

XIX Meeting of the Latin American Network of Central Banks and Finance Ministries

Assessing Fiscal Sustainability: A New Approach

Enrique Mendoza observed that, in order for emerging market (EM) governments and international financial institutions to make appropriate policy regarding countries' sustainable debt levels and fiscal solvency, the determinants of EM volatility must be properly understood. Two particular factors stand out. First, volatility often results from fluctuations in commodity export prices rather than policy decisions. Second, the insurance instruments available to emerging market countries are often ill-suited to their circumstances, with features such as short maturity, inappropriate units of currency, and conditions of payment that are not state-contingent. Thus, many EM countries display higher variations in revenue to GDP ratio than developed countries in spite of having smaller public debt ratios, which complicates efforts to smooth government outlays.

To ascertain a government's sustainable level of debt, Mendoza presented a dynamic general equilibrium model of a small open economy whose government is credibly committed to repay debt. This model holds several implications. First, uncertainty and market frictions indicate that EM countries' sustainable debt levels are much lower than suggested by other models and that those countries' current long-term debt ratios are much higher than their sustainable level of debt. Second, the model can be used to study regime changes in policy or in capital markets, particularly as it incorporates the effects of incomplete markets and liability dollarization. Third, countries with low debt levels can generally forestall fiscal crises for a large number of periods, but this number of periods can be greatly reduced by repeated events such as low realizations of revenue unless governments can be credibly expected to repay debt. Given these circumstances, governments must engage in fiscal reforms to increase and stabilize their revenues to enhance the flexibility of their outlays.

Discussing the paper, Andrés Arias noted that the model captures the stock of debt that a government is willing to repay and incorporates the importance of volatility in fiscal variables. Several unresolved issues nonetheless remained. First, the paper discusses a maximum rather than a target or equilibrium debt level. Second, it is uncertain whether the model may be more useful for governments or for their creditors. Third, the model does not address the states of nature in which countries are likely to default or repay, with the corresponding question of whether governments should base their analyses on worst-case scenarios. A fourth question is how the model can be operationalized in relation to bail-outs, terms of trade shocks, and the inflation tax. The effect of shocks on a country's growth path can lead to higher but not necessarily unsustainable debt levels. Given that policymakers cannot be constrained to a certain debt level under variable circumstances, the probability of default may be better calculated by using a binary tree approach with discrete decision nodes. Fifth, the model may not prove applicable to countries with rigid budget measures, such as Colombia. Finally, a country's debt issuance strategy must be kept consistent with the demands of both internal and external bond buyers.

In further comments, Umberto Della Mea stated that debts are not intrinsically sustainable or unsustainable. Moreover, the relationship between subordinated market debt and senior multilateral debt must be taken into account, and that multilateral lenders may prove harmful to credit markets; from the markets' perspective crises of solvency and liquidity are equivalent. Other questions regarding the model included the following: the relative importance of debt stocks and flows, the particular importance of government fund flows and government capital accounts, and whether the model considers real or nominal values.

Claudio Irigoyen observed that the paper takes into account the uncertainty of countries' revenues, spending and debt dynamics and that the sustainability of debt is linked to the variability of countries' primary surpluses; this framework is flexible enough to accommodate countries' differing fiscal arrangements. He noted, however, several caveats. First, a default strategy is not modeled. Second, the model does not indicate how governments and markets might act as the government approaches a crisis. Third, the model may need to distinguish ex ante between transitory and permanent shocks. Fourth, the variability of revenue and the primary surplus may not represent the most relevant factor to consider, as investors think in terms of "undiversifiable" risks. Fifth, the model omits liquidity problems, which are related to risk; of particular importance is the respective behavior of informed and uninformed international investors, which can contribute to financial contagion.

In subsequent discussion Enrique Mendoza noted that the natural limit of debt is not equal to the sustainable debt level, and that the model assumes governments' interest in smoothing expenditures and avoiding crises. Moreover, the model, which is intended to serve as a fiscal navigation system rather than a basis for prescriptions in every situation, treats public and private debt as equally risky. Guillermo Calvo added that the relative flexibility of public-sector salaries must also be taken into account in determining countries' prospects, that IFIs should serve as leaders in maintaining the functioning of the international financial system, and that making only short-term and costly debt available to EM countries, which are seen as crisis-prone, amounts to a self-fulfilling prophecy. He additionally stated that multiple equilibria of debt levels may exist that depend on changes in international financial markets rather than within countries. José de Gregorio commented that the model does not consider bailout risk and raised the additional question of how spending policies might be used to minimize variability. Sergio Clavijo noted that transfers from national to subnational units of government must be considered as well, and that countries' historical willingness to tax as well as their historical willingness to repay debt must be considered. Guillermo Perry observed that changes in public expenditure can affect growth, and that the purposes for which various types of debt are undertaken must be examined. Ricardo Hausmann stated that the model takes into account only risk-free debt, and that riskier debt requires more insurance. In addition, the sources of volatility, which include exchange rates and GDP in dollars, must be considered as well; the limit to countries' debt in part depends on the composition. It was also noted that overinsurance is possible, particularly as the behavior of markets can change without apparent cause.

Rising from the Ashes: Lessons from Post-Collapse Recoveries in Argentina and Uruguay

Ernesto Talvi stated that systemic features underlay the recoveries of Argentina and Uruguay in both the 1980s, following the 1981-82 Mexican banking crisis, and in the current decade following the 2001 Argentine default. Both U-shaped recoveries have featured a rapid recovery of 80 percent of output within two to three years of the initial shock. From a financial perspective, however, these recoveries are precarious, as they occur without renewed inflows of either external or internal financing, and deleveraging continues throughout the recovery process. Under these conditions of negative net investment firms employ their own unutilized capacity and finance their activities through means that include selling assets and reducing dividends. This reduction of debt and consumption restores “normal” conditions, with results including low debt spreads and recovery led by renewed domestic demand, an even more important factor than a surge in exports made competitive by exchange rate changes.

This recovery process holds clear implications for how debt is valued, involving the initial amount of debt rather than a theoretical measure of sustainability. The recovery of domestic demand, rather than deleveraging per se, produces significant real exchange rate effects that in turn reduce debt as a percentage of gross domestic product; the real exchange rate used to estimate the effects of this change, however, should be neither the pre-collapse level nor the level at the trough of the collapse.

The management of the recovery process, moreover, calls for careful attention, as this process can affect future growth rates and a country’s ability to attract investment. The respective approaches of Uruguay and Argentina illustrate this issue. In the course of addressing its financial crisis Uruguay has left the denomination of debts and deposits unchanged, leaving the resolution process to be decided between banks and creditors, renegotiated debt with the international community, and maintained close and friendly relationships with international financial institutions. At first glance Uruguay’s orderly debt workout may not seem to be rewarded, as Argentina, with a much less orderly process, is experiencing a faster recovery in short-term growth. The Uruguayan approach, however, is likely to provide long-term advantages, particularly in sustained GDP growth.

Discussing the paper’s implications, Juan Pablo Guidotti summarized the circumstances leading to Argentina’s current crisis and the challenges facing the country in the near future. Like much of Latin America, Argentina has moved from an era of financial isolation to one of globalization, with a corresponding change in policy challenges from containing inflation to managing debt and volatility; in the recent past the region has alternated between periods of high growth, accompanied by large current account deficits, and subsequent periods of far lower growth and fiscal adjustment. While globalization permitted the separation of monetary and fiscal functions, which has largely led to stable currencies and a containment of inflation, debt remains a problem, and there may be no correlation between globalization and long-term growth. Instead, the challenges that must be met to ensure growth include fiscal consolidation, sustainable policies, functioning institutions, and the rule of law.

More specifically, Argentina's recovery remains precarious for a variety of reasons. Deleveraging has occurred in the private sector but not the public sector, investment remains low, and concerns have not subsided regarding the functioning and credibility of the country's institutions. Like other countries in the region, Argentina must focus on the sustainability of public debt and move toward greater fiscal discipline, which should attract capital flows, but these changes are complicated by the larger problem of political will.

These long-term concerns must frame any consideration of Argentina's present situation. In spite of a recovery of economic activity, high capital prices, and a largely favorable view of the Kirchner government in Argentina, the country's international reputation has weakened. At the moment there are two predominant views of Argentina's prospects. The first and more optimistic view holds that the current recovery will provide the solution to the country's fiscal problems. A second and more pessimistic view is that a new crisis may occur if Argentina does not undertake significant reforms in the near future; sources of risk include fiscal policy and relations with creditors, monetary policy and its vulnerability to financial variables, and the integrity of the financial system.

Although the government's current political strength may enable it to take decisive action, the window of opportunity for such action may prove narrow for a variety of reasons. First, Argentina's current primary surpluses are resulting from temporary rather than permanent factors. Second, current negotiations with international creditors are at an impasse, making the government increasingly appear unable to balance the debt writedown process and engage in future financial discipline. Third, Argentina's financial system is overinvested in government debt, which suffers from low returns and low levels of liquidity. To avoid another crisis, and to engage in an independent monetary policy, Argentina needs to revise its approach to creditors and find ways to strengthen its primary surplus.

Two further factors may limit the time frame in which the government can act decisively. First, an appreciation in the real exchange rate but not the nominal exchange rate is expected in 2004; this may generate inflationary pressures and produce problems of credibility among a public that has grown accustomed to fixed or low rates of inflation. Second, the current high level of support for the Kirchner government is based on the president's public image rather than political alliances. A decline in his personal popularity is likely to increase the government's political vulnerability and correspondingly reduce its ability to undertake broad initiatives. Under these circumstances the government must act decisively while public support remains strong and maintain its reputation for honesty in order to retain public support.

Fiscal Institutions in Latin America: What Reforms Are Pending?

Ernesto Stein observed that, in the absence of the social planner posited in theory, budgetary institutions, consisting of rules, procedures and practices, are important in addressing a variety of fiscal problems. These problems include common pool issues,

externalities among different units of government, the electoral cycle, strategic indebtedness, principal-agent relationships, and the short time horizons of politicians.

Budgetary institutions generally consist of three types of rules: numerical restrictions, procedural rules, and rules that affect the transparency of the budgeting process. Numerical restrictions, such as the United States' Graham-Rudman-Hollings deficit reduction rules, the European Union's Maastricht criteria, and the balanced-budget requirements of states within the United States, can differ in a variety of ways according to the guidelines selected. Dimensions whereby standards can be set include indicators of fiscal performance, the legal standing of the norms established, the portion of the budget covered by the rule, and the degree of flexibility, the latter involving contingency provisions, ex ante escape clauses, and moving targets defined on the basis of a structural deficit indicator. If numerical restrictions are respected, they can help to resolve many of the problems mentioned above, as well as limit transfers from future generations to the current generation. These restrictions are nonetheless attended by several potential drawbacks: i) the generation of incentives for "creative accounting;" ii) the limitation of tax-smoothing across budget cycles, at least in the case of balanced-budget rules; iii) excessive inflexibility unless rules are contingent or responsive to economic cycles; and iv) non-compliance in the absence of effective enforcement mechanisms.

Procedural rules encompass hierarchical and collegial arrangements; both types affect the rules of the game in which participants interact. Hierarchical rules, such as line-item vetoes, tend to concentrate budgetary power in finance ministries within the executive branch, and in the executive branch vis-à-vis the legislative branch, while collegial rules provide for a more equal relationship between the executive and legislative branches. The advantages of procedural rules include the introduction of fiscal discipline by concentrating power in the authorities responsible for macro stability, the ability to resolve common pool problems, and the flexibility necessary to address cyclical variations in the economy. Procedural rules do not, however, resolve electoral cycle problems, counteract politicians' short time horizons, or prevent strategic indebtedness; moreover, procedural rules can take longer than numerical rules to produce credibility in a government's fiscal policies.

Rules affecting the transparency of the budgetary process involve monitoring by outside actors and the strategic use of macroeconomic estimates. While these rules provide a way to evaluate contingent debt, they remain vulnerable to the problem of creative accounting to sidestep supervision.

These types of rules can serve as either complements or substitutes. For instance, numerical restrictions and procedural rules, which provide alternative means of inducing fiscal discipline, serve to resolve distinct types of problems. Numerical restrictions and transparency rules, on the other hand, are complements. Transparency is necessary to make numerical rules effective, particularly when highly restrictive rules provide incentives for creative accounting.

The empirical experience of numerical budgetary restrictions largely supports the theoretical assessment of their respective advantages and disadvantages. The Gramm-Rudman-Hollings mechanism has yielded only inconclusive results, as goals have been modified, participants have engaged in creative accounting, and attempts to reach fiscal goals have included the sale of assets. The Maastricht criteria, which call for EU member governments to adhere to limited deficit and debt levels in relation to GDP and impose penalties for non-compliance, have likewise achieved mixed results. Although the Maastricht have led to increasing fiscal convergence among member nations, governments have met their goals in part by engaging in creative accounting and curtailing maintenance expenditures. The balanced-budget requirements of American states have also displayed varying results, depending on the legal standing of the budgetary rule, the expenses that are covered by the rule, the stage of the budgetary process at which balance is required. States with more stringent rules experience smaller deficits and are able to borrow at lower interest rates than states with less stringent rules. On the other hand, states with stringent fiscal rules display a limited ability to engage in anticyclical fiscal policy.

Empirical findings from the EU and Latin America on procedural rules and transparency requirements are fairly consistent across countries. In both Europe and Latin America, hierarchical rules tend to produce greater fiscal discipline. In the European case, however, these institutions were able to reduce deficits and debt but did not change governments' ability to stabilize output.

Several countries' recent experiences have attracted particular attention. New Zealand's Fiscal Responsibility Act of 1994, based on procedural rules and transparency, requires the government to announce publicly any deviation from its stated principles of fiscal management and the means and schedule of returning to those principles; in order to manage fluctuations, planning is based on a three-year time horizon. Argentina's Fiscal Solvency Law of 1999, based on numerical rules, was originally intended to achieve a balanced budget by 2003, a deadline subsequently changed to 2005. The law includes the following features: i) a spending rule whereby the real rate of spending growth cannot exceed the real rate of GDP growth; ii) a stabilization fund; iii) a three-year budget cycle; and iv) a variety of measures to improve transparency. Two other features of the law may raise questions: the rules apply only to the central government, and no sanctions for non-compliance are included. Peru's Law of Prudence and Fiscal Transparency, passed in 1999, includes both numerical and procedural rules. In addition to limiting the size of deficits in relation to GDP and the rate at which spending can increase, the law restricts election-year spending, institutes a stabilization fund, and uses a three-year macroeconomic framework; like New Zealand's approach, Peru's law calls for a public announcement of deviations. Weaknesses in the Peruvian legislation include the absence of sanctions and triggering mechanisms, as well as vague definitions of the occasions when deviations are justified. Brazil's Fiscal Responsibility Law of 2000, which applies to all levels of government, limits debt levels, levels of personnel expenditure, and electoral-period spending. Additional provisions include triggering mechanisms for sequestration and spending freezes, as well as stiff sanctions for non-compliance that range from fines to imprisonment; the results of the law have so far proven encouraging,

especially at the municipal level. In contrast to these countries' experience is that of Bolivia, where budgetary planning and execution are concentrated in the executive branch, which enjoys a high level of discretion; the result is an inefficient process with limited transparency and ample incentives for rent-seeking behavior.

Several lessons arise from these experiences. First, procedural rules, transparency, and stated principles of fiscal responsibility are likely to help all countries that aim to improve their fiscal situation. Second, no prescription applies equally to all countries, as the success of fiscal rules depends largely on the institutional context in which they are applied. Third, enforcement mechanisms appear crucial to the success of fiscal rules; this raises the further question of whether macro coordination is needed. Fourth, even if fiscal rules are not followed, they can serve to focus budgetary discussion and promote a culture of fiscal restraint.

Addressing the current fiscal situation in Bolivia, Juan Antonio Morales-Anaya noted that an increasing share of the country's public debt is held by internal creditors. In spite of attempts at reforms, however, government deficits have been increasing. This development stems from the incomplete nature of recent pension reforms, which did not address the pensions of those who retired before those measures took effect; in addition, the diversion of relief funds into poverty programs has caused some expenditures to be seen as entitlements, which in turn impedes efforts to achieve fiscal discipline. Ironically, Bolivia's deficits may have risen because the country's fiscal situation has not yet grown severe enough to compel restraint on the part of interest groups and other political actors; this points to the country's underlying problems of political will and governability. More specifically, a reform agenda must include a fiscal responsibility law and a change in social policy to reduce the importance of transfer payments and payments to subnational governments. Changes are nonetheless complicated by the fact that Bolivia's debt is for the most part not held by international markets, which minimizes the potential for external discipline. To make the transition to more sustainable fiscal management, however, Bolivia will need international assistance at least until 2008, when natural gas exports are scheduled to begin.

Reviewing fiscal institutions and reforms in Mexico, David Madero Suárez observed that Mexico's fiscal prudence since the debt crisis of the early 1980s has led to a low level of public sector debt as a percentage of GDP. While the legal institutions that determine the budget remain largely unchanged, annual budget legislation has increasingly incorporated indebtedness ceilings, limitations on the use of revenue, and budgetary management rules such as quarterly spending evaluations and automatic spending mechanisms that reduce outlays if revenues decrease. Other measures include an oil stabilization fund, clarification of rules on transfers to subnational governments, the incorporation of multi-year macroeconomic forecasts into the budget, and Congressional authorization of public sector-related investment projects.

Both the Fox Administration and the leading opposition party have proposed further fiscal reforms in recent years. Both proposals include the following features: i) beginning

the budget process earlier in the year; ii) setting rules for Federal Government operations in the event that the budget is not approved in order to reduce risks of a shut-down; iii) setting budget-amendment rules; iv) increasing the budget's macroeconomic and fiscal time horizon; v) specifying fiscal responsibility principles; and vi) reducing discretionary powers related to unreported spending. The reforms pending in Mexico are likely to increase fiscal discipline by constraining deficits, implementing procedural rules that would avoid excessive spending, and increasing the transparency of the budgetary process.

In discussion following the presentations, Rodrigo Valdes stated that the region's fiscal problems have in part stemmed from Mercosur's failure to engage in macro coordination, and that the benefits governments derive from fiscally tying their hands are not necessarily clear-cut. Guillermo Perry noted that there can exist both good and bad fiscal rules. Characteristics of bad fiscal rules include the absence of enforcement mechanisms and rigidity in the face of intertemporal problems, which can result in excessive procyclicality. In addition, rules with too much emphasis on short-term conditions can limit long-term investment, and insufficient adjustment occurs at the peak of economic cycles. Self-imposed rules, moreover, generally prove more effective than rules imposed from external or supranational authorities, such as the European Union. Ricardo Hausmann observed that the enforcement of fiscal rules requires an independent scorekeeper to provide realistic estimates of anticipated revenues and non-discretionary spending.

Juan Pablo Guidotti offered several observations on fiscal reform. First, legislators and others tend to see some laws as more legitimate than others. Second, it is important for the legislative branch to have an independent budget authority, like the Congressional Budget Office in the United States. Third, in the executive branch, the Finance Ministry should take the lead in budgetary policy. Fourth, public hearings and/or discussion should be conducted before any action is undertaken. Fifth, in some countries, such as Argentina, changes in revenue are legally prohibited from consideration in spending bills. Sixth, professionalism and independent authority on the part of the civil service are needed to make fiscal discipline effective.

In other comments, Francisco Rodríguez raised the questions of whether institutions are self-enforcing and of what distortions make those institutions necessary. Vito Tanzi noted that fiscal responsibility rules must be explicit, and that countercyclical measures such as those used by Chile in recent years would have helped Uruguay and Argentina during their recent crises. In addition, citing the experience of subnational governments in Italy, he said that data may not be available soon enough to prove useful. In addition, policymakers may not always know whether a change in conditions represents a stage in the economic cycle or a new trend; fiscal rules, moreover, may largely represent intellectual fashion. William Calvo observed that fiscal problems largely involve difficulties in local law or local tax collection. José de Gregorio raised the question of how Bolivia avoided high levels of inflation, and he suggested that it is necessary to avoid imposing a particularly high tax on one sector so as not to thwart investment.

Monetary and Exchange Rate Policy: Results and Challenges

Reviewing El Salvador's move toward dollarization, Luis Aquino stated that the success of the experiment so far has derived from factors specific to El Salvador and that the lessons from this experience may not necessarily be applicable to other countries. Of primary importance was the country's economic strength at the time of dollarization; within this larger context, particularly noteworthy were a sustainable real exchange rate and a low level of de facto dollarization in the financial system. Further factors conducive to dollarization included El Salvador's ongoing integration with the dollar zone through exports and remittances from Salvadoreans working in the United States, as well as having debt primarily in long-term maturities held by bilateral and multilateral institutions.

In addition, the legislation bringing about dollarization took into account the limitations it would place on the financial system. Given that dollarization effectively deprived the Central Bank of the ability to set monetary policy and serve as a lender of last resort, new prudential regulation requires banks to hold high levels of reserves, including reserves of high liquidity and low risk; this strong framework is supported by strict supervision.

The results of dollarization in El Salvador have been largely encouraging. Favorable macroeconomic outcomes include low inflation, competitive interest rates, and strong export growth. Strong growth has also occurred in imports of intermediate and capital goods for domestic production, as well as in remittances from abroad, which cover approximately 79 percent of the trade deficit. Less remarkable but nonetheless positive growth is occurring in private sector credit and overall economic activity.

Surveying Colombia's monetary experience over the past decade, Sergio Clavijo noted that the Central Bank received instrumental authority over monetary policy in 1991. Under this hierarchical framework the Central Bank is charged with pursuing low and stable inflation, but in line with a government development plan that also accords importance to growth and employment; the Central Bank's adherence to the government's larger goals is ensured by the ex officio Board membership of the Minister of Finance. Following the introduction of a floating exchange rate regime in 1999, the Central Bank adopted a policy of inflation targeting in 2000. Communication has subsequently assumed a primary role in the country's monetary policy, which depends on a trinity framework of flexible exchange rates, inflation targeting, and adherence to a monetary-policy rule.

The results of Colombia's policy shift have so far proven encouraging. Inflation has stabilized at approximately 7 percent, a substantial reduction from the 22 percent average of the previous three decades, and the real exchange rate has depreciated by 15 to 20 percent since 1999. Systemic risks nonetheless remain in the wake of the housing finance crisis that began in 1998, and which has cost the country's economy an estimated 4-6 percent of GDP in the period 1998-2007.

The Central Bank appears to have used this crisis, however, as an opportunity to engage in disinflation in order to reduce the indexation of wages and the financial system. The Central Bank's operations have further evolved from point targeting to the use of inflation ranges. To maintain or increase its effectiveness, however, the Central Bank should avoid excessive disinflation and should make use of foreign-exchange options to decrease volatility.

Reviewing Chile's experience with exchange rate flexibility, José de Gregorio noted that until 1999 Chile had utilized various forms of exchange rate control. These regimes have resulted in liquidity crises and appreciations of the real exchange rate that could not be controlled by domestic policy. Since 1999, however, Chile has moved to a flexible exchange rate regime, with an independent monetary policy based on inflation targeting. By adjusting to external and domestic conditions, the fluctuating exchange rate reduces volatility in the economy as a whole and avoids the costs of defending an unrealistic exchange rate.

Chile's exchange rate regime operates within a favorable institutional and political environment. Perhaps the most notable feature of this environment is that only very limited official intervention in the foreign exchange market is allowed. This constraint, designed to prevent a drift toward a managed exchange rate, requires disclosure of the time frame and size of any intervention, as well as the reasons for intervention; the maximum size and duration of interventions are also prescribed. The exchange rate system further benefits from an independent Central Bank, fiscally conservative governments, and a sound financial system, all of which appear to be prerequisites for the success of a floating exchange rate regime.

Given Chile's exchange rate regime, the country faces a variety of opportunities and challenges. The depreciation of the U.S. dollar and the adjustment in the U.S. current account are expected to increase capital inflows to emerging markets. While renewed capital flows are accompanied by the risk of sudden stops, flexible exchange rate systems seem better equipped to postpone or avoid those shocks than fixed or managed regimes. Moreover, the current dilemma of Asia may prove useful, as this experience may provide lessons on how much a currency can be kept depreciated, how inflationary pressures can be contained, and how to address an asset prices boom as capital inflows resume.

In discussion following the presentations, Adrián Armas Rivas discussed the experience of Peru in simultaneously seeking stability and dedollarization. With goals of inflation control and monetary stability, the Central Bank engages in transparent operations with reserve goals and benchmark interest rates. Peru's public debt is increasingly denominated in domestic currency, as is bank lending, but this represents part of a gradual and voluntary process associated with increasing confidence in the country's economy. Guillermo Calvo observed that Ecuador's experience with dollarization deserves continued attention, as even in a dollarized system distinctions remain between tradable and non-tradable goods.

Latin American Tax Reform

Vito Tanzi introduced his comments by noting that governments in the region have generally sought the revenues generated by taxes without considering the inconveniences caused by those taxes and/or changes in tax policy. Additionally, Latin American governments have not yet overcome the factors responsible for low levels of tax collection; these include a high percentage of the labor force in the informal sector, insufficient data for calculating taxes, corruption, deficiencies in the educational system, and an inadequate judicial system. Low levels of tax collection in relation to personal income and high levels of variation in taxation as a percentage of GDP have also complicated the fiscal situation of many countries in the region. The region's situation has been further complicated by the unfortunate convergence of the debt crisis of the 1980s, the effects of high inflation in much of the region, and a decline in revenues from traditional sources such as import duties and trade taxes. The gravity of these problems have at times led policymakers to look for a "magic tax" that would resolve these difficulties, but no single solution can be realistically expected to address all problems.

The most promising area for reform, however, is the adoption of the Value Added Tax (VAT), which serves as a flat tax on consumed income. It has the additional advantage of providing revenue almost immediately rather than on a deferred basis. Reform is also necessary in enhancing the distinction between personal and corporate income taxes. Finally, improvements are needed in tax administration. Measures of particular importance include putting "firewalls" between politicians and the tax administration system in order to provide for stable and transparent operations, and penalties must be made reasonable in order to ensure that they are applied.