MONTHLY REPORT

ECONVIEWS
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Issue #236

THE MONTH AT A GLANCE

RECENT DEVELOPMENTS

- The government's "Omnibus bill" failed to make it past the Lower House of Congress. Most of the proposed reforms were microeconomic/regulatory, but without the increase in export taxes, the fiscal plan must be restructured.
- Country risk fell to 1,764 basis points in February, the lowest since April 2022. In the first weeks of the month dollar bonds rallied 7.9% but Argentine stocks fell 6.5%, affected by the last days of political turmoil. However, the parallel exchange rates remained stable. The BCS trades at ARS 1,081, a 28% spread with the official dollar.
- Monthly inflation slowed from 25.5% in December to 20.6% in January. Our high-frequency survey of online prices suggests February's CPI print will be around 15%. According to INDEC formal wages increased 9% in December, though many unions are negotiating 30-40% increases for Q1, it has been the worst fall in purchasing power since the 2001-02 crisis.
- The Federal Reserve kept its policy rate within the 5.25-5.50% range in its last meeting. January's job report shows a strong labor market and the CPI print was higher than expected at 0.3% monthly and 3.1% year-on-year. Markets are more sceptic about rate cuts in Q2.

FIGURE OF THE MONTH

Since December 11th, the Central Bank has bought

8.7 bn

dollars in the FX market, helping rebuild reserves.

TO BE ALERT

The commercial debt keeps growing: only

21%

of imports were paid in the last two months, the lowest since 2003.

WHAT'S COMING NEXT?

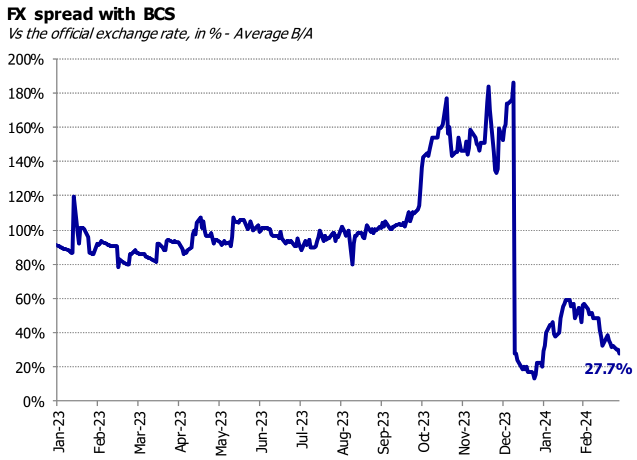
- The government's new political strategy is breaking up the "Omnibus bill" into smaller, more digestible laws. Friday March 1st President Milei will inaugurate Congress' ordinary sessions and probably give a "State of the Union" type speech.
- Public transport fares in Buenos Aires increased 250% in February, and energy and gas bills are set to adjust from 65 to 150% in March. Combined with hikes in fuel taxes and seasonal increases in private education, this will push regulated prices upwards. We believe March's CPI print can be close to 12%m, with chance of single-digit inflation by May.
- Of course, this depends to a high degree on the exchange rate's path. The Central Bank shows little intention of departing from its 2% crawling peg for now, but in the medium term it will lead to unsustainable appreciation. We believe it will shift to something closer to 8% in Q2, setting the stage for a possible unification of the FX market in Q3, after the harvest. This would require a 30% or so devaluation.
- And the government is betting a lot on the harvest. Weather conditions during February were worse than expected, and international prices for soybeans (-26%) and corn (-36%) fell sharply in real terms over the last year. But without the drought, the harvest should still bring around USD 10 billion more than in 2023.

SUMMARY OF MAIN INDICATORS

	Last	Previous		Last	Previous
Economic activity			**Financial data**		
Economic activity (MoM s.a.)	-3.1%	-1.6%	Inflation (monthly)	20.6%	25.5%
Consumer confidence (MoM)	-10.6%	-16.2%	FX spread (21day avg.)	42.2%	47.5%
Industrial activity (MoM s.a.)	-5.4%	-1.1%	Country risk (bps 21day avg.)	1,879	1,945
International accounts			**External data**		
Current Account (USD BN)	-6.10	-6.74	Soybean price (per ton, 21day avg.)	431.4	451.7
CB Reserves (USD BN 21day avg.)	26.45	23.65	Brazilian activity (MoM s.a.)	0.8%	0.1%
Primary balance (ARS BN)	2,010.7	-1,991.3	Financial Conditions Index	26.3	24.3

Source: Econviews based on multiple sources - working days only

GRAPH OF THE MONTH:



Source: Econviews based on Reuters

RECENT ECONOMIC DEVELOPMENTS

JAN	FEB	FEB	FEB	FEB	FEB	FEB
30th	6th	8th	14th	22nd	27th	28th
Econviews Monthly #235: Strengths and weaknesses of Milei's plan + perspectives for the oil and gas sector.	Despite general approval in Lower House, **"Omnibus Bill" scrapped by govt'** due to lack of votes in special	In reprisal for not voting "Omnibus Bill", **Milei eliminates transport subsidies for provinces** worth ARS 100 billion.	**January's CPI comes in at 20.6%**, below expectations. BCS exchange rate trades at ARS 1,081, a 28% spread.	**IMF director Gita Gopinath meets with Milei and economic team,** supports fiscal target but warns about social unrest.	Supreme Court rules Milei government **can't withhold shared federal taxes from Chubut province**.	**Econviews Monthly #236**

POLITICS

The government failed to garner support in Congress for its massive "Omnibus bill" which sought to reform export taxes, labor issues, privatizations, pensions, etc. The new strategy is breaking up the bill into smaller laws which will be debated one-by-one (a more logical first approach). This first political upset has also strained President Milei's relationship with allied parties such as the Radical Civic Union (UCR) and some governors. Tensions with Chubut province raised a breaking point on February 23rd, when the governor threatened to freeze oil exports after the Treasury withheld its assigned share of federal taxes instead of refinancing the province's debt. The Supreme Court finally ruled against the national government.

IMF

Managing director Gita Gopinath visited Buenos Aires in late February, meeting with Milei, his economic team and private sector representatives. The IMF is generally supportive of the fiscal adjustment, although it warned about the need to "preserve the real value of social assistance and pensions" to ensure the program does not lose political support. The Fund also has doubts about FX policy, considering the 2% crawling peg is not sustainable and will end up appreciating the RER again. We believe the government will be able to meet the Q1 targets without much difficulty.

ECONOMIC ACTIVITY

Initial figures show GDP contracted 1.6% in 2023. Activity fell 3.1% between November and December, but the numbers for five other months were also revised downwards. The negative statistical carryover for 2024 is 3.5 points. The sectors of activity which fell the most in December were manufacturing (-8.8%), public utilities like electricity, water and gas (-8.8%), banking (-7.9%), retail (-7.8%) and construction (-5.1%). Only 6 sectors out of 16 had positive variations. Initial data for January shows activity remained deeply depressed, but did not fall much further. We expect GDP to contract 2.6% this year, with a positive effect from agriculture which will help compensate deeper slumps in other sectors.

INFLATION

After December's 25.5% monthly print, the highest since the 1990 hyperinflation, CPI moderated to a still extremely high 20.6% variation in January. Food and drink prices increased 20.4%, while core inflation was 20.2%. Year-on-year, the CPI increased 254%. Both President Milei and Minister Caputo assured February's inflation was closer to 10%. Considering public transport fares increased 250% in Buenos Aires, education is beginning to adjust, gasoline prices rose 6.5% and food is running at 3.7% weekly, we see a figure closer to 15%. Monthly inflation could be back at single digits by May or June, but inertia will still be strong and wage increases will add pressure. We revised our year-on-year forecast for December 2024 is 235%.

MONETARY SECTOR

There is an interesting debate on whether the current monetary policy is restrictive or not. On one side, the monetary base shrunk 35% in real terms over the last two months. The Central Bank has managed to convert the stock of Leliqs into 1-day repos, and also absorbed liquidity through the BOPREAL bonds for importers. However, the policy rate is 100% APR and fixed term deposits pay around 108%, which means with inflation running around 15% effective monthly rates are still negative in real terms. For now, authorities are content to buy up dollars and strengthen international reserves, but if the plan is to loosen capital controls this year, a higher real rate is necessary.

FISCAL ACCOUNTS

In January the national public sector achieved an ARS 2.01 trillion primary surplus, and a 518 billion fiscal surplus. However, this was mostly a by-product of devaluing the official exchange rate and high inflation. Revenues grew 0.7% year-on-year in real terms, boosted by the PAIS tax on dollar purchases (+282%), export duties (+90%) and import taxes (+35%), which all benefit from a weaker peso. Real spending shrunk 39% year-on-year, with sharp contractions in pensions and social programs (-30%), energy and transport subsidies (-64%), wages (-28%) and transfers to provinces (-72%). We believe the government can manage a 0% primary deficit this year, though this requires changes in the tax system aside from cutting spending.

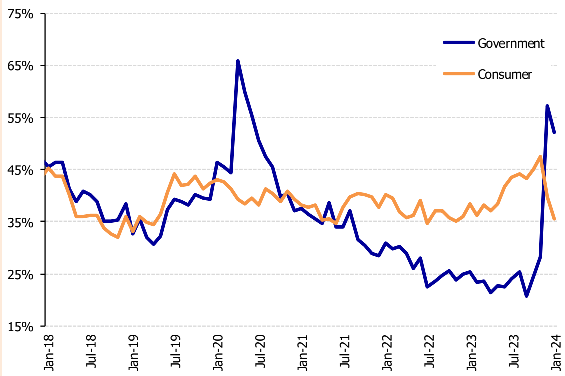
I. So far so good, but many challenges ahead

Javier Milei has had a good beginning on the economic front. Investors like what they see, the IMF supports his policies, and the US has been sending top government officials to visit Buenos Aires, a gesture that is welcome by the government. Despite the tough policy measures that have been implemented Milei´s popular support remains high with a positive image of around 50%.

Not everything has been easy and there are questions about the sustainability of many of the policies. There are concerns about the lack of political support in congress, where he has a very small number of senators and deputies, and about his confrontational style which is alienating members of congress, governors, and part of the population. These situations create risks about his ability to govern, especially if the hardship of the adjustment policies eventually starts to erode his popularity, which is the basis of his political power.

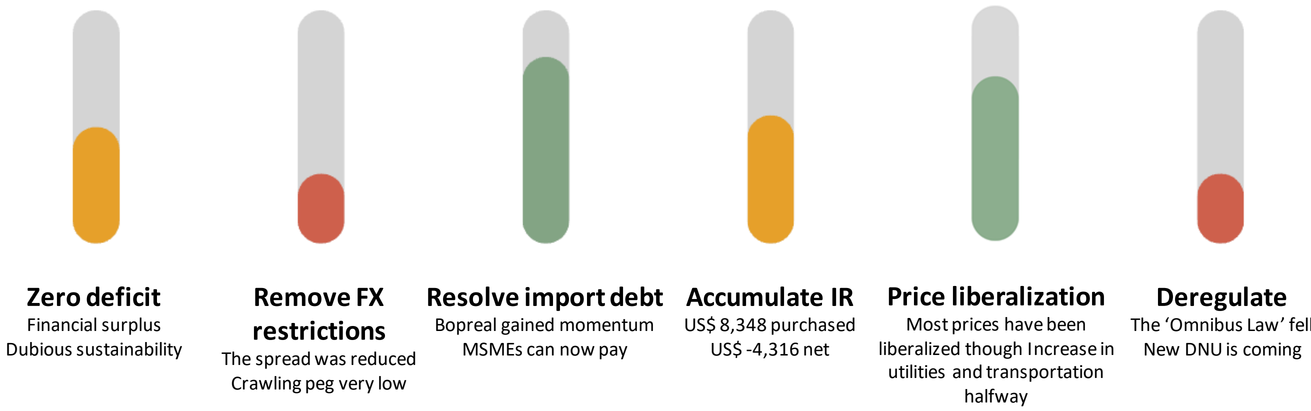
So far, his ability to communicate the policies and to blame the traditional politicians (the "caste") for many of the problems that Argentina is facing, has been an effective way to maintain his popularity. In this way he transformed what were apparent losses in Congress into victories, such as his decision to withdraw the omnibus law that included critical structural reforms and measures to improve the fiscal accounts. However, this withdrawal was clearly a setback that means that he is forced to go to back to Congress, probably with specific laws, with the risk of losing momentum as the political honeymoon period starts to wane.

Graph 1. Consumer and government confidence
In %



Source: Econviews based on UTDT

Graph 2. Goverment objectives and progress



The economic program is based on three main components. The first is to **restore macroeconomic economic stability**, namely, to eliminate the fiscal deficit, to increase international reserves, to eliminate the FX restrictions (the cepo) and to align key relative prices through devaluation and price liberalization. The second component is **a set of structural reforms** which are aimed at deregulating markets (where the labor market is particularly important) and opening the economy to external competition to increase productivity among others. The third component **is a specific program to address high inflation**, which is expected to drop to around eight to ten percent per month soon, a figure that remains well above what is considered low inflation. To bring it down to more reasonable levels, the government it will need to design an anti-inflation program, which will probably take place once the other two components are more advanced.

The large reduction in the fiscal deficit remains the core of the program, which in January led to the first overall fiscal surplus in over a decade. True, the adjustment is based on a draconian reduction in government expenditure that will be difficult to sustain. It is also driven by a large increase in the tax levied on FX purchases, which will need to drastically be reduced (or eliminated) once the exchange rate is unified. Nevertheless, it means a strong determination to deliver Milei's campaign promises of eliminating the fiscal deficit. Market participants are now convinced that Milei is serious about the deficit and that one way or another he will find a way to maintain a prudent fiscal stance.

Chart 1. Fiscal accounts of Central Government

% variations and amounts in ARS billion

	ARS bn Jan-24	YoY Jan-24	YoY real Jan-24
Total revenues	**6,147.2**	**256.7%**	**0.7%**
Tax revenues	5,656.1	256.9%	0.8%
VAT-DGI	1,278.1	288.7%	9.7%
Profits	369.1	122.0%	-37.3%
Social security	1,731.5	165.7%	-25.0%
Debits and credits	532.9	248.3%	-1.7%
Export duties	640.5	574.3%	90.4%
Import duties	263.1	377.3%	34.7%
Non-tax revenues	491.1	254.3%	0.0%
Property rents	240.7	327.4%	20.6%
Primary expenditures	**4,136.5**	**114.6%**	**-39.4%**
Current expenditures	4,059.4	129.1%	-35.3%
Social security	2,670.6	149.2%	-29.7%
Economic subsidies	254.1	27.5%	-64.0%
Energy subsidies	*108.4*	*-19.1%*	*-77.2%*
Salaries and operating exp.	861.6	154.0%	-28.3%
Transfers to provinces	62.1	-0.9%	-72.0%
Transfers to universities	145.7	143.9%	-31.2%
Other current expenditures	65.3	65.7%	-53.2%
Capital expenditures	77.1	-50.3%	-86.0%
Primary balance	**2,010.7**	**-1086.0%**	**-378.3%**
Interests	1,492.3	-	-
Fiscal balance	**518.4**	**-**	**-**

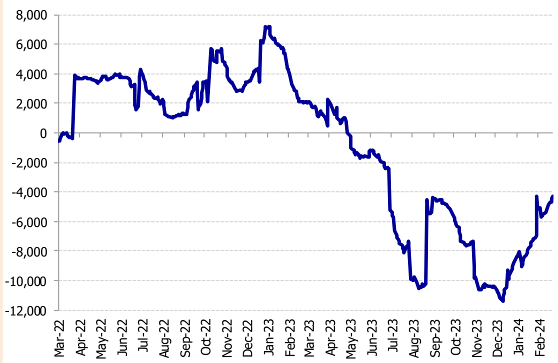
Source: Econviews based on Min. of Economy

The increase in international reserves has been the second cornerstone of the macroeconomic program. The Central Bank has bought over USD 8 billion so far, which provides relief after months in which it was net seller in the FX market. In the process it also reduced the stock of debt that importers had with foreign suppliers, which is one of the main obstacles still today to unify the FX market and eliminate the *cepo*.

Markets have reacted positively to these two developments, as reflected in the rally in Argentine assets. Fiscal surplus and a better external position increase the chances that it could continue to service debt normally and avoid a default or a new debt restructuring. In our view, it is unnecessary to restructure the debt given that Argentina does not a have solvency problem, as net debt remains below 50% of GDP, and that the debt was already restructures in 2020 at very low interest rates and with a schedule of amortizations that are well spread over time. While Argentina's country risk remains very high at around 1700 bps, it has already dropped almost 800 bps from its peak last year and to the extent that the current fiscal and external policies remain solid we expect that the rally in Argentine bonds and stocks could continue.

Graph 3. Net International Reserves

In million USD



Source: Econviews based on BCRA, IMF & own estimates

Despite the achievements in these two fronts, progress has been smaller and, at best, uneven regarding structural reforms. Most of these reforms were included in the far reaching DNU (Executive order) and in the so called "omnibus law" that were prepared by a team led by Federico Sturzenegger. The DNU is still in force, though some parts have been stopped through legal actions and could be contested in Congress, while the omnibus law has been withdrawn. Hopefully there will be progress in the coming months, as Congress starts the ordinary sessions, and the government reintroduces these reforms with a different political strategy.

There are two aspects that are particularly important to complete the macroeconomic stability of the program: inflation and the unification of the foreign exchange market.

On inflation, one could argue that the increases in prices December, January and probably February are evolving in line with market expectations. The maxi-devaluation of December that moved the exchange rate to 800 pesos combined with the liberalization of many regulated prices represented a large nominal, one-time shock to the economy. As a result, it was largely expected that the inflation process would show a "bump" in the sense that the peak of inflation was going to take place in December and January (as it happened), followed by a gradual reduction that would bring inflation down to the pre-devaluation levels. The expectation is that in April inflation is likely to return to around 10 percent, or around the rates that prevailed between September and November of last year. To bring it lower will be more difficult and will require a comprehensive anti-inflation program along the lines of the Real Plan in Brazil in 1994 or the Israeli plan of 1985.

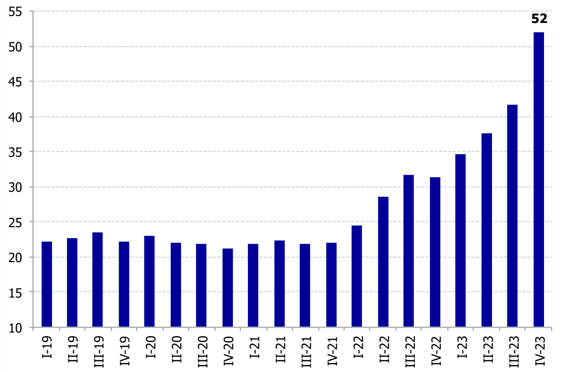
The unification of the foreign exchange market is probably moving at a much slower pace than in 2015, when the Macri administration remove the controls and unified the FX market almost in one shot. The biggest obstacle has been the large stock of debt that importers had with foreign suppliers, which was originally thought to be around 52 billion dollars and is now estimated to be closer to 42 billion dollars. However, those numbers tend to overestimate the size of the problem because around 30 billion dollars are part of the normal commercial debts. The Central Bank has offered some alternatives (including issuing bonds known as Bopreal) that have reduced drastically the problem to around six to eight billion dollars, which is a much more manageable figure.

Despite this progress, and the fact that the spread between the official and the parallel exchange rates has dropped significantly, there has been little progress in removing the controls. The Central Bank is probably waiting to do it in the second quarter when it expects a larger inflow of dollars thanks to the export proceeds from the soybean and corn crops. With a larger inflow of dollars, it should be easier to deal with the remaining pesos that are trapped by the cepo and satisfy the demand for dollars without inflicting undue pressures on the exchange rate.

In the meantime, the policy of depreciating the currency at 2% per month, which is well below the rate of inflation, represents a threat to macroeconomic stability and inflation. The gist of the problem is that Argentina needs a weak currency to increase reserves and generate a large current account surplus. The problem has been in part aggravated by the recent drop in soybean prices which could mean a loss of around five billion dollars. If the Central Bank insists with this rate of depreciation the real exchange rate there is a clear risk that the economy would enter overvalued territory forcing either a step devaluation which would affect inflation or the reimposition of controls with the negative effects that it would have on the business climate.

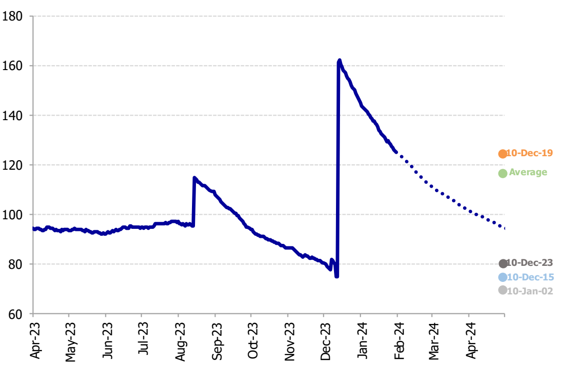
In a nutshell, the program is going well with a few challenges ahead. Some are technical such as the FX or the fiscal situation, where we can expect some trial and error in the process but keeping the situation manageable. The political and social situation is far more difficult to assess. Milei is disruptive in politics, which could be a good thing to foster change. But at the same time, it generates a lot of resistance in society. His manners often don't help the cause. And the social problem (95% the making of the previous administration which left over 40% of people below the poverty line) is genuine. This leads to impatience. And naturally changing many years of mismanagement in several fronts will not happen overnight. The dose of patience of the public opinion will be a crucial ingredient for the stabilization plan.

Graph 4. Goods importers debt
In billion USD



Source: Econviews based on BCRA & own estimates

Graph 5. Real Effective Exchange Rate
Base 100 = 17/12/2015 - Assuming crawling peg at 2% monthly



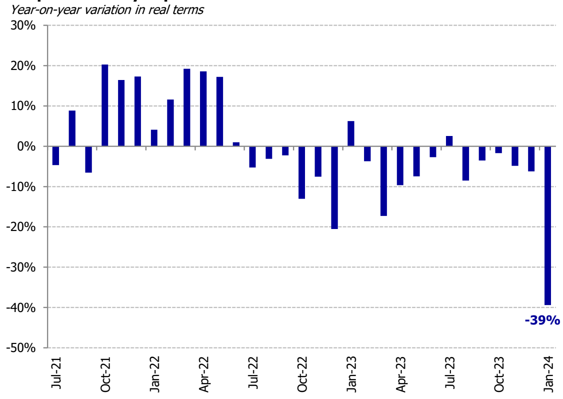
Source: Econviews based on BCRA & own estimates

II. The difficult road towards fiscal balance

As promised, the Milei government is spending less. Primary expenditure fell 39% year-on-year in real terms in January. The president celebrated a "0.1% of GDP fiscal surplus" last month. The question is if this adjustment is sustainable. So far, inflation has done most of the job, eating up pensions and public sector wages, though there has also been progress on reducing transport and energy subsidies.

Pensions and wages are depressed by years of high inflation and relatively low to GDP. Under a successful stabilization plan, both should grow in real terms. Maintaining fiscal balance beyond 2024 will require tax reform and rethinking the relation with the provinces, objectives that are technically but also politically complex. In this special report, **we will analyse how fiscal balance was lost and recovered in past decades, the fiscal outlook for 2024 and the medium-term perspectives**.

Graph 1. Primary expenditures
Year-on-year variation in real terms



Source: Econviews based on Min. of Economy

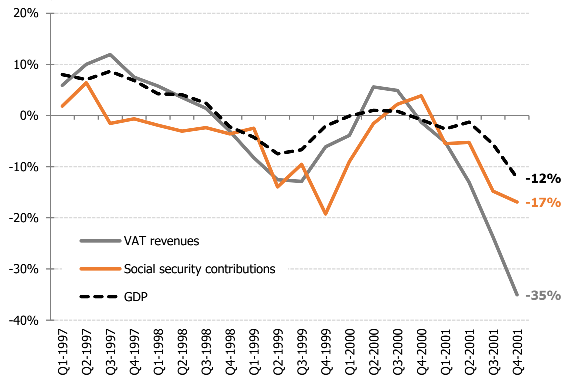
i. A brief fiscal history

The blueprint for a "lean" Argentine state is the 1990s. Hyperinflation in the previous decade laid the consensus for structural reforms under President Menem. From 1995 to 1998, consolidated tax pressure was 18% of GDP with a structure concentrated on VAT and income tax, which had multiplied their revenues by 3 and 5 times, respectively, after rates were increased in the 1992 tax reform.

While the 1990s economic model was discredited by the 2001 crisis, in our view fiscal policy was not a root cause. On average, Argentina ran a 0.5% primary surplus between 1997 and 2001, but interest payments rose from 1 to 4% of GDP ending in a disorderly default. The fiscal problems were more a side effect of macro inconsistency, instead of specific policy mistakes. A key exception was the AFJP pension reform, shown in box 1.

The pegged and overvalued exchange rate translated into real wage rigidity and high unemployment. This led to loss of revenues from both social security contributions and taxes linked to activity like VAT, which were falling at 17% and 35% year-on-year by late 2001, respectively. With a high share of the public debt nominated in dollars, the risk premium for devaluation also amplified Fed rate hikes' impact on debt sustainability. In this context, the government's efforts towards austerity were not enough to avoid the crisis.

Graph 2. Fall in tax revenues during the 2001 crisis
Year-on-year variation



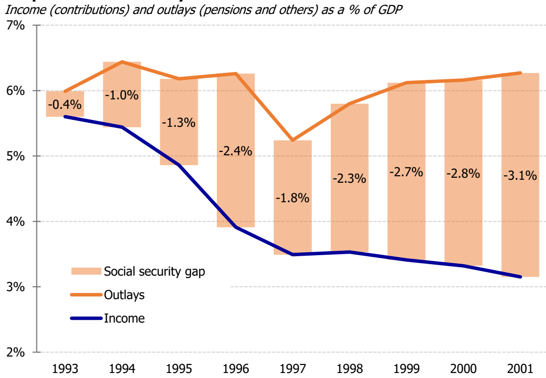
Source: Econviews based on INDEC and AFIP

Box 1: The 1994 AFJP pension reform

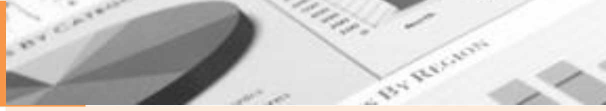
One of the main changes under the Menem administration was **switching pensions from a pay-as-you-go system to a mixed one**. Workers could now choose between contributing to the public system or both public and private funds (AFJPs). Workers who had contributed to the public system before the reform were entitled to basic pensions and compensations, no matter what system they chose.

The AFJP reform was designed to reduce the state's load in the long term (and also strengthen the local capital markets). However, in the transition period it worsened fiscal accounts, **since the state lost social security contributions which went to the private system but had to pay pensioners who had retired under the old system**. In 1993, consolidated social security contributions were 5.6% of GDP and outlays were 6%, a 0.4% gap. By 2001, contributions had fallen to 3.2% and outlays stayed at 6.3%, **a 3-point gap**. Aside from the system's flaws, rising unemployment also bit into contributions.

Graph 3. Social security balance
Income (contributions) and outlays (pensions and others) as a % of GDP



Source: Econviews based on Min. of Economy

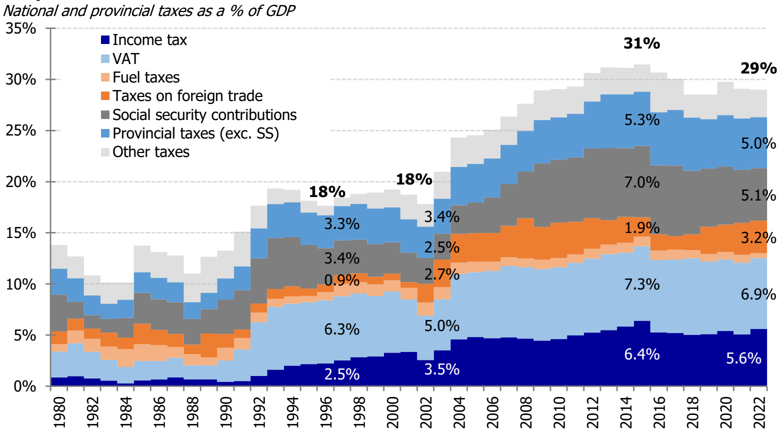


After the 2002 60% RER devaluation and debt default, Argentina switched into a new fiscal regime. The government reintroduced export taxes for agricultural products, at 20-24% rates for cereals and oilseeds, considering they were still competitive due to the weaker peso. The default practically suspended interest payments to bondholders until 2005. And both public sector wages and pensions were depressed in real terms. Between 2003 and 2008, the national government averaged a 1.4% of GDP fiscal surplus.

Argentine economists have long debated why high inflation reappeared in the 2000s, despite fiscal balance and a stable exchange rate (we studied it in depth in our monthly #209). **From a fiscal standpoint, unlike the 1990s, the balance was not sustainable**. The Kirchner administrations used the fiscal space to strengthen the social security net and freeze utility rates. Tax revenues accompanied the growth in spending, up to a point. Export duties and import taxes went from 0.6% of GDP in 2001 to 3.9% in 2008. Income tax thresholds were not adjusted for inflation, swelling revenues from 3.4% to 4.7%. VAT and social security contributions grew in line with the economic recovery.

Provinces doubled payrolls between 2005 and 2015, and provincial taxes' weight in GDP grew from 3.3% in 2001 to 5.3% in 2015, mainly due to the distortive *ingresos brutos* or "turnover tax". **The total fiscal burden grew from 19% of GDP to a peak 31% in 2015. With only homeopathic efforts to correct imbalances, that year the fiscal deficit reached 5.1% of GDP.**

Graph 5. Consolidated fiscal burden
National and provincial taxes as a % of GDP



Source: Econviews based on Min. of Economy

The Macri administration tried to address imbalances, first with a gradual approach and more aggressively after the 2018 currency crisis. By 2019 it had cut the fiscal deficit to 3.6% and reached a 0.2% primary deficit. Unlike the 1990s, Macri's fiscal consolidation was mostly on the expenditures side, as revenues fell by 1.5 points due to tax cuts and the recession.

Energy and transport subsidies were cut by 2 points of GDP. A lower wage bill, due to layoffs in the public sector and accelerating inflation after 2018 contributed another point. The last stretch towards "zero deficit" was the privatization of two thermoelectric plants in 2019, raising 0.3% of GDP and a 1.1-point drop in CAPEX spending, under an IMF program.

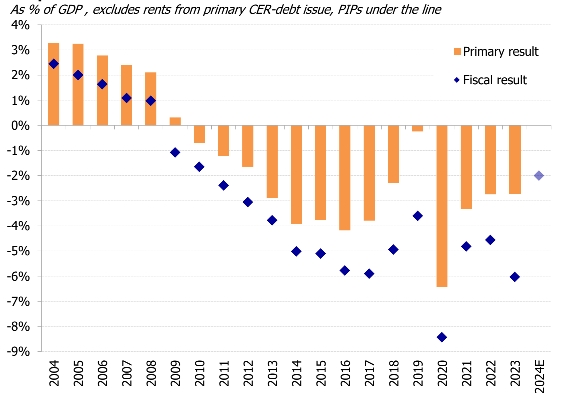
In 2017 the government also set out an ambitious tax reform plan, the "Fiscal Pact", in coordination with the provinces. It focused on lowering labor taxes, income tax for companies and distortive provincial taxes on goods and services (such as *ingresos brutos*, the "turnover tax"), while also

Chart 1. 2001-05 fiscal adjustment
Main changes in revenues and spending as a % of GDP

	2001	2005	Variation in p.p.
Revenues	**15.1%**	**19.0%**	**3.9%**
Taxes on foreign trade	0.5%	2.8%	2.3%
Tax on debits and credits	0.6%	1.4%	0.8%
Income tax	2.2%	3.3%	1.1%
Fuel taxes	1.0%	0.6%	-0.4%
Expenses	**15.0%**	**16.2%**	**1.2%**
Social security	6.3%	4.6%	-1.7%
OPEX (inc. wages)	4.1%	3.9%	-0.3%
Current transfers*	3.4%	5.5%	2.2%
CAPEX	1.0%	2.0%	1.1%
Primary result	**0.0%**	**2.8%**	
Net interest	-4.0%	-2.1%	
Fiscal result	**-4.0%**	**0.7%**	

*to public and private sector, includes subsidies to energy and transport companies
Source: Econviews based on Min. of Economy

Graph 4. National Government - Fiscal accounts
As % of GDP, excludes rents from primary CER-debt issue, PIPs under the line



Source: Econviews based on Min. of Economy

Chart 2. 2016-19 fiscal adjustment
Main changes in revenues and spending as a % of GDP

	2016	2019	Variation in p.p.
Revenues	**19.8%**	**18.3%**	**-1.5%**
Capital income (inc. privatizations)	0.0%	0.6%	0.5%
Expenses	**24.0%**	**18.7%**	**-5.3%**
Energy and transport subsidies	3.5%	1.6%	-2.0%
OPEX (inc. wages)	4.2%	3.3%	-0.9%
Pensions	8.0%	7.8%	-0.1%
Social programs	3.6%	3.5%	-0.1%
CAPEX	2.2%	1.1%	-1.1%
Public investment programs (PIP)*	0.4%	0.2%	
Primary result	**-3.8%**	**-0.2%**	
Net interest	-1.6%	-3.4%	
Fiscal result	**-5.4%**	**-3.6%**	

*included under the line according to 2020 IMF methodology
Source: Econviews based on Min. of Economy

recomposing taxes on fuels. Although it was suspended by the following administration, the 2017 reform succeeded in lowering the fiscal burden from 31% of GDP in 2015 to 28.5% in 2019 (see box 2).

Box 2: The 2017 tax reform.

The spirit of the 2017 reform was to “sustainably lower the fiscal burden” and spur investment, by lowering taxes on companies and employers. **Revenues would fall by 2.9% of GDP by 2022**, split between national and provincial taxes.

The **top income tax rate for companies was supposed to fall from 35 to 25%**. To compensate, the tax on financial profits would increase to 5% for peso investments and 15% for dollar or indexed investments. Both of these reforms were overturned.

Another point was **lowering employer social security contributions** for sectors which paid the higher 21% rate, and raising them for the rest (17%), unifying at a single 19.5% rate. Progress has been slower, with the high rate currently at 20.4%.

The reform aimed to increase excise taxes on alcohol and tobacco and lower them for vehicles and especially electronic products. This was later overturned.

A key part was **lowering the maximum rates for the distortive “turnover tax”** that provinces charge on goods and services. The tax’s weight in GDP lowered from 3.9 to 3.6% between 2017 and 2019 but bounced back to 4% in 2022 since governors abandoned the reform pact after the change of administration.

Chart 3. Proposed cuts in tax rates

2017 reform, planned rates for 2022 and estimated fiscal cost

	2017	Proposal for 2022	Fiscal cost (% of GDP)
Income tax			
Companies	35.0%	25.0%	-1.2%
Financial profits	0.0%	5/15%	0.2%
Employer's SS contributions			
Retail and high billing services	21.0%	19.5%	-1.2%
Other	17.0%	19.5%	
Effect on VAT revenues	-	-	0.3%
Excise taxes			
High graduation alcoholic bev.	25.0%	35.1%	
Electronics from Tierra del Fuego	6.6%	0.0%	0.0%
Electronics	17.0%	3.5%	
Fuel taxes			
As a % of retail liter	29.0%	29.0%	-
Max. provincial "turnover tax"	**4-9.5%**	**0-5%**	**-1.5%**
Provincial real estate tax	Change in property valuations		**0.4%**
Total fiscal cost	-	-	**-2.9%**

Source: Econviews based on Min. of Economy

The pandemic dealt a severe blow to fiscal accounts, but the Fernández administration was unable to correct spending after 2021, allowing energy and transport subsidies to balloon to 2.1% of GDP in 2023. To improve its chances in the elections, the government cut both VAT (temporarily) and income tax (permanently) in late 2023. This led to a 2.7% primary deficit and 6.1% fiscal deficit last year, **not huge by historical standards, but politically tough to correct with real wages and pensions at 20-year minimums. On the other hand, runaway inflation gives Milei a popular mandate to correct the deficit that Macri arguably never had**.

ii. Making it through 2024 and beyond.

On December 13th, Finance Minister Caputo outlined a program to reach a 2% of GDP primary surplus and fiscal balance in 2024, through a 2.2 point increase in revenues and a 2.9 point reduction in spending.

Since then, Congress blocked an increase in export taxes and the proposed tax amnesty. Negotiations to overturn the 2023 income tax reform are still in progress. This leaves fuel taxes and the PAIS tax on dollar purchases as sources of extra revenues, but in order to unify the FX market, the latter must be eliminated. A lesson from past crises is to not underestimate the recession’s effect on taxes linked to activity, either. In our base scenario, **national tax revenues grow only 0.2 points to 17.3% of GDP**.

This means the adjustment will focus on spending cuts, like in 2016-19. Caputo’s plan aims at pensions, wages, transfers to provinces, energy and transport subsidies, CAPEX and social programs. Except for the last item (social containment is key to the plan’s political viability) we tend to agree, **and believe it is possible to cut spending by 2.5 points to 17.3% of GDP**.

Chart 4. 2024E fiscal adjustment

Main changes in revenues and spending as a % of GDP

	2023	2024E	Variation in p.p.
Revenues	**17.0%**	**17.3%**	**0.2%**
5G tender	0.2%	-	-0.2%
Export duties	0.8%	1.9%	1.1%
PAIS tax on dollar purchases	0.8%	1.0%	0.2%
Less revenues due to recession	-	-0.8%	-0.8%
Fuel taxes	0.3%	0.5%	0.2%
Income tax (reverting reform)	1.6%	1.4%	-0.2%
Expenses	**19.8%**	**17.3%**	**-2.5%**
Pensions (exc. bonuses)	7.8%	7.5%	-0.3%
Transfers to provinces	0.8%	0.3%	-0.5%
Energy and transport subsidies	2.1%	1.4%	-0.7%
CAPEX	1.6%	0.9%	-0.7%
Social programs	3.0%	3.0%	0.0%
OPEX (inc. wages)	3.3%	3.0%	-0.3%
Primary result	**-2.7%**	**0.0%**	
Net interest	-3.3%	-2.0%	
Fiscal result	**-6.0%**	**-2.0%**	

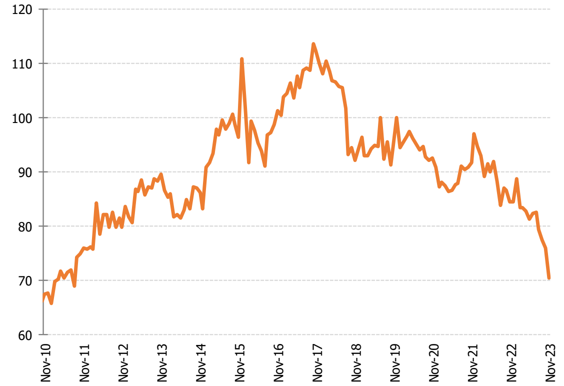
Source: Econviews based on Min. of Economy and own forecasts

What works in 2024 is not good for the medium term. Pensions and social programs are indexed to tax revenues and nominal wages. Once inflation slows down, both will increase in real terms.

Milei likes to appeal to his "blender" metaphor, but eroding real incomes should not be a policy goal. Argentina currently spends the same amount on pensions as in 2011, with over a million new retirees. This does not create incentives to pay into the system. The same goes for public sector wages: depressed salaries are already leading to understaffing in key areas such as education or healthcare and encourage corruption.

While the tax burden remains high, the national government has already reduced spending by 4.2 points of GDP since 2015. At the same time, **the provinces ran a combined 0.3% fiscal surplus in 2022**, an issue we studied in our monthly #230. To ensure balance is long-lasting, authorities should focus on raising progressive taxes, and adjusting discretional transfers and tax exemptions for provinces. This process is as political as it is technical, since unilaterally removing funds is likely to lead to increases in distortive provincial taxes. In this section, **we will focus on the current tax system**.

Graph 6. Pensions in real terms
Seasonally adjusted, Dec-19=100



Source: Econviews based on MECON and INDEC

- <u>**Income tax**</u>

Most economists agree that recovering income tax is priority no. 1. The tax collected 5.7% of GDP in 2022, of which 3.2 points automatically went to the provinces under the federal tax-sharing scheme. In October 2023 the threshold for persons was raised from 6 to 15 minimum wages and collection fell to 4.7% (provinces lost 0.6 points). This year, revenues could fall another 0.8 points. **The 2023 reform eliminated the most progressive tax and strained the relationship with the provinces**.

The status quo wasn't perfect. In 2021 Argentina collected 46% of income tax from individuals and 54% from companies. In developed countries like the US, UK, France or Germany, the share is closer to 80-20%, as taxes on companies are considered more distortive. Latin American countries tend to skew towards a 50-50% share, as informality makes it harder to collect taxes on individuals. But the 2023 reform went in the opposite direction. By overturning it, the government will also gain fiscal space much needed to eliminate the PAIS tax on dollar purchases and unify the FX market.

Chart 5. Income tax by country
Structure and as a % of all revenues, including provincial taxes - 2021-22

	As a % of all revenues	Individuals	Corporate
United States	48%	87%	13%
Mexico	42%	79%	21%
United Kindom	38%	79%	21%
Germany	33%	82%	18%
Colombia	31%	76%	24%
Italy	30%	85%	15%
Spain	30%	39%	61%
Chile	28%	22%	78%
France	27%	51%	49%
Brazil	20%	46%	54%
Argentina	**16%**	**44%**	**56%**

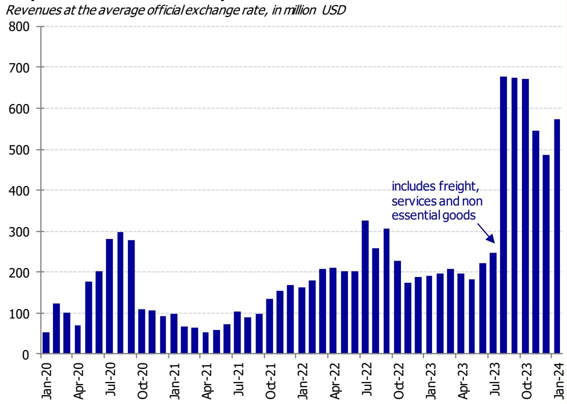
Source: Econviews based on OECD

- <u>**Taxes on foreign trade**</u>

The PAIS tax has snowballed into a huge headache. The Fernández administration created it in December 2019 as a 30% tax on FX purchases for hoarding and tourism purposes and 8% for digital services. Between 2020-22, it raised roughly 0.4% of GDP per year. In July 2023, to counter the drought's fiscal impact, the PAIS tax base was expanded to freight and other services, doubling revenues to 0.8% of GDP.

In December 2023, the Milei administration further expanded it to a 17.5% rate on all non-essential (food, fuels, healthcare) imports of goods, services, and freight, keeping it at 30% for tourism. Combined with devaluating the exchange rate from 360 to 800 pesos per dollar, **this boosted the PAIS tax's potential revenues to 2.1% of GDP in 2024. But it**

Graph 7. PAIS tax on dollar purchases
Revenues at the average official exchange rate, in million USD



Source: Econviews based on Min. of Economy

also set up a difficult trade-off between unifying the FX market and reaching fiscal balance.

If the Central Bank lifts FX controls in July (our base scenario), the Treasury will lose revenues equal to 1.1% of GDP in the second half of 2024. The fiscal outlook for 2025 also worsens. However, when the provinces pressed to include the PAIS tax in the federal tax-sharing system, Milei said he would veto the bill, signalling the tax is not part of his long-term plan.

Some have suggested replacing the PAIS tax with a flat rate "Tobin tax" on currency outflows (excluding goods imports), to reduce exchange rate volatility and strengthen revenues without being too distortive. **A 5% "Tobin tax" could raise 0.1% of GDP per year.** Brazil and Ecuador have a similar tax at 5 and 3.5% rates, respectively, though they are both lowering rates, in Brazil's case aiming to fully eliminate it by 2029.

The silver lining is that a 30% devaluation in July (closing the current FX spread) will raise export duties by around 0.1% of GDP. The impact is relatively small because exports are already priced at an 80/20 blend between the official and the parallel exchange rate, and the bulk of agricultural exports are in Q2.

Chart 6. Fiscal impact of removing FX restrictions
Revenues in billion ARS and as a % of GDP - 2024F

	As a % of GDP
PAIS tax on dollar purchases	
Without unifying FX market	2.1%
Unifying FX market in Jul-24	1.0%
Export duties	
Without unifying (80/20) and "Omnibus bill" reforms	3.1%
Without unifying (80/20)	1.8%
Unifying FX market in Jul-24	1.9%
Net fiscal impact of unifying FX market	**-1.0%**
Memo item: revenues from a 5% rate "Tobin tax"	0.1%

Source: Econviews based on INDEC and own estimates

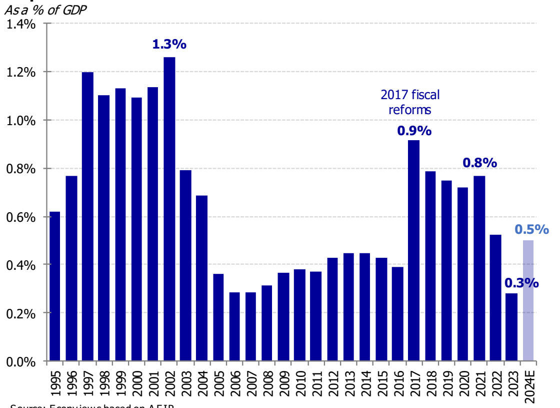
- <u>Fuel taxes</u>

The government is raising fuel taxes after a three-year freeze. The 2017 reforms redesigned the tax as a single fixed sum in pesos, set at 29% of the retail price of gasoline and indexed quarterly to CPI. This boosted revenue from 0.4% of GDP in 2016 to 0.9% the following year, a percentage closer to OECD countries like France or the UK. At the same time, the fixed sum tax helped cushion swings in international prices or the exchange rate.

To control inflation, the Fernández administration postponed adjustments. Between January 2021 and November 2023, the fixed sum rose from 18 to 28 pesos, only 51%, while gasoline prices leapt 333%. Last year, fuel tax revenues shrunk to 0.3% of GDP.

The new administration wants to apply the delayed 2021-23 adjustments between February and May 2024, raising the fixed sum from 28 to 190 pesos, a 610% increase. With our estimates, it would need to increase another 86% to make up for that period's inflation, though further hikes are politically tough and will also fan inflation.

Graph 8. Historical fuel taxes
As a % of GDP



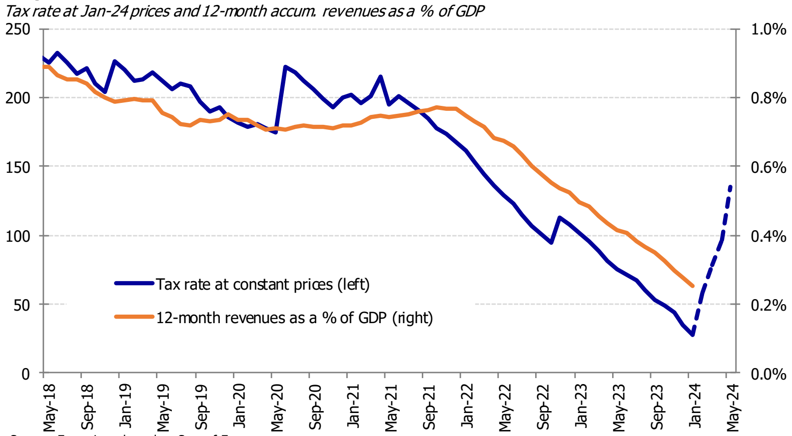
Source: Econviews based on AFIP

Chart 7. Fuel taxes by country
Consolidated for all levels of government - 2021

	As a % of all revenues	As a % of GDP
Argentina	**2.6%**	**0.8%**
Chile	2.8%	0.6%
Colombia	2.0%	0.4%
Costa Rica	4.7%	1.3%
France	2.7%	1.2%
Peru	2.3%	0.4%
UK	2.8%	1.1%

Source: Econviews based on OECD

Graph 9. Forecast increase in fuel tax rates
Tax rate at Jan-24 prices and 12-month accum. revenues as a % of GDP



Source: Econviews based on Sec. of Energy

The planned increase will adjust the tax to its real value of 2022, when revenues were 0.5% of GDP. In an optimistic scenario, it could raise a similar amount this year, considering the recession will also weight on gasoline consumption. 23% of the tax is shared with the provinces, but local governments want to increase that amount to compensate for the recent cut in transport subsidies.

Medium-term, increasing the fuel tax to 1% of GDP is reasonable and **green**. OECD research shows that transport fuel taxes are also **progressive** in nature, as middle and high-income households tend to spend more. The inverse is true for electricity and heating fuels (natural gas), however.

The original omnibus law also had a new framework for excise taxes, which could have not only eliminated a market distortion, but also increased revenues by another 0.2% of GDP. Not a game changer, but every little piece matters in this retrenchment attempt. Let's see if the government reintroduces this matter later in the year.

- <u>Federal tax exemptions</u>

According to the Ministry of Economy's own estimates, **the combination of special tax regimes and exemptions amounted to 2.5% of GDP in 2023**. 0.7 points come from economic promotion regimes, of which the most salient is the one for Tierra del Fuego province, which exempts activities on the island from VAT, income tax, import taxes and excises on electronic products for 0.4% of GDP. Other estimates consider the actual fiscal cost is lower after considering multiplier effects.

Aside from promotion regimes and industrial policy, the state waives 1.8% of GDP in other tax exemptions, mainly VAT. However, 0.9 points are from lower rates on food and beverage, healthcare, and education services. The argument can be put forward that it would be more progressive to directly subsidize low-income households instead of making the products cheaper for everyone. In the current situation, it seems difficult to increase taxes on basic staples and healthcare, as their prices already lead the CPI.

From the other exemptions, income tax on judges and judicial officers at 0.2% of GDP stands out, though it does not apply to appointments made after 2017. Efforts to include older officials have been blocked by courts, but the fiscal cost should fade out over time.

Chart 8. Federal tax exemptions

Fiscal cost as a % of GDP - 2023

	As a % of GDP
Economic promotion regimes	**0.7%**
Tierra del Fuego	0.4%
Excluding economics promotion regimes	**1.8%**
VAT	**1.2%**
Healthcare and education	0.5%
Food and beverages	0.4%
Income tax	**0.3%**
Judges and judicial officers	0.2%
Fuel taxes	**0.3%**
Social security contributions	**0.1%**
Total	**2.5%**

Source: Econviews based on Min. of Economy

Base Scenario

	2021	2022	2023 E	2024 F	2025 F
Inflation (eop)	50.9%	94.8%	211.4%	235.0%	85.0%
Exchange rate ARS/USD (eop)	102.8	177.1	808.5	2,269.6	4,086.1
Exchange rate ARS/USD (eop, YoY)	22.1%	72.4%	356.4%	180.7%	70.0%
Real exchange rate ARS/USD (eop, Dec-01=100)	137.5	129.8	196.4	169.5	169.1
Paralell exchange rate ARS/USD (eop)	203.1	340.8	972.8	2,269.6	4,086.1
Spread with official exchange rate (eop)	97.7%	92.4%	20.3%	0.0%	0.0%
Gross reserves (USD billion, eop)	39.7	44.9	23.1	36.9	40.7
Net international reserves (USD billion, eop)	2.3	7.7	-8.6	3.7	9.0
Policy rate (eop)	38.0%	75.0%	100.0%	100.0%	60.0%
GDP (YoY)	10.7%	5.0%	-1.6%	-2.6%	7.9%
Formal wages in real terms (aop, YoY)	0.4%	0.3%	-2.0%	-2.0%	3.9%
Primary result (% GDP)*	-3.3%	-2.7%	-2.7%	0.0%	1.0%
Fiscal result (% GDP)*	-4.8%	-4.1%	-6.0%	-2.0%	-1.0%
EMBI Argentina (spread in bps, eop)	1,703	2,196	1,907	1,200	600
Public net debt (% GDP)	45.5%	46.1%	47.2%	48.2%	48.2%
Current account (% GDP)	3.0%	3.0%	-3.8%	1.8%	1.4%

Source: EconViews

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