6. The fiscal deficit reduction targets will be met

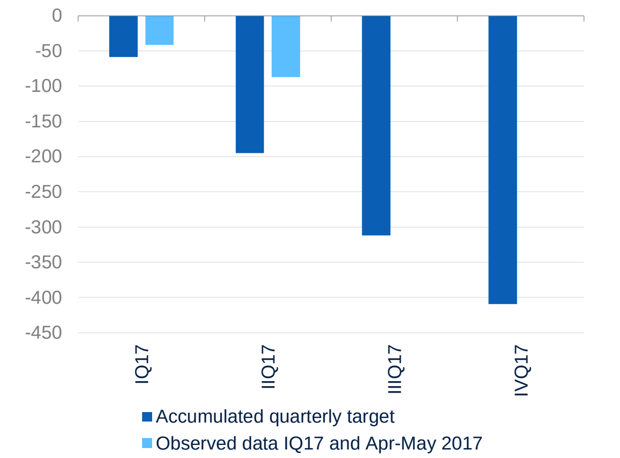
Although they leave little room for an integral tax reform

In the first five months of 2017, total fiscal revenues grew by 33.7% YoY, almost 10 pp more than inflation, as did tax revenues (+31% YoY). This improvement in collections is basically explained by an increase of 35.8% YoY in social security contributions (representing 37% of revenues) and the collection of penalties due to the fiscal amnesty that have amounted to more than 10% of the total fiscal income so far this year. However, we estimate that for the rest of 2017, the effect of the tax amnesty will be diluted so that fiscal revenues will increase by only 27% YoY for the full year, still above the increase in primary spending estimated to be at 24.7% YoY in 2017.

In the first 5 months of the year, public expenditure excluding interest grew at a rate of 33% YoY driven mainly by Pensions and social benefits. The latter will increase this year in real terms due to their indexation to past inflation and because of the "Historical Reparation" program that promises to adjust pensions vis-a-vis their past shortcomings regarding adjustment for inflation. Transfers to provinces for the restitution of Social Security funds also climbed above the average, the latter driven by a Supreme Court ruling at the end of 2015. In contrast, economic subsidies fell sharply in real terms, in particular those for energy sectors due to the increase in electricity and natural gas tariffs. These trends will continue in the second half of the year but the year-on-year increase in spending in the last quarter will be much lower than the current one due to the fact that the steep increase in expenditure (cancellation of floating debt and advanced transfers to the provinces using the extraordinary income from the fiscal amnesty) that took place at the end of 2016 will not be repeated. In this scenario, we believe that there will be no difficulties in meeting the primary deficit target of 4.2% of GDP this year. In fact, the first semester's target will be easily complied with since the accumulated deficit over the first 5 months of the year amounts to only 45% of the first half-year target, allowing more space for the seasonal expansion of end-of-year spending without putting the annual target at risk (Figure 6.1).

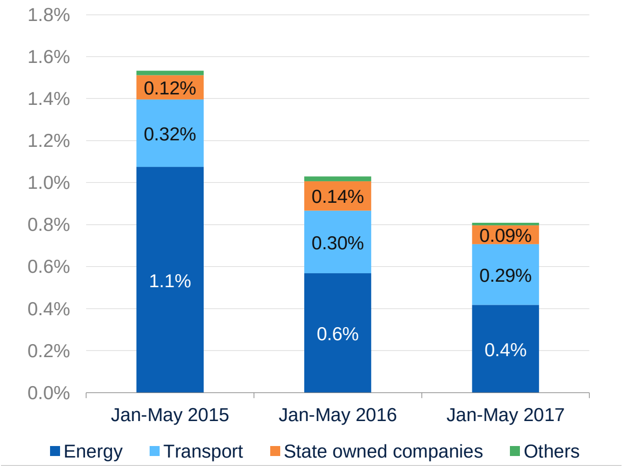
Instead, the 2018 target of reducing the primary deficit to 3.2% of GDP looks more ambitious as it implies a reduction in spending of 1% of GDP to be achieved basically through the reduction of energy and transport subsidies because, on a disinflationary path, due to the Law of Mobility that indexes them to past salary increases, pensions and social subsidies will continue to increase in real terms. The government is committed to moving a tax and social security reform forward in 2018 in order to reduce tax pressure on formal sectors of the economy and to improve competitiveness. The reform aims to be comprehensive but gradually applied and focused on reducing tax distortions such as lowering the Tax on Bank Debits and Credits that discourages banking penetration or lowering non-wage payroll taxes to encourage formal employment. However, with these demanding fiscal consolidation goals, it is unlikely that the reform will involve a substantial decline in taxes in the short term unless the 2016-17 fiscal amnesty results in a great expansion of the tax base. At the same time, an initial agreement not to increase provincial expenditure in real terms was signed by the majority of governors, but the negotiation of the provincial fiscal responsibility Law in Congress will take time and, in the short-term, will not enable a significant decline in provincial taxes that also generate great distortions (as in the case of Gross Income Tax).

Figure 6.1 Fiscal performance accumulated to May 2017 and fiscal targets ($ billion)



Source: BBVA Research on data from the Ministry of Economy

Figure 6.2 Subsidies to economic sectors (% of GDP)



Source: BBVA Research based on ASAP and Ministry of Economy data

The public sector financial needs of USD 40 billion for 2017 have practically been complete covered by debt issues to date. With the recent placement of USD 2.75 billion in a 100-year bond in international markets and a USD 4.5 billion adjustable- MPR rate bond, it would only be necessary to complete the USD short-term Letes issuance program and issue USD 2.4 billion in the domestic market to fulfill the financial program for the year. The MSCI's recent decision to keep Argentina within the category of frontier (rather than emerging) market did not have a major impact on the bond market and it is to be expected that Argentina's debt spreads will continue to decline gradually after any electoral uncertainties have been cleared. This means that we do not foresee financing problems in 2018 when international debt repayments will be lower and the total financing needs, excluding the short-term Letes maturities, will be similar to those of 2017 even assuming less assistance from the BCRA to the Treasury.

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