

Executive Summary

REGULATIONS & STAGNATION:

**the case of
argentina**

**FUNDACION DE
INVESTIGACIONES
ECONOMICAS
LATINOAMERICANAS**

International Center for Economic Growth

— *Executive Summary* —

Regulations and Stagnation

The Case of Argentina

Fundación de Investigaciones
Económicas Latinoamericanas



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Preface

This executive summary sets forth the principal conclusions of the book *Regulaciones y Estancamiento: El Caso Argentino*, which was published in December 1988.* The book, which is the result of an ICEG-FIEL joint research project, evaluates the effects of a set of government regulations on the Argentine economy.

The study was developed under the general supervision of Daniel Artana and Enrique Szewach, chief economists of FIEL, and with the collaboration of Jorge Bogo, Juan Luis Bour, Juan Carlos Iarezza, Carlos Perez Rovira, and Luis Soto. FIEL research assistants and administrative personnel also participated in the study. Other contributors to the study included the Argentine Chamber of Commerce, the Argentine Industrial Association, the Buenos Aires Trade Bureau, the Argentine Rural Society, and the Argentine Business Council.

The book examines the cost of state intervention in some sectors of the Argentine economy. Similar studies of government regulations in other countries have played a fundamental role in deregulation and have contributed to a greater understanding of how such regulations affect the economy as a whole. In its conclusion that regulations can produce high costs of many types, the book reminds us that social costs as well as administrative, compliance, and efficiency costs must be considered when weighing the desirability of instituting, modifying, or eliminating any government regulation. The original study has been widely publicized in Argentina and has had considerable influence on

**Regulaciones y Estancamiento*, available only in Spanish, may be ordered from FIEL, Esmeralda 320, Buenos Aires, Argentina.

policy and public opinion. The International Center for Economic Growth is pleased to have contributed to the publication of the larger study and to sponsor the publication of this executive summary edition.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
November 1990

Summary of Conclusions

An analysis of the various regulations imposed by the Argentine government yields some interesting conclusions and recommendations for improvement.

International experience indicates that world opinion has overestimated the advantages of state intervention in the economy. It is important not only to weigh the costs of intervention but also to work toward designing a more rational regulatory framework. The costs of maintaining regulations may be categorized as follows: administrative costs, compliance costs, and efficiency costs. The cost of any one regulation may be calculated as the sum of the costs of the above-mentioned categories.

This study examines seven areas of regulation and estimates the costs attached to each one.

1. *Labor market regulations* are structured in the form of a rigid legal pyramid, and wage policy has flattened public sector wage scales, creating, in fact, an approximately 3 percent lower rate of return on education than in the private sector. The result has been an exodus of qualified personnel from the public sector and a subsequent deterioration in the average aptitude of the government worker. These regulations have also artificially reduced the demand for temporary employment, decreased the wage of the temporary employee, and overexpanded employment in the public sector (because of the concessions given to public workers).

Recommendation: The deregulation of the labor market should be based on the decentralization of wage negotiations and on the creation of a more stable framework, which can be achieved only through less state intervention in short-term wage policies. The hiring of temporary workers must be eased and the preferential treatments to public workers must stop.

2. *Capital-market regulations* fix limits on stock market commissions, which impede price competition among stockbrokers. These restrictions also add to the cost of buying and selling stock. At the same time, preferential loans and other government subsidies have helped ensure the permanence of closed-stock or family corporations. Furthermore, in addition to the economic instability of the country, the tax code has discriminated against the stock market in favor of public debt.

Recommendation: A 50 percent reduction in fixed taxes and commissions on stock market transactions would result in a 10 percent increase in the amount traded on the market.

Development of the Argentine stock market could be facilitated through several means: legislation for private pension funds; a more neutral tax system; the stabilization of the Argentine economy by eliminating its fiscal deficit; the deregulation of market commissions; the elimination of subsidies given to selected groups of firms; and making the insurance market more flexible by allowing companies to hold a higher proportion of shares from other firms.

3. *Foreign investment regulations* generate a cost of approximately 9 percent of nonautomatic investment. These regulations require foreign investors to receive federal permission to invest in certain sectors of the economy, and impose unnecessary paperwork and delays. Reinvestment of profits is automatic.

Recommendation: It is necessary to eliminate the discriminatory treatment of foreign investment and to simplify paperwork. A sizable increase in the flow of foreign investment, however, will require a more stable economic environment and the respecting of property rights.

4. *Technology-transfer regulations* place approval and rejection responsibilities with the application authority, whose examination process seems to work rather efficiently, despite a three-month delay that implies an annual cost of approximately \$19 million.

Budgetary costs add up to \$100,000 a year, and the cost of fulfilling the legal requirements is \$500,000.

Recommendation: Some sort of regulation on transfers of technology is needed because of the externalities involved. For instance, it would be desirable to build a device to ease the access to new technological information, because it would reduce search costs.

5. *Regulations on approving new products and quality control* for food are under the jurisdiction of provincial governments. The federal government registers the products and oversees compliance with the code. The quality control of food production is concentrated in large production companies' because of the lack of resources of government agencies. This reveals a poor allocation of budgetary resources that must be reversed. New pharmaceutical products, on the other hand, must be approved by the Secretariat of Health, which is also responsible for supervising pharmacies and drugs on the market. The average application approval time is thirty months. The cost of this delay is more than \$15 million.

Recommendation: Food policy must be made consistent with the Food Code of the World Codex. The administration of the Health Secretariat should be improved, and import regulations should be revised.

6. *Telecommunications regulations* have established a state monopoly on the industry, in contrast to international trends and to what would be suggested by the evolution of technology. The present Argentine system calls for increasing statism and centralization.

A conservative estimate of the cost to the private sector caused by the inefficiencies of the national telephone company (ENTEL) is approximately \$190 million a year.

Recommendation: To remedy this situation, the rules of the game must change dramatically. It has been proposed that long-distance service be deregulated to permit free competition, at least in some regions, and that local services be regionalized, with privatization and regulation through tariffs (because of its condition of natural monopoly).

7. *Industrial promotion regulations* are governed by the Secretariat of Industry and Foreign Trade (SICE), which authorizes industrial promotion projects. This approval process generally takes three years. Investment secured under this scheme amounted to \$5.9 billion between 1973 and 1987 (14 percent of gross private investment in durable equipment). In the provinces that benefited the most, employment has sharply increased. In general, the number of workers in SICE-approved projects represents only 4 percent of the industrial labor force, and the present value of government expenditures in industrial promotion is equal to approximately 110 percent of the promoted investment.

Recommendation: Only one incentive measure should be implemented on a national scale: a tax deduction. That is, the amount of the investment can be expensed in corporation income tax. Special subsidies should be channeled through the existing federal tax sharing system. The

provinces would be free to transfer these additional funds to whichever companies they decide merit the incentive.

An Overview of *Regulations and Stagnation*

In the past few years, there has been intense debate in Argentina over the efficiency of state activity. The increasing size of the public sector has been associated with an obvious deterioration in the quality of life and poor economic growth and stability.

Rigorous analysis of these phenomena has previously concentrated on state activity or on the public sector's role in the direct provision of goods and services, which in Argentina is undertaken through state-owned enterprises.¹ The necessary emphasis has not been placed on one important aspect of public sector intervention in the economy: government regulations. Indeed, state intervention in the economy is not limited to the tasks of running the government or to supervising the actions of its enterprises; the state also intervenes by establishing regulations, taxes, and subsidies that affect the private sector and can cause serious economic losses to the society as a whole.

Economic analyses of regulations in other countries have taken on great importance in the past few years and have played a fundamental role in the current global deregulation movement. Theoretical discussion on the topic is quite extensive and has been enriched with empirical evidence from several other countries that have adopted deregulatory policies.² International experience clearly indicates that world opinion has overestimated the advantages of state intervention in the economy. A critical revision of the roles of both the state and the private sector in the economy must weigh the cost of government regulations. Recommendations

for change must be free of ideological bias and must contribute to design of a more rational regulatory framework.

Because of the problems involved in obtaining reliable data, even in the developed countries, only approximate estimates of the costs and benefits of regulations could be calculated. For the same reason, research had to be limited to an analysis of individual markets, that is, an analysis that ignores the relationship between the market being studied and other sectors.

The costs imposed by regulations may be classified as follows:

- *Administrative costs:* This category includes the cost of running the administrative agency, including the expenses for personnel, equipment, and operation.

Compliance costs: These are the costs incurred by private economic agents in complying with the regulations issued by the government. They include a wide variety of items ranging from expenditures for the personnel and materials needed to complete the paperwork, to investments needed to provide adequate protection for workers—which can often run into important capital expenditures.

- *Efficiency costs:* Economists refer to these as the net waste of resources caused by market distortions. If the government imposes a tax on the consumption of a certain good, for example, the consumers will suffer the welfare loss that comes from paying a higher price for the same product. The suppliers of the good will also lose because they receive a lower net income. In general, the combined loss to consumers and producers is greater than the revenue to the government. The difference between this revenue and the combined loss to consumers and producers results in a net loss to society. This welfare cost originates in the gap between the price (including tax) paid by the consumer, which represents the value the consumer assigns to another consumption unit, and the price obtained by the producers, which reflects the cost of production. The absence of the tax, therefore, would result in an in-

crease in the production of a good, to which consumers would assign a value in excess of the production cost at the margin.

Regulations can have the same effect as a tax in that they can increase the cost of the final product and generate a loss of efficiency similar to that described in the above example. In this case, both demanders and suppliers will no longer undertake some transactions because regulations have increased the cost of production.

To summarize, the cost of a regulation may be calculated as the sum of the costs of three components: (1) those of administering the regulation, (2) those involved in complying with the regulation, and (3) those derived from the loss of efficiency. These costs must be compared with the benefits of the regulation in order to know whether government intervention is justified. In other words, even when a market failure makes it necessary to introduce a regulation, given that the regulation has some cost, a cost-benefit analysis must be made to determine whether it is worthwhile.

The possibility of conducting an exhaustive analysis varies in each case and depends mostly on the amount of available data. This study attempts to calculate at least one of the costs described above for each of the regulations it analyzes.

It should be pointed out that this study emphasizes the cost of the regulations selected for analysis and not the design of proposals to reform any of these areas. Nevertheless, guidelines for modifying or rescinding the regulation are offered as a way either of increasing efficiency or of complying with the regulation or its objective at a lower cost to society.

The first step in the research was to select the most relevant government regulations for analysis. A survey was taken among private firms in order to pinpoint the regulations causing the greatest damage, in the opinion of those most affected by them.

In designing the questions for the survey, the term *regulation* was used in its broadest sense, so that a variety of government interventions (taxes, subsidies, regulations, etc.) could be included, and because from an economic point of view, the consequences of such state policies are very similar. For example, a smaller inflow of foreign invest-

ment may be caused by tax differentials or bureaucratic obstacles, but the effect of both regulations is the same: a reduced flow of capital as the cost of investing in the country becomes more expensive.

This survey of the private sector helped select the following sets of regulations for evaluation: regulations covering the labor markets; capital markets; industrial promotion; foreign investment and transfer of technology; telecommunications; and the systems for approving new products and carrying out quality control. These items were selected so as to include general regulations with the potential to affect all economic sectors, regulations on specific sectors (telecommunications and industrial development), and regulations on certain types of firms (foreign investment law).

At the same time, the relative importance that Argentine society assigns to a given regulation was also taken into account. The following areas, for example, either have been recently modified or are under consideration for reform: labor legislation, industrial development policy, the telecommunications industry, the transfer-of-technology laws, and capital market regulations.

Labor Market Regulations

Argentine labor legislation is structured in the form of a pyramid, that is, firm level agreements must fit into the framework set up by more general regulations, which are highly restrictive. The Labor Contract Law determines the minimum conditions required for hiring a worker. These dispositions enacted by the above-mentioned law cannot be modified by mutual consent. Unfortunately, this law does not consider differences in firm location, temporary employment possibilities, or any other special circumstances, even when they might increase employment and productivity levels.

Argentine wage policy of the past few decades has been characterized by its instability and by the flattening of public sector wage scales. The ratio of the maximum wage to the minimum wage in the federal government for example, reached an average of 7.7:1 between 1973 and 1983; this ratio went down to 5.1:1 in 1987.