

Simon Bolivar's Babies: Industrial Regulation as a Cause of Failure in South America

South America is a place of some mystery to many Australians. We have little shared history, culture, geography or language, and as such, we have largely operated in a parallel universe to them.

It therefore often comes as some surprise to Australians to learn that the vast bulk of the South American continent has experienced political independence for nearly 200 years (longer than Australia, New Zealand, Canada, Germany, Italy or China) and a century ago was a very wealthy region of the world. Per capita wealth in Argentina was the highest in the early 20th century.

Where it all went wrong is beyond the scope of this paper and, to be frank, is not a focus of the HR Nicholls Society. However it is generally accepted by just about all experts that the fault lies with a toxic mix of the failure of political institutions and economic populism (read: socialist policies).

Yet sadly, South Americans still don't seem to have learned all their lessons. Some of the dictators may have disappeared, but economic populism is as rampant as ever. Perhaps the two most glaring examples of this today are Argentina and Venezuela.

The Argentine default of 2001, for example, was blamed on the free market (as though capitalism were to blame for the government racking up gigantic budget deficits) and even Chile, the most recently successful economy in South America, is about to succumb to the false utopia of "free" tertiary education.

Unsurprisingly, the populist programs in both Argentina and Venezuela include massive regulation of the labour market.

Argentina

Argentina was largely built by the British. The two countries formed close diplomatic relations in the early 19th century out of Britain's geopolitical rivalry with Spain and the Argentines were only too happy to accept their support. At one point in the late 19th century, a full 10% of all British investment was in Argentina. By 1939, 39% of all money invested in Argentina came from British sources.

Harrods even opened a store in Buenos Aires in 1912 – the only store they have ever opened outside of London (the store still exists but ended its association with Harrods in the 1940s). Argentines were so influenced by the British that they took up the practice of taking afternoon tea and began to play soccer. It was as close a country ever came to being a British colony!

Needless to say, Argentina was flourishing. In 1909, per capita income in Argentina was 50 percent higher than in Italy, 180 percent higher than Japan, and almost five times higher than in neighbouring Brazil. Over the course of the 20th century, Argentina's relative standing in world incomes fell sharply. By 2000, Argentina's income was less than half that of Italy or Japan.

In its heyday, Argentina thrived as a trading giant of beef and grain. It is still widely recognised today that the extremely fertile Pampas region produces some of the world's best quality agricultural products. They had a natural competitive advantage in this area, and

not having participated in either world war, they were very well placed to take advantage of an export-driven growth model to supply the reconstruction and starving masses in post-war Europe and Asia. Instead they turned inwards.

Essentially the rot started with the election of Hipolito Yrigoyen as President for the second time in 1928. In his first term from 1916 to 1922, Yrigoyen had proven himself to be very socialist. He regularly ruled in favour of trade unions and in 1922 recognised the Soviet Union and sent them foreign aid. This frightened the hardline conservative generals, whom by the late 20s had become enamoured with the Fascist ideals of Mussolini. Once the Depression hit in 1929 and Yrigoyen became increasingly unpopular in the face of rapidly rising unemployment, a group of generals led by Jose Felix Uriburu took the chance to launch a successful putsch.

Argentina never saw real democracy again until 1983. The Uriburu coup set off a chain of military takeovers and bogus elections, some of which saw General Juan Peron take the reins of power – and he fashioned a dark legacy that lasts to this day.

Peron may have been a military strongman, yet he was also a national socialist. There is very little in the ideology of Peron that differs from fascism, but for the overt racism. Peron's own name for his movement was the "Justicialists", which is a derivative of the Spanish word for 'social justice'.

Trade barriers went up and massive welfare programs were established. In 1929 total foreign trade in and out of Argentina accounted for 80% of total domestic tradable production and it had been as high as 120% in 1909. By 1976 this had fallen to 19% and even today is only about 30%. Peron's appeal was that his reign coincided with the magical post war boom that all economies benefitted from, so in the harder years that naturally followed, a sense of nostalgia built up around him and his policies. It remains one of the greatest examples of why correlation does not necessarily mean cause.

Nestor Kirchner was a Ph.D. student from Buenos Aires in the late 60s who found himself attracted to Peronism. He joined the Peronist Youth (who made it known that Che Guevara was their hero) and Peron actively championed this group. A few years later he became the governor of a far-flung Patagonian province and was run in the 2003 Presidential election as a stalking horse for Eduardo Duhalde, who was attempting to thwart the liberal Carlos Menem from winning another term by splitting the Peronist vote.

Despite only winning 22% of the vote, Mr Kirchner was surprisingly elected after Menem withdrew from the race before the scheduled run off. His wife, Cristina Fernandez Kirchner, later became President herself from 2007, amassed a personal fortune in office of \$70m and has recently begun a campaign of asset nationalisations. So it's fair to say that the Kirchners are not known for their liberalising tendencies.

Kirchner introduced the *Labour Law No. 25,877* (Argentines number their laws chronologically) in 2004. When read in conjunction with the *Employment Contract Law No. 20,744* (introduced by General Videla in 1976) the following aspects of Argentine labour law really stand out for their inflexibility:

- Illegal to work more than an average 55 hours per week
- Casual employment is illegal;
- Social Security payments (17% from employee, 27% from employer);
- Compulsory life insurance premiums
- Compulsory six monthly bonus of two week's pay;
- 15 days' notice of termination during probationary period. One month's notice up to 5 years of service. Two months' notice beyond that.

- Severance payments are one-third of the time served by an employee (e.g. an employee of six years' service must receive severance of two years pay) and must be paid within 4 days
- Paid sick leave of up to 12 consecutive months (dependent on length of service), even if an injury was picked up outside of work
- 17 public holidays
- Contracts are reviewable at any time, even if agreed in writing, should a condition cause "moral harm" to an employee
- Collective bargaining unobtainable for non-union members
- Union delegates cannot be dismissed, no matter the reason, either during their term as delegate or for one year thereafter
- Financial penalties for incorrectly recording employee payroll data accrue to the said employee (e.g. misspelled addresses)
- Dismissal with cause can only be for reasons "offensive or prejudicial" to the employer. This does not include poor performance, though it does include tardiness.
- Damages for unfair dismissal include exemplary damages for emotional stress.
- If you wish to make more than 15% of your staff (or 5% where you have more than 1000 staff) redundant, you require personal approval by the Minister of Labour.
- Minimum wage of US\$8.70/hour (compared with UK \$8.76, Brazil \$2.18, Chile \$3.02, Uruguay \$1.77, Colombia \$2.18, Ecuador \$3.96, Hong Kong \$3.98, Czech Republic \$3.29, Russia \$1.81 and Mexico \$0.89) which is 120% of average GDP per head.

This means that the effective hourly rate to employ an Argentine is about \$13/hour, or \$25,700 per annum. But GDP per head is only \$18,000.

Venezuela

The recent history of Venezuela is quite well known, owing to the infamy of the recently deceased dictator, President Hugo Chavez.

Venezuelan GDP peaked in 1977 (the Second Oil Crisis) and has been going backwards ever since. In the last two decades particularly, GDP per capita has grown on average by just 0.8% p.a. compared with the global average of 2.1%. Most of this sclerotic growth can be blamed entirely upon Chavez and his disbelief in the virtues of markets.

Chavez was born to a very poor family in the remote inland regions of Venezuela. He was of mixed racial heritage and had a forebear who had famously fought as a rebel against the ruling clique many decades earlier. Everything about young Chavez marked him as an outsider and he embraced this and gravitated towards other outsiders, such as radical socialists.

Chavez joined the army at age 17 because he thought it may enable him to get a start to a baseball career he always dreamed of. Instead he made the early acquaintance of some Panamanian cadets who had participated in a recent revolution in that country. This very much appealed to Chavez's ambition to disturb the accepted order. He became committed to a military career as his ticket to power.

After a failed coup in 1992 that he served time in prison for leading, Chavez opted to change tack by establishing a political party and claiming he was a democrat. His timing was good. The oil dependent Venezuelan economy was suffering in the late 90s from low global oil prices and his brand of opposition to the existing order proved popular. He was elected as president in 1999 and immediately commenced a program of nationalisations - everything from the big state oil company, down to manufacturers of steel reo bar - immense welfare spending and packing the judiciary and government with his supporters.

Chavez also imposed a new *Constitution of Venezuela* to cement his authority, and this document is a very comprehensive and prescriptive list of socialist “rights”, such as these specific to industrial and labour issues:

“Article 90: Working hours shall not exceed eight hours per day...”

“Article 91: ...The State guarantees workers in both the public and the private sector a vital minimum salary which shall be adjusted each year, taking as one of the references the cost of a basic market basket.”

“Article 95: “The promoters and the directors of the union enjoy immunity from dismissal from their employment for the period and on the terms required to enable them to carry out their functions.”

In May 2012 a long-discussed reform was enacted, as the *Ley Orgánica del Trabajo, los Trabajadores y las Trabajadoras* (LOTTT) (English for “*Basic Labour Law, Workers and Working*”) and this came into effect on 7 May 2013, two days after Chavez died of cancer.

Some highlights of the LOTTT are as follows:

- Minimum wage of \$3.47 (compare again with Brazil \$2.18, Chile \$3.02, Uruguay \$1.77, Colombia \$2.18, Ecuador \$3.96, Hong Kong \$3.98, Czech Republic \$3.29, Russia \$1.81 and Mexico \$0.89)
- All allegations made by employees are accepted as truthful, unless proven otherwise
- Casual work banned
- One month probationary period. All terminations for cause after this time are completely prohibited, lest a labour court gives approval
- Termination by reason of redundancy is not allowed (Bolivia is the only other nation where redundancy is illegal), unless it has the approval of the Ministry and it’s a “mass sacking” (typically more than 10% of the workforce).
- Up to 30 days annual leave
- Sick leave is unlimited, provided it can be supported by a doctor’s note. First three days on any occasion must be paid by the employer, and then subsequent days come from the social security fund.
- Paid Saturdays and Sundays
- 17 public holidays
- 15% profit share for all staff (rated based on service)
- 30 days’ pay per year in ‘seniority bonus’ which must be deposited with the Government and paid upon request
- Compulsory childcare facilities if > 20 employees
- Provision of lunch
- At least 5% of employees must be declared as permanently disabled
- 26 parental leave (paid by the social security fund) but once back at work, mothers are entitled to an hour’s worth of breast feeding breaks per day
- Social security fund (employee 4%, employer 11%)
- National Institute for Training and Socialist Education Levy of 2% plus a further 0.5% of the profit share cake
- Unemployment Insurance 2.5%
- National Housing & Habitat Bank Levy 3%
- Up to 10% for a yet-to-be-created national OH&S fund
- Anti-Drug National Institute – 1% of profits
- For science, technology and innovation to the Ministry of the People's Power of Science and Technology, up to 2% of the company's gross revenue.

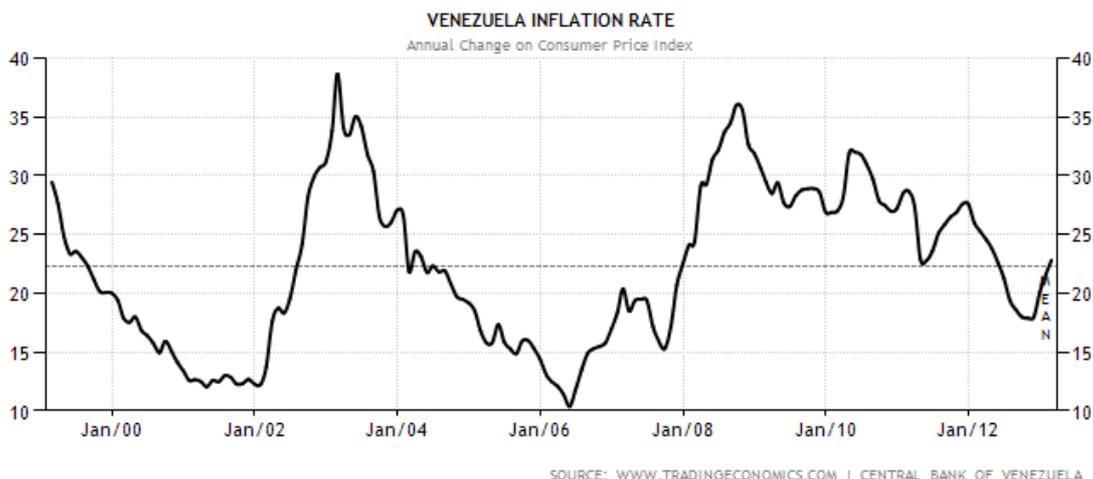
All of these on-costs add up to nearly 100% of the hourly rate - and that's before the unlimited sick leave is taken into account. So in effect, the effective minimum wage in Venezuela is nearly \$7 an hour, or \$13,800 per annum. Doesn't sound like much to us, but when you consider that per capita GDP is \$13,200 in PPP terms, this makes the official minimum wage cost higher than total income. In other words, the minimum wage is set at above market equilibrium.

Needless to say, no one in Venezuela or Argentina is working. Labour Productivity has plummeted. *The Economist* recently reported that since the law in Venezuela commenced, daily absentee rates as high as 40% nationally have been recorded. Recalcitrant employees therefore have to be paid off to resign. For those who aren't employed, the official unemployment rate is relatively low at 7.4% as of Feb 14. But the official stats are ropery (they seem to vary up to 5% from month to month) and now nearly 20% of the labour market is employed by the state. The government has been hoovering up employees to deflate the unemployment statistics. This is clearly unsustainable as public debt begins to swell accordingly. They've run out of businesses to soak, so now they are starting to soak future taxpayers.

An identical situation is also happening in Argentina. Teachers unions in Buenos Aires went on strike in March over wage demands. The government offered annual increases of 25.5%. The unions described such offers as "provocative" and declared it was 40% or else. But they have an arguable case. The Buenos Aires provincial government just concluded pay negotiations with their police that included 100% pay rises!

The World Economic Forum ranks Venezuela 134th out of 148 countries for competitiveness, ranking behind even Zimbabwe. Argentina comes in at 104th. The WEF actually describes the Venezuelan system of hiring and firing as the worst in the world. The only reason it isn't further down the ranking than 134th is because its top marginal tax rate is 34% which is relatively low by global standards and it has a high percentage of female workforce participation when compared with many Muslim nations.

And it's not just businesses who are suffering from crippling costs. Venezuela now has the fastest accelerating rate of inflation in the world. It reached 56% on annual basis last month and has been below 10% since the 90s. Inflation has unofficially averaged 25% in Argentina since 2008 (the dodgy official stats say it's about 10%).



It is true that Venezuela's inflation is not just driven by rising input costs. To pay for their insane public spending and debt, they have been printing money too. M2 has grown by over 300% since 2010. But remember, as discussed, the Constitution of Venezuela guarantees

indexed minimum wages. And as we Australians know from the indexation experience of the 70s, wages and price inflation form a vicious cycle in indexation where one feeds the other in an accelerating way like a snowball rolling down a hill. Technically this is called *in-built inflation*. And that's exactly what is happening in Venezuela. It's a cycle that in their case can only be broken by a bout of deflation caused by a catastrophic economic shock. Oil prices returning to their 90s levels would be the most obvious candidate for that.

Of course, it's exactly the poor Venezuelans who thought that Chavismo was a God-send that we now hurt most by the predictable consequences. The vast majority of Venezuelans don't have bank accounts and so can't take advantage of higher saving interest, nor can they hedge their inflation risk by purchasing condos in Miami like many wealthy Venezuelans do.

The poor are now fighting back. New President, Nicolas Maduro, hand-picked by Chavez to replace succeed him and who was elected partly because he claimed Chavez was appearing to him from the beyond the grave, has this week reportedly sunk to approval ratings of 36% and has shown no sign of being able to control violent street protests over food shortages that started in January that have so far led to the death of 40 persons and thousands more arrested. It would appear that even the union movement is now upset with the government there as their members are complaining about undernourished children.



It is now only a matter of time before Venezuela will be forced to default upon its debt. And once it can no longer tap external sources for cash, the reckoning will come for government spending.

Lessons for Australia

It says a lot about the frailties of the human mind that socialism continues to appeal to so many, despite all the evidence of history. Money spent by the state today always has to be repaid one day. The more you spend now, the more you have to repay later. The economic collapse is always caused by the same policies that seemed to be magic pudding years earlier. Yet bizarrely many of the world's poorest people continue to find populism appealing, despite the long term costs to their interests. But then again, Perhaps that's why they're poor to begin with.

The lessons from South America prove once again that government regulation of the labour market has negative outcomes for employers and employees alike. No one gains over the long term, apart from politicians' egos.

And the South American experience on trade union density is very similar to that of the rest of the world. In the absence of forced membership and closed shops, density is rapidly falling globally. Whilst it remains somewhat higher compared to Australia it is declining nonetheless. This is a problem that has plagued the union movement for decades now and they try many strategies to deal with it, with varying success. Some unions become ultra-militant, others completely shed the militancy. Others employ sales reps to hit the road and sign members up. Most of this get temporary membership spikes, but on the whole, many more leave than join.

I think I know why - and it's something that Stuart Wood QC alluded to in a paper to this Society a few years ago - labour market regulation can actually eat the unions' lunch, so to speak. The original three-page *Conciliation and Arbitration Act* from 1904 granted powers to unions and led to central wage fixation, but everything else was left to the field. Few public officers existed to police the legislation. In this environment unions thrived.

But consider the situation today. Work Choices, Fair Work, whatever the political incarnation, the legislation runs to thousands of pages, it is highly prescriptive and doesn't leave a helluva lot to enterprise level bargaining. The state now also employs legions of inspectors and receives thousands of complaints via phone and website from aggrieved employees. These were jobs once done by unions.

Ironically, the unions have done themselves out of a job. Almost to a man they would argue that the Fair Work Act is great piece of legislation. It was a 'hard-fought-gain'. But its very essence as a prescriptive list of employee rights and entitlements, enforced by public officers, renders the union movement obsolete.

I see the unions in this case as being like typewriters. We stopped buying them once computers came along. They didn't disappear overnight, but sales steadily declined for decades until they were finally put to sleep.

Kyle Kutasi
Perth, Australia

17 May 2014