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**Jorge C. Avila**

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Economic Denationalization as an Antidote against Populism

Jorge C. Avila<sup>1</sup>

Introduction

Populism and Latin America, especially Argentina, are very good friends. Since the Great Depression, a shock from which the country has been unable to recover, Argentina is a classic example of Populism. Her economic decline for the last eighty years attests in this sense. As Populism is a hybrid of interventionist policies that go away and come again according to circumstances, in the long run, this non-system is possibly more harmful than Socialism. Public opinion becomes too baffled to find Populism guilty of economic failure.

My question is this: How do we set a limit to Populist economic policies? International experience suggests that denationalization of key economic fields may prove a durable limit to Populism. In the following paragraphs, I will discuss a) the origins and consequences of Argentine Populism, b) a program for denationalization, c) the ideas of an Argentine forerunner of denationalization, d) denationalization as an experiment in human design, e) the need of non-reversible policies or the economic logic of denationalization, and f) the role of education in moving from Populism to a long-lasting market order. I will conclude, in the final paragraph, that the role of education as a change factor is unclear.

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## I. Argentine Populism: Ways and Results

Though the Argentine economic decline has become a classic reference, let me make just a few remarks to add perspective. A century ago, the economic organization of this country was one of the most liberal and efficient in the World. Argentine prosperity was founded on three pillars: openness to trade, gold standard, and fiscal federalism (Ávila 2011, II, 37-45). Exports were a large fraction of GDP, mortgage loans were half the GDP, and Provinces collected almost all their revenues by themselves. British railway capitalists demanded no risk premium for the huge investments they were sinking in the country, and per-capita income was the same as the Anglo-Saxon average (USA, Great Britain, Australia, and Canada).

In 1930, international circumstances forced Argentina to abandon the Anglo-Argentine Treaty for Amity, Trade and Navigation that was the legal foundation of Anglo-Argentine trade and investment for more than a century (Ferns 1966). We think the Great Depression was the triggering factor of a regime change that led the country to commercial autarky and political isolation. In a few years, Argentina lost her historic bond to Britain, a superpower at that time, and found herself pushed to the outdoors.

Around 1935 the country's economic organization changed dramatically. In the coming decades Argentina would become a very closed economy (only more open than Brazil and Iran), experience a classic hyperinflation, several banking panics and two defaults on her debt with the resulting highest country-risk premium of the World for a thirty-years period (ten percentage points per annum on average); at the same time, the country would convert into a unitary state from the fiscal standpoint. In the last years, Argentine per-capita income has fallen to forty per cent of the Anglo-Saxon average (Ávila 2012, II).

Populism has reached its maximum possibilities in present day Argentina. There is no real limit to currency devaluation, beyond the political cost of uncontrolled inflation (bank runs are unlikely because banks are not trustworthy and deposits are pretty low); there is no real limit to trade interference, in spite of Mercosur, and there is no limit either to the power of the President over provincial governors due to political management of federal funds.

Populism generally involves tinkering with property rights, through nationalization when property is given up with or without proper compensation, or through policies leading

to sizable changes in the market value of affected property. Argentina has undergone both types of violation of private property. There is no difference between them as to their long-run impact upon capital accumulation and growth. Recent examples of the first kind are the nationalizations of pension funds and water utilities; recent examples of the second kind are very frequent currency devaluations, freezing tariffs of public utilities, banning of meat and wheat exports, and so on.

## II. Denationalization in Practice

An economic organization founded on protectionism, central banking and fiscal centralism, all leading to nationalism and international isolation, should be considered one of the basic causes of Argentine Populism over the last eighty years. This kind of organization is prone to Populism due to its intrinsic unaccountability and reversibility. In this setting, Presidents tend to deal not with Congress, powerful governors and foreign powers but with local interest groups, provincial beggars and peripheral countries. An organization like this entails a low cost of repudiation of the rules governing the economy. In turn, a low cost of repudiation entails a high probability of reversion of economic rules and consequently a high country risk premium. Through this process, Populism ends up hindering investment, productivity, and growth, apart from federalism and basic civil liberties.

The Argentine case is a good example of path dependence. The Great Depression meant two things for the country: the demise of the Anglo-Argentine Treaty and the loss of key export markets. The consequences of these facts were political isolation and protectionism. In a few years, international trends and political isolation led to foreign exchange controls, central banking, and nationalization of tax collection. In this way, a regime characterized by unaccountability and reversibility was born. Migué (1993, 59) pointed out in this sense that “broad historical trends... are consistent with the thesis that spending and regulatory instruments can be more easily employed on a large scale when trade barriers are steep.”

A proposal to establish a limit to Populism consists of taking away from the jurisdiction of the national government the key fields of international trade, money and banking, and tax collection. Regarding trade, denationalization means to place foreign trade under the jurisdiction of a free trade agreement with a superpower. For instance, an FTA with the

USA would force the Argentine government to comply with a definite tariff structure and common rules regarding intellectual property, protection of investments, official supplies, the environment and the labor market. Thus, to denationalize in this field is equal to *supra-nationalize*.

Regarding money, denationalization means to substitute a world reserve currency for the national currency. Regarding banking, it means to place local commercial banks under the same jurisdiction as foreign resident banks.<sup>2</sup> To denationalize in this field is equal to *internationalize*.<sup>3</sup>

Regarding public finance, denationalization means to decentralize the collection of tax revenues. This involves making provinces accountable for collecting most revenues so that political power is effectively divided. To denationalize in this field is equal to *provincialize*.

The only purpose of denationalizing foreign trade, money and banking is to make sure that key areas of the economy remain safe from the discretion of the Argentine jurisdiction. The really high cost of repudiation of supranational and international agreements should discourage interventions of the national government in those areas. In this way, the country-risk premium should go down and capital accumulation within national borders should go up.

The goal of denationalizing tax collection is to restrict the power of central government. Think that 24 small Populist governors should be less harmful than a domineering Populist President. Tax competition among provinces should lead to lower taxes, better spending, and more effective democracy.<sup>4</sup> We must warn nevertheless that the reversion cost of tax decentralization is low. Why? Because the recreation of a centralized system by a future government won't involve a repudiation of international agreements, that could stigmatize and isolate the country.

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<sup>2</sup> Central banks of foreign commercial banks become the lenders of last resort of local banks, and local banks comply with the regulations established by foreign surveillance authorities.

<sup>3</sup> Benegas Lynch Jr. pointed me out that the fundamental benefit of the existence of nations and frontiers is to decentralize power. I agree. Let me add that supra-nationalization and inter-nationalization entail transferring jurisdiction from the government of the Populist country to many supra-national treaties and many bodies of surveillance.

<sup>4</sup> North and Weingast (1989) have argued that “de facto federalism” was behind the vast expansion of British enterprise in the 18<sup>th</sup> century. “The fragmentation of power between the king and the Parliament effectively prevented the national government from imposing taxes and regulations on commercial enterprises and (...) such governmental activity occurred instead at local levels. Not only did the localities impose most taxes and regulations, but they were actively engaged in competition with one another for commercial advantage; as a result, taxes and regulation remained relatively light.”

### III. Alberdi and the Cost of Repudiation

My thesis is not new. Friedrich Hayek (1978) wrote a proposal for denationalizing money, which I have enjoyed reading though it does not fit altogether in the Argentine history of institutional reversibility. Juan Baustista Alberdi (1854), the 19<sup>th</sup> century Argentine social thinker, wrote perceptively on the stabilizing influence on domestic institutions of treaties with superpowers (Britain, France, and the US at his time):

“We must sign treaties to surround with equal immunity every ship, every railway, canal, wharf, factory, where waves the flag of the friend nation to which belongs the one who exploits those industries, making use of the civil right consecrated by the Constitution. (...) This will be the only way to preserve them from the dangers of the unending civil war; that is, to attract them from abroad, to fix them to the country, and to get a fall in the interest rate by way of reducing the risks that make it soar.”

Our “shining city in the hill” would take the form of a confederation of small provincial republics, active player in world trade and investment thanks to treaties with superpowers, with a currency and banking system imported from the “islands of stability” of the World. Would Alberdi have approved of this picture? There is evidence that he would have done so regarding the trade side of the picture. On the money and banking side, though he didn’t write down any specific preference, we think that after learning about a system that led to hyperinflation and repeated banking restrictions, he would have shared our view on this matter. Now, on the fiscal side of the picture Alberdi did have a specific preference. Since the challenge at the time he wrote was to create a central government, he preferred to build a strong federation. Nevertheless, after 150 years of growing concentration of political and financial power in the hands of the central government, we think that he would have revised his view on this matter. Better than most Argentine thinkers, Alberdi knew that for a city to shine the Leviathan has to be restrained.



#### IV. Non-Reversible Policies

A good policy is a necessary condition for capital accumulation. The sufficient condition is a good and non-reversible policy. Regarding trade reform, the successful British (1846) and Chilean (1973-2003) unilateral openings are the exceptions that prove the rule, while the successful forced Japanese opening (1950s), the successful supra-national Spanish opening (from the 1970s on), the successful bilateral Mexican opening (from the 1990s on), and the successful bilateral Argentine opening (1862-1930) are the rule itself (Ávila 2011, II). Rodrik (2000) stresses that a trade reform often involves importation of institutions from abroad, adding that “perhaps the major NAFTA contribution to the Mexican economy was the factor of irreversibility and locking in of the economic reform that the agreement provided.”

Reversibility, repudiation cost and country-risk point to the same idea. Because of its low expectations of reversibility we think that a supra-national trade opening is superior to a unilateral one from the economic point of view. When investors perceive a low degree of reversibility, the process of resource reallocation, from the import-substituting sector to the export sector, speeds up and foreign investment jumps.

The same argument makes advisable the denationalization of money and banking in the unstable and Populist country. For Argentina a floating exchange rate policy is a dangerous thing and convertibility of the local currency is doomed to reversion. What is left, then? Dollarization should be the appropriate policy. It is nevertheless rejected by every politician I know even when Argentina is the fourth most dollarized country after Bolivia, Nicaragua and Russia, which also underwent hyperinflation, bank runs, civil unrest or civil war (Feige 2003, Feige et al 2000, 2002). Euroization may be an attractive option for an anti-American country like Argentina.

Five banking panics in the last thirty years, the low level of deposits in resident banks and the sizable deposits of Argentine residents in Uruguayan and American banks attest to the suitability of an offshore banking system. Not only to foster savings but also to recreate long-term credit to resident families and firms.

## V. Is Denationalization an Experiment in Human Design?

According to Hayek (1988, 7, 76-77) the “spontaneous extended human order created by a competitive market” is more efficient in creating wealth and preserving civil liberties than the “deliberated arrangement of human interaction by a central authority.” Hayek calls the latter human design. Yet in the last thirty years we have witnessed a portentous exercise in human design: Spain has become a member of the European Union. Spain and the rest of the EU have free trade in goods and services, free mobility of labor and capital resources, a common currency, and, I’ll dare to say, even a common banking system. The Spanish risk premium has thus fallen sharply, triggering the Spanish economic miracle.

The EU has denationalized trade, money and banking, while preserving a decentralized collection of taxes. Let’s focus on the challenging replacement of the Spanish peseta for the euro, the common currency whose rate of expansion is controlled by the European Central Bank. Hayek (1978, VIII to XV) opposed the creation of a common currency, suggesting instead the development of a competitive, transnational, private money and banking system. What monetary and banking arrangement is better for the Populist and unstable country? Hayek (ibid, 96) discarded his own proposal for the case of a Populist country:

“Many countries would probably try, by subsidies or similar measures, to preserve a locally established bank issuing a distinct national currency that would be available side by side with the international currencies, (...) There would then be some danger that the nationalist and socialist forces active in a silly agitation against multinational corporations would lead governments, by advantages conceded to the national institution, to bring about a gradual return to the present system of privileged national issuers of currency.”

The Hayek system has but a small chance to settle down in a Populist country, because that system is fundamentally reversible. That’s why we prefer to import money and banking institutions from abroad. Being the Hayek system the outgrowth of a competitive process of discovery, it should be more efficient than the denationalization of money and banking. Yet the latter appears to be more stable. The general argument of Hayek is valid for Socialism.

Not much for Populism. This non-system wouldn't allow competition the time needed for the discovery process to produce its fruits.

#### VI. How do We Get from Populism to a Lasting Market Order?

The traditional answer to this important question is education. Plain observation led me not to believe in the power of education as a source of economic growth. I think education is a consequence, not a cause, of growth. Douglass North (1993, 1994) wrote two revealing passages on this question. The first one says that education is not a sufficient condition for growth and highlights the need for efficient institutions.

“Richard Easterlin’s presidential address to the Economic History Association in 1980 reflected the widespread optimism that education was the solution for economic growth. But while investment in education may be a necessary condition, it is clearly insufficient, as the recent evidence from third world countries and particularly Eastern Europe economies will attest. Easterlin’s own data (and his discussion) point to poor countries such as Rumania and the Philippines that had long histories of educational investment above the threshold level that he thought would make a difference but did not result in sustained growth; the former Soviet Union had both high levels of formal education and a skilled labor force. Equally important are the incentives which lead economic and political organizations to invest in productive institutions.”

The second passage says that economic decline not necessarily induces perceptions leading to appropriate reforms in the ruling classes of the affected country.

“But it is a fact of history; one of the most enduring and significant lessons to be derived from the past. It is not that economies in the past have not been aware of their inferior or declining competitive positions. They have. But perceptions about the reasons are something else again. Spain’s long decline in the seventeenth century from the most powerful nation in the western world since the Roman empire to a second rate power was a consequence of recurrent war and fiscal crises. The policies that were considered feasible in

the context of the institutional constraints and perceptions of the actors were price controls, tax increases and repeated confiscations. As for the perceptions of the actors here is Jan De Vries description of the efforts to reverse the decline: *‘But it was not a society unaware of what was happening. A whole school of economic reformers... wrote mountains of tracts pleading for new measures... Indeed in 1623 a Junta de Reformación recommended to the new king, Philip IV, a series of measures including taxes to encourage early marriage (and hence population growth), limitations on the number of servants, the establishment of a bank, prohibitions on the import of luxuries, the closing of brothels, and the prohibition of the teaching of Latin in small towns (to reduce the flight from agriculture of peasants who had acquired a smattering of education)...’* As the foregoing quotation makes clear there is no guarantee that economic decline will induce perceptions on the part of the actors that will lead to reversal of that decline, improving performance.”

We know that education increases individual productivity and the standard of living within an efficient institutional setting. Yet for the Populist country the key question is whether or not education influences perceptions in a way conducive to a long-lasting market order. North’s observation on Rumania and the Philippines and the absurd policy suggestions of the educated members of the seventeenth-century Spanish think tank, raise serious doubts on the usefulness of education to identify the causes of national economic failure.

## VII. Concluding Remarks

We have provided an answer to the question posed at the beginning: yes, we can establish a limit to Populism through denationalization of key economic fields. We have also advanced possible ways to achieve this goal: tax decentralization, which brings the citizen closer to government decisions and heightens political competition; supranational trade agreements, which make local industry face foreign competition in a way perceived as irreversible by entrepreneurs and investors, and the importation of money and banking institutions in view of its relative stability.

As far as I know, there exist three ways to move a Populist country to a long-lasting market order. First, most reformers are strong believers in the potential of education. They

think that educated people will make better choices on the economic organization of the country. We think this is a daring hypothesis. Second, following specially North (1996, 10-11), most economists think that the economic reform might be the outcome of a revolution; that's to say, the result of a conflict between organizations with different interests over the existing institutional framework. Some Argentine economists and historians argue that this hypothesis was proved right for this country in the 19<sup>th</sup> century. It didn't work, however, in the 20<sup>th</sup> century. Populism has been able to thrive in the last eighty years mainly because of the dispersion of the export sector's political power and also because of 'path dependence.'<sup>5</sup> Last but not least, we've got a default hypothesis: the way of the World. It says, in short, that Argentina is the problem and the World is the solution. In this final case, the reform would take on the shape of international and supranational agreements, reflecting a mix of World and regional pressures and opportunities.

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<sup>5</sup> The country's terms of trade (or the incentives for the exporting sector to lobby for trade liberalization) have not been really high during this period. For this reason, we shouldn't dismiss the possibility that many years of high terms of trade may prompt the kind of conflict that eventually would lead to economic reform.

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