recipients from receiving "gold-plated" pensions at taxpayer expense).
- Cut defense spending: Argentina is at peace with all its neighbors.
- Cut intelligence spending: Argentina is not fighting guerillas and is highly unlikely to be a target of terrorists.
- Cut the budget of the Congress (a unicameral legislature would make this easier).
- Increase audits of taxpayers substantially. Shift suitable government employees who are redundant in other ministries to auditing and tax collection, where they have the potential to increase revenue. Note that this recommendation depends on a previous drastic simplification of the tax code; increasing audits with the current code would simply perpetuate the popular feeling that the tax code is arbitrary and unjust.
- Maintain spending to provide subsistence to heads of households.

The efficiency of public universities, as measured by their graduation rates, is low. Universities should admit fewer students; the money thus saved should be used to ensure that elementary and secondary students actually learn what they are supposed to learn.

Budget procedures (probably a longer-term project)

- Require the Congress to have a supermajority (60 or 67 percent) to approve any new taxes, increases in tax rates or tax bases and increases in the level of government debt during peacetime.

The financial system (a mixture of immediate and longer-term action)

We assume that economic reform will not occur for some months, and that when it does happen, the financial system will have been reduced to an extremely low level, as it was by 1991. The freeze of bank deposits (corralito) will have been resolved through inflation, bank failures, and government ownership of most of the banking system. Having been robbed of their savings three times in 20 years, Argentines will not trust onshore banks. Lending will only return slowly, because lenders will be afraid of a repeat of pesofication. We propose these steps:

- If the problems of the banking system have not yet been resolved, there will be a need to separate the system into two parts: the system of payments for current activity, and long-term savings. The payments system needs to be unquestionably solvent and liquid so as to avoid economic paralysis; savings will not be liquid and in some cases not even solvent.
- Remove minimum liquidity requirements immediately.
- Remove interest-rate ceilings immediately.
- Allow or even encourage "offshorization" of the banking system — immediately, if possible. The idea here is to allow a type of competition that will help preserve the property rights of depositors.
- To the extent possible (which may be almost zero), reverse the damage from pesofication of deposits — this will be a longer-term undertaking.
- Sell government-owned banks — a longer-term undertaking.

Unemployment and labor law (a mixture of short- and longer-term action)

The long-term solution to unemployment is rapid economic growth. Even economies that have institutions hindering flexibility in their labor markets can reduce unemployment to low levels if they grow fast enough. For example, Ireland reduced its unemployment rate from 15.6 percent in 1993 to under 4 percent in 2001. Over that period, its real GDP growth was roughly 9 percent a year. With more flexibility in labor market institutions, unemployment can fall even faster.

- Reducing tax rates will reduce the cost of hiring employees. Argentina's "tax wedge" on labor (the difference between what the employer pays and what the employee receives) has been estimated about 42 percent for a worker who is single, versus 31 percent in the United States.
- Eliminate penalties for firing employees. Where firing employees is costly, employers are less willing to hire permanent employees. If eliminating the penalties immediately is not politically feasible, eliminate them first for net additions to employment. (So, if an employer has 50 employees on a specified date and then hires new employees, the 50 employees with longest seniority are covered by the penalty scheme and all remaining employees are not.) Establish a target unemployment figure (say, 8 percent) that will trigger complete elimination of penalties.

Other (a mixture of short- and longer-term action)

- Price controls — Remove price and quantity restrictions that attempt to dictate where and at what price producers of petroleum and other products can sell their goods.
- Legal system — Allow parties to business transactions to agree in advance to binding arbitration not subject to further review by Argentine courts. The purpose here is to make settlement of legal disputes more efficient.
- Private pensions — Allow or even encourage "offshorization" of the pension system, immediately if possible.
- Personnel — Entrust management of the reform program to people who believe in it, to avoid some problems

Ecuador encountered with its dollarization and other reforms.

Argentina, the IMF, and other international organizations

Our proposals do not depend on Argentina receiving loans from the IMF. The IMF's advice to Argentina in the last few years has been bad. Receiving the IMF's approval could be helpful for Argentina to gain access to other foreign credit. However, we recommend that Argentina not increase its current level of IMF borrowing: the risk is too great that as conditions for further loans, the IMF will require policies that are counterproductive. In the extreme case (which we hope can be avoided), Argentina should be prepared to default rather than accept IMF recommendations for new tax increases and other policies that will throttle the economy.

Presented to Dr. Carlos Menem, former President of Argentina, on June 11, 2002 at a meeting held at the Cato Institute, Washington, D.C.