MOODY'S
INVESTORS SERVICE

SECTOR COMMENT
10 July 2018

Rate this Research

TABLE OF CONTENTS

Contacts

Ursula Cassinerio +54.11.5129.2645
Associate Analyst
ursula.cassinerio@moodys.com

Alejandro Olivo +1.212.553.3837
Associate Managing Director
alejandro.olivo@moodys.com

Regional & Local Governments – Argentina

Provinces will continue to face challenges despite new tighter fiscal regulations

Argentine provinces will continue to face a number of fiscal challenges and experience continued disparities in their economic performance over the next two years despite the approval of a new, more rigorous, fiscal responsibility law in 2018. These challenges include increased salary costs because of rising inflation and higher debt charges after provinces increased their exposure to the capital markets in the past two years, because bonds have higher interest rates than loans from the federal government. The new law will be credit positive if Argentina's central government enforces it in a more credible and consistent manner than the previous law over the next three to five years.

» **Previous fiscal responsibility law was ineffective and not properly enforced.** The previous fiscal responsibility law, which was in place up to December 2017, experienced noncompliance by regional and local governments (RLGs) in some instances because they were unable to cut their high burden of current expenses. Argentina's central government was also lenient in its enforcement of the law. Moreover, the law did not effectively tackle chronic fiscal challenges, such as negative financial results and disparities in performance among the different provinces.

» **New law is likely to be more rigorous, more effectively enforced.** Since taking office in 2015, the government of President Mauricio Macri has sought to address Argentina's economic imbalances and cut the fiscal deficit. The new fiscal responsibility law is designed to be more stringent than the previous law, which was approved in 2004 and the most relevant sections of the new law relate to the control of current expenses. To support Argentina's fiscal consolidation efforts, the federal government will have to be consistent in its enforcement of the new law, starting from 2018.

» **Despite the new law, a number of fiscal challenges will remain.**Rising personnel costs and higher debt servicing expenses are likely to remain despite the new fiscal responsibility law. More expensive debt, higher inflation and pressure to spend ahead of a general election planned for 2019 may make it difficult for provincial governments to comply with the new law. In addition, until a new regime to share taxes between the federal government and the provinces is approved, provincial governments will likely continue to experience mixed financial results.

Previous fiscal responsibility law was ineffective and not properly enforced

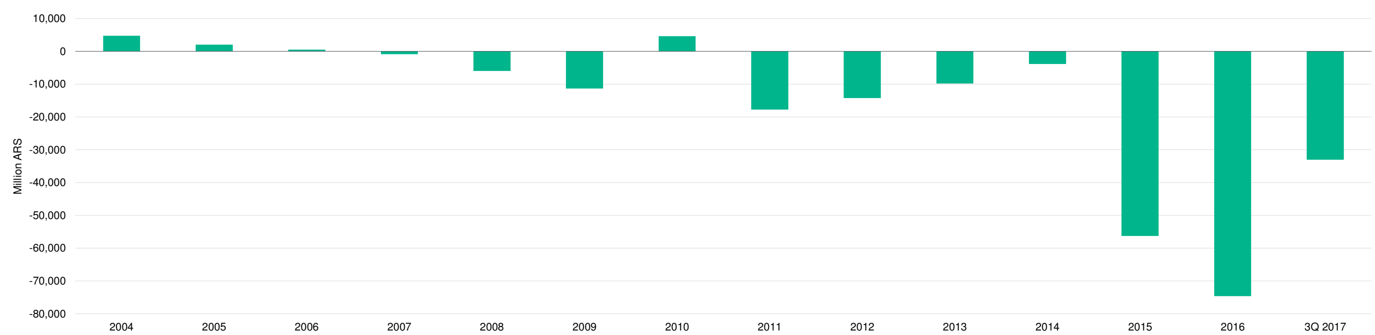
The previous fiscal responsibility law was not complied with in some instances, neither with regard to the quantitative requirements of the law, such as the specific ratio of debt service to current revenue or a determined growth of current expenses nor with regard to its qualitative requirements, such as ensuring transparency when disclosing information.

There are two main reasons for this noncompliance. Firstly, RLGs have a high burden of current expenses, mainly personnel costs. These represent about 50% of RLGs' current spending and in many instances could not be reduced, particularly given the pressure exerted by labor unions to ensure salary levels keep pace with high inflation. Since 2007, when Argentina's inflation rate stated to rise, personnel costs have expanded at a higher rate than revenue, straining the finances of many provinces.

Secondly, there was leniency in enforcing the law. The federal government did not impose the sanctions established by the law, which are financial and reputational in nature. The law does not stipulate judicial consequences, as other fiscal responsibility laws in Latin America do. In addition, there have been instances where the federal government intentionally relaxed the requirements. For example, starting in 2009, the requirement for federal budgets not to exceed the ratio of 15% of debt service to current revenue was suspended to allow provincial governments to fund additional spending on social welfare during the global financial crisis. However, this requirement remained suspended until 2017, many years after the global financial crisis ended.

Exhibit 1

Argentine provinces have historically reported volatile and increasingly negative financial results...



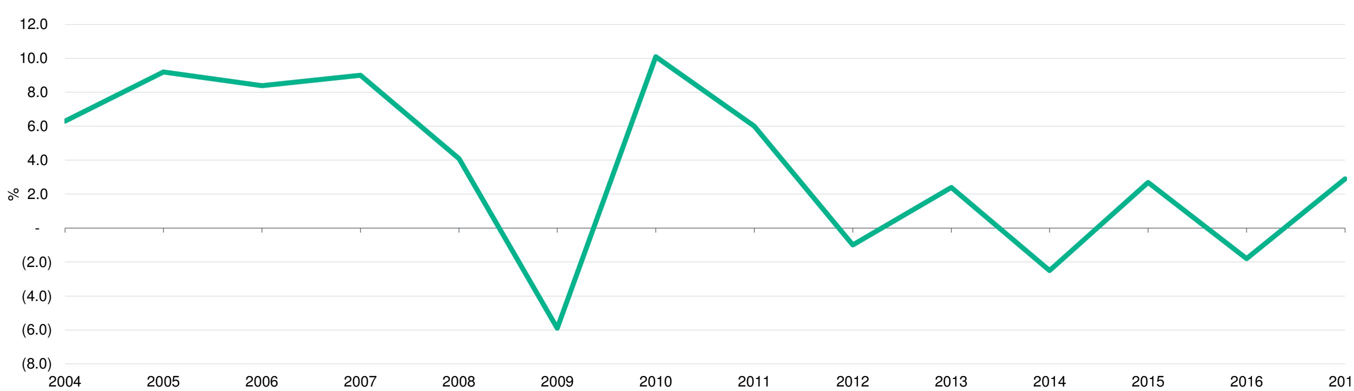
[1] Consolidated results for the 24 Argentine jurisdictions; [2] Includes central administration, decentralized agencies and special accounts

Source: Provincial Coordination Subsecretary, Ministry of Treasury and Public Finance

Exhibit 2

... while Argentina's economy has also experienced volatile economic growth

Real GDP (% change, year-over-year)



Source: Moody's Investors Service

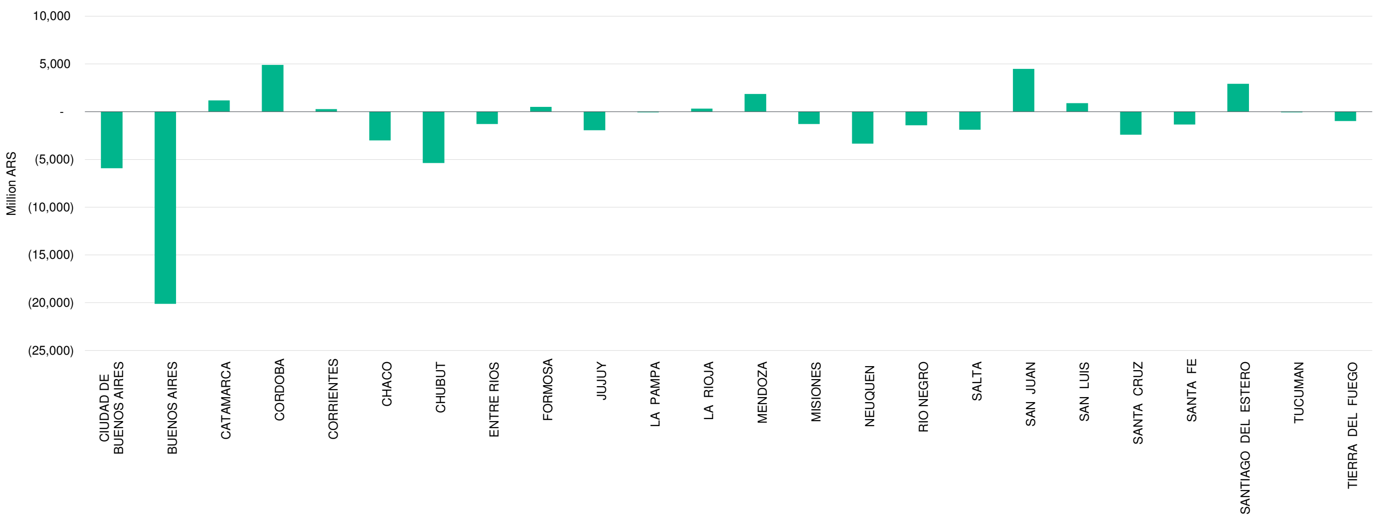
Furthermore, apart from the compliance and enforcement issues, the existence of a fiscal responsibility regime did not effectively deter provinces from reporting negative or volatile results (see Exhibit 1). As the previous law excluded debt service payments and refers to primary results, RLGs were not prevented from reporting negative financial results as their debt levels expanded. Moreover, the law did not prompt any changes in the financial link between the provinces and the sovereign, which left the provinces exposed to the volatile nature of Argentina's economy (see Exhibit 2).

The previous law was also ineffective at curbing the financial disparities between different regions. Argentine provinces have historically shown great disparity in their financial results, partly because of an outdated tax-sharing regime between the provinces and the federal government (see Exhibit 3). The 2004 fiscal responsibility law did not address the problems within the tax-sharing regime, which was created in 1988. Although an amendment to Argentina's national constitution in 1994 stated that the tax-sharing regime had to be reformed by 1996, this has never been achieved because of a lack of consensus among RLGs.

Exhibit 3

Mixed financial results for Argentine provinces [1] [2]

Accumulated financial results for the third quarter of 2017



[1] Consolidated results for the 24 Argentine jurisdictions; [2] Includes central administration, decentralized agencies and special accounts

Source: Provincial Coordination Subsecretary, Ministry of Treasury and Public Finance

New law is likely to be more stringent and more effectively enforced

The new fiscal responsibility law will likely be more stringent and more effectively enforced than the previous law, particularly with regard to the control of current expenses. The following provisions of the new law will likely have the highest impact on the credit quality of Argentine provinces:

» The nominal growth rate of primary expenditure for an RLG cannot exceed the growth rate of the projected consumer price index. This applies to both budgeted and incurred expenses. For those jurisdictions that reported positive financial results in the last year, their primary expenses calculation will exclude operating expenses related to new investments in education, healthcare and safety. For those jurisdictions that in the previous year reported primary operating deficits, or do not comply with the requirement listed above, their primary expenses calculations will also exclude capital spending from any financing source. From 2020, those RLGs that report a financial surplus will be exempt from the expenses requirements listed above. Instead, their current primary expenses will have to remain below the projected nominal gross domestic product (GDP) growth rate.

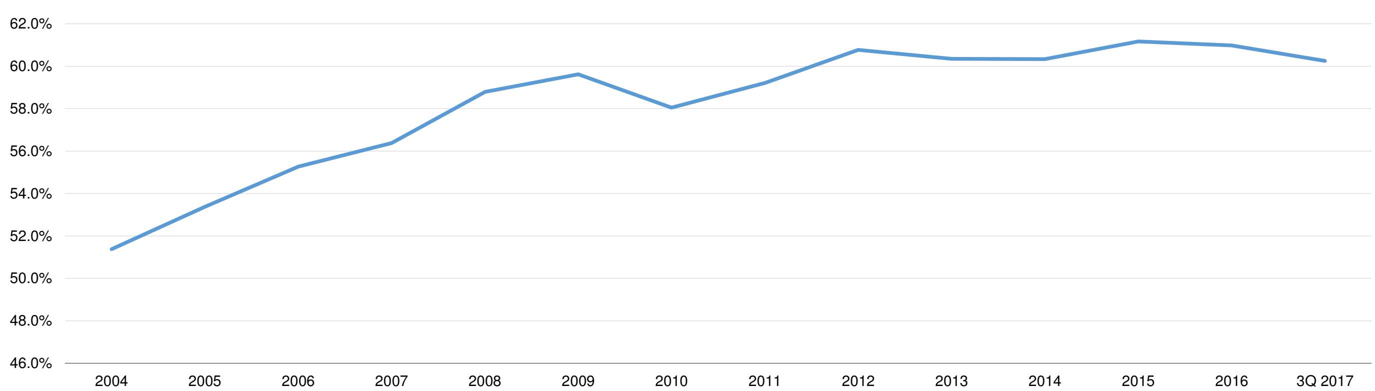
» The federal government and RLGs will commit to not exceeding the current ratio of public sector employees to total population. Those RLGs that achieve financial surpluses will be able to recruit additional employees to work in social services. Also, starting in 2018, the Federal Fiscal Responsibility Council, the organization responsible for measuring compliance with the fiscal responsibility law, will determine the optimum quantity of public employees per jurisdiction.

Among provinces rated by Moody's, Chubut (B3 stable), Rio Negro (B2 stable) and Tierra del Fuego (Caa1 positive) are more likely to be affected by these provisions as they all reported gross operating deficits in fiscal 2017.

The new fiscal responsibility law will be credit positive if Argentina's federal government enforces it in a credible and consistent manner over the next three to five years. On June 7, 2018, Argentina secured a three-year $50 billion standby agreement from the International Monetary Fund (IMF). At the same time, the government unveiled its fiscal consolidation plans and announced its aim to achieve a balanced primary result by 2020. To achieve this target, the government will have to cut overall primary spending by 3.7% of GDP between 2017 and 2020. The government has also pledged to ensure that the Federal Fiscal Responsibility Council will have all the funding it needs to carry out its functions.

Given these efforts, the federal government will likely enforce the fiscal responsibility law in a more rigorous way than previously. To ensure compliance with the requirements, the government can make use of certain provisions in the law. These include denying authorization to take on debt, imposing limits to granting guarantees and limiting federal transfers for noncompliant jurisdictions.

Exhibit 4
Argentine RLGs have a high burden of personnel expenses as a share of current expenses
Personnel expenses to current expenses (%) [1] [2]



[1] Consolidated results for the 24 Argentine jurisdictions; [2] Includes central administration, decentralized agencies and special accounts
Source: Provincial Coordination Subsecretary, Ministry of Treasury and Public Finance

Despite the new law, a number of fiscal challenges will remain

Fiscal challenges, such as rising personnel costs, are likely to continue for the next two years, despite the tighter fiscal regulations. While provinces are required to maintain a certain number of public employees, personnel costs have previously been difficult to cut because of inflationary pressure and the power of the country's labor unions.

In addition, some provinces such as Tucuman (B2 stable), Santa Fe (B2 stable) and Cordoba (B2 stable) agreed to variable salary rises this year that are triggered by rising inflation, so until inflation is brought under control RLGs will continue to spend more on personnel costs. The inflation rate is forecast to reach 27% by the end of 2018, from 24.8% in 2017, before falling back to 20% in 2019. Aside from the need to comply with the new law, it will be essential that Argentine RLGs cut their employment costs to halt the trend of volatile operating results seen in the last few years.

Provinces also face higher interest expenses after issuing more bonds in the capital markets, rather than taking out loans with the federal government, which tend to carry lower interest rates than bonds (see Exhibit 5). Because of a greater appetite for issuing debt on the capital markets since 2016, bonds now represent 60% of the total debt held by RLGs, compared with 40% three years earlier.

Exhibit 5

Argentine provinces have increased their issuance of bonds through the capital markets
Share of debt by type of creditor (%) [1] [2]

[1] Consolidated results for the 24 Argentine jurisdictions; [2] Includes central administration, decentralized agencies and special accounts
Source: Provincial Coordination Subsecretary, Ministry of Treasury and Public Finance

Local governments in Argentina may come under pressure to increase current and capital spending as the country prepares to hold presidential, gubernatorial and legislative elections in mid-2019. Until the election, RLGs will have to balance compliance with the requirements of the fiscal responsibility law with demands for higher spending from voters.

Argentina's new fiscal responsibility law — main elements and changes

Federal government disclosure

The new law eliminates the need for the federal government to disclose to the Federal Fiscal Responsibility Council the debt limits for the federal government and RLGs for the next fiscal year.

Federal Fiscal Responsibility Council disclosure

The new law requires the Federal Fiscal Responsibility Council to communicate their compliance reports to Argentina's Congress before June each year.

Primary expenditure

The previous fiscal responsibility regime established that the budgeted primary expenditure growth rate of RLGs could not exceed the projected nominal GDP growth rate. Primary expenditure was defined as current expenses plus capital spending excluding interest payments, expenditure financed by supranational entities and capital spending devoted to social infrastructure.

The new law requires the following:

(1) The nominal growth rate of RLGs' primary expenditure cannot exceed the growth rate of the projected consumer price index. This applies for both budgeted and incurred expenses.

(2) Primary expenses will be defined as following: Current expenses excluding expenditure financed by multilaterals; transfers to municipalities; current expenditure financed with nonautomatic earmarked transfers by the federal government; and current expenditure devoted to fulfilling national interest public policies.

(3) For those jurisdictions that exhibited positive financial results in the previous year, their primary expenses calculation will exclude operating expenses related to new investments in education, healthcare and safety.

(4) For those jurisdictions that in the previous year exhibited primary operating deficits or that do not comply with the requirements listed above, their primary expenses calculations will also exclude capital spending from any financing source.

(5) Starting in 2020, those RLGs that report a financial surplus will be exempt from the expenses requirements listed above. Instead, the RLGs' current primary expenses will have to remain below the projected nominal GDP growth rate.

Personnel expenses

The federal government and RLGs will commit to not exceeding the current ratio of public sector employees to total population. Those jurisdictions that report financial surpluses could hire new staff to work in social services. Also, starting in 2018, the Federal Fiscal Responsibility Council will determine the optimum quantity of public employees per jurisdiction.

Sale of assets and debt proceeds

The new law clearly specifies that proceeds from the sale of fixed assets must be allotted to capital spending. However, it no longer explicitly prohibits provincial governments from using debt proceeds to fund current spending.

New administration transitions

The new law states that during the last two quarters of an administration, government officials cannot increase current expenses. During that time, the sale of fixed assets is also not allowed.

Tax revenue

The new law establishes a commitment by the federal government and RLGs to adopt tax policies to increase productivity in the corporate sector and bolster economic growth, while also maintaining the sustainability of public finances.

Transparency of information

RLGs should calculate their local GDP using a similar methodology as the National Statistical Institute.

Indebtedness

Only those compliant jurisdictions will be able to take on new debt with supranational entities, such as The World Bank and the Inter-American Development Bank, and federal programs. The federal government also retains the power to establish procedures and timing for authorizing new debt by RLGs.

Exceptions

Only those jurisdictions that have presented positive financial results for the last two years can request exceptions to the fiscal responsibility requirements, and this applies only in special circumstances.

Moody's related publications

» Sovereign Monitor: focus on Argentina, June 2018

» Argentina's preliminary agreement with IMF would support funding, fiscal consolidation and independent monetary policy, June 2018

» Surging interest rates, currency depreciation put pressure on Argentine issuers, May 2018

» Argentina's currency pressures are credit negative for the sovereign, May 2018

» Credit Opinion: Government of Argentina, April 2018

» Argentina's new pension law advances government's reform efforts, December 2017

» Argentina: FAQ on economic and policy reform prospects, December 2017

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

REPORT NUMBER 1128753

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Moody's
INVESTORS SERVICE