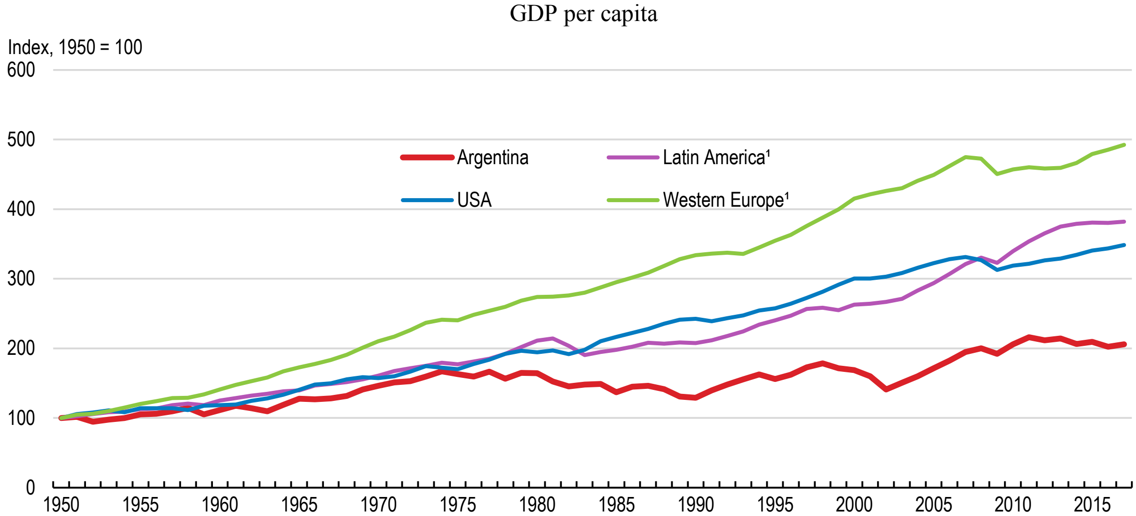
Key policy insights

Significant reforms have been undertaken since 2015 to strengthen growth and well-being, as reported in the 2017 OECD Economic Survey of Argentina. Access to international capital markets was restored, the credibility of national statistics was re-established and social protection was enhanced while cutting back on ineffective spending. A tax reform, a new competition law, improvements in the sustainability of the pension system, new legal frameworks for capital markets and for public-private partnerships, the creation of a new independent fiscal council and a commitment to strengthen the independence of the Central Bank followed.

In the medium term, these and additional reforms will help to raise prosperity for all Argentinians by strengthening productivity, which is the principal long-term challenge. Over many decades, the economy has been held back by weak policy settings. Productivity growth has been low, and even negative over the last 20 years. This explains why incomes have fallen behind those in Latin American and other countries over time (Figure 1).

Figure 1. Argentina has lost ground relative to other economies

GDP per capita



1. Western Europe includes: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and United Kingdom; Latin America includes: Brazil, Chile, Colombia, Mexico and Peru.

Source: OECD calculations based on Bolt and Van Zanden (2014) (see http://www.ggdc.net/maddison/maddison-project/data.htm).

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The severe economic crisis that unfolded as of April 2018 and pushed the economy into a deep recession, however, has shifted the immediate policy focus to restoring confidence and unwinding significant fiscal and external imbalances. As confidence tumbled, the value of the currency halved while interest rates, unemployment and inflation soared. Swift and decisive policy responses were necessary and will lay the grounds for a return of macroeconomic stability, but are adding further to the downturn in the short run. Current policy plans are projected to lift the economy out of the recession, but significant risks remain around this projection.

Against this background, the main messages of the Survey are:

- Escaping the crisis requires restoring lost confidence. Building solid macroeconomic foundations and continuing reforms is a precondition for stronger and more inclusive growth.
- Creating more and better jobs will hinge on higher productivity, for which structural policy reforms are crucial.
- Supporting vulnerable groups and reducing inequalities will require a strong social transfer system compatible with fiscal sustainability, as well as education, training and health policies.

Box 1. A glance at Argentina's economic history

Argentina's per capita incomes were among the top ten in the world a century ago, when they were 92% of the average of the 16 richest economies (Bolt and van Zanden, 2014). Today, per capita incomes are 43% of those same 16 rich economies. Food exports were initially the basis for Argentina's high incomes, but foreign demand plummeted during the Great Depression and the associated fall in customs revenues was at the root of the first in a long row of fiscal crises. The economy became more inward-focused as of 1930 when the country suffered the first of six military coups during the 20th century.

This inward focus continued after World War II, as policies featured import substitution to develop industry at the expense of agriculture, nationalisations and large state enterprises, the rising power of unions and tight regulation of the economy. The combination of trade protection and a significant state-owned sector lessened somewhat in the mid-1950s, in a succession of brief military and civilian governments.

However, the weakness of both the external and fiscal balances continued into the 1960s and early 70s, leading to an unstable growth performance and bouts of inflation, including a first hyperinflation in 1975. The military dictatorship of the 1970s and the democratic government of the 1980s continued to struggle with fiscal crises, resulting from spending ambitions exceeding revenues and exacerbated by the Latin American debt crisis starting in 1982, and the lack of a competitive export sector after decades of import-substituting industrialisation. The country fell into a fully-fledged hyperinflation in 1989-90. Between 1970 and 1990, real per capita incomes fell by over 20%.

While the economy returned to growth after 1990 in the context of lower import tariffs, foreign investment, a currency pegged to the US dollar and falling inflation, volatility did not recede. Export competitiveness faltered following the Asian crisis and the devaluation of the Brazilian Real and by the late 1990s the economy was facing a severe recession. Rising fiscal imbalances led to the 2001 debt default and the end of the currency peg. The impoverishing effect of the crisis was exacerbated by the subsequent devaluation which wiped out large amounts of household savings. Despite the recurrent crises, the growth performance of Argentina between 1990 and 2010 allowed it to begin a process of convergence with the developed world.

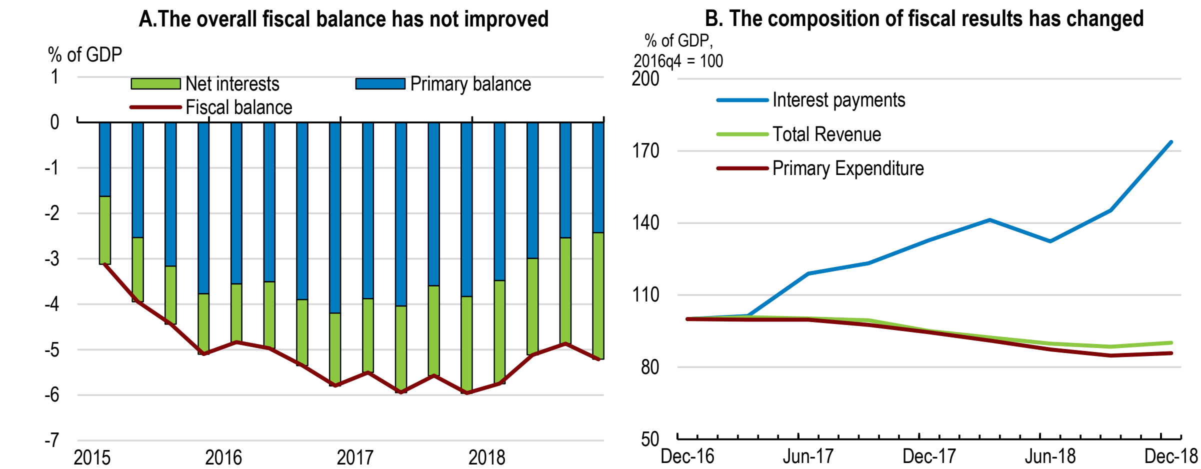
Despite recent reforms, significant vulnerabilities have built up

The current administration faced an economy on the brink of collapse in late 2015, with a primary fiscal deficit of almost 4% of GDP and significant unpaid arrears and contingencies. Between 2007 and 2015, public expenditures increased from 28% of GDP to 40%, close to the OECD average of 42.4%. This included over 3.5% of GDP in subsidies for energy and transport, with a regressive social impact as their main beneficiaries were middle-class households in the capital region (Castro and Barafani, 2015[1]). Public employment and pension expenditures also rose visibly, the latter as a result of an expansion of non-contributory pensions. By 2015, the increasing recourse of the previous administration to one-off revenue sources and monetary financing was reaching its limits, as inflation had risen to 25% and net currency reserves were almost depleted. This resulted in a difficult choice between an immediate fiscal contraction that would have led the economy into a deep recession or the recourse to new sources of financing.

Trying to break with a history of adjustment through sharp contractions, the authorities opted for a gradual reduction of the fiscal deficit combined with efforts to improve infrastructure to ensure political support for reform. Domestic financial markets are underdeveloped and were too small to finance the transition, as domestic saving is low and often invested is foreign-currency denominated assets. At the same time, an agreement with hold-out creditors in early 2016 re-established access to foreign financing. The objective of achieving a balanced budget over a period of five years generated sizeable external borrowing needs, which was covered by issuing foreign-currency debt. In a context of low public debt, abundant international liquidity and investor interest in Argentine assets in 2016-2017, the resulting vulnerabilities appeared manageable.

While primary expenditures fell gradually, rising interest payments held back visible reductions in the overall fiscal deficit (Figure 2). Unpaid expenditure commitments of the previous administration added to primary spending in 2016, while the agreement with hold-out creditors added to interest payments. This was further exacerbated by a 2017 tax reform that reduced revenues by 2% of GDP. Previous OECD recommendations had called for a revenue-neutral tax reform (Table 7).

Figure 2. Fiscal policy adjusted only gradually



Source: Ministry of the Treasury, CEIC, OECD calculations.

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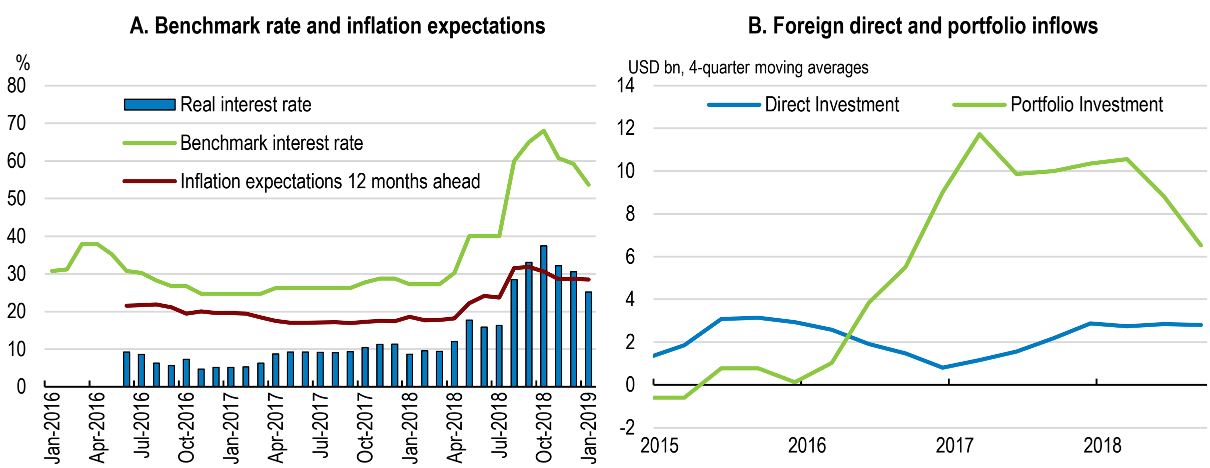
The moderate pace of fiscal adjustment was combined with tight monetary policy to bring inflation to single digits within two years. While the original targets turned out excessively ambitious, high ex-ante real interest rates of over 8% reflected the strong burden put on monetary policy (Figure 3). These high interest rates attracted large portfolio capital inflows.

Figure 3. High interest rates attracted portfolio inflows



Source: INDEC, CEIC.

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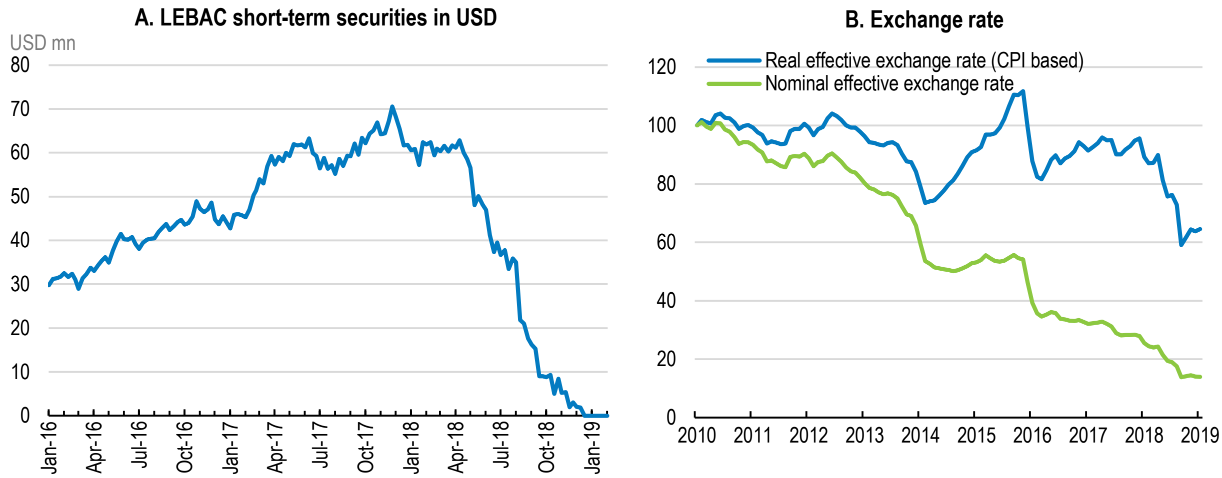
Capital inflows created a number of challenges and vulnerabilities (Figure 4). The real exchange rate appreciated, holding back necessary adjustments in the real economy, including the development of new export opportunities. The short maturities of capital inflows, including large carry trades, generated significant roll-over risks. Short-term Central Bank liabilities (LEBACs) used for the sterilisation of the inflows and accumulation of reserves had reached 10% of GDP by mid-2018.

Figure 4. Capital inflows implied real appreciation and short-term vulnerabilities



Source: OECD Exchange rate database, Central Bank.

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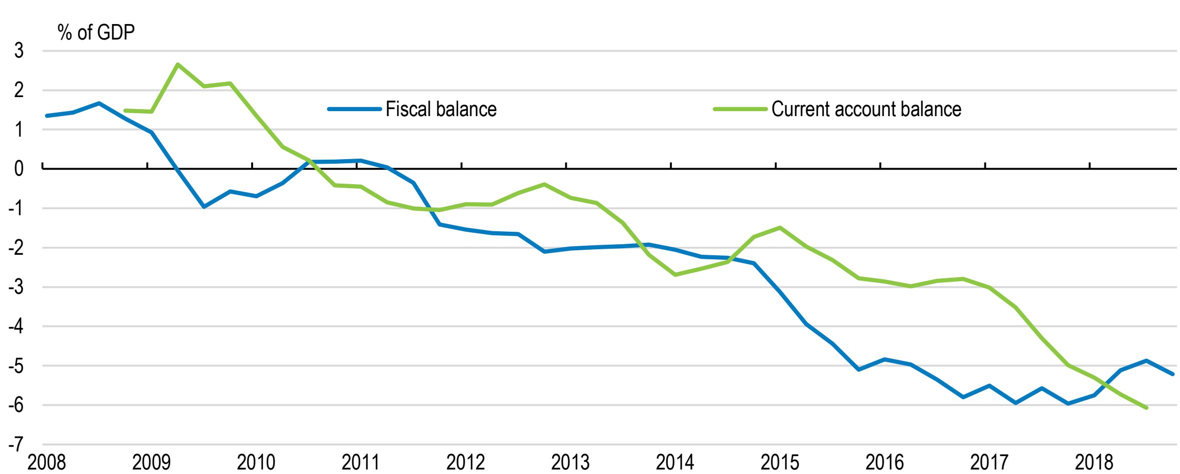
As the fiscal deficit remained high and capital inflows held up strong, fiscal and external imbalances widened, making the economy increasingly vulnerable (Figure 5). The size of the current account deficit doubled between end-2015 and mid-2018, peaking at 6% of GDP. At the same time, the rising headline fiscal deficit did not show a clear turnaround until mid-2018.

Figure 5. Fiscal and external imbalances have widened



Source: INDEC, Ministry of the Treasury, CEIC.

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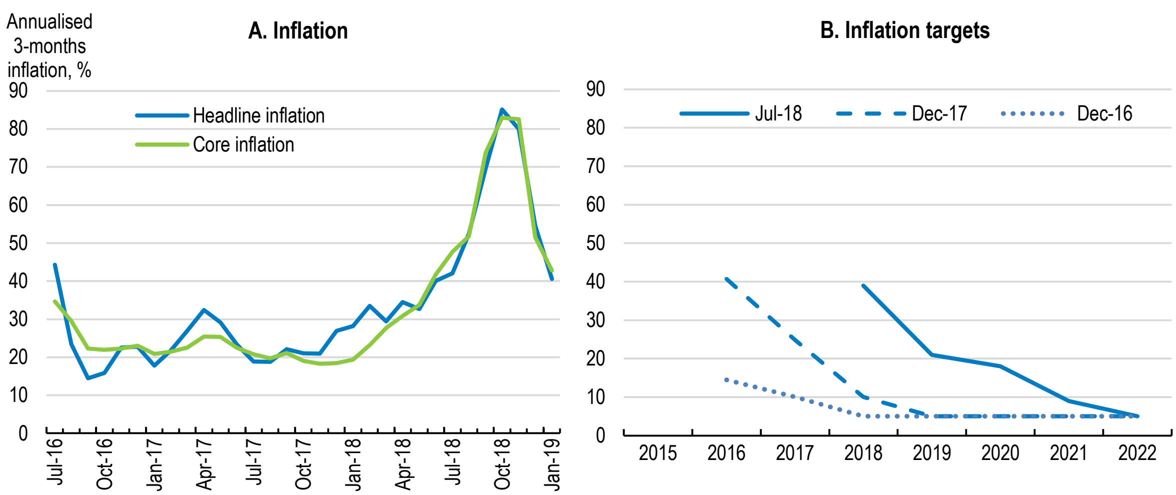
After an initial spike in 2016 related to the removal of energy subsidies, inflation declined until early 2018 (Figure 6, Panel A). Inflation expectations were on a downward trajectory, even though above inflation targets. However, the power of monetary policy to tame inflation was significantly hampered by a weak credit channel and the need for a simultaneous adjustment of relative prices as large-scale legacy subsidies were being reduced. Backward-looking wage negotiations further added to significant inflation inertia.

Inflation targets were revised twice by the executive, arguably adding to the low credibility of monetary policy (Figure 6, Panel B). Particularly the December 2017 revision, which led the Central Bank to lower interest rates amid high inflation, raised doubts about the *de facto* independence of monetary authorities. The Central Bank has no formal independence and its governor can be replaced by the executive at any time after a non-binding consultation with Congress. In addition, monetary financing through regular transfers of non-realised profits to the Treasury, which continued until June 7, 2018, undermined the financial independence of the Central Bank. Core inflation began to rise markedly in the aftermath of these events.

Figure 6. Inflation has spiked as targets have moved



Note: Headline and core inflation in Panel A represent the nationwide indices as of their creation in January 2017, combined with monthly changes based on the indices for the capital region before that.
Source: INDEC; Central Bank of Argentina.

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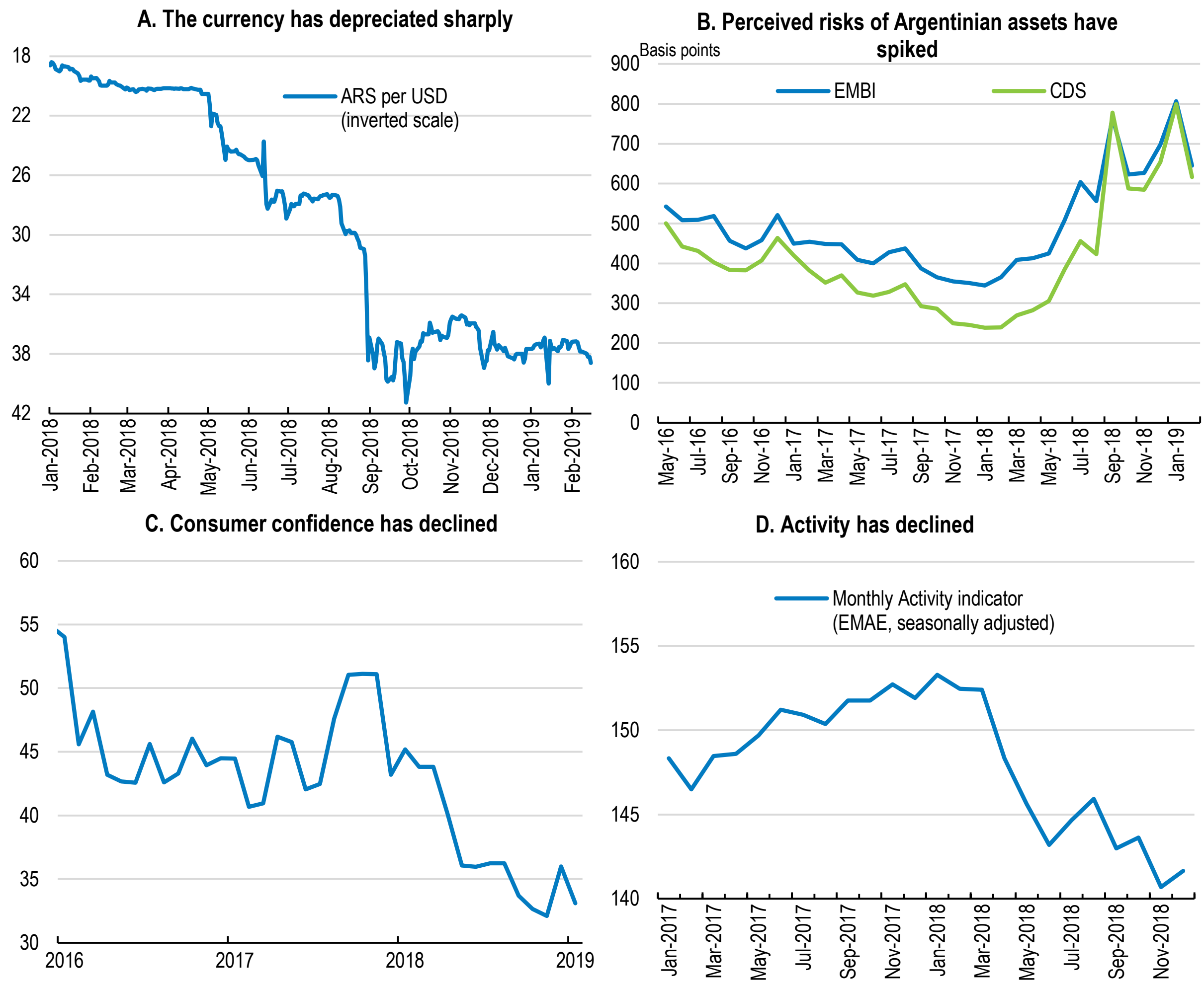
A deep recession set in after a sudden reversal of capital flows

Against this background of vulnerabilities, markets reacted with a sudden capital flight out of peso-denominated assets as of late April 2018. The value of the currency declined sharply amidst severe confidence losses, rising risk premiums, faltering growth and rising inflation (Figure 7). Over the following six months, the peso lost almost 50% of its value. While it is hard to pin down a single reason for this unexpected chain of events, possible factors include rising US interest rates and the resulting declining appetite for emerging market assets, the slow decline of the headline fiscal deficit, a lower demand for Argentinian pesos stemming from the exceptional drought and the resulting collapse of agricultural exports as well as a lack of confidence in the independence of the Central Bank and the conduct of monetary policy. Estimates suggest that overall non-resident capital flows into emerging markets declined by some USD 120 billion between 2017 and 2018 (Institute of International Finance, 2018[2]), and the weather-related shortfall of agricultural export revenues amounted to USD 8 billion, equivalent to 2% of Argentina's GDP.

Figure 7. Short-term indicators have deteriorated



Source: Central Bank, INDEC, CEIC.

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Threatened by losing access to foreign financing and a serious liquidity crunch, the authorities reacted in a timely and decisive manner by accelerating the fiscal adjustment, raising interest rates, retiring the stock of short-term LEBAC securities and seeking a USD 56.3 billion financing arrangement with the International Monetary Fund (Box 2).

The gradual approach to fiscal adjustment was abandoned and current fiscal targets aim for an elimination of the primary deficit in 2019, followed by a primary surplus of 1% of GDP in 2020 (Figure 8). These new targets imply a fiscal effort of almost 6% of GDP during 2018-2020, which is a large consolidation in historical and international comparison. The strong fiscal contraction will be a drag on growth, at least for some time, and its implementation without a majority in Congress a challenge. At the same time, not meeting the fiscal commitments would have much larger economic costs, including a major economic crisis. Adhering to fiscal targets will be seen as a litmus test for the authorities and should be the priority.

Box 2. Argentina's IMF programme

Between late April and September 2018, Argentina's currency depreciated by 50% as investors shunned domestic currency for dollar assets. This reflected loss of confidence due to the gradual economic adjustment plan, especially the slow reduction of the headline fiscal deficit, which implied large external financing needs, and the fact that inflation had surged again following a relaxation of monetary policy.

In July 2018, the government agreed a USD 50 billion financing arrangement with the International Monetary Fund (IMF), which was renegotiated and expanded to a total of USD 56.3 billion in September to reduce the dependence on market financing during 2019 and 2020. The programme is based on four pillars.

A first pillar of the programme is to restore market confidence through lower federal financing needs, ensured by new primary fiscal targets of 0% of GDP in 2019 and 1% in 2020 as part of a budget approved by Congress in November 2018. Providing sufficient resources to the newly created Congress Budgetary Office and a strengthening of tax authorities are further structural benchmarks under this pillar.

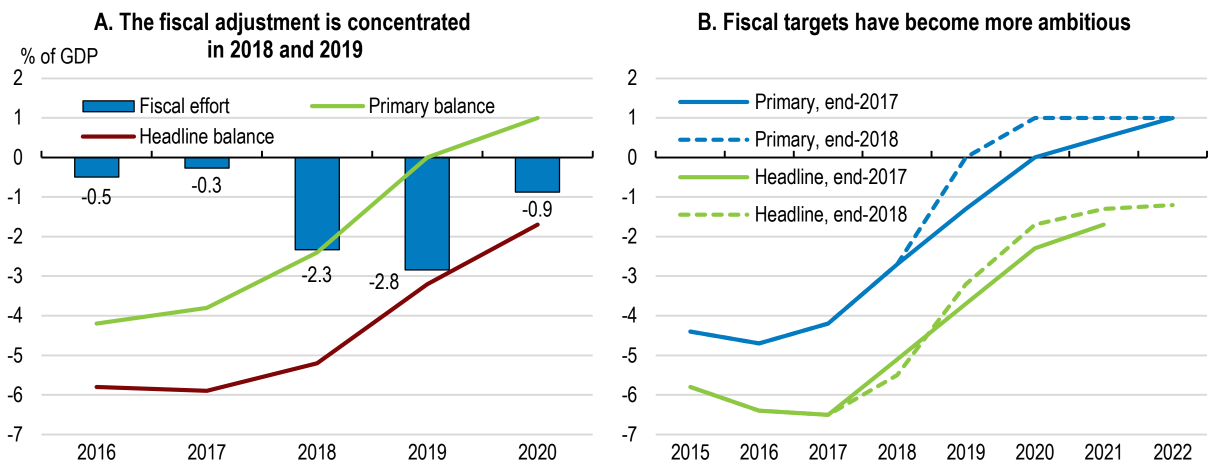
A second pillar is to protect society's most vulnerable by strengthening the social safety net, including through a redesign of assistance programmes and a protection of social spending, with the possibility of accommodating additional spending on pre-identified, means-tested social assistance projects under certain conditions.

A third pillar aims to strengthen the credibility of the Central Bank by providing it with more institutional and operational independence and autonomy, through a new Central Bank charter to be submitted to Congress. These efforts also include improvements in the Central Bank balance sheet and the extinction of short-term peso-denominated Central Bank debt in the hands of the general public (LEBACs). A new type of Central Bank debt (LELIQ) will only be sold to domestic banks. Non-transferable and non-interest bearing legacy government securities will be repurchased over time to reduce the Central Bank's net claim on the government and strengthen its balance sheet.

A fourth pillar is to lessen the strains on the balance of payments by rebuilding international reserves and reducing the current account deficit.

Adjustments of this size imply difficult choices. While some of the envisaged consolidation measures will have limited side effects on growth and inclusiveness in the short term, in other cases the potential trade-off between consolidation and other policy objectives can by eased by implementing structural reforms (OECD, 2013[3]) The fiscal adjustment is largely based on reductions in expenditures, including a cut in capital expenditures (worth 0.5% of GDP), further reductions in subsidies (0.7% of GDP), a real wage and hiring freeze for civil servants (0.2% of GDP) and a 20% real reduction of all other current expenditures (0.2% of GDP).

Figure 8. Fiscal consolidation has been frontloaded



Note: Fiscal effort is defined as the year-on-year difference of the structural primary balance, which is adjusted for cyclical factors.
Source: Ministry of the Treasury, CEIC, OECD calculations.

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Revenue increases will come from a new temporary tax on exports to be applied until end-2020, at 10% for exports of primary goods and services and at 7.5% on all other exports. This is expected to raise an annual 1.1% of GDP in additional revenues and has the advantage of being easy to implement. New restrictions on international trade work against the needed outward re-orientation of the economy and can only be justified by the emergency character of the situation, but the authorities have been clear that they see export taxes as a temporary emergency measure. Moreover, it is important to note that in the current context, these taxes take back only a part of the 50% depreciation. For non-commodity exports where – unlike in agriculture – competitiveness has been a serious issue in the past, the authorities should monitor carefully to what extent this new tax slows down the development of new export opportunities. It is also crucial to ensure that these taxes are not extended beyond 2020, if they cannot be phased out earlier.

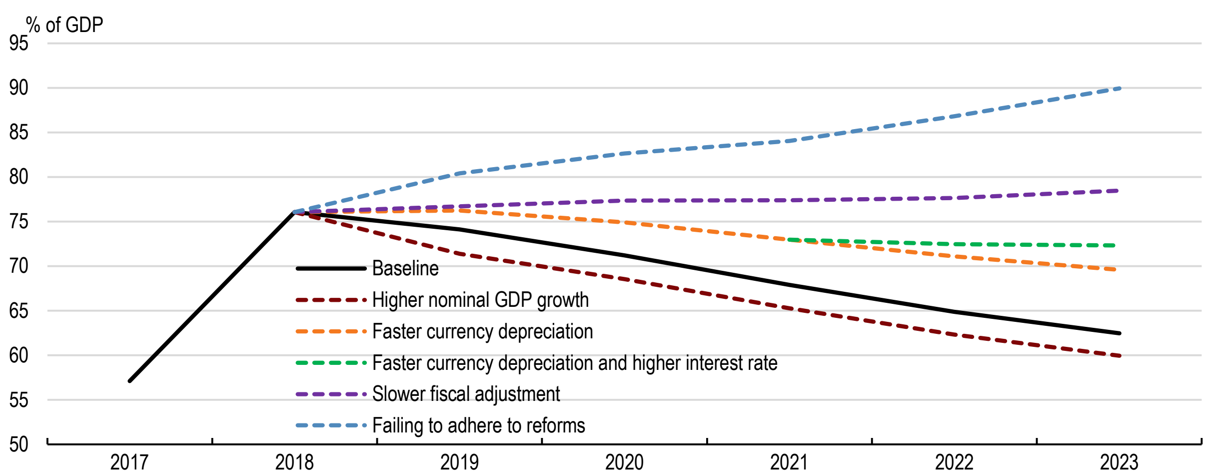
Social expenditures, which make up more than half of primary spending, are being protected and can be expanded further to mitigate social hardship caused by the crisis. The agreement with the IMF provides a space of 0.2% of GDP to raise spending on well-targeted social benefits in case real-time measures of poverty deteriorate, and this space should be used as much as necessary.

After rising over 30 percentage points due to the depreciation, gross public debt is projected to reach 76% of GDP at the end of 2018, which is among the highest for emerging economies. Over 75% of debt is denominated in foreign currency and interest payments amount to 2.8% of GDP, above the OECD average of almost 2% of GDP. Current fiscal plans are sufficient for debt to decline relative to GDP as of 2020, to reach 62% of GDP in 2023 in the baseline scenario (Figure 9). The declining trajectory of gross public debt is subject to risks, and the prospects for debt sustainability would look less benign in several alternative scenarios. For example, failing to adhere to the current ambitious fiscal targets and maintaining the 2018 primary deficit would imply a continuously rising debt, to reach 78% of GDP in 2023. Renewed market turbulence causing faster currency depreciation and higher market interest rates as of 2021, when market financing will once again need to cover much of public financing needs, would flatten the downward trajectory of debt. In a scenario where reforms stall, both with respect to fiscal adjustment and structural reforms, implying lower growth, stronger depreciation and higher market interest rates, debt levels would rise continuously to 90% of GDP.

Looking ahead, the authorities should strengthen efforts to raise the share of domestic currency debt to reduce the vulnerability of public finances stemming from exchange rate developments, although it will take time to rebuild the necessary investor confidence in macroeconomic stability and in domestic-currency assets with longer maturities. Currently, the debt-sustainability analysis is highly sensitive to the assumed exchange rate.

At the same time, over 40% of gross public debt is held by other public sector entities including the social security fund and faces no roll-over risks. Regarding liquidity risks, net debt, which stands at 50% of GDP, may be a more accurate measure. Net debt is projected to decline to below 40% of GDP by 2023 in the baseline scenario and would not exceed 55% of GDP by 2023 in any of the scenarios considered. Still, if the central government were to experience payment difficulties, in the long run these could spread over into other parts of the public administration, including the social security administration, and lead into a negative feedback loop.

Figure 9. Gross public debt is stabilising under several scenarios



Note: In the baseline scenario, the primary deficit is as in government targets and the real exchange rate appreciates by an average of 3% per year over 2019-2023. Real GDP growth is as in Table 1 and 2.5% per annum thereafter. The currency composition of public debt is assumed constant. The slower fiscal adjustment scenario assumes 2% of GDP less fiscal adjustment each year over 2019-2023, with no changes in other variables. The higher nominal growth scenarios assume a combined increase in real GDP growth and inflation of 5 percentage points each year. The faster currency depreciation scenario assumes 20% higher increases in the ARS/USD exchange rate each year. The scenario with faster depreciation and higher interest rates assumes in addition 200 bps higher interest rates for both USD and ARS debt as of 2021, when market funding will become more important. The failure to adhere to reforms scenario assumes 2% of GDP slower fiscal adjustment each year, 2% lower growth due to a failure to implement structural reforms, in addition to faster depreciation and higher interest rates as of 2021 as in the scenarios above.
Source: OECD calculations.

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Monetary policy authorities decelerated the growth of the monetary base from 44% year-on-year in late September to a monthly growth of 0% as of October and committed to keep the monetary base almost constant until June 2019. This changes the target of monetary policy from targeting inflation to targeting the monetary base, at least temporarily, with a return to inflation targeting envisaged once inflation has come down visibly. With inflation at 51%, this new monetary policy will have a strong contractionary effect and currently results in a benchmark interest rate of 64%, down from a peak of 73% in October 2018. In conjunction with contractionary fiscal policy and public sector wage restraint, which could help guide collective bargaining in other sectors, the current policy stance is likely to achieve a significant reduction in inflation.

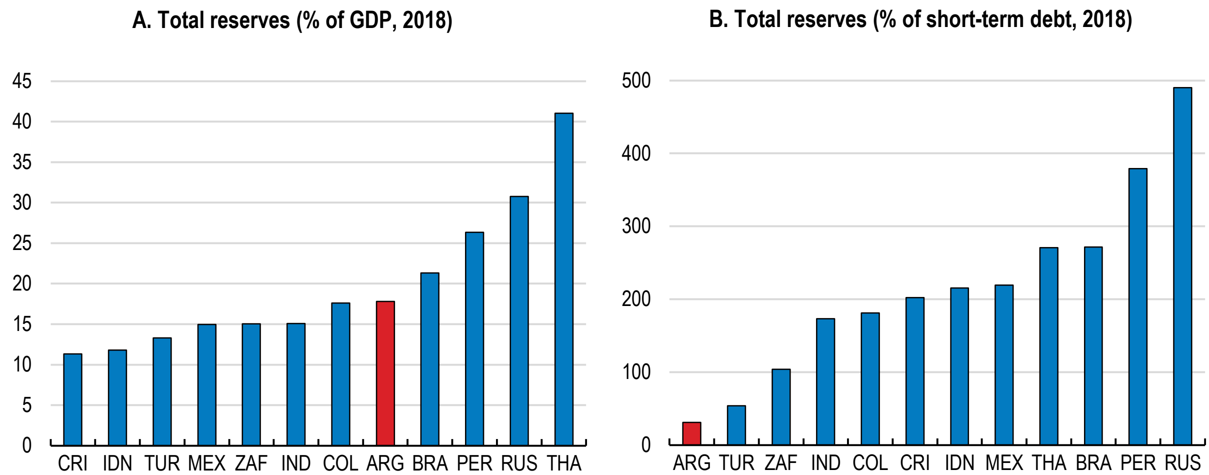
The new regime enhances transparency as changes in the monetary base are observable with short lags. At the same time, well-known drawbacks of monetary targeting have led several countries to abandon this regime in favour of inflation targeting in the past. Most notably, changes in the velocity of money, which measures the link between money and nominal incomes, can imply an unstable relationship between monetary aggregates and inflation. In the current high-inflation and high-volatility environment, this possibility could make monetary targeting less effective. At the same time, the effectiveness of the previous inflation targeting regime based on changes in interest rates suffered from a weak transmission, particularly in times of crisis when already low credit transaction volumes had dried up even further and the credibility of monetary policy had been questioned. In this context, money supply targeting is a reasonable temporary measure, but targets to reduce inflation are equally important.

A new framework that limits currency interventions to extreme volatility, as defined by instances where the exchange rate leaves a moving corridor, reflects the trade-off between keeping exchange rate volatility low to anchor expectations and the scarcity of currency reserves. If the ARS/USD exchange exceeds the corridor of +-15%, daily central bank interventions to strengthen the peso are limited to USD 150 million. At the same time, the Central Bank can purchase limited currency reserves without sterilisation if the exchange rate falls below the lower bound of the corridor. This would allow market-determined interest rates to come down.

Prior to September 2018, central bank interventions in currency markets had produced losses in reserves of USD 13 billion, but had only limited success in stabilising the currency. Currency reserves of 18% of GDP are mid-range in international comparison, but relative to short-term debt, reserves are much lower (Figure 10). This places severe limits on the potential scope for currency interventions. The new exchange rate regime strikes a reasonable balance between preserving a flexible exchange rate and limiting interventions on one hand, and legitimate concerns about extreme exchange rate volatility, which have strong effects on expectations in Argentina, on the other.

A number of institutional weaknesses in the monetary policy framework are being addressed. Authorities have committed to recapitalising the Central Bank to clearly defined levels of capital and future monetary financing will be limited to realised profits provided the Central Bank capitalisation is achieved. In addition, the Treasury will buy back non-transferable legacy treasury bonds held by the Central Bank (currently USD 32 billion). Changes to the charter of the Central Bank will strengthen its independence by defining clearly the circumstances and procedures by which members of the monetary policy committee can be dismissed and by focusing its mandate on price stability. These changes, however, are still pending implementation and the approval of Congress. Doing so will be crucial for bringing down inflation durably.

Figure 10. Currency reserves are low in international comparison



Source: IMF, CEIC, OECD Economic Outlook Database.

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A recovery is expected to start as of 2019

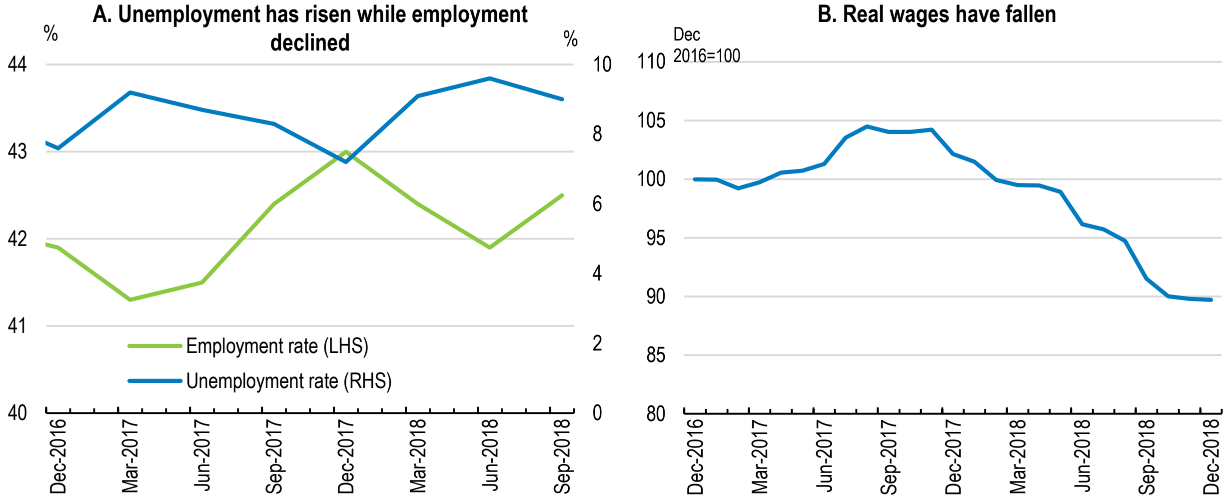
Against this difficult background, the economy fell into recession as of the second quarter of 2018 with domestic demand contracting sharply. A simultaneous decline in exports was due to a record drought that resulted in an exceptionally bad harvest.

Looking ahead, a number of forces will continue to constrain domestic demand. Confidence is recovering slowly from the turbulent events between March and September of 2018 and this will require visible improvements in both fiscal outcomes and inflation, in addition to a stabilisation of the exchange rate. Given the economy's high dollarization, the exchange rate is one of the most widely observed economic variables.

Both fiscal and monetary policies will have significant contractionary effects on growth according to OECD projections, until at least July 2019 for the case of monetary policy and well into 2020 for fiscal policy. Domestic interest rates, which are endogenous under the new monetary regime, will decline to the extent that demand for domestic-currency assets recovers, which itself is intimately linked to a more stable exchange rate.

Higher inflation curbed household consumption and affected particularly low-income earners. Unemployment rose and average real wages declined by 12% during the first 11 months of 2018 (Figure 11). This decline has been particularly pronounced in the two northern and relatively poorer regions of the country. Investment, which had been leading the expansion, contracted sharply in the context of increasing uncertainty, rising import prices and tighter financial conditions. Few investment projects will generate returns that exceed current local-currency interest rates and an easing of financing conditions will be key for the timing of the recovery.

Figure 11. Labour market conditions have deteriorated



Note: Real wages cover public and private formal and informal employment, deflated by CPI.
Source: INDEC, CEIC.

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Against this background, growth contracted sharply in 2018 and OECD projections do not expect a return of positive growth – on a quarter-on-quarter basis – before mid-2019, which implies negative growth for 2019 when comparing average annual GDP levels. Unemployment, which usually reacts with a lag, will rise until 2020 (Table 1). Using the fiscal space foreseen in the IMF agreement for spending more on well-targeted social benefits can mitigate the likely increase in poverty and this space should be used to the extent that poverty indicators deteriorate. As part of the crisis response, recipients of means-tested family allowances have already received extraordinary one-off payments and inflation adjustments.

Exports will lead the way out of the recession as of 2019, while domestic demand will take longer to recover given the tight monetary and fiscal policies. Several factors underpin projected improvements in export performance. For one, expert projections for agricultural production are promising due to expected favourable weather conditions (USDA, 2018[4]). The recently concluded wheat harvest was very strong and confirmed that picture. Currently, agricultural products account for around 40% of exports (Table 2). Assuming stable prices for agricultural exports, these volume projections would imply export growth of almost 16% for 2019 if they were to fully realise. At the same time, the more competitive real exchange rate is likely to spur non-agricultural exports as well. Non-primary exports have increased by 27% in volumes at annual rates during the second half of 2018. The new level of the exchange rate is the most competitive one that Argentina has had in 10 years (IERAL, 2018[5]). The current account deficit of currently 6% of GDP is projected to fall in 2019, with a further decline projected for 2020.

Table 1. Macroeconomic indicators

	2014	2015	2016	2017	2018	2019	2020
GDP at market prices	-2.5	2.7	-1.8	2.9	-2.5	-1.5	2.3
Private consumption	-4.4	3.5	-1.4	1.2	-2.1	-4.1	2.1
Government consumption	2.9	6.8	0.3	2.2	-3.5	-4.9	-2.6
Gross fixed capital formation	-6.8	3.8	-5.1	11.0	-5.1	-15.3	3.3
Total domestic demand	-3.9	4.0	-1.6	6.3	-2.6	-5.3	1.6
Stockbuilding[1]	-0.3	-1	-0.5	1.8	0.1	0.4	0.0
Exports	-7.0	-0.6	3.7	0.4	-2.0	15.0	7.9
Imports	-11.5	5.7	5.4	15.0	-2.5	-4.7	4.2
Net exports[1]	0.7	-0.9	-0.3	-2.0	0.1	3.0	0.9
Other indicators							
CPI inflation[2]	38.4	24.0	42.4	24.8	47.6	34.0	25.0
Core inflation[3]				21.1	47.7	33.0	25.0
Unemployment rate	...[4]	...	8.5	8.4	9.5	12.0	13.0
Fiscal balance (per cent of GDP)	-4.0	-5.6	-5.8	-5.9	-5.2	-3.2	-1.7
Primary balance (per cent of GDP)	...	-4.4	-5.0	-3.8	-2.4	0.0	1.0
Public sector debt (gross, per cent of GDP)			55.0	57.6	76.1	74.1	71.2
Current account balance (per cent of GDP)	-1.5	-2.7	-2.8	-5.6	-5.2	-1.2	-0.6

1. Contribution to changes in real GDP.
2. Before 2017, for Greater Buenos Aires only. End-of-period, December-on-December changes.
3. End-of-period, December-on-December changes.
4. Not comparable with later data.
Source: OECD projections, OECD Economic Outlook Database, INDEC, Central Bank.

Table 2. The structure of exports and imports

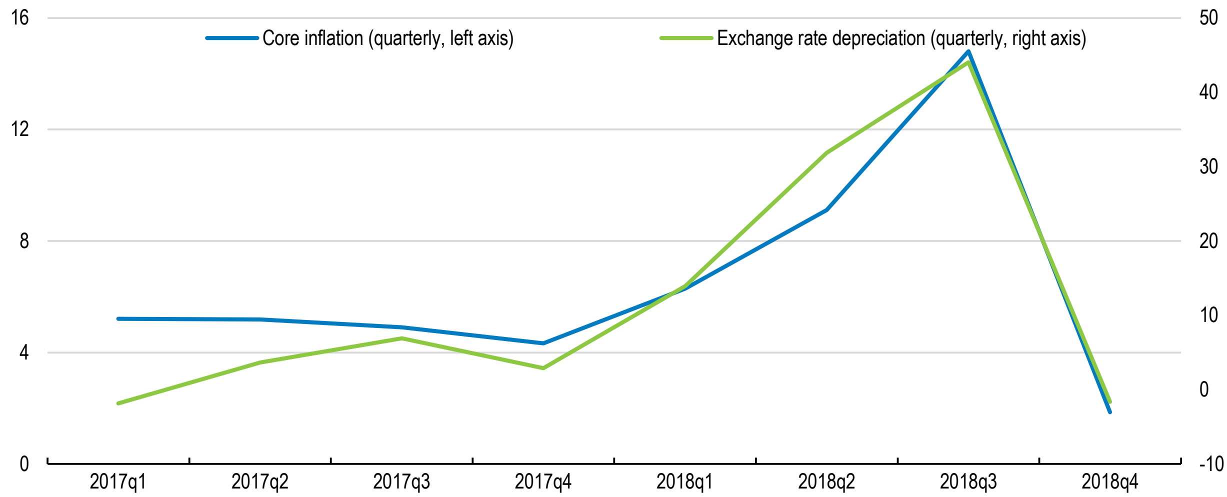
10 main exported and imported goods in 2017 (in % of total exports and total imports, respectively)

Exports (in % of total exports)		Imports (in % of total imports)	
Soybean meal	15.6	Motor cars and other motor vehicles	9.4
Corn	6.7	Parts and accessories for motor vehicles	4.2
Soybean oil	6.4	Electrical apparatus for line telephony or line telegraphy	3.4
Motor vehicles for the transport of goods	5.6	Petroleum gases and other gaseous hydrocarbons	3.3
Soybeans	4.7	Motor vehicles for the transport of goods	3.1
Wheat	4.0	Petroleum oils, other than crude petroleum	3.0
Gold	3.9	Automatic data processing machines and parts thereof	2.0
Motor cars and other motor vehicles	2.6	Medicaments	1.9
Prepared binders for foundry moulds or cores	2.2	Parts for machinery	1.9
Crustaceans	2.1	Other aircraft (for example, helicopters, aeroplanes); spacecraft	1.6

Source: OECD calculations based on WITS data.

Inflation will be determined by developments in exchange rate, administrative prices and macroeconomic policies. Recent data reveal a strong and almost simultaneous correlation between exchange rate depreciation and core inflation (Figure 12). The exchange rate has stabilised since September 2018 and most of the direct inflation effects of depreciation in 2018 have now tapered out.

Figure 12. Exchange rate depreciation and core inflation are visibly correlated



Source: Central Bank.

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Pressures from administrative prices related to the continued subsidy withdrawal will recede temporarily as of November 2018, but new subsidy reductions are planned for the first half of 2019. The adjustments in relative prices have already come a long way. The government's medium-term objective to achieve 90% cost coverage implies that subsidies will need to be reduced by another 0.7% of GDP during 2019. The remaining 10% difference between revenues and costs, approximately 0.4% of GDP, reflect recently introduced targeted social energy tariffs for low-income households and transport subsidies for those who commute from the periphery to city centres combining several means of transport.

Contractionary macroeconomic policies are projected to reduce inflation visibly during 2019. Given year-on-year inflation of 51% in February 2019, however, the decline will be gradual and Argentina will have to live with high inflation for some time. Empirical analysis suggests that about 90% of current monthly inflation is determined by inertia, after controlling for changes in policies and the exchange rate. This limits the possible slope of disinflation, even with tight policies.

Risks around the recovery remain in place

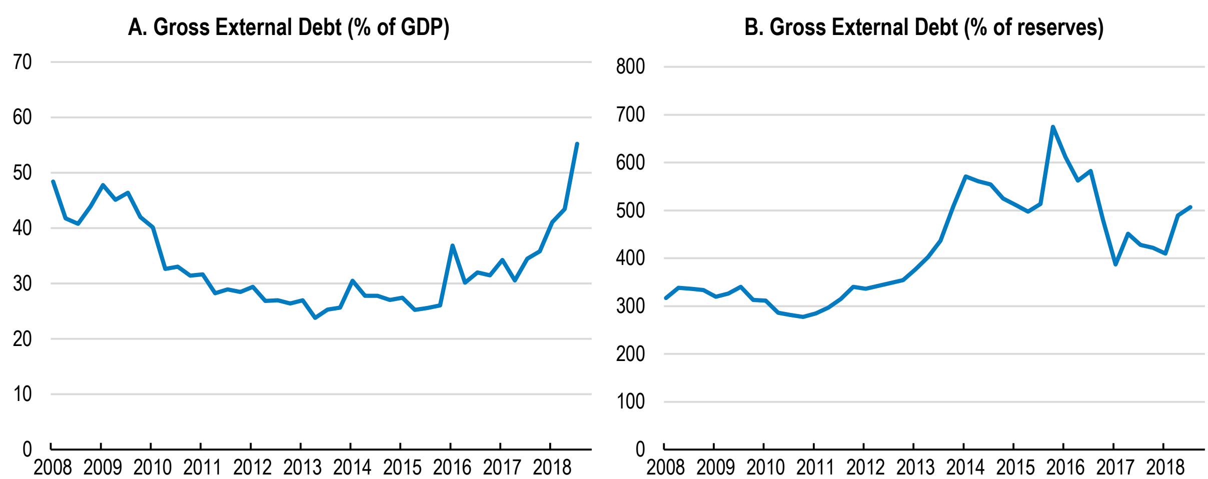
If the current projections materialise, the adjustment will leave the economy with more solid macroeconomic fundamentals and reduced vulnerabilities (Table 3). This will translate into a recovery of confidence and a significant growth pickup as of mid-2019. The adjustment is subject to risks, however.

Domestic demand could contract more than projected against the background of simultaneous fiscal and monetary tightening. The demand effects of the planned monetary contraction, in particular, are difficult to quantify at this point. In the case of a deeper and more prolonged recession, higher unemployment and a deterioration of social indicators could undermine political support for the adjustment and add to political risks.

Political risks around the implementation and adherence to the reform agenda, and hence around the recovery from the current recession, exist in light of the 2019 presidential elections. Indeed, future surprises will be more likely to come from politics than from the economy. While less ambition on structural reforms would lead to lower growth, possible fiscal slippage could cause sudden confidence losses, with possible spill-over effects beyond Argentina, including lower risk appetite for emerging market assets among global investors. Fiscal slippage could also lead to higher risk premiums and unsustainable debt dynamics. IMF financing will cover the bulk of financing needs until 2020, mitigating liquidity risks in the short term.

A return of exchange rate volatility would likely dent confidence and lower the demand for peso assets, which would in turn imply that domestic interest rates would stay high for longer, delaying the recovery of investment and consumption. Faster depreciation would also raise the risk profile of public debt, as over 70% of public debt is denominated in foreign currency. It would also raise external debt, which currently amounts to 55% of GDP, almost 5 times higher than currency reserves (Figure 13). At the same time, a period of renewed real appreciation of the currency could erode parts of the competitiveness gains resulting from the recent depreciation of the currency.

Figure 13. External debt has risen



Source: IMF, CEIC.

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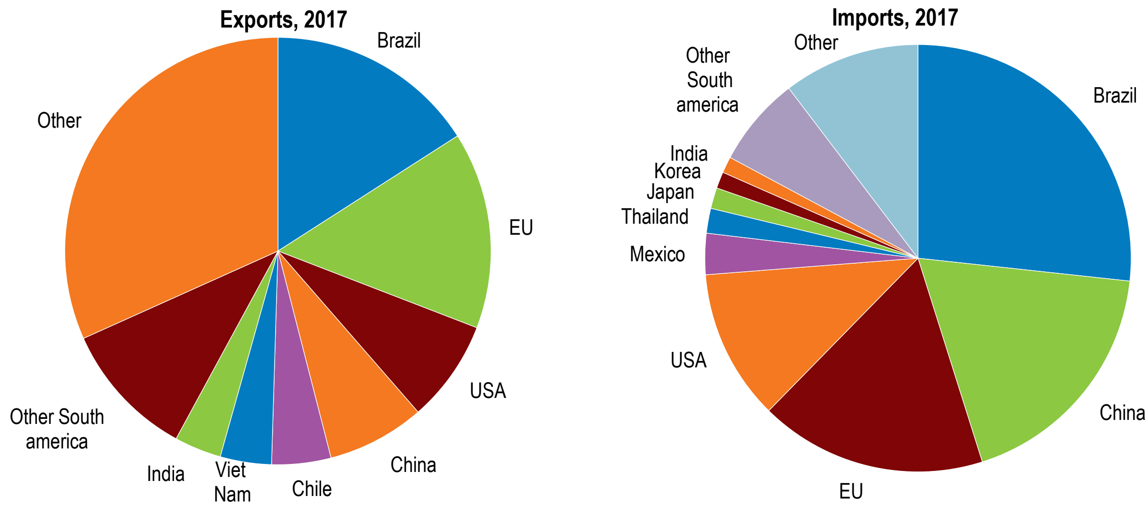
The size of the export response is a potential upside risk, in light of uncertainty about the rebound of agricultural yields and the response of other exports to the more competitive real exchange rate. In the medium run, improvements in export performance could be significantly higher still if authorities seize the opportunity of the newly gained competitiveness to lower trade barriers (see Chapter 1). At the same time, increasingly sluggish world trade growth or a derailed recovery in Brazil, Argentina's major trading partner, could lead to lower export demand (Figure 14).

Figure 14. Main trading partners



Source: OECD calculations based on WITS data.

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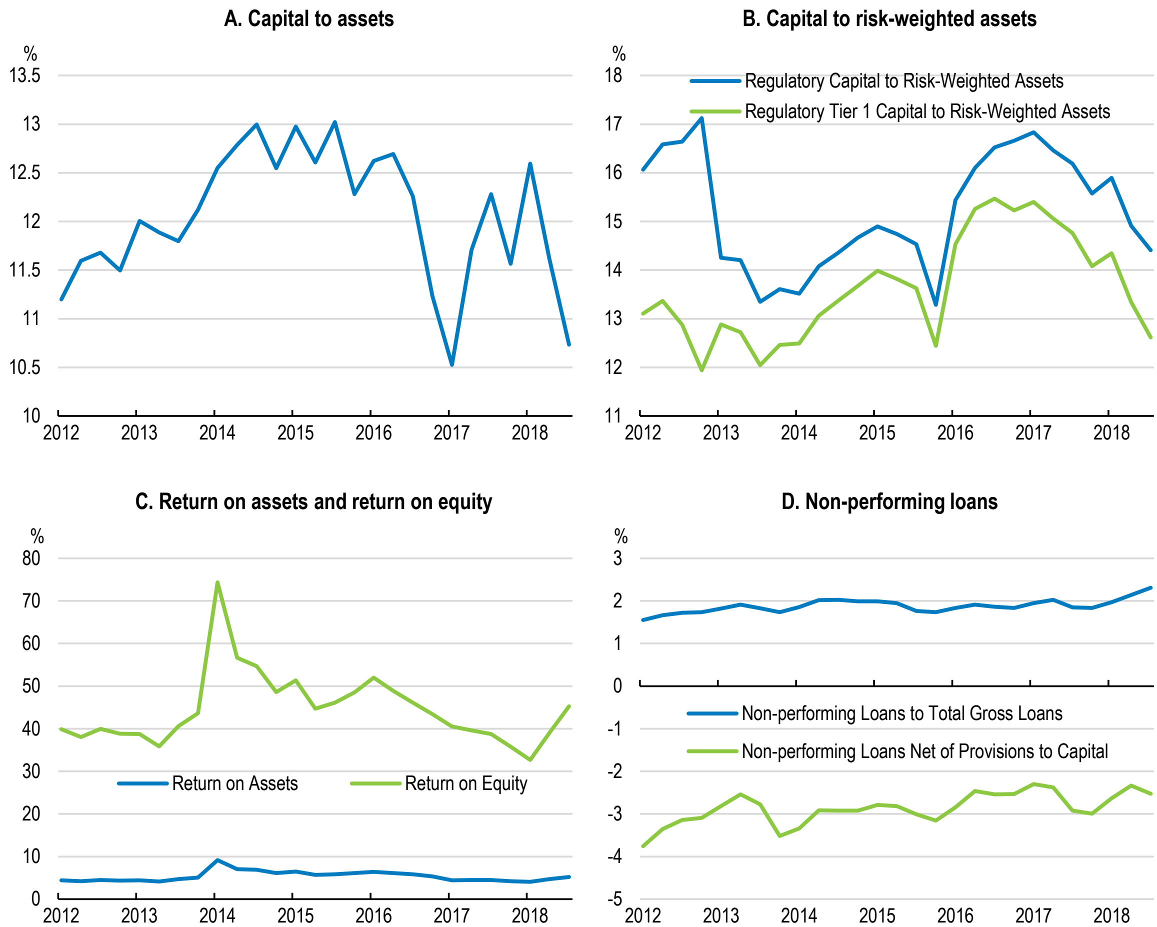
Risks to the decline of inflation risks could come from possible difficulties in keeping nominal wage growth in collective bargaining agreements in line with likely future inflation, as opposed to past inflation. Finally, in the run-up to the October 2019 elections, political risks include a lower commitment to honouring obligations vis-à-vis international creditors, which could lead into a severe crisis. Recent revelations of widespread corruption during the previous administration could delay the implementation of infrastructure projects. Construction companies that are involved in these revelations may become ineligible for public works or as partners in public-private partnerships, which would reduce investment.

Risks could also emanate from the financial sector. The authorities consider that most banks are solid and can withstand substantial levels of stress, reflecting large capital and liquidity buffers, as well as the quality of their assets (Figure 15; BCRA, 2018). 61 out of Argentina's 77 banks exceed the 6% Tier 1 capital ratio recommended under Basel III. At the same time, capital ratios have only limited predictive power for banking distress. Based on available information, banks are profitable and 3.1% of loans to the private sector are non-performing. Currency mismatches exist, but due to strict regulations, only 22% of bank liabilities are denominated in foreign currency. Foreign currency loans to the private sector, which are only extended to exporters and their suppliers, amount to only 13% of bank assets, or 29% of credit to the private sector.

Figure 15. Financial market indicators



Source: Central Bank, IMF.

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Table 3. Potential major vulnerabilities

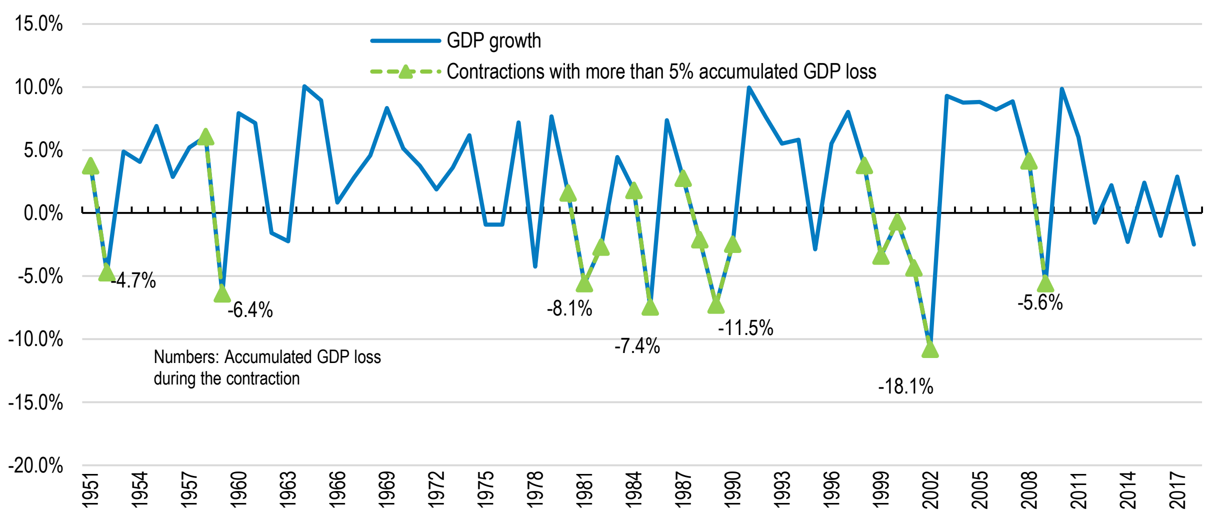
Uncertainty	Possible outcome
Failure to adhere to fiscal commitments	In the case that a future government decided not to honour fiscal commitments with the IMF, further IMF financing could be withdrawn and Argentina could lose market access, triggering an immediate liquidity crunch.
Another round of sudden exchange rate depreciation	Strong depreciation would create challenges for the sustainability of public debt. It would also cause another spike in inflation and reduce confidence. This would throw the economy back into recession.

Medium-term priorities for strengthening inclusive and sustainable growth

Recovery from the crisis is the most urgent priority in the short term, but raising well-being and prosperity also requires tackling a number of more medium-term challenges. Meeting these challenges calls for evidence-based policy design, but also for getting the sequencing of reforms right.

Finding a stable and sustainable path out of the crisis is closely related to some of Argentina's structural challenges. Consecutive boom and bust cycles, often sparked by unsustainable fiscal expansions, have favoured short-term fixes over the pursuit of long-term development strategies, impeded the development of financial markets and led to high degrees of dollarization. A lack of consensus for solving structural weaknesses have left no other way to correct past excesses than through recurrent crises and sharp contractions, whose burden has typically fallen disproportionately on the most vulnerable (Figure 16).

Figure 16. Growth has been volatile



Source: Kidyba, S. and L. Suárez (2017). "Aplicación de índices encadenados al empalme de series. Argentina 1950 – 2015." *Programa de investigación en cuentas nacionales (PICNA)* – FCE – UBA; OECD calculations.

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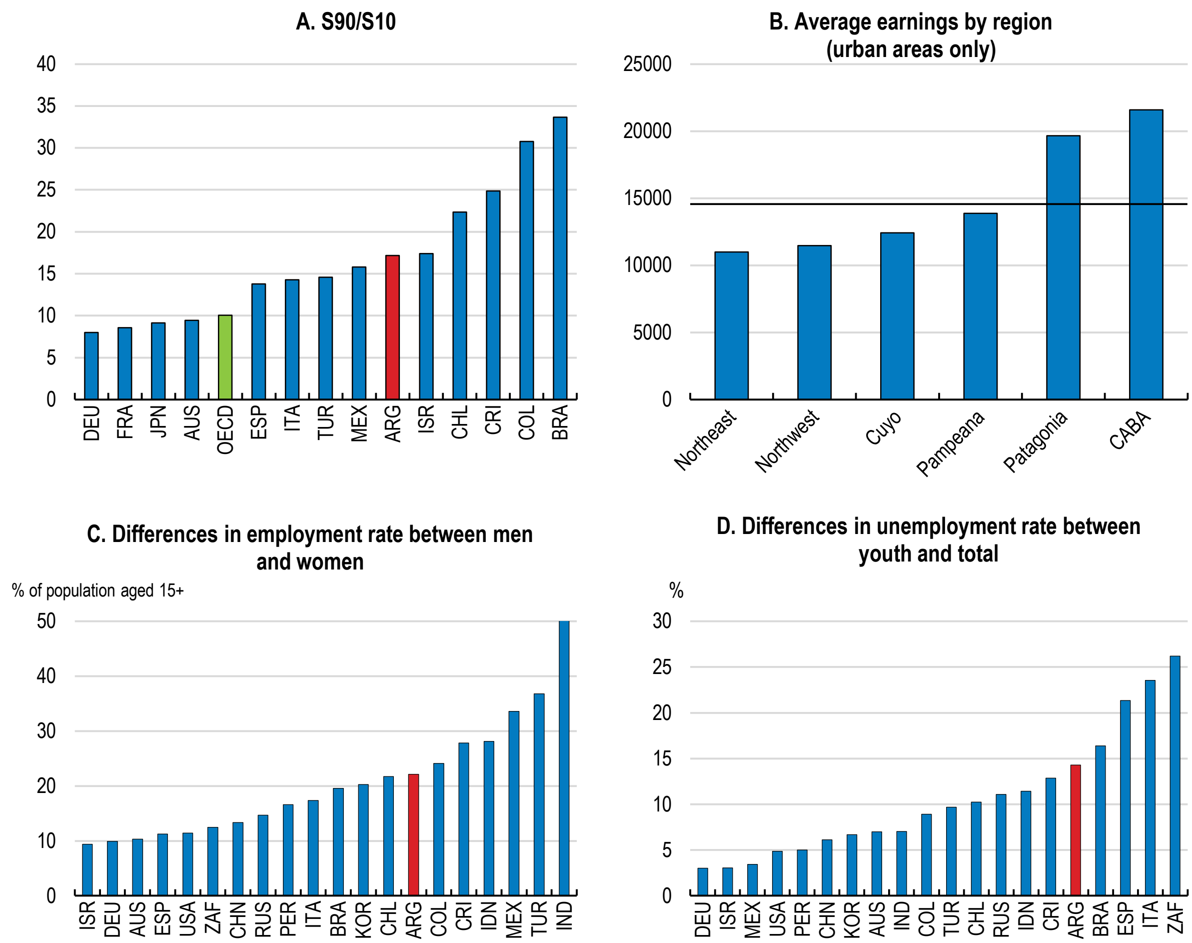
Building the foundations for a period of growth without any major crisis is a precondition for raising average living standards. Productivity improvements will play a key role in this context, as Argentina's productivity performance has been weak over the last 20 years (Baumann Fonay and Cohan, 2018[6]). Improvements in productivity are the basis for creating quality jobs and for sustainable improvements in wages and living conditions. But raising productivity is also about expanding the productive assets of an economy by investing in the skills of its people, allowing everyone to contribute to stronger productivity growth and ensuring that it benefits all part of society (OECD, 2018[7]).

Slow productivity growth and economic instability gave rise to high inequalities. The richest 10% of the population pocket 17 times more income than the poorest 10%, although this is still lower than in other Latin American countries (Figure 17). By contrast, regional income disparities are higher than elsewhere in the region (Gennaioli et al., 2014[8]). Strong links between socio-economic background and outcomes in education and health suggest a lack of equal opportunities.

Figure 17. Inequalities exist in several dimensions



Note: CABA = City of Buenos Aires. Youth unemployment applies to ages 15-24. Data refer to 2017 or latest available year.
Source: World Bank WDI; ILO, INDEC (EPH 2017).

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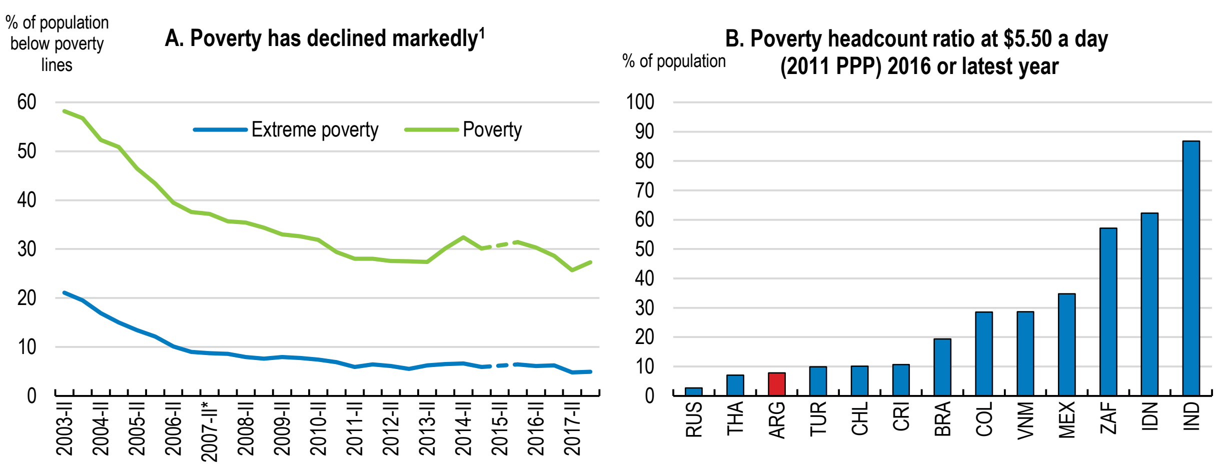
Women are underrepresented in high-level positions in a number of sectors, including the justice system and the private sector. Women and youths do less well on labour markets, mother and child mortalities in poorer provinces are a multiple of those in the capital. Moreover, women often take the responsibility for unpaid care work within the family. Regional differences in social services and the infrastructure for the care of children and older persons imply that gender inequalities and women's difficulties in accessing formal employment are often more pronounced in lagging regions and rural areas, especially for lower-income women. Strengthening and expanding a comprehensive public care system to attenuate social and geographical divides and stronger policy action towards reconciling work and family life for both women and men could help. Women are also victims of violence and face difficulties accessing reproductive services. There may also be scope for implementing measures, including temporary ones, to combat social stereotypes that are detrimental to women.

Indigenous people are almost twice as likely to live in slum-like areas than others and face obstacles in accessing justice, land, education, health care and basic services. Finally, there may be scope to strengthen the position of migrants, especially with respect to their access to social services.

Around 27% of Argentinians live in poverty and 5% in extreme poverty, although it is half the level prevailing after the last major crisis in the early 2000s (Figure 18). This declining trend continued during 2016 and 2017, until the recession raised poverty again during 2018. Persistent pockets of poverty are unevenly distributed across the territory, with concentrations in the Greater Buenos Aires area and the northern provinces.

Figure 18. Poverty has declined and is lower than in other emerging economies



1. Data are representative for urban centres of more than 100 000 inhabitants. The pre-2016 series attempts to emulate the current methodology used by INDEC for comparability. Data for the second half of 2015 are not available.
Source: Tornarolli (2018), INDEC.

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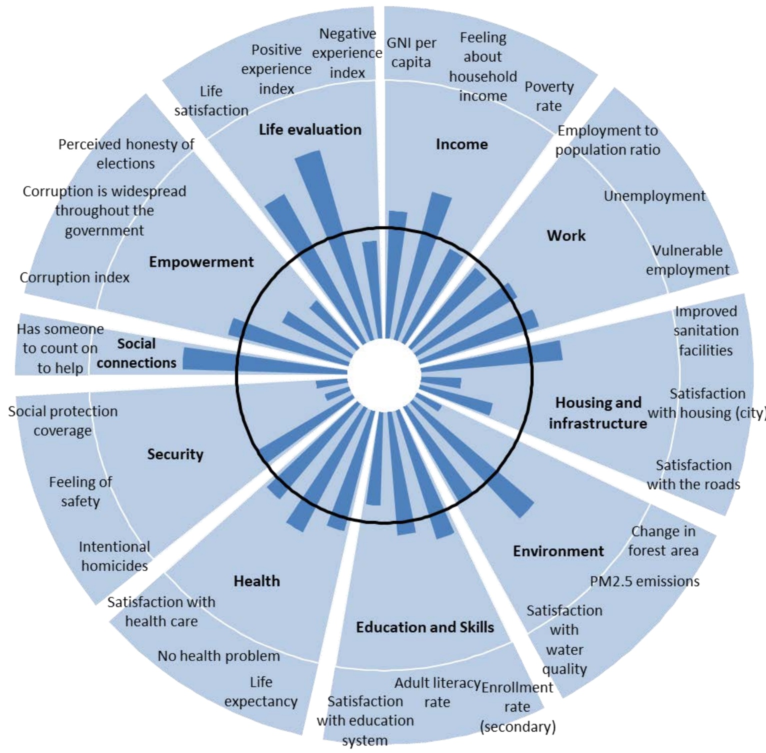
While well-being indicators show relatively good performance in social connections, life evaluation and health, scores are worse in social protection, safety, housing infrastructure and the perceived prevalence of corruption (Figure 19).

Figure 19. Well-being indicators



Note: The bars represent the observed well-being values for Argentina and the black circle shows the expected values based on Argentina's level of GDP per capita, based on regression analysis. The observed values falling inside the black circle indicate areas where Argentina performs poorly in terms of what might be expected from a country with a similar level of GDP per capita.
Source: OECD (2015), PISA Database, www.oecd.org/pisa/data/2015; Transparency International (2016), 2016 Corruption Perceptions Index, www.transparency.org/cpi2016; Gallup (2017), Gallup World Poll, www.gallup.com/services/170945/world-poll.aspx; and World Bank (2017), World Development Indicators (database), https://data.worldbank.org/data-catalog/world-development-indicators. OECD calculations based on OECD Better Life Index – 2017 Edition, www.oecdbetterlifeindex.org.

Past and new structural reforms could have substantial pay-offs

Important steps have already been taken to build a sustainable framework of economic policies, within which new growth opportunities for all can be seized, while protecting those at risk of falling behind (Box 3). OECD estimates suggest that reforms undertaken since early 2016 will raise GDP by almost 7 percentage points of GDP over a decade, equivalent to 0.7 percentage points higher growth each year.

Still, further improvements in structural policy settings will have substantial payoffs for well-being, jobs and prosperity. Long-run GDP effects from further structural reform could be as high as 20% over 10 years, corresponding to an average higher annual GDP growth of 2 percentage points (Table 4). This would have a substantial impact on incomes, but many of these reforms would also make growth more inclusive.

Reducing high barriers to international trade and to entrepreneurship, for example, would raise growth and bring substantial benefits to low-income households (Chapter 1). Reforms on the labour market would help to create better quality jobs and enable many workers who are currently in informal jobs to get formal employment. Improving the working of the public sector could also improve the equality of opportunities, for which stronger institutions are crucial. Several other policy areas could also benefit from reforms, even if the resulting growth effects are not always easy to quantify. For example, improving public spending, taxes and the fiscal framework could deliver better public services, reduce distortions and free up resources to boost social protection, which is particularly important in the current difficult times. Moreover, the commitment to future generations calls for a sustainable use of Argentina's rich natural resources.

Table 4. Expected gains from past and new structural reform are substantial

Estimated impact of selected reforms on real GDP

Reform	Effect of reforms implemented since 2016	Additional benefit of further reforms
Reforms on product markets:		
Lower trade barriers (e.g. by reducing tariffs and non-tariff barriers)	2.6%	13%
Reduce barriers to entrepreneurship (e.g. by cutting administrative burdens and limiting anti-competitive effects of regulation)	2.6%	5.3%
Labour Market Reform	-	0.5%
Reduce corruption (e.g. by improving procurement laws and whistle-blower procedures)	0.8%	1.0%
Improve government effectiveness (e.g. by undertaking systematic audits and evaluations)	0.6%	0.5%
All of the above	6.6%	20.3%
Corresponding to an average annual growth increase of:	**0.7 percentage points**	**2.0 percentage points**

Note: These estimates were obtained on the basis of: i) a numerical indicator of Argentina's policy stance in each policy area, taken from OECD/World Bank Product Market Regulation indicators, World Bank's World Governance Indicators, Doing Business and World Development indicators; ii) a simulated policy shock to the indicator, defined as moving Argentina to the average of the three regional peers Chile, Colombia and Mexico; iii) the quantification framework developed in Égert, 2017[9], which provides an estimate of the impact of changes in the indicator on long-term output growth with a time horizon of 10 years. These quantifications are subject to uncertainty, both about their size and about the time horizon of their materialisation.
Source: OECD calculations.

Box 3. Recent and ongoing reform initiatives

Since late 2015, the following reforms have been implemented:

- Currency controls have been abolished and an agreement with holdout creditors from the 2001 debt default restored access to market financing.
- A cumbersome system of import licensing was replaced by a new system and the number of goods subject to non-automatic licensing reduced. Tariffs have been zeroed for a few select products including notebook and tablet computers.
- National statistics have been overhauled.
- Large and untargeted subsidies for energy and transport are being phased out gradually, while maintaining some targeted benefits for low-income users.
- Social benefits have been expanded, including to the self-employed.

Since the mid-term elections in October 2017, further reforms have included:

- A tax reform will gradually reduce some of the most distortive taxes, including the provincial turnover tax and the financial transaction tax. It has also reduced the tax wedge for low-income earner, reducing disincentives for formalisation.
- A new competition law has established a new competition authority with greater personal and financial independence.
- A new indexation mechanism for old-age pensions has improved the system's sustainability.
- A new law for Public-Private Partnerships (PPPs) and a new Capital Markets law have been passed.
- A new fiscal responsibility law has put limits on many central-government and subnational spending items and reduced budget uncertainty for the provinces.
- A Congressional Budget Office has been created.
- The authorities have committed to submitting a law to Congress to strengthen the independence of the Central Bank by barring monetary financing and defining clear conditions for the dismissal of senior Central Bank staff.

Public expenditures and taxes could be more effective

Public spending has seen a sharp increase of 15 percentage points of GDP over more than a decade until 2016. Part of this extra spending has led to improvements in social protection, including additional spending on pensions and social benefits, but subsidies and rising public payroll expenditures account for large parts of this additional spending (Table 5). The sharp increase has generated scope for reducing public spending going forward, especially by raising the efficiency of public expenditure.

Table 5. The Composition of public revenues and expenditures

% of GDP	2016	2017
Fiscal balance	**-5.8**	**-6.1**
Primary balance	-4.2	-3.8
Interest balance	-1.6	-2.1
Expenditures (Central government only)	**24.1**	**22.8**
Contributory pensions	8.0	8.7
Other social expenditures	3.7	3.6
Subsidies	3.6	2.1
Operative expenditures incl. wages and transfers to provinces	6.7	6.3
Public investment	2.2	2.0
Revenues	**30.8**	**30.3**
Personal income taxes	2.1	2.2
Corporate income taxes	2.9	2.8
Social security contributions	6.8	6.9
VAT	7.1	7.3
Provincial sales taxes	3.9	4.0
Specific excise taxes	1.7	1.8
Taxes on exports	0.8	0.6
Taxes on imports	0.8	0.6
Financial transaction taxes	1.6	1.7
Property taxes (federal and provincial)	1.4	1.5
Other taxes	1.7	0.7

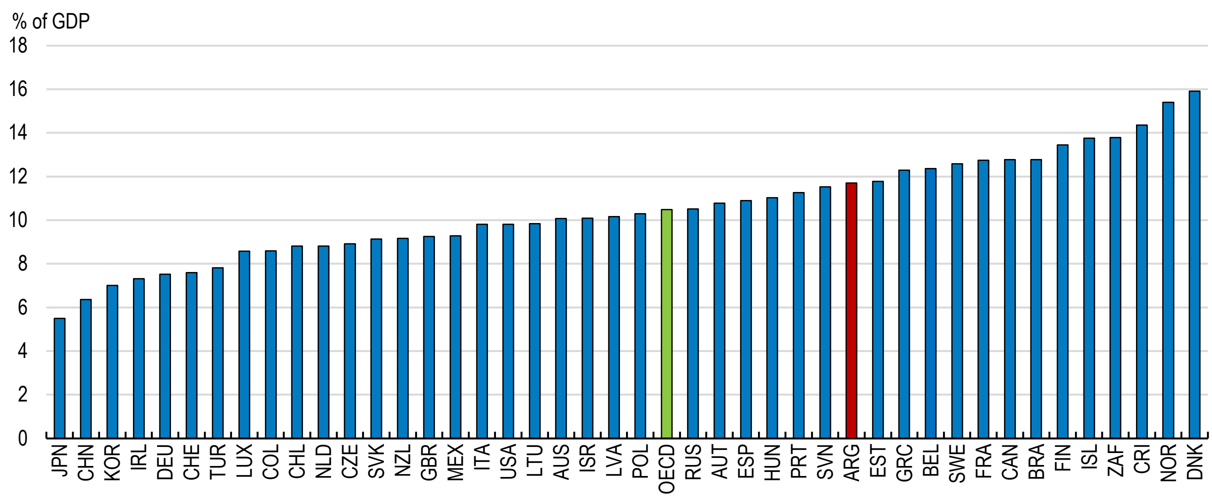
1. Contribution to changes in real GDP.
Source: OECD projections, OECD Economic Outlook Database, INDEC, Central Bank.

The size of the public administration is one such example. Public employment increased by 70% between 2001 and 2014, particularly at the provincial level, and at 11.7% of GDP public sector payroll was above the average of OECD countries in 2016 (Figure 1). Since 2017, public employment growth has been capped at population growth. This is a step in the right direction, but there may be scope for further action. Other current expenditures are also high and public procurement has had a poor track record in the past, as evidenced by recent revisions of previously inflated supplier contracts which allowed substantial savings. The acceleration of the fiscal adjustment includes a real wage and hiring freeze for civil servants and a 20% reduction of other current expenditures, both of which are welcome choices.

Significant progress has been made with respect to the state-owned enterprises sector, which are active in areas such as oil and gas, electricity generation, air and rail transportation, paper production, banking, shipyards, among others and have 125 000 employees. Recently, the sector has become deficit-free as a whole (OECD, 2018[9]). Still, phasing out remaining transfers to a few state-owned companies could allow further savings. The state should carefully evaluate and disclose the objectives that justify state ownership and subject these to a recurrent review. Authorities should also continue monitoring the implementation of financial and non-financial targets.

Figure 20. Public payroll expenditures are high

Compensation of general government employees as a percentage of GDP, 2016 or latest available year



Source: OECD Government at a glance (2017).

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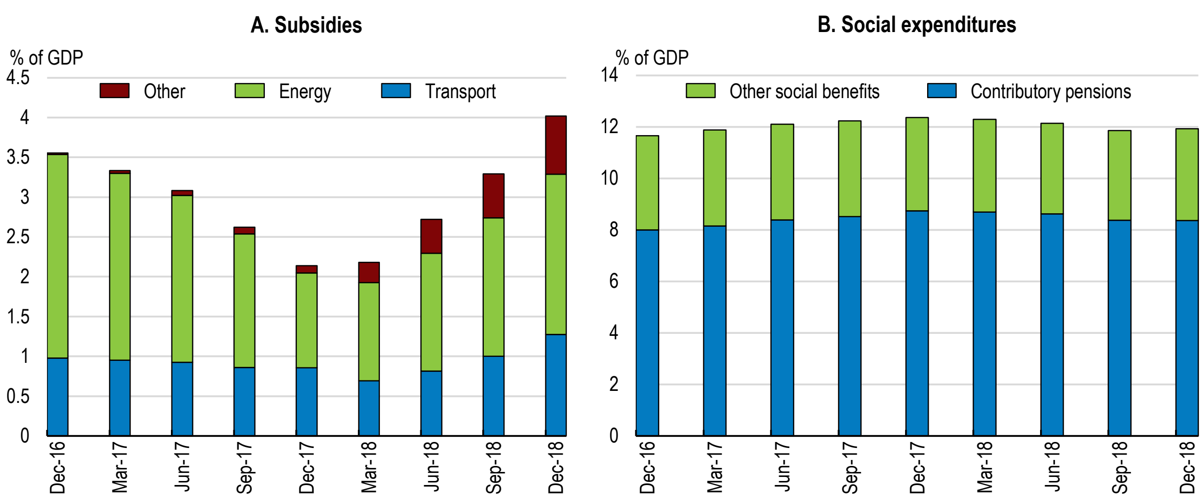
Public investment, which was already insufficient to bring about timely improvements in widespread infrastructure bottlenecks, has been cut by 0.7% of GDP in the context of the new fiscal targets. Being easy to reduce, new public investment often bears a disproportionate share of the burden of fiscal adjustments. The authorities intend to finance much of the ambitious previous infrastructure plans through private-public partnerships (PPPs), for which a new framework law has been passed recently. PPPs can be a useful way to finance public investment in some cases, if risk-sharing is appropriately defined and the full budget implications over their whole life-cycle are properly accounted for in the medium-term budget framework. As per the agreement with the IMF, PPP expenditures will be measured as part of the deficit when the expenditures are made. The present value of all future contingent liabilities from PPPs, many of which are in foreign currency, has been capped at 7% of GDP.

Subsidies for energy and transport reached 3.6% of GDP and are being phased out (Figure 21). Recent plans to accelerate the phasing out of energy subsidies are welcome as these subsidies have regressive distributional effects, besides discouraging energy efficiency (Castro and Barafani, 2015[1]; World Bank, 2015[10]; Lakner et al., 2016[11]). The main beneficiaries of subsidies on electricity and piped gas have been relatively well-off urban households in the capital region, as vulnerable households in less privileged areas are often not connected to the grid and rely on more expensive bottled gas.

Subsidies for public transport have a better social footprint, especially for trips between inner cities and suburban areas, home to many low-income households. Improving the targeting of these subsidies is still possible, however, especially since the introduction of electronic pre-paid travel cards. These have allowed reducing the combined fares for transfers between different means of transport during longer trips to the suburbs.

One argument for maintaining such targeted subsidies is their well-targeted social impact. Evidence from Bogotá, Colombia, suggests that targeted public transport subsidies for poor households have increased hourly wages of workers benefiting from the subsidy, suggesting they increased their productivity by giving them access to better jobs and improving time management (ITF, 2017[12]). Targeted subsidies also make it easier to charge prices which cover full operating costs to other users, freeing resources for improvements in the service and helping to reduce pollution from car use. Policies to integrate housing and transport planning at the metropolitan level can also help to encourage public transport use. Developing location-based transport accessibility indicators is a useful first step in this direction (ITF, 2017[12]).

Figure 21. Social expenditures are rising while subsidies have declined



Source: Ministry of the Treasury.

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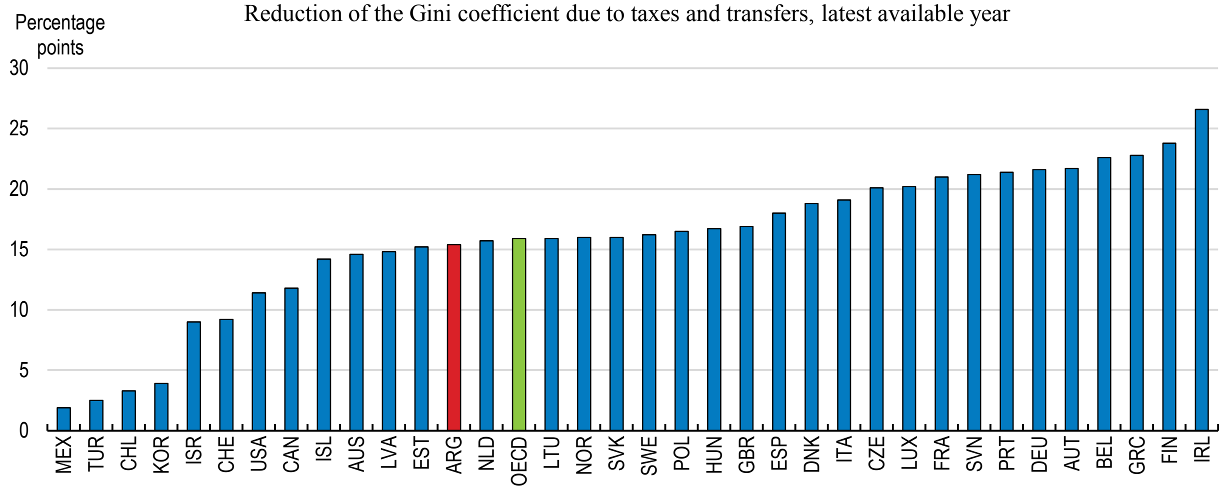
Social benefits have a significant effect on poverty and inequality

Social spending is similar in size to that of some OECD countries and is being preserved in the context of fiscal consolidation (Figure 21). It is also successful in reducing income inequalities (Figure 22). Social policy will remain important to achieve more inclusive growth and cushion the current recession. However, given scarce resources, cost-effectiveness can be enhanced through a better coordination of the large number of policies and programmes offered by different levels of government and different ministries, for example through shared targeting instruments for multiple programs (World Bank, 2015[10]). The establishment of a single window for access to social benefits and the merger of some previous programmes have been steps into this direction.

Figure 22. Transfers and taxes alleviate inequalities

Reduction of the Gini coefficient due to taxes and transfers, latest available year



Source: Rossignolo and Arnold, 2019[13].

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A combination of contributory and non-contributory pensions reduces old-age poverty to below 10% of the age group. The almost universal pension coverage stands out in Latin America, but at almost 11% of GDP pension spending is also high. Pension spending exceeds the combined expenditure on health and education, while covering only 15% of the population.

Contributory pensions require 30 years of contributions and the retirement age is 65 years for men and 60 for women. A more gradual definition of the minimum threshold of 30 years of contribution for contributory pension benefits could reduce inequities and strengthen workers' incentives for formalisation. Non-contributory pensions of 80% of the regular minimum pension have a strong distributional impact and are granted solely on the condition of age for those without contributory pensions.

A pension deficit of 3% of GDP is covered from general taxation. This shortfall is likely to remain stable until the demographic bonus ends in the late 2030s. However, pension spending would surge to 21% of GDP by 2065 without parametric changes suggesting a need for a wider reform of the system in the medium run (Izquierdo, Pessino and Vuletin, 2018[13]). Recent policy changes have included the possibility to postpone retirement age to 70 and an adjustment to the benefit indexation formula from public revenues to inflation and wages, which have slightly improved long-run sustainability.

In light of demographic trends and the strong social spending bias towards the elderly, a political discussion about the future of the pension system will be inevitable to ensure the sustainability of the pension system. In the meantime, one way to rationalise pension spending while reducing inequities would be to align the more generous special regimes for some professions including teachers, judges, the military and legislators with the general regime.

The recently expanded conditional cash transfer scheme *Asignación Universal por Hijo* (AUH) reaches 4 million children, at a cost of 1.3% of GDP. The incidence of these well-targeted allowances is concentrated on the poorest 20% of the population, for which they represent 40% of family income. Benefits per child are around 70% of the poverty line and have been raised recently in the context of the recession. The scheme also acts as a force against regional disparities, by providing the same level of benefits across the country. The benefits are conditional on health controls and school attendance.

These benefits have led to significant improvements with respect to attendance rates, intra-year dropout rates and primary school completion rates, with particular benefits for girls aged 12 to 17 (Edo et al., 2017[14]; Edo and Marchionni, 2018[15]). The large number of beneficiaries presents an opportunity for building up a unified and shared database of poor families, similar to Brazil's *cadastro único* or a similar instrument in Chile (Arnold and Jalles, 2014[16]). Shared tools and registries could improve coordination and targeting of different policy programmes, often administered by different ministries, and allow more effective social protection at lower costs (World Bank, 2015[17]). Recent plans to allow the social security administration access to tax data to determine eligibility for means-tested benefits and reduce overlap are a step into the right direction.

A recent tax reform is reducing distortions but more remains to be done

Argentina's tax system remains fragmented and distortive. Lacking progressivity, it contributes little to the reduction of existing inequities. A tax reform decided in 2017 will reduce some existing distortions and lower the overall tax burden on businesses over a period of 5 years, to stimulate investment and formal employment.

For businesses, the reform focuses on reducing statutory corporate income tax rates while raising the taxation of distributed profits and on gradual phase-out of the most distortive taxes such as a provincial turnover tax. This tax has a cascading effect and creates an artificial incentive for vertical integration, as there is no deduction for the tax paid at earlier production stages (as there would be in a VAT). It hurts competitiveness and acts as an interprovincial tariff barrier, as different tax rates are applied depending on the domestic origin of goods. As part of the accelerated fiscal adjustment, the gradual phase-out schedule of this tax has been revised and partly postponed upon request from the provinces, for which this tax is a major source of revenues. In the medium run, it will be important to continue the process of phasing out the turnover tax.

Special promotional tax regimes for specific sectors and production locations, such as those benefiting the assembly of imported electronics parts in the remote province of Tierra del Fuego, should be subjected to thorough cost-benefit evaluations. The benchmark for potential benefits should be the existence of productivity improvements and the prospects for these activities to become sustainable without tax benefits in the future, not simply production increases. To the extent that some of the incentives provided by these regimes are simply exemptions from otherwise stringent import barriers, their effectiveness may be eroded anyhow in the context of a wider opening towards the global economy, which could bring about substantial benefits for Argentina (Chapter 1).

A financial transaction tax on every transaction in checking and saving accounts creates incentives to settle payments in cash, acting as a barrier for financial inclusion and formalisation. Plans to make this tax fully deductible from corporate income taxes have also been postponed in light of its significant revenues amounting to 1% of GDP. Looking ahead, the financial transaction tax should be abolished once the fiscal situation permits it.

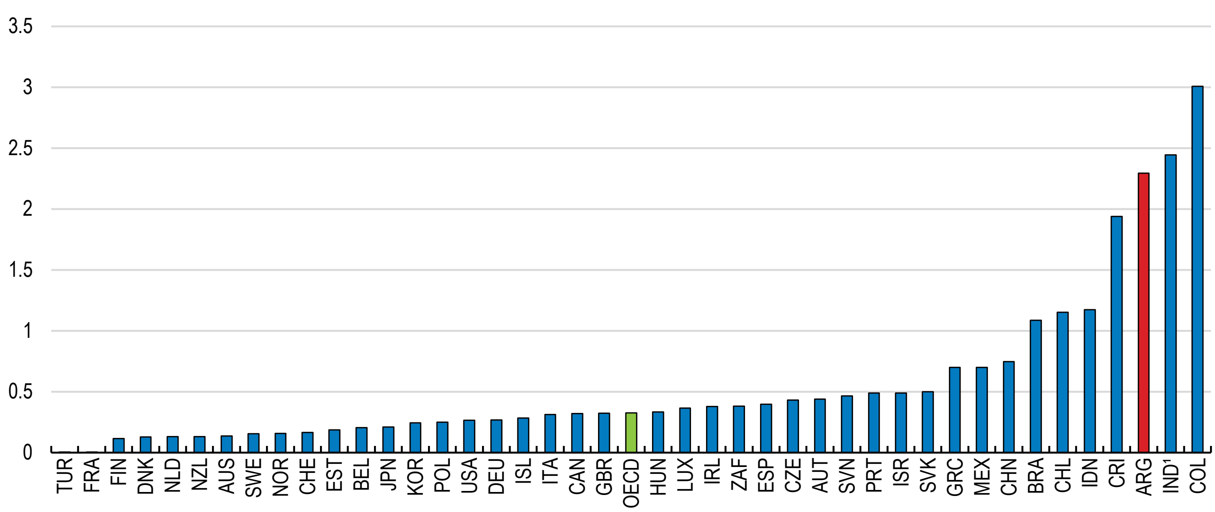
For personal income taxes, the tax reform did not reduce the high basic exemption of over 2.3 times the average income, below which personal income tax is not owed. As a result of this, only the top 15% of the economically active population pays personal income taxes (Figure 23). Lowering the thresholds while ensuring a progressive rate schedule would most likely raise more revenues in a more progressive way. Given how high the current threshold is, there is significant room for lowering it even without including workers with low incomes, who are affected by informality. The taxation of financial income of individuals, established in 2018, is likely to improve the progressivity of the personal income tax system.

Further base broadening could result from extending personal income taxes to judges and other employees of the judiciary branch, most of whose salaries are currently tax-exempt. This causes revenue losses of approximately 0.05% of GDP. A recent agreement subjected employees of the judiciary hired after 2017 to personal income taxes, but only for a small part of their salary. There is no compelling reason why specific occupations should be exempt from income taxation and this exemption is at odds with current practice in other countries, as well as with the widely accepted objective of seeking broad tax bases.

Moreover, a simplified tax system for independent workers and micro enterprises (*Monotributo*), whose main objective is to bring low-income earners into the formal sector, can also be used by individuals with higher incomes. As a result, the scheme generates low tax burdens for liberal professionals with medium or high incomes and exempts their services from VAT.

Figure 23. Few people pay personal income tax

Income threshold where single taxpayers start paying income tax, measured as a multiple of the average wage



Note: For India, the average worker income is for the organised manufacturing sector as reported in the Annual Survey of Industries.
Source: OECD calculations for Argentina, China, India, Indonesia and South Africa; and OECD Taxing Wages 2017 for the rest of the countries.

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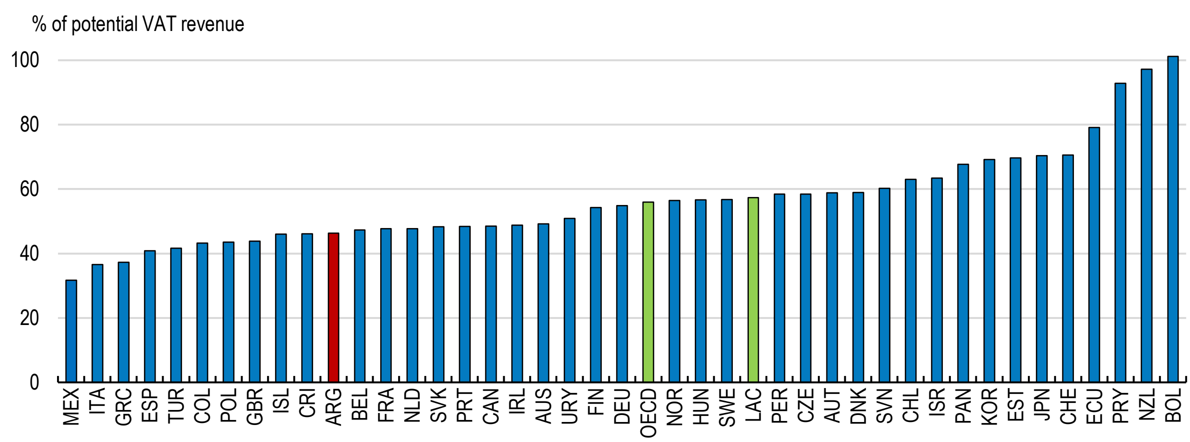
Broadening the VAT base could be one source of revenues. The country's low VAT revenue ratio to potential suggests that Argentina collects only 46% of the potential VAT revenues of applying the standard rate to all consumption (Figure 24). This corresponds to around 3.5% of GDP. Exemptions and reduced rates account for almost 1% of GDP in lost revenues, while estimates suggest that the rest due to evasion (Artana et al., 2015[18]). Exempt goods like medicines, education and transportation are an important part of the consumption basket of low-income households, but these goods are also consumed by better-off households, who pocket the bulk of this tax expenditure. In fact, only the lower rate on food brings larger benefits to low-income households than to high-income households (Artana et al., 2015[18]). Simulations based on household data suggest that applying the current standard rate of 21% on all consumption would have limited distributional effects, which could be compensated through transfers to low-income households with significantly less resources than the revenue losses resulting from reduced rates (Artana et al., 2015[18]).

Improvements in VAT tax collection have been supported by promoting electronic invoicing, which will be mandatory for all taxpayers as of April 2019. Recent directives to make acceptance of debit cards mandatory can help to reduce cash transactions and the scope for VAT evasion.

Figure 24. VAT revenues could be higher with stronger compliance and less use of reduced rates

VAT Revenue Ratio, 2014



Note: The VAT revenue ratio (VRR) is defined as the ratio between the actual value-added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. The OECD aggregate is an unweighted average of data shown (excluding Latvia) and data for Canada cover federal VAT only.
Source: Calculations based on OECD (2016), OECD Tax Database, OECD Revenue Statistics and OECD National Accounts Statistics (databases), OECD Revenue Statistics for Latin American countries, 2016.

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Table 6. Financial assessment of fiscal recommendations

Fiscal recommendation	Estimated impact on fiscal balance
Use the fiscal space agreed for this purpose to raise spending on well-targeted social transfers.	-0.2% of GDP
Align the conditions of special pension regimes for select professions with general pension rules.	1% of GDP (for the near future, more later)
Broaden the VAT base by reducing exemptions and special rates.	1% of GDP
Lower the basic deduction in personal income taxes.	1% of GDP
Seek efficiency improvements in education, including by merging fragmented teacher training institutions.	Revenue-neutral.
Use the resulting savings to - expand early childhood education. - bolster adult training programmes.	Revenue-neutral.
Reduce tariffs and non-tariff barriers.	-0.6% of GDP for eliminating all tariffs.

Note: The numbers in this table are estimates and some of them are subject to considerable uncertainty.

The fiscal framework has been improved

Fiscal relations between the central government and the provinces have long been challenging. With most revenues collected at the central level, provinces have traditionally relied on transfers from the central government to provide key social services such as education and basic health-care. Much of these transfers have been discretionary and subject to political negotiations, often in return for provinces' votes in the Senate. This generated budget uncertainties and hampered medium-term policy planning at the provincial level, exacerbating regional inequalities. A 2017 law has significantly raised the share of automatic transfers, which should ease tensions between the central government and the provinces over the sharing of resources. This new fiscal pact was agreed in return for a provincial-level expenditure rule limiting the growth of most current primary expenditures to inflation and confirming the need for central government consent when provinces wish to issue debt. Compliance with provinces' expenditure rule is monitored by a special federal council.

The same law also mandates zero real growth for current primary expenditures at the federal level, excluding increases in pension expenditures due to automatic indexation of benefits. An expenditure rule is a useful tool to lock in the hard-earned benefits of improving fiscal balances because compliance can be judged against a simple observable target, expenditure, which is easy to calculate and explain to voters and markets. Since automatic stabilisers operate predominantly through the revenue side, an expenditure rule would not be very pro-cyclical. The experience with such a rule has been positive in Peru and the Netherlands, for example (Berganza, 2011[19]; Ayuso-i-Casals, 2012[20]). At the same time, the authorities could consider extending the rule to all federal level expenditures, given that all expenditures ultimately affect the development of public debt in the same way. In its current form, the rule is not sufficient to ensure the sustainability of public debt and is less stringent than short-term fiscal targets for 2019 and 2020.

A newly established independent congressional budget office has started to produce fiscal impact projections and cost-benefit analyses. Building on this progress by charging the budget office with regular ex-ante assessments of compliance with medium-term fiscal plans, and with a possible future fiscal rule, could enhance fiscal policy credibility. Almost all European Union countries have created an independent fiscal institution with this mandate by now. (Beetsma et al., 2018[21]; Hagemann, 2011[22]). In Latin America, Brazil has recently created such an institution to improve the transparency of compliance with its new expenditure rule, and the institution is publishing high-quality reports on fiscal prospects and compliance with fiscal rules.

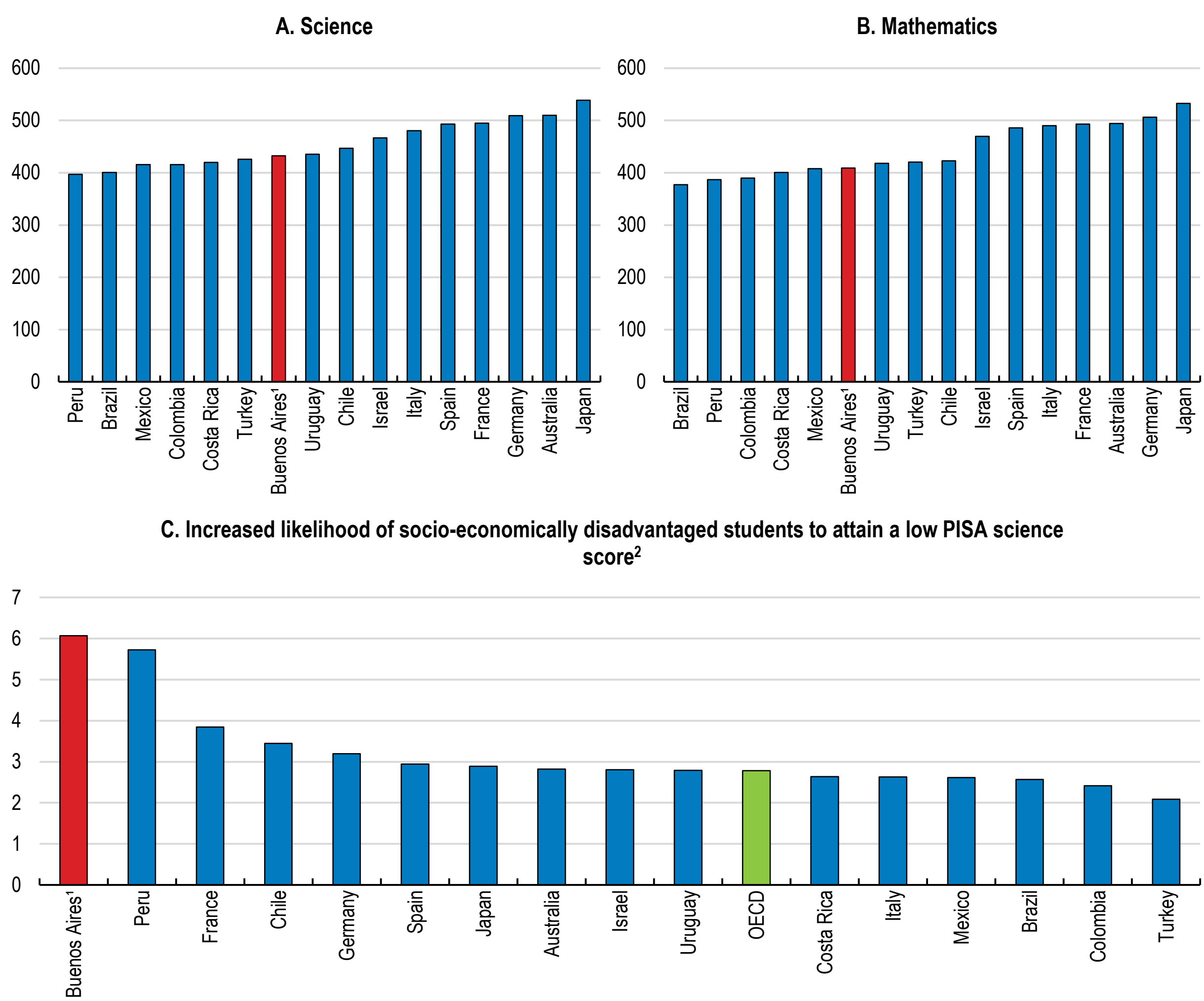
Table 7. Past OECD recommendations on macroeconomic policies

Recommendations	Actions taken since the 2017 Survey
Ensure fiscal sustainability by continuing to pursue planned fiscal targets but allow temporary deviations in either direction from the targets if growth disappoints or surprises on the upside.	Fiscal results have improved and recently revised fiscal target aim at a significant acceleration of fiscal consolidation.
Phase out energy subsidies. Rationalise public employment, particularly in the provinces. Achieve further cost savings in state-owned enterprises and improve their governance. Undertake an expenditure review.	Energy subsidies are declining visibly. Public employment is falling. The state-owned enterprise sector as a whole has become deficit free. There has been no systematic across-the-board expenditure review.
Undertake a revenue-neutral tax reform, including - Lowering the income threshold where taxpayers start paying personal income taxes. - Phasing out the provincial turnover tax and financial transaction tax. - Broadening the base of value added taxes. - Introducing progressivity into social security contributions. - Lowering social security contributions temporarily for low-paid workers whose jobs are brought into the formal sector.	A tax reform reduced revenues by about 2% of GDP over two years. The income threshold for paying taxes has risen rather than declined. These taxes are being phased out. No progress made. Incomes below a threshold level have been exempted from social security contributions. This reduction has be implemented as part of the tax reform. In addition, some social benefits can be maintained as an employment subsidy for up to 2 years for workers whose jobs are brought into the formal sector.
Introduce an expenditure rule and consider implementing a debt target over time. Use an independent fiscal council to assess compliance with the rules.	A new law mandates zero real growth of most current primary expenditures at the federal and provincial levels, but could be extended to all expenditures. A congressional budget office has been created and the federal council for fiscal responsibility has been strengthened.
Limit dismissal of the Central Bank governor to severe misconduct. Simplify the Central Bank's mandate, prioritising price stability.	No concrete action yet, but a commitment to implement a law covering these two issues.
Strengthen the capacities and independence of bodies investigating corruption, reorganise and strengthen courts and enact the corporate liability bill to prosecute bribery.	The corporate liability bill has been enacted.

The education system can do more to reduce inequalities

At almost 6% of GDP, Argentina spends more than other countries on education (Figure 25). However, the return on this spending is comparatively weak. Low student achievements suggest challenges in the quality of education (Figure 26). Two-thirds of 15 year old students in the city of Buenos Aires do not have basic-level proficiency in reading, mathematics and science (OECD, 2016[23]). OECD PISA results are only available for the capital city of Buenos Aires, and students in major urban centres generally outperform the national average. Moreover, the education system exacerbates inequalities as students from weak socio-economic backgrounds are 6 times more likely to have low educational attainment than others.

Figure 25. Learning outcomes reflect quality shortcomings and inequalities



1. Data for Argentina refer to capital city of Buenos Aires only due to methodological shortcomings in the way the underlying tests were conducted in other provinces. They may therefore overestimate the national average.
2. A socio-economically disadvantaged student is a student in the bottom quarter of the distribution of the PISA index of economic, social and cultural status (ESCS) within his or her each country/economy. A low PISA score is defined as scoring below Level 2 in science.
Source: OECD, PISA 2015 Database.

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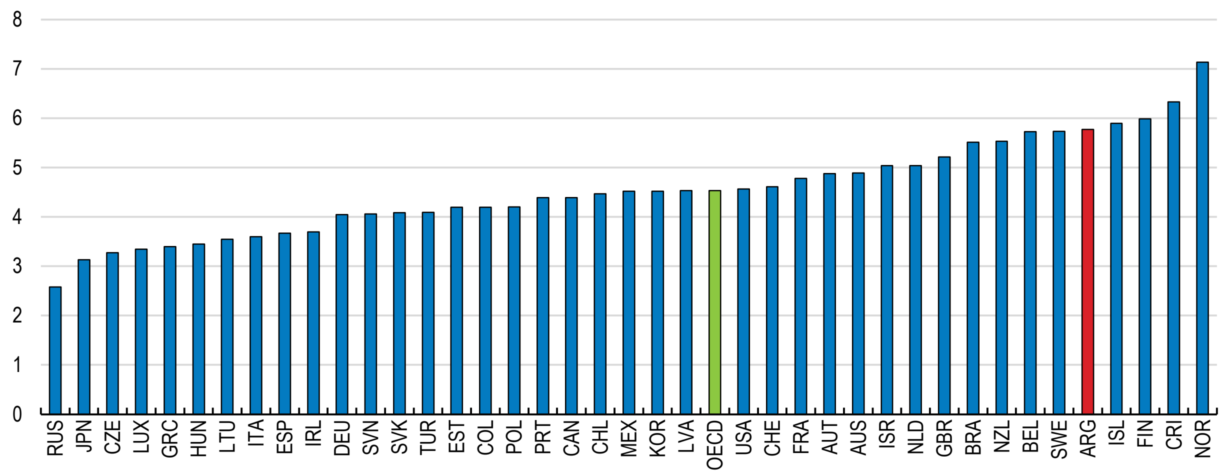
Educational attainments are above the OECD average in secondary education, but low and declining for tertiary education (Figure 27). Still, 40% of secondary students leave school without a degree. Dropping out often reflects students' failure to acquire essential skills during early childhood, exacerbated by frequent grade repetition later on. Grade repetition tends to be a costly practice with little discernible benefits on learning outcomes (Ikeda and García, 2014[24]). This could be addressed by further expanding early childhood education, which tends to improve student competencies for years to come and adds more to reading outcomes than one additional year of formal schooling (OECD, 2012[25]). Boosting early education would offer a double dividend, as it would also facilitate greater female participation in the labour market. Coverage is only 43% for 3-year olds, compared to the OECD average of 76% (OECD, 2018[26]). In order to be effective, however, maintaining good quality and regular monitoring will be necessary.

Figure 26. Education expenditures are high

Public expenditure on education as a percentage of GDP



Source: World Bank; and OECD Education at a glance.

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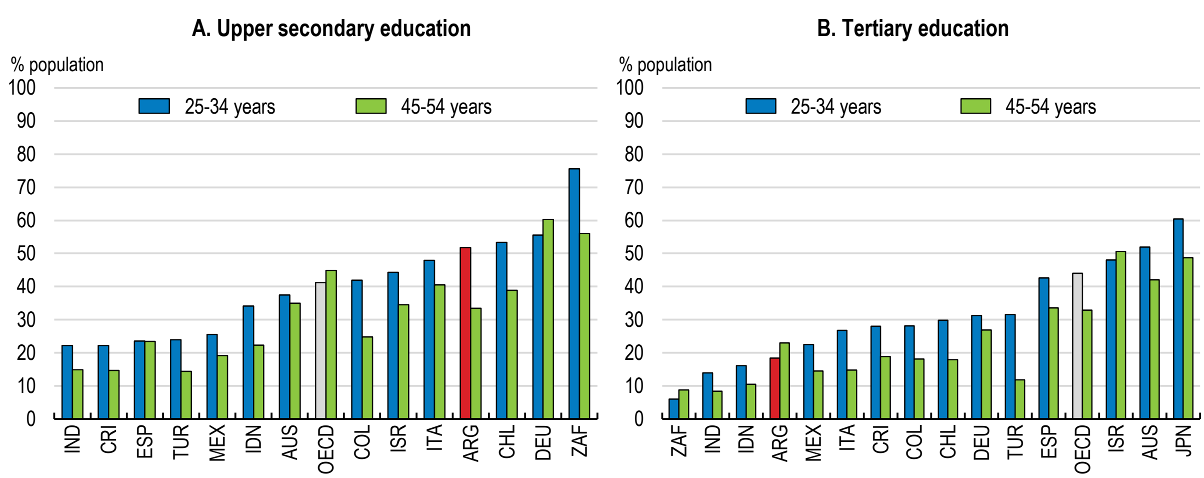
Figure 27. Educational attainments compare well in secondary, but not in tertiary



Source: OECD, Education at a Glance: OECD Indicators. INDEC (2016e) for Argentina.

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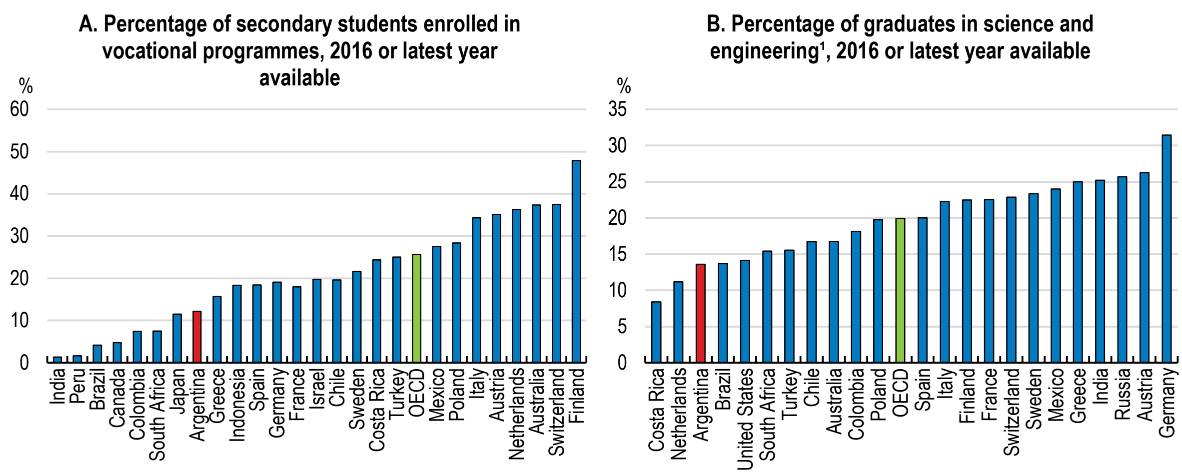
Improving teacher quality through better teacher training can improve learning outcomes while resulting in cost savings, thus strengthening spending efficiency in education. Argentina has over 1 000 teacher training institutions, often characterised by a lack of quality standards, no systematic evaluations and an insufficient scale. Merging some of them and professionalising their management could lead to significant savings and also improve the governance and low transparency in the use of public funds. In addition, teacher skill shortages could also be addressed by allowing university graduates to become teachers.

The opportunities for students to acquire vocational education and training and more technical degrees could be expanded (Figure 28, Panel A). More vocational training would also improve equity as it could provide labour-market relevant training opportunities to less academically-inclined students who are at risk of dropping out of the school system. Skill shortages for engineers and technical degrees reflect a tertiary education system that produces too few graduates in science, technology, engineering or mathematics (Figure 28, Panel B).

Figure 28. Few students follow technical courses and careers



1. This includes all the tertiary graduates in the fields of Engineering, Manufacturing, Construction, Natural Sciences, Mathematics and Statistics. Data refer to the latest available year.

Source: World Bank World Development Indicators database; OECD Education at a Glance database; and UNESCO Education database.

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Access to health care is unequal

While access to health care is in principle meant to be universal, the health system is fragmented and characterised by inequities according to incomes, health insurance modalities and provinces. Maternal and child mortality can differ by as much as 8 times across different parts of the country. Non-communicable diseases have become a leading cause of death. Air pollution is also among three out of four leading causes of years of life lost (World Bank, 2016[27]). The system also faces sustainability issues as spending is expected to rise from currently 7.1% of GDP to 10.3% by 2065 as the population ages. (Izquierdo, Pessino and Vuletin, 2018[13])

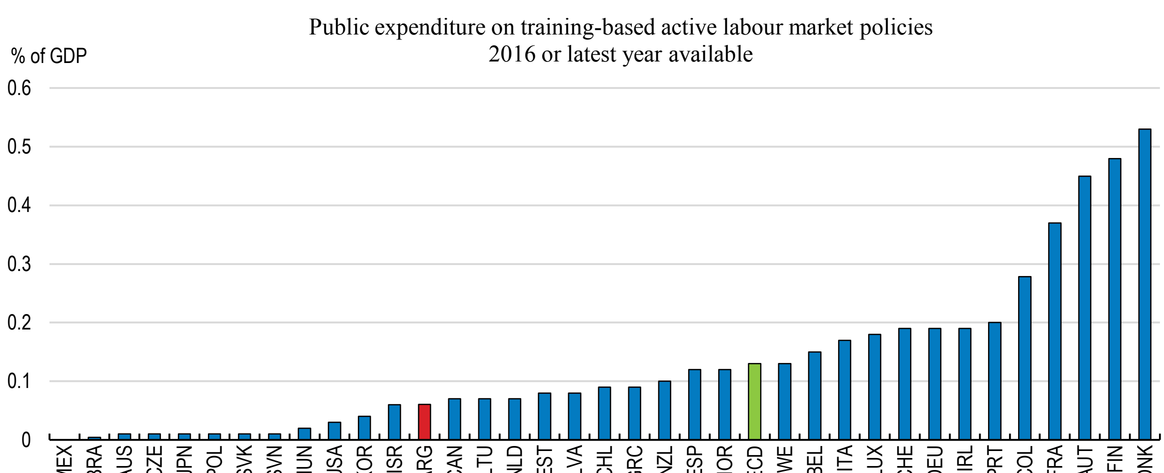
The universal public health system provides basic health services. However, coverage is effectively not universal and severe challenges in access to health services remain in many areas. The public system is the only health coverage for 30% of the population. Service provision, including public hospitals, is the responsibility of the provinces and per capita expenditures vary substantially across regions. A further deterioration of health infrastructure in the context of the present fiscal adjustment should be avoided. A stronger focus on primary care could help to achieve efficiency improvements, as would centralised nationwide care manuals to guide treatment choice.

Around 60% of the population has additional cover through occupation-based health insurance schemes (*obras sociales*). These over 300 schemes are usually administered by trade unions and lack sufficient scale. Some have faced governance challenges, with evidence of funds being diverted from the provision of health services to other purposes. Some of them have frequently failed to cover included services. Recent measures require filing annual financial accounts with a public agency, which could be followed up by a systematic collection of quality indicators. Centralising purchasing could eliminate differences in prices paid and hence the scope for kick-backs. Ultimately the largest potential for cost savings and better health services, however, lies in merging these occupation-based schemes while professionalising their management. In light of quality issues with these schemes, around 10-15% of the population has subscribed to private-sector health plans to obtain better healthcare services.

Active labour market policies are weak

Active labour market policies to equip working-age Argentinians with better skills are underdeveloped (Figure 29). Training policies may have a durable impact on employability and improve the beneficiaries' income-generating potential. Benefits can be significant especially to women (Bergemann and Van Den Berg, 2006[28]). The programmes will become more important as the economy continues its structural transformation and some workers will need to find new jobs in different firms or industries. Recently established cash transfers to adults who return to school or acquire professional training have been taken up by 260 000 adults and go in the right direction. After some time, an impact evaluation of this programme would be useful.

Figure 29. Labour market training policies could be expanded



Source: OECD Public expenditure and participant stocks on LMP database; ILO.

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Labour market duality contributes to informality

One third of the workforce is precluded from the benefits of formal employment, including access to contributory pensions, sectoral health insurance schemes and protection against the income loss associated with unemployment. The low social protection for informal workers contrasts with comparatively rigid employment protection legislation in the formal labour market (Figure 30). Tackling informality will require a comprehensive strategy, including both stronger incentives for formal employment and stronger enforcement of existing requirements to declare workers and firms.

Incentives for declaring previously informal or for creating new formal jobs have enhanced by a 2017 programme called EMPALME that allows beneficiaries of social programmes to maintain their benefits when they find formal employment, while the employer can deduct the amount of the benefit from the wage bill. Effectively, this implies a conversion of social benefits into an employment subsidy over 24 months for those workers.

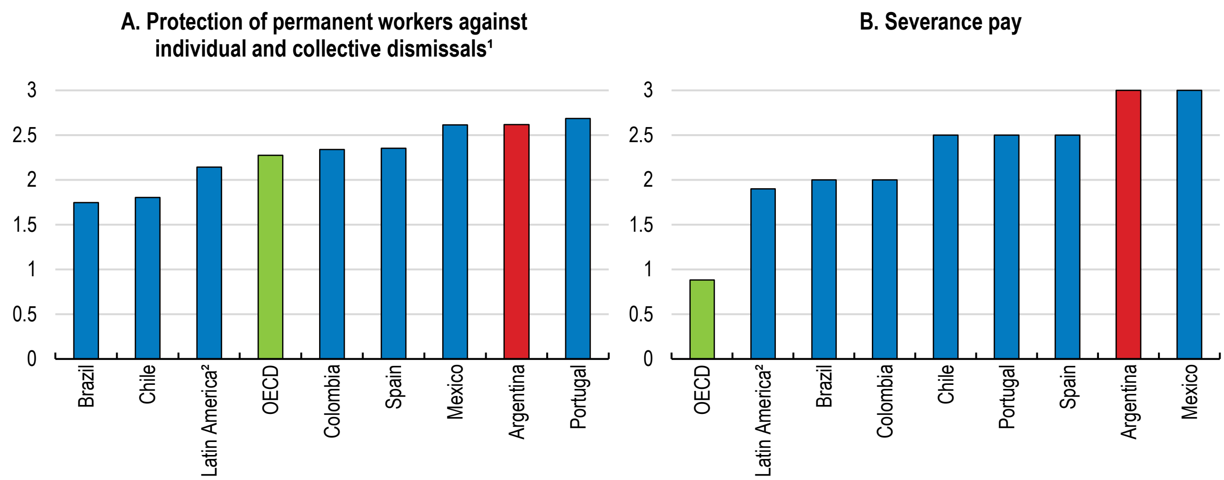
Reforms on labour markets play a key role. High levels of severance payments for individual dismissals, which often end in court, drive up costs and uncertainties related to formal hiring. In fact, empirical analysis suggests that firms facing more difficulties with labour regulations and competition from the informal sector have lower productivity (Chapter 1, Annex). This duality makes it difficult for some categories of workers, including women and youths, to enter formal employment and, in combination with other factors such as taxes and regulations, often leads entire enterprises to remain informal. OECD analysis based on a recent household survey suggest that informal workers earn about 36% less than formal workers, after accounting for other relevant personal and employment characteristics.

Striking a better balance between granting a reasonable level of protection against job loss and reducing labour informality is needed. One way ahead to improve the incentives to create new formal jobs would be to extend the unemployment insurance scheme currently used in the construction sector on an economy-wide basis. In this scheme, monthly employer contributions accumulate on individual worker accounts, over time. Such individual accounts can then be used to finance income support in the case of layoffs, similar to the scheme applied in Chile.

For newly created jobs, this protection could replace the income support currently coming from severance payments. For employers, this would reduce the financial burden of dismissals, as the contributions would have already been paid on a monthly basis. As a result, the scheme could reduce disincentives for formal hiring at no fiscal cost and foster a quicker recovery of job creation. If remaining account balances could be carried over to a new job, such a system would be an effective way to protect people rather than protecting individual work relationships. Job turnover is likely to be significant in the medium term, given that current industrial structures are the legacy of a highly protected and regulated environment that no longer reflects the best use of future opportunities. In addition, the newly arising opportunities from a more open economy bear the potential to create better-paying jobs but will require some entrepreneurship including trial and error, which would be supported by lower labour market rigidity.

Figure 30. Labour market regulations are relatively rigid

2014 or last available year



Note: The OECD indicators of employment protection are synthetic indicators of the strictness of regulation on dismissals and the use of temporary contracts, expressed on a scale from 0 (least restrictive) to 6 (most restrictive). They are compiled from 21 items covering different aspects of employment protection regulations as they were in force on January 1st of each year.

1. Reflects an average of severance pay requirements after 4 and 20 years of tenure.
2. Latin America includes: Brazil, Chile, Colombia, Mexico and Peru.

Source: OECD/IAB Employment Protection Database, 2013 update.

StatLink https://doi.org/10.1787/888933942847

Reducing gender inequalities and supporting the young

Women are facing a number of disadvantages on labour markets and their participation is over 20 percentage points lower than for men. When they work, they spend an average of 31 hours in market employment, 10 hours less than men (González Rozada, 2017[29]). This difference explains their lower monthly earnings, which fall short of men's earnings by 23%, although women actually receive slightly higher hourly wages than men, both in the formal and informal sectors (INDEC, n.d.[30]). One reason why women may be constrained to work less remunerated hours may be that they spend more time with non-remunerated domestic tasks (Ministerio de Trabajo Empleo y Seguridad Social, 2017[31]). These disparities in opportunities across gender strengthen the argument for expanding early-childhood education, as the availability of affordable childcare is a key factor explaining cross-country differences in female labour market participation (OECD, 2012[32]).

Gender gaps are particularly visible among management positions, 64% of which are filled with men (Ministerio de Trabajo Empleo y Seguridad Social, 2017[31]). Given a higher average educational attainment of women, this suggests unexploited potential for improving management quality, where international surveys point to significant gaps (Bloom et al., 2014[33]).

Young women are particularly disadvantaged and often have a weak labour market attachment. 30% of women aged 15-29 are neither in employment, education nor training (NEET). With two thirds of these engaged in caregiving, this is often related to difficulties combining paid work with raising a family, which could be addressed with expanding early childhood education. Long periods of being NEET worsen future labour market prospects for these women, contributing to the intergenerational persistence of inequality.

Table 8. Past OECD recommendations on inclusive growth

Recommendations	Actions taken since the 2017 Survey
Strengthen mechanisms to identify and support students at risk of dropping out through tutoring and individualised support.	No progress made.
Merge teacher training institutions and strengthen their quality standards, governance, accounting requirements and transparency.	In the capital city of Buenos Aires, a new law has created a centralised teacher training institution. No progress made in other subnational jurisdictions.
Scale up training, employment services, and incentives for small business development.	The budget for active labour market policies and vocational training in collaboration with private sector companies has been increased. Still, there is scope for further expansion of active labour market programmes.
Expand early childhood education, promote flexible working time arrangements and extend paternity leave.	New early childhood education centres are being built. Paternity leave has been raised to 15 days.
Enforce formalisation and compliance with more labour inspections, in conjunction with other measures to strengthen incentives for formalisation mentioned above.	The recent tax reform has reduced social security contributions for low-paid workers. In addition, some social benefits can be maintained as an employment subsidy for up to two years for workers whose jobs are brought into the formal sector.
Index pension benefits to consumer prices.	A new pension indexation formula is largely based on consumer price developments.
Align retirement ages for women to those for men.	No progress made.
Integrate existing social protection programmes and allow them to share registries and targeting tools.	No progress made.

Fighting corruption and strengthening institutions

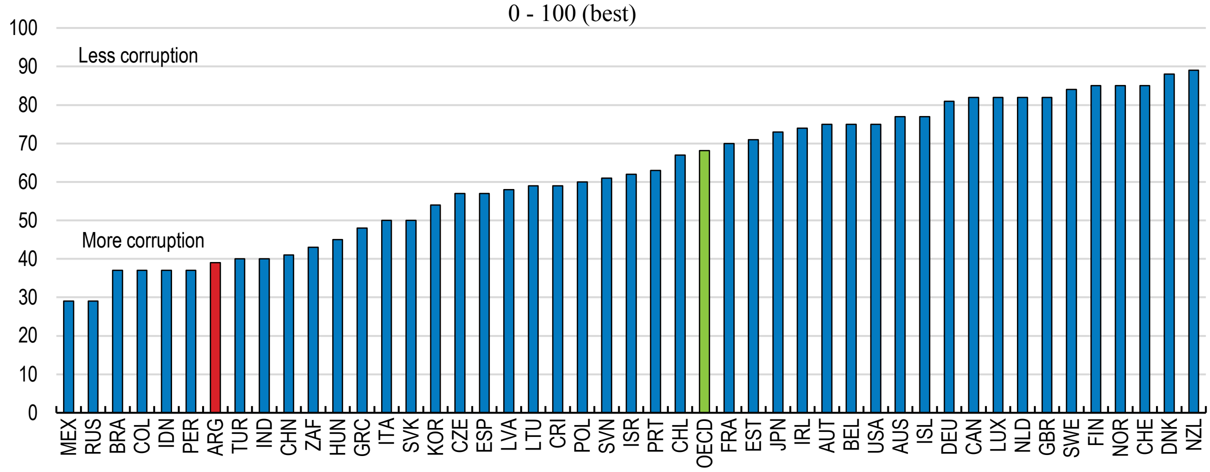
Corruption perceptions remain high despite recent improvements. Argentina scored 35 out of 100 in 2017 on the Transparency International Index (Figure 31), well below the OECD average. However, it improved its overall ranking by 10 ranks within a year. Corruption undermines the trust in public institutions, diverts precious public resources and affects the quality of public services and infrastructure on which many people, especially those with low incomes, rely every day. Recently initiated corruption investigations against former government officials and private companies have highlighted past corruption, but have also testified to the rising courage of the judiciary to pursue corruption allegations after over a decade of inaction.

Starting from a difficult legacy, the central government is tackling corruption on many fronts (OECD, 2019[34]). A Corporate Liability Law of 2017 and the 2018 Guidelines have addressed concerns about lack of corporate liability for corruption. An anti-corruption office founded in 1999 has become highly visible since 2016 and has proven an asset for speeding up progress on fighting corruption. The anti-corruption office has strengthened procedures to prevent and manage conflicts of interests in the Executive, resulting in multiple recommendations to senior officials. It also accepts and investigates anonymous whistleblower reports of misconduct. A reform of the Publics Ethics Law is envisaged for 2019, enhancing -among other things- the operational and financial autonomy of the anti-corruption office.

As a result of these efforts, compliance with mandatory asset disclosures of senior public officials in the executive branch has risen from 50% to 90% and can soon be accomplished electronically. It may be useful to extend this disclosure obligation to subnational governments or even officials of trade unions that exercise public duties such as the management of health insurance schemes or teacher training. Enhancing the scope for disciplinary action within the public sector would also help to punish misconduct more effectively.

Figure 31. Perceived levels of corruption remain high

Corruption perception index, 2017
0 - 100 (best)



Source: Transparency International, available at https://www.transparency.org/research/cpi/overview.

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Typical high-risk areas for corruption include infrastructure projects, extractive industries, customs, public procurement and state-owned enterprises. Streamlining bureaucratic procedures and enhancing transparency can help in all of these areas. For example, centralised purchasing bodies and electronic procurement reduce the scope for side-payments and reduce costs by limiting collusion. Deploying modern technology more widely across the public administration has strong potential for enhancing transparency and reducing the scope for misconduct (OECD, 2011). A recent decree aims at improving the recovery of assets from corruption cases, in line with earlier OECD recommendations.

Extending the institutional progress made at the central government level across the entire public administration will be the next major challenge, as commitment varies at the provincial or municipal levels. Almost half of the provinces have no public ethics law, and the federal-level ethics law does not apply to provincial administrations. Although the federal system imposes limits on the leverage of the central government vis-à-vis the provinces, conditioning some transfers to subnational governments on progress in corruption prevention and transparency may be one useful way forward.

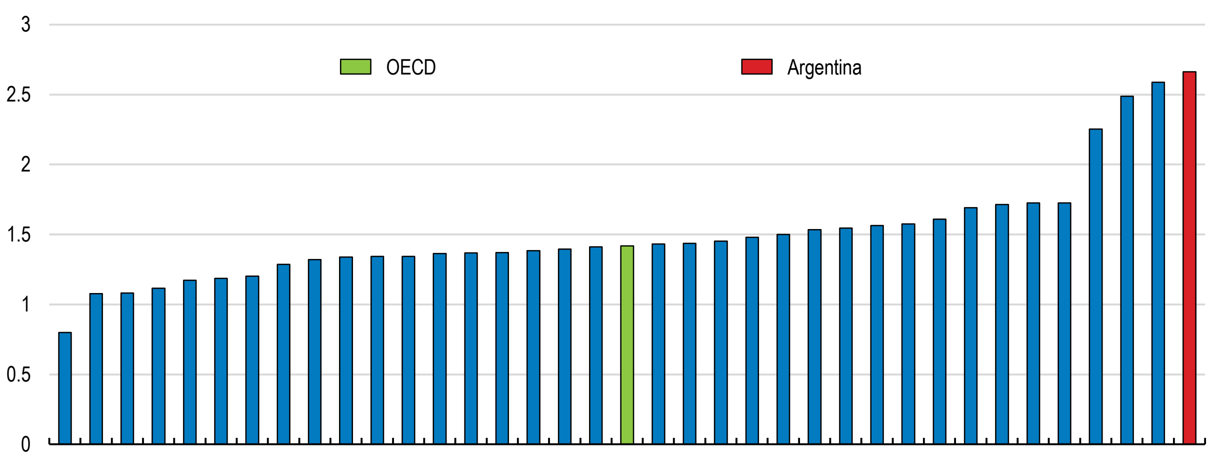
Productivity is low due to high barriers to entrepreneurship, trade barriers and difficulties in access to finance

Current macroeconomic challenges make it all the more important to make rapid progress on structural reforms that can raise productivity. This is a key condition for rising prosperity through more and better jobs and higher wages, especially since many jobs are presently trapped in activities with limited potential for productivity growth. At the current juncture, Argentina should favour a swift implementation of key reforms that can stimulate medium-term productivity growth and at the same time support investment and job creation in the short-term. This is the case for product market reforms, which have a high growth-pay-off, facilitate the entry of new firms, and are likely to translate into job creation.

Regulations on product markets serve a variety of legitimate objectives, but if ill-designed they can impose unnecessary restrictions on competition, and therefore on growth, living standards and ultimately well-being. Competition, which induces firms to become efficient or exit, has been traditionally weak and poor domestic policies have held back competitiveness of Argentinian producers, thus impeding them from exploiting their full productivity potential. The OECD Product Market Regulation Indicator and its sub-indicators measure the competition-restrictiveness of product market regulations across a wide range of countries. A recent update of the PMR indicator suggests that Argentina tops the list of countries with respect to the restrictiveness of product market regulations (Figure 32).

Figure 32. There is room to reduce the restrictiveness of product market regulations

OECD Product Market Regulation Indicator 2018 (Preliminary version)



Note: The OECD indicators of product market regulation are synthetic indicators that summarise a wide array of regulatory provisions on product markets across countries, with a focus on the degree to which these regulations restrict competition. They are expressed on a scale from 0 (least restrictive) to 6 (most restrictive). Data are preliminary and refer to 2018. The OECD average shown does not include the United States and Japan.
Source: OECD Product market regulation database.

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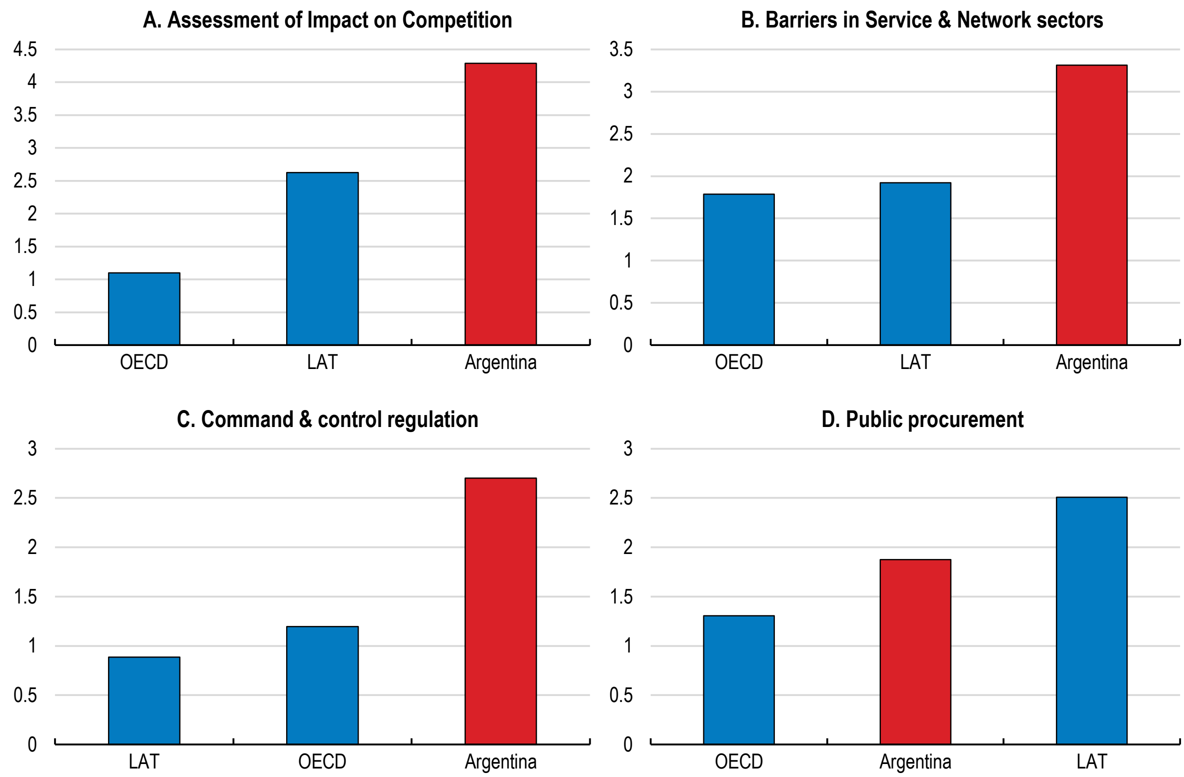
Argentina has still the highest barriers to domestic entry in Latin America, well above the average of Brazil, Mexico or Chile (Figure 33). This is mainly due to high large entry barriers in network and services sectors, which can also have downstream effects on non-regulated sectors of the economy that use the output of the regulated sectors as intermediate inputs (Arnold et al., 2016[35]). The new entrepreneurship law (ley de emprendedores) has been an important step to reduce administrative burdens for start-ups of sole proprietary firms, as it facilitates firms' start-up by creating a new type of firm, which can be set up in one day. However, the barriers for creating a public limited company are still very high. This may be reflected by the fact that Argentina's manufacturing sector is characterised by a small number of young firms. The average Argentinian firm is 27 years old, well above average age of 21 years in Latin America and 17 years in OECD economies (Chapter 1). OECD work based on cross-country firm level data indicates that young firms create more jobs (Criscuolo, Gal and Menon, 2014[36]). Over the last decade and across all countries analysed, 42% of all jobs were created by enterprises less than 5 years old. In Argentina, only 6% of firms are younger than 5 years.

Figure 33. Product market regulations could allow more room for competition

OECD Product Market Regulation Indicator (Preliminary version)



Note: The OECD average shown does not include the United States and Japan. LAT is the average of Brazil, Chile and Mexico. Data are preliminary and refer to 2018.
Source: OECD Product market regulation database.

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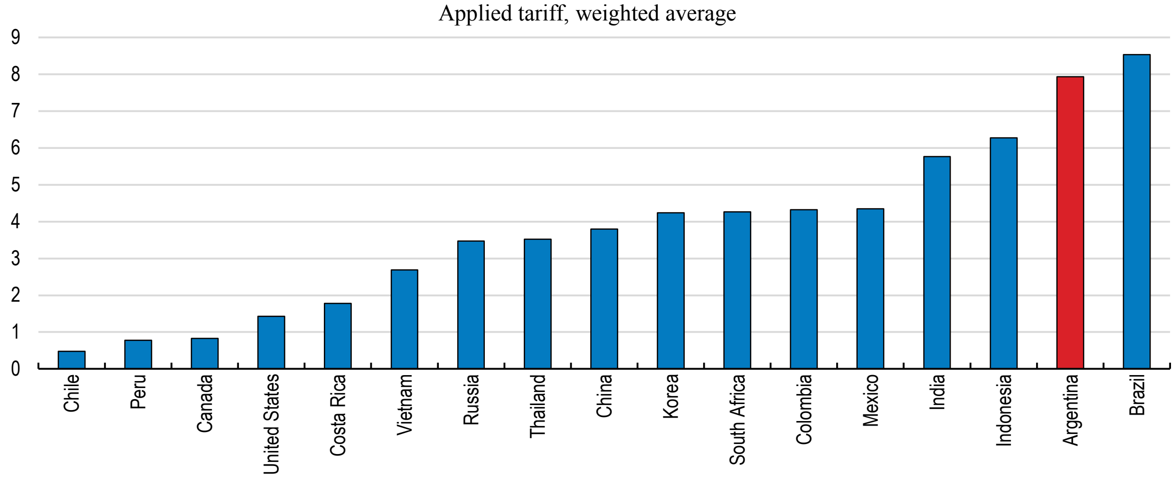
Besides domestic barriers, the economy is significantly less integrated into the world economy than other emerging market economies, with exports and imports only accounting for less than 30% of GDP. This is largely the effect of exceptionally high trade barriers in international comparison (Figure 34). Given how closed the economy is, a swift removal of trade barriers, starting with sectors that provide key intermediate and capital inputs to other parts of the economy, could support significant productivity improvements, as discussed in Chapter 1. The benefits of a stronger integration into the global economy would disproportionally accrue to those with lower incomes.

A quick materialisation of positive effects and the minimisation of adjustment costs depend crucially on finding the best sequencing of policy reforms. In light of the strong empirical evidence underpinning the benefits of better access to inputs, sectors providing key intermediate inputs to other parts of the economy, but also capital goods, should be a first priority. This would benefit all sectors of the economy and in turn help to boost exports, as with expanded access to modern technology embodied in foreign inputs local companies can become more productive and competitive in global markets (Amiti and Konings, 2007[37]). Reducing tariffs in intermediate sectors and eliminating most non-tariff measures would hence be an obvious first step, and could happen immediately to create new jobs and tap into new export opportunities, especially in light of weak domestic demand. Fiscal concerns should not hold back such a reform as total tariff revenues currently amount to only around 0.7% of GDP and the productivity effects of better integration would likely lead to an expansion of activity and additional tax revenues from growing downstream sectors.

Figure 34. Tariff barriers are high

Applied tariff, weighted average



Source: World Integrated Trade Solution database (WITS).

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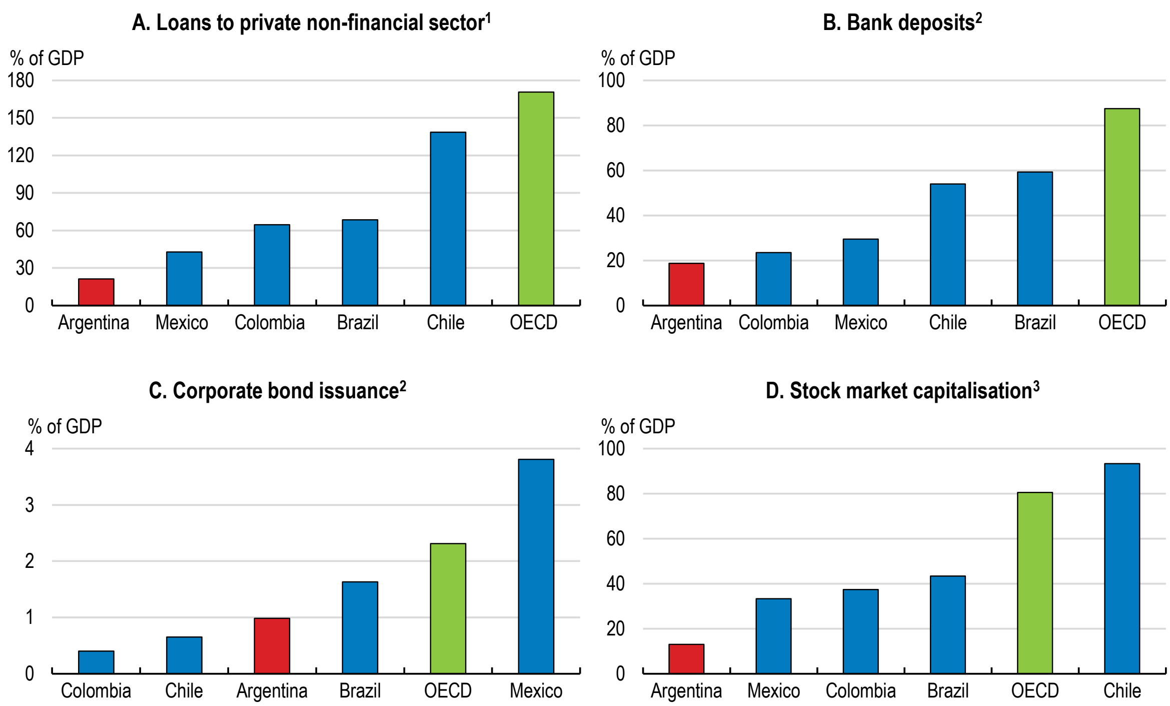
The removal of barriers to both domestic and external competition will create opportunities for new firms or industries to emerge, but these can thrive only if some activities from the past scale down to free resources for these newcomers. Current economic structures of industries and firms evolved under very different economic conditions, characterised by weak competition and a heavily regulated and protected productive sector. More competitive economies reap significant productivity benefits from a constant process of reallocating workers and capital across industries and firms (Andrews and Cingano, 2014[38]; Syverson, 2011[39]; Olley and Pakes, 1996[40]; Bartelsman, Haltiwanger and Scarpetta, 2009[41]; Foster, Haltiwanger and Krizan, 2001[42]).

The political economy of accommodating this necessary structural transformation is not easy. Resistance from workers whose jobs may vanish or change across firms or industries can be at least partly addressed by strengthening social safety nets, with a focus on protecting workers rather than jobs. Resistance from incumbent firms, however, should be met with caution as protecting firms against newly arising competition slows down the necessary changes. Finding the right sequencing, good communication and effective flanking policies to ensure that the benefits are shared by all can significantly facilitate the implementation of reforms.

Low credit penetration makes access to finance very difficult and holds back investment. The financial sector is small and serves mostly for payment transactions, rather than financial intermediation (Figure 35). Credit to the private sector amounts to 15% of GDP or 84% of deposits. With deposits and lending heavily focused on the short term, maturity transformation is minimal. The almost complete absence of domestic institutional investors is a severe challenge, although the mutual fund industry has grown in recent years. A recent capital markets law has made regulation more rules-based and will help develop alternative sources of finance in the future. As the most sophisticated issuer of financial instruments, the public sector should take the lead in selling peso-denominated financial instruments and continue to build a yield curve to serve as reference prices for the development of private capital markets.

Figure 35. The financial sector is less developed than in other countries

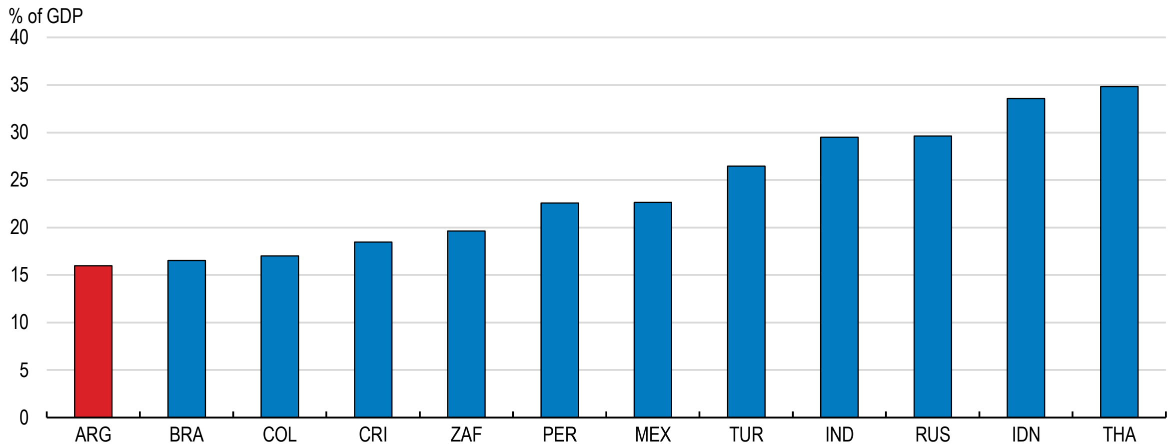


1. Data refer 2017Q4.
2. Data refer to 2016.
3. Data refer to 2017.
Source: Bank of International Settlements; and World Bank Financial Development and Structure Dataset.

StatLink https://doi.org/10.1787/888933942904

A key factor behind shallow domestic financial markets and short maturities is the scarcity of domestic savings (Figure 36). Moreover, many savers prefer to save in foreign currency, often outside the domestic banking system. Dollar-denominated assets, which include domestic real estate, have traditionally been a preferred saving vehicle. More deposits, including inflation-indexed ones, would enable banks to lend more and would reduce Argentina's reliance on external savings. But rebuilding savers' confidence in domestic financial intermediation takes time, not least due to circular causalities between savers' trust in the domestic financial system and currency on one hand and macroeconomic volatility on the other.

Figure 36. Gross domestic saving is low



Source: World Bank WDI.

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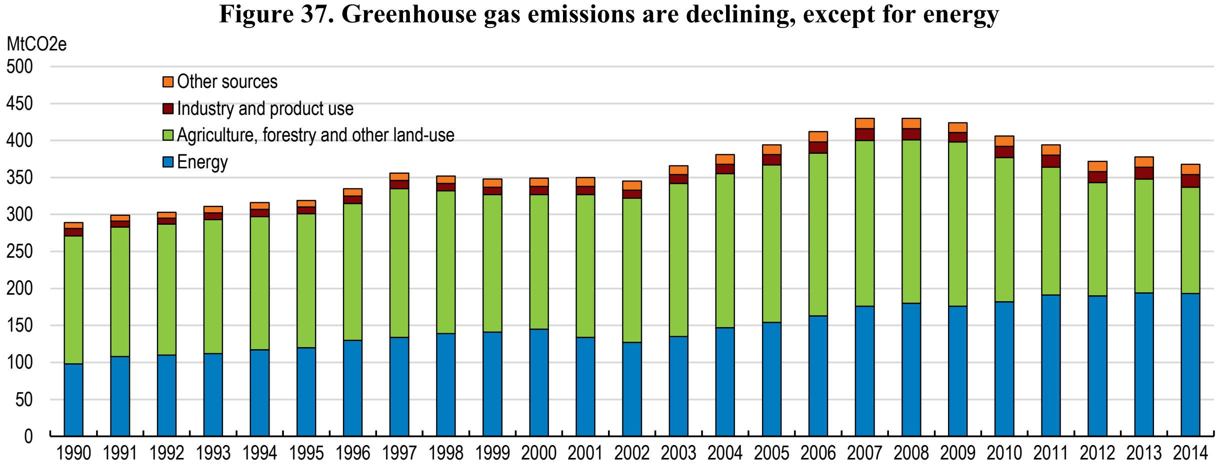
Natural resources could be used in a more sustainable way while reducing greenhouse gas emissions

More than 50% of Argentina's greenhouse gas (GHG) emissions come from the energy sector, while almost 40% come from agriculture, forestry and other land uses (Figure 37). Emissions have been declining since 2008, mostly due to reduced deforestation. Current absolute targets of 483 MT CO_2 equivalent correspond to an 18% decline relative to a business-as-usual scenario by 2030 (República Argentina, 2018[43]). Longer-term targets have not been set but are planned for 2020. As in many countries, more ambitious targets would be needed to meet the objectives of the Paris agreement. With appropriate policies, such targets could be consistent with stronger, more sustainable and inclusive economic growth (OECD, 2017[44]).

Figure 37. Greenhouse gas emissions are declining, except for energy



Source: Secretaría de Ambiente y Desarrollo Sustentable. *Emisiones de Gases de Efecto Invernadero*. Available at: http://inventariogei.ambiente.gob.ar.

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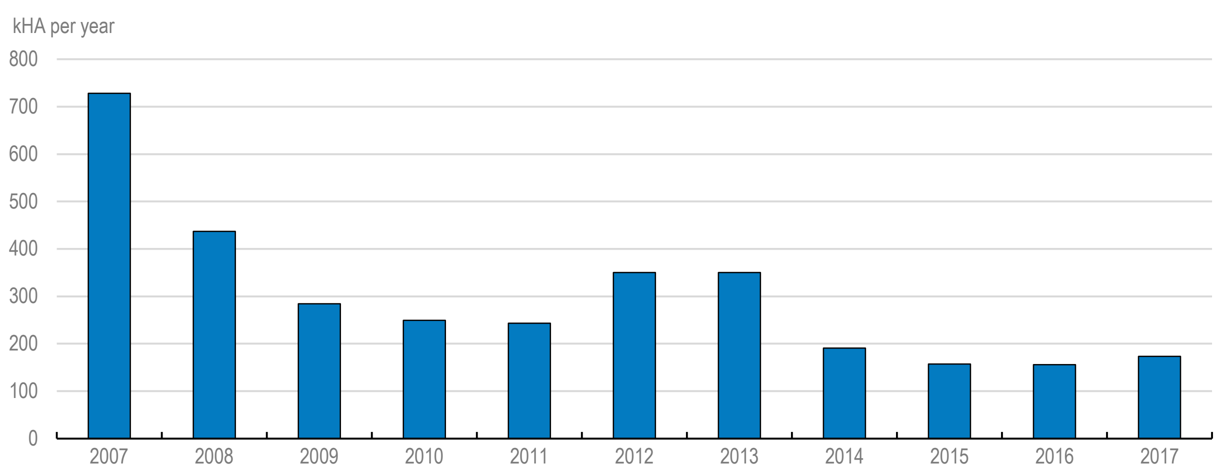
Argentina has lost almost 13% of its forest area since 2001, more than the size of the Netherlands (Figure 38). This has been associated, among other factors, with the expansion of livestock production and industrial-scale agriculture, especially soy, which has become the most important agricultural and export product (World Bank, 2016[27]).

Deforestation has been on a downward trend (Figure 38). A 2007 Forest Law protects 80% of the native forests from deforestation and has halved deforestation. However, weak enforcement capacity in provincial jurisdictions has limited the bite of the forest protection measures contained in Argentina's Forest Law. Reclassifications of protected forest areas by provincial authorities as well as illegal logging have caused higher GHG emissions and a loss of biodiversity (Aguiar et al., 2018[45]; Volante and Seghezzo, 2018[46]). Argentina is currently developing an automatic early warning system to track down illegal deforestation in real time. In addition, measures are being taken to restore native forests and promote the sustainable productive use of the forest, including sustainable livestock production in forest lands. Brazil's success using real-time satellite imagery to track down deforestation highlights the potential benefits of technology to strengthen enforcement (OECD, 2015[47]; Burgess, Costa and Olken, 2018[48]).

Figure 38. Native forest cover loss has slowed down but remains substantial



Source: Secretaría de Ambiente y Desarrollo Sustentable.

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Agricultural expansion, led to a large extent by increased soybean production, has been possible due to the quick adoption of technological innovation combining no-tillage farming, glyphosate for weed control and genetically modified, pesticide-resistant soy varieties (OECD, 2019[49]; World Bank, 2016[27]). This has allowed a 40% increase in soybean agricultural yields, while increasing carbon stocks and preserving soil structure (Secretaría de Agroindustria, Accessed 2018[50]).

The use of insecticides and herbicides has increased since 1993, although it remains below OECD levels. Possible risks to human health or the environment are being discussed globally and are uncertain. This would warrant a more systematic analysis of possible hazards. Argentina has made progress in this area, but could undertake an in-depth evaluation of the negative externalities associated with different types of pesticides, their level of application and impact at specific locations and hotspots, with a view to implementing targeted measures to manage pesticide use. For example, Sweden, Denmark, Norway, France, Italy and Mexico apply specific taxes on pesticides, in addition to health and safety rules for agricultural workers.

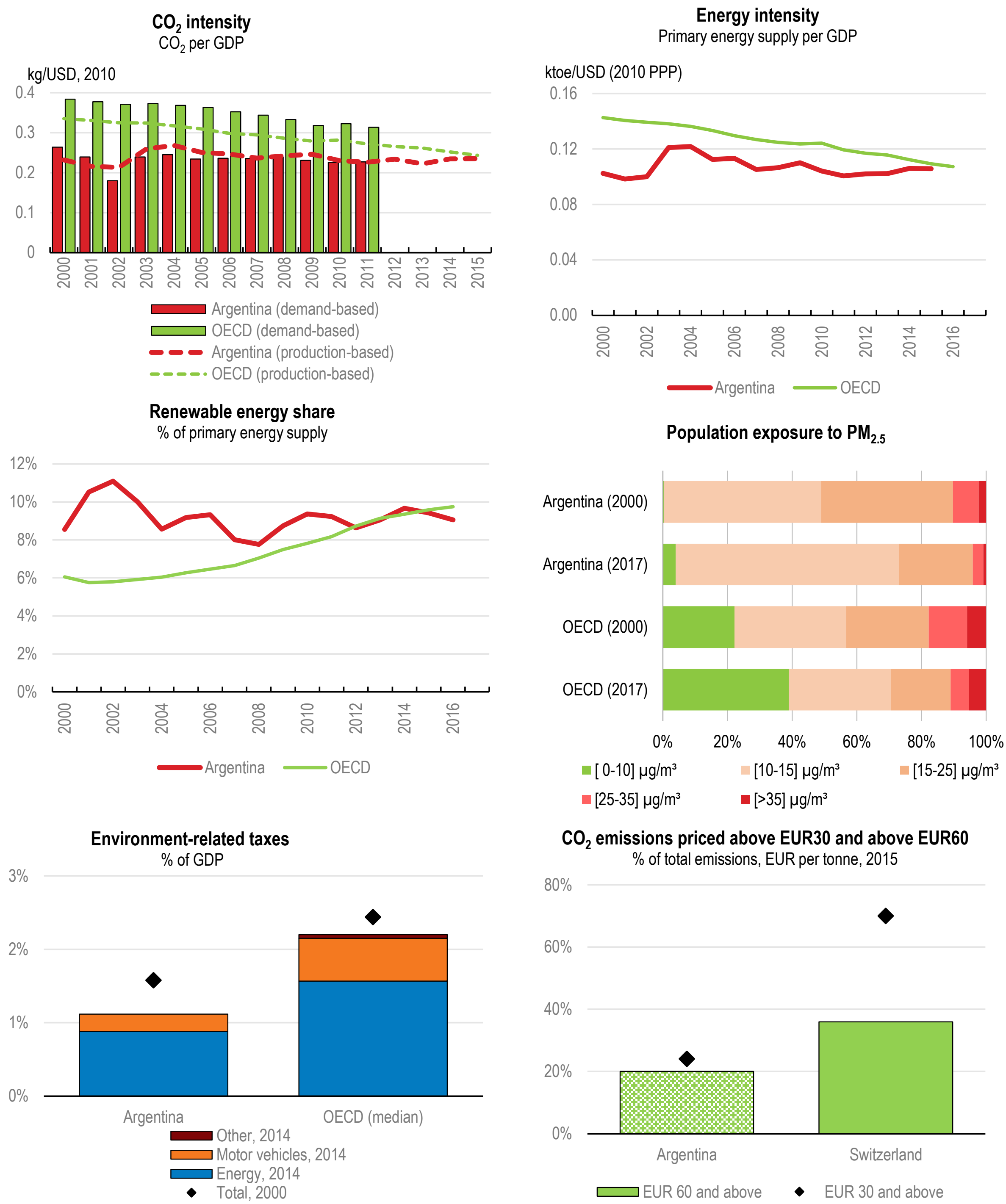
Energy production is 60% from thermal sources (World Bank, 2016[27]). Building on recent progress in expanding renewable energy production and the new legal framework for renewable energies and distributed generation has significant potential to reduce energy-related emissions. Only 20% of hydro generation potential is used, while wind and solar energy production are of high quality in Patagonia and the north-western region, respectively (World Bank Group, 2019[51]). Where subsidies are required for stimulating investment in renewable energy, reverse auctions to install capacity with the least support may be cheaper than the current practice of guaranteeing a fixed price in foreign currency.

Energy intensity has declined despite subsidies, which are being phased out, and low taxation, and it remains below the OECD average (Figure 39). Energy taxes cover 25% of CO2 emissions at or above the widely used benchmark of EUR 30 (OECD, 2018[52]). A carbon tax of around EUR 8.50 has been introduced in 2017. Raising carbon taxes gradually would help achieve climate policy targets efficiently and provide more tax revenues. Energy taxes have the additional advantage that they are difficult to avoid. Reviewing the exemption of natural gas, perhaps in conjunction with improved building regulations, would further strengthen incentives for energy efficiency. Despite widespread use of heating and air conditioning, even upscale dwellings generally lack thermal insulation.

Higher carbon taxation could raise revenues, reduce energy-related GHG emissions and fight air pollution at the same time, although it would require a careful assessment of the distributional consequences on the poor. Most of Argentina's 92% urban population is exposed to small particle concentrations exceeding the WHO-recommended limit of 10 micrograms per cubic metre, with concentrations 6 times above that in Buenos Aires (OECD, 2018[53]).

Information on air quality remains patchy and should be improved, but passenger and cargo vehicles are major pollutants, as half the vehicles are older than 10 years (22% older than 20 years) and 35% are diesel powered (World Bank, 2016[27]). Diesel transport fuel is taxed less than petrol, although it is more environmentally harmful, while agriculture is exempt from fuel taxes. Compressed natural gas is also widely used to power vehicles, and results in lower greenhouse gas emissions compared to gasoline and diesel fuels. Taxing vehicles depending on their emissions, including their CO_2 and NO_x performance, could reduce emissions and pollution. This would imply higher taxes on more polluting vehicles and higher taxes on diesel fuel. As a first step into this direction, energy efficiency labelling will become mandatory by 2020. New investment in natural gas production is expected to increase the use of natural gas in the transport sector, reducing GHG and PM emissions.

Figure 39. Green growth indicators



Source: OECD

StatLink http://dx.doi.org/10.1787/888933942980

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