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Central Intelligence Agency



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Argentina's Economic Reforms: A Scorecard



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Summary

Over the past three years, President Raul Alfonsin has frequently emphasized the need for structural changes to secure long-term economic growth for Argentina, but rhetoric has far outpaced reality. Although Buenos Aires has taken many small steps toward reform, it has, for political reasons, avoided the thorough changes many experts judge necessary for major economic improvement--such as comprehensive privatization, a free exchange rate, and structural reform of the labor market. As a result, the cumulative effect of Alfonsin's halfhearted steps has been deteriorating public confidence in his management of the economy, the reappearance of triple-digit inflation and a current account that is in chronic deficit. We believe Alfonsin is unlikely to step up the pace of reform significantly. Moreover, given the proximity of presidential elections--they may be held as early as 28 May 1989--and the very real possibility

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that a statist-oriented Peronist may win, even bold changes at this late date would probably be insufficient to stimulate private investment. [redacted]

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### A Sector-by-Sector Look

In our view, President Alfonsin was particularly well positioned to push sweeping economic reforms, and his failure to do so both represents the loss of an historic opportunity and clouds the prospects for such change during the next administration. Alfonsin's election in 1983 represented a thorough repudiation of military rule and a mandate for change on many fronts. While the strong influence of Argentina's major interest groups makes reform exceedingly difficult under any circumstances, we believe Alfonsin's incomplete understanding of economics and his pursuit of an ever-elusive political consensus for his actions led him to pass up at least two timely occasions to launch far-reaching structural reform.

- Alfonsin's popularity immediately after the June 1985 implementation of his Austral stabilization program gave him a mandate to take more sweeping action on the economic front. Instead, he exploited high public approval ratings and the ensuing political honeymoon to pursue constitutional and military changes.
- Alfonsin also failed to take the opportunity provided after the 1987 off-year elections, which the government lost because of the deteriorating economy, to take bold measures that could have boosted his party's chances for the next presidential contest. Since he cannot run again, such steps would have incurred little personal political risk. [redacted]

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Instead, since 1985, Alfonsin has implemented reforms only gradually and on a piecemeal basis, in various sectors of the economy--often at the urging of the World Bank. The initial results of most of his changes, such as his original effort to stimulate investment in the oil sector, were disappointing. Although several subsequent moves have shown promise, their cumulative effect has been insufficient to offset investors' perceptions that Alfonsin's heart is not in the reform program and that his economic team is operating only on a day-to-day basis. [redacted]

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### The Tax Problem

Collecting taxes is an especially vexing problem. Although Argentines frequently complain about the myriad taxes imposed, most simply refuse to pay income tax, and evasion of the value-added tax on goods is estimated at 70 percent, according to press reports. Businesses also regularly evade taxes. A mere one percent of Argentina's 30,000 industries accounts for 80 percent of the government's income from the corporate earnings tax. A mindset that values independence and defiance of authority--and not civic responsibility or conforming with the law--encourages such evasion, as does the interrelated fact that at least half of all economic activity occurs "underground." Argentines, moreover, complain that government-provided services are not worth paying for. These attitudes partly explain why, in one recent poll, 70 percent of the Argentines surveyed regarded taking a pencil from the office as wrong, but only 50 percent believed the same about tax evasion. [redacted]

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Because Argentines so successfully avoid paying taxes, governments have been obliged to resort to levies that are easier to collect but are inefficient or impede productivity. Thus, Argentina has taxes on exports, financial transactions, and "forced savings," which require the relative handful of individuals and corporations already paying taxes to deposit additional sums with the government, theoretically to be returned in five years, after accruing interest far below market rates. [redacted]

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President Alfonsin's limited efforts to increase the meager tax take have included an amnesty--the eleventh one since 1970--the computerization of the Directorate of Taxation, and the hiring of additional auditors. From time to time, he also shepherds tax increases through Congress. However, much of the revenue from his most recent packages--a new forced savings plan, a major increase in the tax on fuels, and higher taxes on checks received Congressional approval in January, while increases in the levies on cigarettes and savings accounts were approved in May--was earmarked for specific increases in spending rather than to close the fiscal deficit. Because of increasingly rapid inflation, which causes the real value of tax payments to shrink before they can be collected, real tax receipts actually decreased last year. [redacted]

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### Reforming State-Owned Enterprises

Reforming state-owned enterprises represents a particularly difficult challenge because they are so numerous, have entrenched, politically powerful sources of support, and fundamentally affect vital areas of the economy. Argentina has

over 300 such firms, the largest of which dominate the oil, gas, electricity, telephone, mail, railway and airline industries. Notoriously inefficient, they typically provide inferior-quality goods and services, employ too many people, overpay private suppliers for purchases by at least one-third, according to a recent government study, and regularly fail to cover their own costs. Their losses account for at least half the federal budget deficit and their borrowing constitutes one-fourth of the foreign debt. [redacted]

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President Alfonsin has wrestled with the problem of reforming state enterprises since the inception of his Austral Plan. He began by freezing public hiring, and then created two new secretariats to oversee the restructuring of the sector. In a major policy address in February 1986, Alfonsin announced plans to privatize the state steel company as well as five petrochemical firms; several months later he submitted to Congress legislation that would grant the executive branch greater leeway in selling state enterprises. During the remainder of that year, the secretariats were unable to overcome bureaucratic resistance to change, while stiff union resistance blocked the sale of the steel firm and the privatization legislation failed in Congress. Buenos Aires recently announced new plans to privatize the petrochemical companies. [redacted]

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In December 1986, Alfonsin gave up on the secretariats, replacing them with a semiautonomous holding company tasked with increasing the efficiency of the thirteen largest state firms. Some progress occurred last year as Buenos Aires privatized a small airline and began soliciting private-sector participation in areas previously monopolized by the state-owned enterprises. Since the beginning of 1988, Buenos Aires has offered minority participation in the telephone company and the major state airline to foreign firms, and promised to end Treasury subsidies to state firms by the end of the year. The US Embassy reports, however, that two key government officials may be receiving pay-offs from a state enterprise supplier to block the telephone deal, and we believe Buenos Aires is likely to experience difficulty obtaining Congressional approval for the airline proposal. The government has already backed away from its promise to end subsidies. [redacted]

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#### *Petroleum--An Illustrative Case*

*The decline of Argentina's petroleum industry dramatically points up the weaknesses of Argentina's state-owned enterprises. Argentine oil production has decreased each year since 1982, culminating in the politically embarrassing need to import oil in 1987-- after several years of self-sufficiency. Although the*

state-owned oil company (YPF), Argentina's first state enterprise, is an important national symbol and a great source of pride, it is also one of the few oil companies in the world that consistently loses money.

Alfonsin started to restructure the oil industry in 1985 with the unveiling of his so-called Houston Plan, an unprecedented opening of large tracts of land to foreign investment in oil exploration and development. He hoped to generate a huge inflow of cash to supplement the limited YPF budget. These efforts were hindered by interest groups ranging from the YPF bureaucracy to private sector firms that benefited from their business relationships with the company. As a result, early tenders offered terms unattractive to potential investors and drew little interest. After Alfonsin replaced top personnel in the energy sector, YPF developed more favorable contract terms that generated stronger investor participation in the most recent offering. Because of extensive delays in final contract approval by a multitude of government officials, however, only two firms are near the drilling stage. Most of the other successful bidders for exploration blocks are still tied up in contract negotiations that have dragged on for up to two years, and future tenders are on hold until the administrative logjam is cleared. Given the time involved in bringing oil projects to fruition, results of the program will not be apparent for several years even if Buenos Aires can smooth out its bureaucratic problems.

To make short-term gains against declining production, Alfonsin announced in June 1987 that private firms agreeing to raise production levels above their current contractual obligations would be offered substantially higher prices for their oil. Fifteen such contracts were signed last month, but the investment needed to boost output will delay much of the effectiveness of the plan into next year. Authorities are also completing a plan that will offer private firms the right to pay a user fee and extract oil from current YPF operating areas. While the US Embassy does not believe this option is sufficiently attractive to generate much international interest, it will offer participants the free disposition of oil produced--current production must be sold to YPF--and could be an important first step in the deregulation of the industry.

### Spurring Agriculture

Agriculture, a much-neglected engine of growth for the Argentine economy, has been a victim in recent years of low world prices and developed country subsidies, as well as an Argentine mindset that views farmers as a rich and privileged class to be taxed for industry's benefit. In 1986, Argentina received its first major structural adjustment loan from the World Bank after promising to replace agricultural export taxes with a land tax designed to spur production on underutilized property. Shortly before the September 1987 elections, Alfonsin eliminated export taxes on grain and significantly reduced them on other products. On the other hand, the federal land tax--opposed by farmers who already pay local land taxes--died in Congress, leaving the decrease in income from export taxes inadequately offset by new sources of revenue. Alfonsin also temporarily imposed price controls on live cattle and meat, causing ranchers to question whether they should rebuild cattle stocks, despite strong internal demand. [redacted]

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### Deregulating Industry

Argentine private industry--most heavily concentrated in the food processing, chemical, automotive, machinery and equipment, and textile sectors--has long enjoyed government subsidies and has been protected from foreign imports by "infant industry" and "buy Argentine" arguments. Industrial promotion programs offering tax incentives, export financing schemes--which the US Embassy judges have done little to augment industrial exports--and "sweetheart" deals to supply state firms ensured them healthy profits. "Prior consultation" regulations allowed Argentine manufacturers to prevent the import of goods manufactured domestically. [redacted]

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Under the aegis of a \$500 million trade policy reform loan from the World Bank finalized in 1987, Buenos Aires has made some headway in dismantling regulations. Argentina is allowing goods to enter duty-free provided they are used to manufacture products that are subsequently exported. Buenos Aires is also simplifying procedures at ports--paperwork now takes several weeks--and has transferred 1000 out of the list of 7000 categories requiring "prior consultation" to the automatic export list. Last February Argentina announced the "opening" of the petrochemical and iron/steel sectors by transferring products from these sectors off the prior consultation list and imposing a uniform 25 percent tariff on related imports. Moreover, Buenos Aires recently changed its "buy Argentina" regulations to substantially shorten the time period during which domestic manufacturers can petition

state enterprises to purchase their products rather than imports, and require petitioners to place a deposit with the government while it investigates their claims. [REDACTED]

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### Restructuring Banking

Argentina's ailing banking system suffers from fundamental structural problems, according to US Embassy and World Bank studies.<sup>1</sup> Most important among these are government ownership and subsidization of banks and over-regulation of banking activity, as well as official and private bank lending on the basis of political rather than economic considerations. Moreover, chronic high inflation and excessive labor costs have contributed to exceptionally uncompetitive spreads between deposit and loan rates. These systemic difficulties are compounded by the Central Bank's lack of independence, regulatory capacity, and control over money supply. They also contribute to Argentina's economic troubles: government subsidies to banks help fuel inflation, and the inability of the system to mobilize domestic capital effectively has been at the root of Argentina's dependency on foreign financing. [REDACTED]

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President Alfonsin, using conditions attached to a \$400 million World Bank banking sector loan as a guideline, has implemented a number of reforms over the past 20 months which, although modest in scope, have led to some progress. These reforms have included the elimination of "regulated" interest rates, a decrease in the availability of subsidies to federal and provincial banks, a crackdown against fraudulent banking practices, and the closing, merger, or liquidation of troubled private banks. However, at the behest of the Peronist Party--which controls 17 out of 22 governorships--Buenos Aires is at least temporarily replacing Central Bank subsidies to profligate provincial banks with Treasury loans. [REDACTED]

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### The Road to Comprehensive Reform

In our view, substantial reform is still needed to place Argentina on a path toward long-term economic growth. Far-reaching change is particularly difficult in a society as highly politicized as Argentina's, with strongly entrenched interest groups that can readily defy the Federal government. Academic literature and recent experiences with structural reform in the UK and even chronically troubled Bolivia indicate,

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however, that interest group objections can be overcome when comprehensive reform is implemented swiftly and decisively.

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Labor--militant and well-organized--epitomizes the problem of an entrenched interest group in Argentina. Over the years, the unions' power has enabled them to perpetuate the overstaffing that is a prime factor in running up expenses and impeding productivity and innovation. The growing replacement of blue-collar jobs with white-collar ones, however, and public irritation over the frequency of strikes, may open a window of opportunity for a reformist government. Significant workforce reductions, tempered by an unemployment insurance program sponsored by an organization such as the World Bank, would enable private and state enterprises to lower costs, contributing to a drop in inflation. Diminished job security--and inflation--might dampen the Argentine workers' enthusiasm for frequent strikes. Moreover, employers could redirect a portion of the money saved by a reduction in workforce to finance pay increases for the workers who remain to spur productivity and eliminate a key motivation for corruption. In turn, a simultaneous drop in inflation and a decrease in bribe-taking by better-paid auditors would immediately increase tax receipts.

Regarding state-owned enterprises, [redacted] [redacted] in light of the numerous forces positioned to thwart incremental change--nothing short of 100-percent privatization will stem government losses. Moreover, recent opinion polls show that a majority of the public--exasperated with highly unreliable telephone and train service--supports the sale of most state firms with the exception of the oil company. The privatization of railroads, grain terminals, and the national shipping fleet would generate a positive ripple effect throughout the agricultural and industrial sectors. Simultaneous deregulation of previously monopolized sectors would, in our view, be needed to ensure the competitive provision of goods and services. The wholesale elimination of reams of government rules and regulations would also decrease the opportunity for corruption and help nudge workers out of the untaxable "underground" economy.

On the trade front, experience elsewhere indicates that a floating exchange rate and a much greater reduction in protectionist measures would benefit both agriculture and industry. Moreover, Argentina would probably do well to follow Chile's example and diversify its agriculture by producing more fruits and vegetables for Northern hemisphere markets. Lastly, Argentina will need to maintain a set of consistent, free-market, pro-export policies over a long period of time to encourage farmers and businessmen to make long-term investments.



Much remains to be done if the Argentine banking system is to become a net contributor to economic growth. In our view, closing the provincial banks and either privatizing or closing the federal ones would lead to far greater efficiency. Over time, Argentina would also benefit from lowering reserve requirements, allowing private banks to maintain positive real interest rates and enabling banks, rather than the government, to act as the primary conduit for credit. A self-insurance scheme-- already on the drawing board in the World Bank's loan proposal-- is needed to ensure that the taxpayer does not pay for banks' poor investment decisions. Such changes would foster a greater availability of domestic capital for investors. In addition, a reduction in inflation and staffing costs would enhance bank competitiveness and profitability. Finally, making the Central Bank independent of the Executive office would minimize the influence of day-to-day political constraints. [REDACTED]

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### Outlook and Implications

Given Alfonsin's mixed track record to date, he is far more likely to continue a piecemeal approach to economic reform than to implement proposals like those outlined above. Worker lay-offs, in particular, would probably consign his Radical Party to defeat in the presidential elections. [REDACTED]

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Even if Alfonsin were to initiate far-reaching structural changes, however, the possibility that Carlos Menem, the Peronists' nationalist, populist candidate for office, might gain the presidency next year and undo many of those reforms will likely keep investors on the sidelines. Menem believes the state should continue to play a major role in the economy and opposes privatization. He generally favors heavy regulatory and protectionist policies and believes that the government should direct credit by exerting full control over bank deposits. Menem also opposes the idea that worker lay-offs may be needed to promote efficiency and that fiscal deficits cause inflation. Menem's electoral prospects are enhanced by the belief among some Argentines that the current economic deterioration proves that free-market economics do not work. [REDACTED]

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On the other hand, should Eduardo Angeloz, a member of the Radical Party's more conservative faction, win the presidency, we expect a greater commitment to reform. Although he would have to deal with the same powerful interest groups that have stunted changes to date, as well as Peronist control of at least one and possibly both houses of Congress, Angeloz believes far more deeply in reform than Alfonsin and would work much harder against vested interests. On the campaign trail, Angeloz has already taken the politically controversial stand that workers should not be paid while on strike. He has shown himself to be an able

administrator as governor of Cordoba--one of the few Argentine provinces that is in the black. In our view, Angeloz's election would ensure the logical continuation of the reforms that Alfonsin has only tentatively implemented.

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