PD-AAR-608 -1- 40994 Proj. 5280098 PN-

AID 1025-1 (7-71) (FACE SHEET)

NONCAPITAL PROJECT PAPER (PROP)

I. PROJECT IDENTIFICATION

1. PROJECT TITLE

FISCAL POLICY AND MANAGEMENT

2. PROJECT NO. (M.O. 1095.2) 528-11-750-98

3. RECIPIENT (specify)

[X] COUNTRY URUGUAY

[ ] REGIONAL ______ [ ] INTERREGIONAL ______

4. LIFE OF PROJECT

BEGINS FY 1976

ENDS FY 1977

5. SUBMISSION

[X] ORIGINAL June 9,1975 DATE

[ ] REV. NO. ______ DATE

CONTR./PASA NO. ______

II. FUNDING ($000) AND MAN MONTHS (MM) REQUIREMENTS

A. FUNDING BY FISCAL YEAR	B. TOTAL $	C. PERSONNEL		D. PARTICIPANTS		E. COMMODITIES $	F. OTHER COSTS $	G. PASA/CONTR.		H. LOCAL EXCHANGE CURRENCY RATE: $ US ___ (U.S. OWNED)		
		(1) $	(2) MM	(1) $	(2) MM			(1) $	(2) MM	(1) U.S. GRANT LOAN	(2) COOP COUNTRY (A) JOINT	(B) BUDGET
1. PRIOR THRU ACTUAL FY												
2. OPRN FY 1976	121	45	16	26	15			95	16			46
3. BUDGET FY IQ	12	12	3					12	3			4
4. BUDGET +1 FY 1977	92	92	16					92	16			31
5. BUDGET +2 FY												
6. BUDGET +3 FY												
7. ALL SUBQ. FY												
8. GRAND TOTAL	225	199	35	26	15			199	35			81

9. OTHER DONOR CONTRIBUTIONS

(A) NAME OF DONOR	(B) KIND OF GOODS/SERVICES	(C) AMOUNT
OAS	12 m.m. Technical Advisor	-

III. ORIGINATING OFFICE CLEARANCE

	TITLE	DATE
1. DRAFTER JH Jerome Hurehan/Ivan Trabal/L.Horwitz	Program Officer/Tax Advisor/ AID Rep.	6/8/75
2. CLEARANCE OFFICER Leonard J. Horwitz	AID Representative	

IV. PROJECT AUTHORIZATION

1. CONDITIONS OF APPROVAL

2. CLEARANCES

BUR/OFF.	SIGNATURE	DATE	BUR/OFF	SIGNATURE	DATE
LA/DR	John R. Breen JRB	phone MJ 6/24/75	LA/DP	Larry Harrison	phone MJ 6/20/75
LA/MRSD	Donor M. Lion (phone)	6/20/75			
LA/GC	Irv Levy (phone)	6/24/75	LA/OPNS	Cecil Uyehara	phone MJ 6/24/75
LA/APU	Pat Matheson PBM	6/20/75	LA/DR	William Feldman	phone MJ 6/20/75

3. APPROVAL AAs OR OFFICE DIRECTORS

SIGNATURE [signature] DATE [illegible]

TITLE Assistant Administrator/LA Bureau

4. APPROVAL A/AID (See M.O. 1025.1 VI C)

SIGNATURE ______ DATE ______

ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

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A. Statement of the Goal

The sector goal is to upgrade significantly the GOU capacity to analyze and formulate sound economic policies and implement them effectively. This goal was indicated as a major area of Mission concentration in the FY 1974-75 DAP.

The sub-goal is to enhance GOU capability to analyze and formulate fiscal policies and to upgrade their management in order to improve fiscal performance generally and specifically to reduce fiscal deficits and expand revenue.

This project will assist the GOU in attaining both goals.

Goal and sub-goal attainment will be assessed both qualitatively and quantitatively. The improved fiscal policy capability will be qualitatively assessed by overall fiscal performance during the life of the project as can be ascertained in IMF, IBRD, CECIES, and other reports. Improved fiscal management capability can be evaluated by measuring increased revenue collection in real terms attributable to improved tax administration.

Improved fiscal policy can likewise be assessed by GOU performance in satisfactorily meeting the fiscal targets and conditions of the IMF Standby Agreement, signed in May, 1975, which cover the program year April 1, 1975 to March 31, 1976. In its letter of intent to the IMF, the GOU indicated its intent to reduce the Central Government's fiscal deficit from 26 percent of expenditures in 1974 to 15 percent in 1975. While firm estimates are not available for 1976, it is expected that the fiscal deficit will be reduced to 10-12 percent. A further GOU target is to increase revenue collections from 11 percent of GDP in 1973 to 16-18 percent in 1977 in real terms. To the extent that fiscal deficits are a major source of inflation in Uruguay, a reduction in the rate of inflation could also indicate improved fiscal performance. The GOU stabilization target is to cut the rate of inflation to 40-50 percent in 1975 as compared to 107 percent in 1974, and to around 25-30 percent in 1976.

Basic assumptions with respect to goal and sub-goal achievement include:

(1) a continuation of political, economic and social stability.

(2) a continuation of strong civilian-military support for the GOU's economic stabilization and development program as reflected in IMF Standby Agreement.

(3) satisfactory performance under the IMF Standby Agreement.

(4) no serious new deterioration in world economic conditions which will further restrict Uruguayan export prospects.

B. Statement of Project Purposes

This project has two basic purposes:

1. To improve the capacity of the Office of Planning and Budget (OPP), (which has responsibility within the GOU for fiscal policy formulation) to analyze, formulate, and evaluate fiscal policies and programs, to identify emerging fiscal problems and to evaluate and monitor fiscal performance.

2. To upgrade the capacity of the General Tax Office (Dirección General Impositiva, DGI) to administer effectively tax collection systems for the value-added (IVA), imputed land potential productivity, (IMPROME) and excise taxes (alcohol, tobacco, fuels, beverages).

The two project purposes are clearly inter-related and are essential ingredients of any program to improve fiscal performance. Tax administration effectiveness, in great measure, is a function of fiscal policy.

Since the appointment of the present GOU economic team in July, 1974, there has been a substantial improvement in coordination and integration of fiscal policy and tax administration functions.

Project purposes achievement, corresponding to the two stated purposes, will be both quantitatively and qualitatively measured, as follows:

(1) Improved fiscal policy analysis, planning, and evaluation capability in OPP will be qualitatively evaluated on an annual basis primarily through IMF, IBRD, and CEPCIES reports and reviews.

By the end of the project, OPP will also have a fully institutionalized capability to undertake technically competent analysis of fiscal policy problems and performance, including analysis of the behavior of various taxes and their effects on macro and sectoral growth, stabilization goals, foreign trade, employment and income distribution. OPP will be capable of continuing analysis of fiscal performance and of anticipating fiscal problems and of formulating strategies and proposals for dealing with them. Essentially, it will be well equipped to ensure that fiscal policies are consonant with overall economic policies and flexibly adapting to changes in these policies.

(2) Improved tax administration capabilities will have been evidenced by effectively functioning management systems which will clearly identify non-filers, detect evaders, and provide timely and relevant statistical data for enforcement purposes. These systems will ensure maximum possible revenue collections of the IVA, IMPROME, and excise taxes. Time lags between incurring tax liabilities and tax payments will be substantially reduced or eliminated.

Key assumptions relevant to the two project purposes are:

1. That OPP will provide competent personnel to work with the AID Advisor and will organize its Fiscal Policy and Program staff to take maximum advantage of the assistance, and that OPP will organize training seminars to improve the professional capability of its staff.

2. That DGI will continue to provide effective leadership in qualitative improvement of tax administration and will provide in a timely fashion personnel, facilities, budgetary support and other contributions essential to project success. That fiscal policy will continue to emphasize IVA, IMPROME and excise taxes as the cornerstone of revenue collections and that an educational campaign to foster improved tax compliance will be undertaken.

C. Statement of Project Outputs

1. In respect to Fiscal Policy

The outputs of the fiscal policy element of this project will be high quality fiscal analysis, planning, and evaluation, with an institutionalized capability in this area located in OPP. More specific-cally, the outputs will be evidenced by studies undertaken, completed and published on various fiscal policy matters, seminars held and on-the-job training provided by the AID Advisor.

The specific studies to be carried out by the advisor and his counterparts during the life of the project are as follows:

(a) An assessment of IMPROME and other taxes direct and indirect affecting the agricultural sector to identify tax incidence on the producer. Specific attention will be focused on the best means and timing of gradually incorporating export and other taxes affecting the producer into the IMPROME tax.

(b) An analysis of the economic effects of export taxes generally on production, employment, trade, income and distribution and proposed alternatives to these which would further GOU stabilization - development goals.

(c) A review and evaluation of the system of tax incentives, their costs, effects, and desirability.

(d) An analysis and evaluation of the structure and functioning of the value-added tax (IVA) - its economic impact and consistency with stabilization - development goals.

(e) A comprehensive review and evaluation of excise taxes, (alcohol, tobacco, fuels, and beverages), their economic effects, and their future within the actual tax system.

All studies indicated above will contain recommendations for alternative strategies or revising the structure and design of the taxes under study as may be necessary to enhance their revenue productivity and improve fiscal performance.

2. In respect to Tax Administration

The outputs of the tax administration sub-project will result largely from the full range of DGI efforts to improve the IVA, IMPROME and excise tax systems. The AID/IRS long-term and short-term advisors will provide essential technical assistance and advice, but their specific outputs (reports, recommendations, advice, instruction, etc.) will result in project outputs only as DGI translates this assistance into concrete actions. Clearly many discrete outputs must be accomplished as a result of the joint DGI/IRS effort in order for the project purpose to be accomplished. We have identified the following important and key outputs which are expected to result and which will lead to the attainment of the project purpose:

(a) Improved, simplified and standardized audit and collection systems and procedures developed, implemented and effectively utilized for IVA, IMPROME and excise taxes. Filing and payment of tax returns reduced from approximately two hours to less than 30 minutes. Internal processing of tax returns reduced from approximately 120 days to 45 days. Delinquent taxpayers detected within 30 days after due date of return.

(b) Controls effectively used on non-payment of installment accounts and payments of quotas (or estimated tax payments). Accounts in default detected and taxpayers notified within 10 days after due date of payment.

(c) Evasion in payment of IMPROME taxes reduced by 30%. Delinquent returns and payments reduced from 30% to 3-5% of universe.

(d) Tax amnesties eliminated due to the existence of effective controls on non-filers and other delinquent taxpayers.

(e) Criteria for selection of tax returns for nationwide audit and audit guidelines being used for conducting nationwide audits. Up to date criteria developed for the retention of returns for audits by industry, by size, geographical location, etc. Audit coverage extended to interior.

(f) The reorganization of DGI fully completed and DGI operating effectively. Progress being made towards housing DGI in one location.

(g) Systems designed for creation, control and maintenance of computerized master file. A computerized master file of taxpayers will be prepared, each identified by a numerically sequenced number with a check digit for control.

(h) Improved managerial and technical capability throughout the DGI system. Channels of command clearly defined, authority delegated, staff functions identified and self improvement capability institutionalized.

(i) Restructured training program to support reorganization and needs of tax system with relevant and timely courses being provided. All of the assumptions made for the goal and purpose sections (above) remain equally valid assumptions in considering whether or not these outputs can reasonably be expected to result in the accomplishment of the project purpose. We also assume the GOU will continue to assign primary importance to IVA, IMPROME and excise taxes as principal sources of revenue.

D. Statement of Project Inputs

In respect to the Fiscal Policy element, AID will provide the contract services over 4 man months of an outstanding fiscal policy advisor knowledgeable of Uruguay's fiscal problems and Spanish speaking. His visits to Uruguay will be at times convenient to both the advisor and the GOU.

In respect to the Tax Administration element, AID will provide : (a) one long term IRS tax administration advisor expected to be on board in July or August of 1975 for a two year tour (or most probably for 27 months), (b) one short-term IRS tax advisor on alcohol, tobacco and beverages taxes to provide approximately 8 man months of advisory assistance over the life of the project at spaced intervals to be agreed upon, and (c) 15 man months of short-term participant training in tax administration.

The GOU inputs will consist mainly of costs for all the personnel working in DGI on the IVA, IMPROME and excise taxes plus all those working in OPP on fiscal policy matters. More specifically, the GOU will provide various counterparts to the USAID advisors, as required, to work with them either full time or part time on various activities being carried out under the project. Additionally, sufficient budgetary funds will be provided for DGI and OPP, and particularly, adequate funds will be provided to DGI to permit it to implement the needed changes in the tax system. DGI and OPP will also provide adequate facilities, administrative support and secretarial services for the USAID advisors. They, as well as the Ministry of Economy and Finance, will contribute to the evaluations of the project when they are scheduled.

The OAS will also continue to provide one long-term advisor on data processing to DGI.

The budget for the USAID inputs and the GOU contribution is provided in the Table on page 10.

We assume host country will provide counterpart personnel, budget, and other facilities needed to support this project.

Counterpart personnel (whose salaries constitute a portion of GOU contribution to the project) will work exclusively on activities related to this project.

	FY 76	I.Q.	FY 77
Fiscal Policy			
4 months $250 per day	15.000		15.000
4 round trips U.S.-Mont.U.S.	2.000		2.000
Per diems	1.200		1.200
Miscellaneous	100		100
Tax Administration			
IRS long term 27 m/m	58.455	12.174	56.395
IRS short term 8 M/M	17,772		17,772
Participants			
15 MM short term U.S.	26.250		
Totals	120,727	12.174	92,417

Grand Total $225,318

GOU Contribution (in U.S. dollars)

	FY 76	I.Q.	FY 77
Fiscal Policy			
3 Counterpart technicians			
$400 each per month - 36 M/M	7,200		7,200
In kind - Office space			
Secretarial Services etc. during			
12 months x 200	1,200		1,200
	8,400		8,400
Tax Administration			
6 Counterpart technicians			
$400 each per month - 117 M/M	21,600	3,600	21,600
12 M/M participant training-salaries	4,500		
International transportation	10,000		
In kind - Office space			
secretarial services, etc. during			
27 months x 200	2,400	600	2,400
	38,500	4,200	24,000
Total	$ 46,000	$ 4,200	$ 31,500

Grand Total: $ 81,700

PART E - ECONOMIC SETTING

1. The Background

Uruguay's economic performance over the past two decades has been among the poorest of any country in the free world not afflicted by war or natural disaster. It has been beset variously by stagnation of production, chronic high inflation, recurring fiscal and balance of payments deficits, high unemployment and underemployment, declining real income, deteriorating physical infrastructure, institutional paralysis and continuing emigration.

The basic causes stem from a long history of inappropriate economic policies resulting in serious structural distortions in the economy.

A serious imbalance exists between a large urban sector (80 percent of the population) which is heavily dependent on the small agricultural sector (17 percent of GDP) which contributed 85 percent of Uruguay's export earnings and pays for most imports. The import demands of the urban sector, primarily to support a highly protected industrial sector, have far outstripped the capacity of the agricultural sector to generate foreign exchange earnings. The resulting balance of payments constraint on imports has been the principal factor in limiting growth, particularly in the industrial sector.

To support the consumption and social welfare aspirations of the urban sector, the agricultural sector has, in the past, been subjected to tax, pricing and exchange rate policies designed to produce large income transfers to the urban sector. The result has been to provide disincentives to agricultural investment, inhibit the introduction of new technology and stagnate production. Likewise, a highly protected urban industrial sector, mostly geared to supply a small domestic market, soon exhausted its growth possibilities and produced stagnation in that sector as well. To mitigate the economic squeeze, past Uruguayan governments have sought to control every economic variable in sight. The GOU created a large, costly bureaucracy designed to allocate scarce resources and intervene in private economic decision-making. To the extent the bureaucracy became dysfunctional in carrying out its interventionist role, the private sector was adversely affected together with economic growth.

2. National Development Plans and Policies

After a political restructuring took place in 1973, the Bordaberry Administration began a fundamental development-reform effort. It approved a National Development Plan (1973-77) and at the San Miguel and Nirvana meetings (August and October 1973), translated the broad goals of the Plan into specific policy and program guidelines. Essentially, these guidelines call for (1) a gradual reduction of state intervention in the economy to allow productive patterns to be determined by market forces, (2) rejuvenation of agriculture through a variety of incentives, including higher producer prices and a gradual substitution of land productivity taxes for export taxes, (3) realistic exchange rates, (4) elimination of impediments to export and liberalization of imports, and (5) restructuring of production toward an export orientation and along the lines of international comparative advantage.

The National Development Plan (1973-77) contains an exceptionally candid diagnostic of the historical causes of stagnation and inflation which in great measure confirms the analyses of international experts and development agencies over the years. The Plan does not pretend to formulate a complete macro-model nor provide comprehensive sectoral analyses backed by medium or long term investment programs. Rather, it provides a coherent set of national development goals, defines a strategy, and enumerates a number of the policy, program, and institutional changes needed if the goals are to be realized. While its sectoral assessments are uneven as to scope and quality of analysis, those pertaining to agriculture and industrial development contain a clear orientation and focus that serve as guides to policy and program action. The authors of the Plan recognized the dynamic nature of the Plan and stressed the need for extensive work in refining the assumptions, expanding sectoral analyses, formulating policies, programs, and investment plans needed for the Plan's rational implementation.

It remained for the high level meetings of civilian and military leaders at San Miguel and Nirvana (August and October 1973) to flesh out the Plan and define the indicated policy and program actions to advance toward the agreed goals and strategy. An analysis of the San Miguel and Nirvana policy guidelines is contained in the 1973-74 DAP for Uruguay. Some twenty months have gone by since San Miguel and Nirvana and by any measure, overall performance has been impressive in initiating the policies and programs called for in these guidelines.

For example, during 1974 and 1975, there has been steady progress in gradually moving away from statist intervention in the economy toward a free market orientation. There has been selective liberalization of price controls and more rational criteria are being applied in considering price increases. Industrial promotion and foreign investment laws have been put into effect. A perceptible improvement has occurred in the operations and financial management of several state enterprises (airlines, ports, postal and rail systems). Prices of goods and services provided by state enterprises have been raised appreciably to reduce operating (and fiscal) deficits. A reform of the banking system is being carried out to help develop a functioning capital market, enhance its role as an instrument of development and establish a rational credit system. Export procedures are being simplified and the import regime liberalized. A system of monetary correction (readjustment) of bank loans for productive investments will soon be initiated.

A basic reform of the tax system took place in 1974 designed to reduce or eliminate a number of low yield nuisance taxes and to increase the incidence of the value added tax (IVA), the land productivity tax (IMPROME), and excise taxes on total revenues. In line with GOU fiscal strategy, these taxes will become the GOU's principal revenue sources. A basic reorganization of the tax administration system was initiated in early 1975.

A fundamental restructuring of the trade and payments system was launched in 1975 as part of the GOU's economic program agreed to with the IMF. Likewise, as part of this agreement, a stabilization program is now in effect designed to cut the inflation rate in half in 1975 from the 107 percent recorded in 1974. The exchange rate system has also been reformed involving a liberalization of the financial foreign exchange market and a dramatic reduction in the past overvaluation of the commercial rate until at present the two rates are close to equilibrium.

The agricultural sector has been incentivized by favorable price, exchange rate, tax, and credit policies, which has resulted in growth of the crop sector while the livestock sector continues to stagnate due to external factors. Programs to develop new agricultural technology and extend it to rural producers have been initiated. A major effort is underway to expand exports of traditional and non-traditional agricultural products.

A civil service reform has been advanced designed to reduce excess personnel and retrain others to affect a more rational utilization of manpower. Reform of the social security system continues under study as efforts are made to design the reform along lines consistent with the GOU's economic stabilization-development program. A new social security reform law is promised for 1975.

Intensive sectoral studies (assisted by IBRD/UNDP) are underway for the agricultural and transportation sectors designed to formulate long term investment programs. Important progress has been made in planning and implementation of the energy sector program, with the Salto Grande hydroelectric project in construction, plans for interconnection programs with Argentina, and probably Brazil, completed and the feasibility established of the Palmar hydroelectric project on the Rio Negro for which financing arrangements are well advanced.

Perhaps the most positive factor benefitting GOU development prospects was the appointment in July 1974 of Alejandro Vegh Villegas as Minister of Economy and Finance. Vegh, an experienced economist/engineer and a highly regarded development planner, committed himself to a vigorous implementation of the National Development Plan and the San Miguel and Nirvana policy guidelines. His market-oriented economic policy was launched by action in October 1974 to liberalize the financial foreign exchange market and modify the interest rate structure. Also, in October 1974, Vegh requested an IMF Standby Agreement and IBRD development assistance. The IMF and IBRD agreed to begin negotiations on the basis of GOU agreement to prepare a comprehensive macro-economic program encompassing both stabilization and development goals. The program, to be described below, was developed between December 1974 and March 1975 and was finally accepted by the country's highest political and military authorities. On May 12, the IMF Board of Executive Directors approved the GOU request for a Standby Agreement (First Tranche).

3. Recent Economic Developments 1/

a. Trends through 1974

Recent economic developments in Uruguay have been dominated by large swings in the international terms of trade. In 1973 an increase in world prices for Uruguay's two major exports, beef and wool, led to a marked improvement in the balance of payments. The favorable terms of trade were short-lived, however. Higher prices for petroleum at the beginning of 1974 completely wiped out the previous gain, and the subsequent downturn in meat and wool prices late last year left the terms of trade at the end of 1974 worse than at any time in the past several years.

Largely because of these price developments, Uruguay's balance of payments on current account went from a surplus of SDR 31 million in 1973 to a deficit of SDR 88 million in 1974 (Table 1). About two-thirds of this deterioration can be accounted for by higher costs of petroleum imports, which rose from SDR 45 million in 1973 to SDR 126 million in 1974, with only a 2.5 percent growth in volume. The remaining deterioration in the current account also appears to have been caused by price changes (principally higher import prices for sugar, wheat, fertilizer, and industrial raw materials), as the volume of imports declined while the volume of exports rose slightly in 1974. These price and volume series for international trade goods must be regarded as only rough approximations, but they indicate that the loss of income to Uruguay between 1973 and 1974 resulting from unfavorable movements in the terms of trade was equivalent to about 8 percent of GDP.

Uruguay's overall balance of payments has followed the same path as the current account, switching from a surplus of SDR 73 million in 1973 to a deficit of SDR 48 million in 1974. Despite this large deficit, the gross foreign assets of the monetary authorities declined by only SDR 3 million in 1974, after purchases of almost SDR 47 million under the Fund's 1974 Oil Facility. At the end of 1974, Uruguay's gross international reserves were SDR 206 million, equivalent to about six months of imports. Gold--valued at SDR 35 per ounce--comprised SDR 124 million of these reserves, but about one-fifth of the gold had been pledged temporarily to a foreign commercial bank as collateral for a medium-term loan.

1/ This section excerpted from IMF Staff Report on Uruguay, SM/75/96, April 25, 1975.

Table 1: Uruguay: Summary Balance of Payments
(In millions of SDRs)

	1972	1973	1974	Projected 1975
Goods, services, and transfers	41.9	31.2	-88.2	-100.0
Trade	0.1	32.7	-85.4	- 85.0
Exports	(259.4) 1/	(275.3)	(318.5)	(300.0)
Imports, c.i.f.	(197.1)	(242.6)	(403.9)	(385.0)
Other	-18.0	-1.5	-2.8	- 15.0
Capital (including errors and omissions)	-24.3	41.6	40.1	19.7
Allocation of SDRs	7.3	--	--	--
Counterpart of reduction in gold reserves	-37.1	--	--	--
Net foreign assets of monetary authorities (increase -)	12.2	-72.8	48.1	80.3

Sources: Central Bank of Uruguay; and IMF staff estimates

1/ Includes SDR 62.2 million proceeds from sale of gold.

Against this background of a deteriorating external position, Uruguay's wage-credit-price-exchange rate spiral accelerated further in 1974. According to the consumer index, prices rose by 107 percent compared with 78 percent in the previous year. Nominal wage adjustments also were larger, but real wages are estimated to have declined by about one percent following a two percent decline in 1973. Continuing the policy of frequent, small adjustments of the exchange rate, the peso in the commercial market was depreciated thirteen times for a cumulative depreciation of 77 percent in terms of pesos per U.S. dollar. This was much faster than the 28 percent depreciation in 1973, but less than would have been indicated by differential price movements in Uruguay and the outside world. Total bank credit increased by 84 percent in 1974 (as a percentage of monetary liabilities outstanding at the beginning of the year) compared with 48 percent the previous year.

The central government finances weakened considerably in 1974, the deficit reaching over 26 percent of expenditure compared with nine percent in 1973. This was caused by several factors, including particularly the authorities' attempts to protect domestic consumers and producers from the deterioration in the terms of trade, described above. Public sector wages were increased sharply early in the year, and the domestic consumer prices of wheat, fertilizer, and sugar were subsidized from the budget to offset the rise in their imported prices. Moreover, as world prices

declined for beef and wool in the second half of 1974, the export taxes on these products were virtually eliminated, further weakening the Treasury's position. (For a detailed IMF analysis of Uruguay's public finances, see Annex A).
GDP at constant prices is estimated to have risen 1.9 percent in 1974, which is about the same as the average growth rate of the past decade.

b. Prospects and Policies

The world market for Uruguay's principal exports has continued to be unfavorable in the early months of 1975, and total export earnings are expected to decline this year. In particular, average prices for beef exports, which were US$1,700 per ton in the first quarter of 1974 and US$1,500 per ton for the full year 1974, were below US$1,100 per ton in the first months of 1975. World prices for wool also have declined to about one-half the level at the beginning of last year, although -- as in the case of beef -- they remain well above the prices received in 1971. Apart from the low world prices, Uruguay recently has been faced with a problem of exporting beef at any price. Because of domestic over-supplies, the EEC, which bought about half of Uruguay's beef exports in the early 1970s, has been closed to imports since June 1974 and is not expected to reopen on a large scale in the near future. This reduction in demand for meat is particularly unfortunate for Uruguay because of the heavy investment to improve pastures and increase herds which has been made in recent years with assistance from the IBRD. The detailed projection of Uruguay's 1975 balance of payments, with a prospective deficit of SDR 80 million, is presented in a separate staff report on Uruguay's intention to request a purchase under the 1975 Oil Facility, which will be circulated shortly.

c. GOU Stabilization-Development Program

Against this background of a large balance of payments deficit and continued unfavorable prospects for exports, Uruguay has adopted a financial program for the period April 1,1975-March 31,1976 in connection with a request for an IMF Standby arrangement in the first credit tranche. In essence, Uruguay's program is designed to reduce the budget deficit to about 14 percent of expenditure, and to limit inflation to 30 percent and the balance of payments deficit to US$70 million in the 12 months from April 1975 through March 1976. (This payments deficit in the program year is considerably smaller than that projected for calendar 1975, mainly because beef exports are expected to begin recovering in the early months of 1976.)

This 12-month plan was initiated at the beginning of April with a series of adjustments in wages, prices, and the exchange rate designed to create an appropriate point of departure for a pause in the wage-price-credit-exchange rate spiral. The April measures included an increase in private and public sector wages of 30,000 pesos per month-representing an average of 10 percent; increases in public sector tariffs of between 10 percent and 20 percent; and a further 10 percent depreciation of the peso, following a particularly rapid depreciation during the previous six months, as explained below.

The projected improvement in Uruguay's fiscal position in the next 12 months will result mainly from a substantial increase in taxation on petroleum products, other smaller tax adjustments, and improvements in tax administration, together with the elimination of subsidies on major consumer products, which accounted for four percent of total budget expenditure in 1974. Some of these measures were announced early this year and the remainder in April. Reduction of the budget deficit was an important precondition for the successful implementation of the credit program, which is designed to be compatible with the balance of payments target and the sharp reduction in the rate of inflation.

In addition to the quantitative targets, Uruguay's program for the next 12 months includes several measures to reduce the restrictiveness of the exchange and trade system. The Uruguayan authorities believe that the complex exchange system and the virtual quota system for imports which have existed in recent years were major roadblocks to vigorous economic growth, and they attach high priority to the early removal of these restrictions. Consequently they have announced the elimination, effective June 1, 1975 of the system of deposit-free quotas for imports, and effective July 1, 1975 of the minimum 180-day financing requirement for private sector imports. The dual exchange market is being retained for the time being, but the spread between the commercial and financial rates has been reduced from about 40 percent last October to only about 10 percent in mid-April. This narrowing of the spread was achieved mainly by a rapid depreciation of the peso in the commercial market, which in the past six months has totalled 67 percent in terms of pesos per US dollar, while domestic inflation in this period is estimated to have been 45-50 percent.

The GOU stabilization-development program is probably the most ambitious and comprehensive series of economic reforms Uruguay has undertaken in recent years. Unlike previous IMF Standbys which focused primarily on austerity measures to reduce inflation, the present program seeks to link austerity with a complementary development effort assisted by IBRD and private bank loans, which will stimulate productive sectors and help maintain reasonable levels of employment and economic activity.

Most important however, it represents an effort simultaneously to stabilize and restructure the economy away from its past inward-looking focus on import-substitution industrialization toward an export orientation for both agricultural and agri-industrial products and agricultural diversification through expanding non-traditional exports.

Equally significant to the economic policy reforms are the institutional reforms announced. The Bank of the Republic (BOR) has been virtually stripped of its past pervasive control over foreign commerce and its freedom to operate independently of GOU credit programs. Hereafter, the Central Bank, now dominated by supporters of Minister Vegh, will manage the import regime and control BOR credit emission through its rediscount facilities. This latter reform was insisted on by the IMF to ensure that the BOR would not emit credit beyond the limits of the agreed credit program indicated in the Standby.

On the basis of the IMF authorization of a Standby, the IBRD is actively moving ahead to provide substantial development assistance in the industrial, agricultural, energy, and transportation sectors. It is well advanced toward making a US$35 million industrial sector loan and a US$15 million livestock development loan in 1975. In addition, it is planning a major lending program in the energy sector in 1976 including partial financing for the Palmar Dam and a national power distribution network. It is also carrying out sectoral analyses in agriculture and transportation which could lead to substantial new Bank lending in these sectors by 1977.

Implementation of the GOU's stabilization-development program will naturally involve some short term strains including some decline in real incomes as Uruguayans take the long-awaited "cure" toward the restoration of the country's economic health. However, given the critical economic problems afflicting the country, and the firm political-military support given so far to Minister Vegh's program, Uruguay appears to be in the most auspicious position in years to make real progress in attaining its goals of self-sustaining growth.

An IMF Standby should also likely trigger additional credits from international banking institutions to assist the GOU in dealing with its balance of payments problems in 1975. GOU agreement with a syndicate of private banks for a US$110 million loan, guaranteed by gold, is in final stages of negotiation.

Thus, the IMF Standby, which Minister Vegh believes is important for internal economic discipline, will also lead to significant additional international assistance geared both to help Uruguay to cope with her short term balance of payments problems and also to provide the necessary external resources for the country's longer term development effort.

An important new factor to be taken into account is a new economic cooperation agreement between Uruguay and Argentina. The agreement provides capital goods import credits and trade concessions which will permit a range of Uruguayan exports to enter the Argentine market without duties. The agreement also provides a US$50 million credit to the GOU Central Bank for financing private sector capital goods imports. A similar agreement is being negotiated with Brazil and should be signed in 1975. Conversations have been held with Bolivian and Paraguayan authorities for complementary economic cooperation agreements. Thus, for the first time in many years, Uruguay will have access to the markets of her large neighbors and expanded trade relations with Bolivia and Paraguay. This is especially significant for the proposed AID loan in agriculture since Brazil in 1974 became Uruguay's most important export market, especially for meat. There are many indications that the Brazilian market is ready to absorb substantial amounts of agricultural exports from Uruguay, particularly wheat, and a variety of non-traditional products. If these new agreements function as expected and if Uruguay can effectively implement its export development strategy, the medium and long term development prospects would appear to be favorable.

F. Project Rationale

1. Importance of Fiscal Policy and Management

In its commitment to the IMF under the Standby, the GOU has the requirement of reducing its fiscal deficit from 26% of expenditures in 1974 to 14% in the 1975-76 program years. This will require both adjustments in tax rates, some changes in tax policies but primarily a major effort to expand revenue collections through improved tax administration. The GOU expects that improvements in tax administration will account for 5-6% of the required 12% reduction in the fiscal deficit.

Most international experts who have studied Uruguay's economy have reached a concensus that the chronic inflation of the past decades has its roots in fiscal problems. IBRD and IMF reports have long stressed fiscal factors in inflation. A USAID Contract advisor, Dr. Arnold A. Harberger, in a report entitled The Role of Fiscal Factor's in Uruguay's Inflation, prepared for the GOU in 1975, also makes this point. Harberger states that an effective solution to inflation depends "critically on the reactivation of the process of economic growth as well as on expenditure restraint and an additional tax effort".

The GOU economic stabilization-development program, agreed to with the IMF, lays the basis for near term stabilization and longer term growth. That program contains a number of elements of expenditure restraint such as reducing or eliminating subsidies and limitations on wage increases, but it is unlikely that any substantial progress will be made over the near term to reduce government employment, which accounts for over 70% of GOU expenditures, despite some thinning out of excess personnel in various ministries and state enterprises. In the area of tax policy, the GOU considers that after its basic tax reform of 1974, a period of consolidation is now in order where the existing tax structure should be allowed to function without new changes to allow time to evaluate its revenue productivity.

These factors have thus led the GOU and Mission to the conclusion that the major fiscal effort must be in the area of fiscal policy planning, evaluation and in tax administration.

While the DGI has benefitted from AID/IRS assistance in recent years, all of which has laid a useful basic for the present revitalization effort ot tax administration, such assistance, oriented specifically to increasing revenues from the value added, land productivity and excise taxes, is now more needed than ever, if the GOU is to meet their fiscal targets under the Standby Agreement.

2. IVA, IMPROME and Excise Taxes

During 1974 the GOU carried out a fundamental revision of its fiscal strategy, primarily through a series of basic tax policy reforms designed to make the tax system a more effective instrument for development as well as a revenue source. Specifically, a number of low yield, hard-to-administer nuisance taxes were reduced or eliminated and the entire tax system was reoriented to emphasize two basic taxes, the value added tax (IVA) and the land productivity tax (IMPROME). (1)

Considerable dependence is being placed by the GOU on the IVA and IMPROME taxes to become the major revenue producers which will be capable of providing the needed thrust to expand revenues to the essential levels to meet the GOU targets. In addition, approximately one-third of the national revenues are derived from excise taxes.

The IVA tax was collected for the first time in 1973. IMPROME although approved in 1969, did not generate its first payments until 1971 and these were based on crude estimated income property evaluations were completed and coefficients established in 1973 and IMPROME was not fully implemented, as far as the basic system is concerned until 1974. Furthermore, it was not until November, 1974 that the IMPROME tax return form was redesigned to provide the additional necessary information which can be cross referenced to the cadaster rolls and the first beginning of any attempt to simplify, standardize and improve collection procedures did not get underway until near the end of US FY 1975. Thus both IVA and IMPROME are relatively new taxes and in need of substantial tax administration refinements. See Table on page 13 for data on IVA, IMPROME and Excise tax collection.

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(1) The purpose of the IMPROME tax is to encourage farmers toward a more intensive use of the land. Since the tax is based on the potential productivity of the land, the effect is to create a large tax burden for those who use land inefficiently and only a small burden on those who use intensive methods.

Internal Revenue Collections and Projections

Period 1972 - 1977 (Constant Prices - Base 1972 = 100)

50.76% 25.65 (Billions of Pesos)

Type of Tax	1972	1973 Amount	1973 %	1974 Amount	1974 %	1975 Est. Amount	1975 Est. %	1976 Proj. Amount	1976 Proj. %	1977 Proj. Amount	1977 Proj. %		Increase 1975-1977
Value Added (IVA)	-0-	31.4	–	41.3	+31.5 31.5	52.2	+26.4 66.3	62.6	+20 99.4	76.4	+22 143.3		46.4
Improme	5.1	8.3	+62.7 62.7	7.7	-7.2 51.0	8.4	+9.1 64.7	10.5	+25 105.8	12.8	+22 151.0		52.4
Excise Taxes (Alcohol, Food, Beverages, Tobacco, etc).	31.0	47.2	+52.3 52.3	47.7	+1.1 53.9	57.5	+20.5 85.5	66.1	+15 113.2	76.6	+16 147.1		33.2
Sub-Total	36.1	86.9	+140.7 140.7	96.7	+11.3 167.7	118.1	+22.1 227.1	139.2	+17.9 285.6	165.8	+19.1 359.3		40.4
Other Taxes	85.1	54.3	-36.2 36.2	45.0	-17.1 47.1	49.5	+10.0 41.5	52.5	+6.1 38.3	57.7	+10 32.2		16.6
Total Revenue	121.2	141.2	+16.5 16.5	141.7	+0.4 16.9	167.6	+18.3 38.3	191.7	+14.4 58.2	223.5	+16.6 84.4		33.4
Percentage of IVA, Improme, Excise Taxes to Total Revenues	29.8	61.5		68.2		70.5		72.6		74.2			
GDP	1.279.7	1.291.5	0.9	1316.2	1.9	1.342.5	+2	1369.4	+2	1.396.8	+2		4.0
Percentage of Total Rev. to GDP	9.5	10.9		10.8		12.5		14		16			

Excise taxes, particularly alcohol, beverages and tobacco taxes and fuels (or combustibles) taxes have been ignored until recently, despite being a major producer of revenues. A report by a USAID/IRS TDY tax advisor in June, 1975 revealed an almost complete lack of essential controls and a real need for better management systems and administrative procedures for these taxes.

In order to accomplish the GOU fiscal targets, it will be necessary to establish and institutionalize tax collection and audit systems capable of expending revenues to realize at least a 40% increase in real terms through material improvements in the administration of the IVA, IMPROME and Excise Tax (especially alcohol, beverage, tobacco and fuels taxes) by the end of CY 1977 as compared with CY 1975.

During the first four months of 1975 significantly meaningful progress has been achieved in the area of tax administration. A functional reorganization of DGI is in progress, systems improvements are being carried out and some personnel are being reassigned to more productive enforcement areas.

Increased revenues, in real as well as nominal terms can be expected from last year's higher rates for both IVA and corporate income taxes. With similar effect, the tax credits from export bonuses may be reduced.

A campaign has begun to raise tax collection efficiency. The tax service itself estimates that over 25% of liable firms evade the IVA tax, the government's largest single revenue source. Until now, taxpayers have had little incentive to pay on time, as the low rate of penalties (in relation to inflation) plus the custom of periodic tax amnesties has weakened the system. The GOU has recently raised penalty charges and assigned more inspectors to the IVA tax, which will account for about 40% of revenues.

In relation to the GOU's target of reducing the deficit by about 11-12 percentage points to 15% of expenditures in 1975, the savings on subsidies should contribute 3%, improved tax enforcement is counted on for 5%, and higher taxes, principally petroleum, tobacco and IVA should cover 5%.

3. <u>Recent and Continuing AID Activities related to this Project:</u>

Since 1964 USAID has provided assistance through an IRS/PASA to the GOU tax office with mixed results. In some years signs of progress have been quite hopeful; in others they have presented little more than minimum justification for continuing the program. However, much essential grandwork has been completed. Several current employees of DGI have received training in the U.S. In the past year there have been significant concrete accomplishments, and it is based on the experience of the past six months that USAID feels that continued assistance should be provided. During the past year new legislation has been approved to facilitate (a) the retention of qualified staff for DGI through higher salaries, (b) a more adequate level of operating funds for the tax office through increased budgetary allocations for this purpose, and (c) the institution of internal audit capability through the creation of an internal audit unit. Also for the first time a tax code has been approved in tax administration. During the past six months meaningful, rapid progress has been achieved as evidenced by a joint GOU/USAID evaluation conducted on June 2, 1975.

This evaluation revealed the following progress and accomplishments:

Plans for the reorganization by function of the Director General of Taxes (DGI) were completed and approved and implementation is under way. The creation of five divisions has been authorized: audit, collection, planning, legal counsel and administration. The Office of Inspector General will become the Division of Audit and the Office of the Income will become the Division of Collection. The Offices of Director and Internal Taxes will be eliminated and the Divisions of Legal Counsel, Planning and Administration will be created. Pursuant to these plans, the audit division has been consolidated and is presently operational. Legal authority for these changes will be included in the forthcoming Annual Budget Review (Rendición de Cuentas).

Other actions include the following:

(a) Reassignment of excess personnel to enforcement activities creating a force of 200 inspectors for countrywide enforcement with priority given to IVA and IMPROME and the elimination and consolidation of smaller offices in the interior.

(b) Creation of a unit of 25 inspectors to follow up on non-filers and taxpayers in default on installment accounts.

(c) Establishment of more stringent controls on the granting of installment accounts privileges.

(d) Approval of plans to re-train excess personnel.

(e) Authority to conduct a study of the Office of Internal Taxes which administers excise taxes.

(f) Approval of the implementation of the single-payment document in conjunction with the phased-out of the Bank of the Republic as the collection agent for the Tax Office.

(g) Publication of a monthly bulletin which include the latest laws, decrees, administrative rulings, etc. and which is given maximum geographical distribution.

Other related actions taken by the GOU:

(a) Increase of the monthly rate of interest from 4 to 5%.

(b) No tax amnesties included in the Annual Budget Review (Rendición de Cuentas).

A copy of the evaluation report is attached.

Under the Economic and Management Training project, USAID has also provided assistance in the form of participant training to various GOU agencies, particularly OPP and the Ministry of Economy and Fiance, in the area of economics, including fiscal policy. This project is closely related to the Fiscal Policy and Management project, and the two will be carefully coordinated. We expect to send some technicians from OPP for participant training under the training project and these technicians will utilize their training upon their return in working with the USAID contract advisor in carrying out fiscal studies in OPP.

Under the Development Studies project (funded under technical support) the USAID has commissioned a series of studies on various economic matters in Uruguay. Some of these studies have related to fiscal matters, and the Minister of Economy and Finance has given full support to these efforts. The studies, some of which have been completed and others are in the process of being completed, have and will be used as a guide to the planning and implementation of long-term fiscal reform in the GOU. Some of the studies have been carried out under the leadership of Dr. Harberger, who, it is expected, will provide the short-term advisory services to OPP anticipated under the Fiscal Policy and Management project.

The GOU's recent economic measures, (particularly its ability to obtain an IMF Standby Agreement) inclüding the proposals for improved national tax administration, signal a turn-around in the Uruguayan economy after nearly two decades of stagnation. Principally, for this reason we believe the new project in Fiscal Policy and Management can help the GOU achieve its fiscal reform goals and is a target of opportunity for USAID, characterized by a modest input in return for a potentially high return. For the first time in many years, we believe the climate now exists for undertaking meaningful reforms with reasonable expectation of success, and that USAID support of them could have real impact during the GOU transition to more responsible financial management. This project will afford USAID opportunity to play a significant role in helping the GOU at a critical point with its plans to improve the national tax collection machinery and improve its overall fiscal performance as part of a broader GOU economic reform program supported by the IMF and the World Bank.

Section G - Course of Action (1) Tentative* Implementation Plan

Action Agent	Date	Description of Action
USASI	6/75	Submit PROP and evaluation of old tax project to AID/W.
IRS	6/75	Report of IRS advisor on excise taxes containing recommen tions for improvements and legislative changes (from old tax project).
AID/W	6/75	PROP approved.
USAID	6/75	Preparation of ProAg, firm workplan (including reorga zation of DGI) and PIO/T.
GOU	6/75	Laws for establishment of new tax organization submitted in Rendición de Cuentas.
USAID/GOU	7/75	Sign ProAg, submit PIO/T to AID/W.
AID/W-IRS	7/75	AID/IRS advisor arrives for 2 yr. tour.
GOU	7/75	Approval by Council of State of DGI reorganization.
GOU/DGI	7/75	Counterparts, office space, facilities, secretary assigned to IRS advisor (to continue from terminating project).
DGI	7/75	Plan and implement year-round nationwide taxpayer education campaign - will be continuing activity during life of project.
DGI	8/75	Unification of audit function. (Already authorized by DGI. Physical implementation depending on locating building).
DGI/IRS	8/75	Detailed work plan for project drawn up and agreed to.
DGI	8/75	Increase from 10-25 the number of inspectors to follow-up on non-filers.
DGI/IRS	8/75 to 9/77	In-house training course for improvement of administration of IVA and IMPROME. Excess audit personnel (from repeal of stamp tax) who have been reassigned to IVA and IMPROME audit groups will be retrained. Several such courses will be given over life of project.
DGI/IRS	8/75	Complete study of system of installment accounts and recommend improvements for timely control of accounts in default.
GOU	9/75	Approval by Civil Service Commission of DGI's identification of positions, identification of personnel, grade and salary structure, etc. as part of implementation of the reorganization of DGI.

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Implementation Plan (cont.)

Action Agent	Date	Description of Action
DGI/IRS	9/75	Begin a study which would lead to recommendations for implementation of better controls on IVA and IMPROME.
DGI/IRS	9/75	Begin a study on entire collection system for purpose of recommending changes to make system more compatible with ADP requirements.
DGI	9/75	Effort begun to improve and increase existing statistical reporting system through use of data processing - continuing activity.
GOU	10/75	Legislative changes required for implementing improvements in excise taxes completed.
DGI/IRS	11/75	Implementation orders issued to improve excise taxes.
AID/IRS	11/75	2 mos. TDY of IRS excise tax advisor to assist in implementation of needed changes.
IRS	12/75	IRS advisors report containing recommendations for establishment of computerized master file of taxpayers for IVA and IMPROME.
DGI/IRS	1/76	Instructions issued for up-dating master file.
DGI	1/76	Management changes completed in ADP to improve and maximize ADP effort.
DGI	3/76	Simplify format of tax returns and payment documents to facilitate keypunch and reduce filing time.
DGI	3/76	Creation of computerized consolidated updated master tax file.
AID/IRS	3/76	2 mos. TDY of IRS excise tax advisor.
DGI/IRS	7/76	Course on analysis and interpretation of financial and profit and loss statements for employees of the installment payment unit.
GOU/USAID/IRS	7/76	Evaluation of project.
DGI/IRS	10/76	Full implementation of improved excise tax system.
DGI	12/76	Updated master file completed.
DGI	3/77	Updated master file system fully operational.
GOU/USAID/IRS	7/77	Evaluation of project.

*To be replaced by a firm workplan annexed to the ProAg signed by AID and the GOU.

(cont.)

Implementation Plan (cont.)

Action Agent	Date	Description of Action
GOU/USAID/IRS	7/77 to 9/77	Writing end of project reports and wrapping up final bits and pieces.
	9/77	Project terminates, IRS tax advisor returns to U.S., project purpose accomplished.

Note: USAID short-term fiscal policy advisor will provide 4 man months of assistance at spaced intervals over the life of the project, the exact timing to be determined.

2) Narrative Statement re Method of Approach

In close and direct coordination with the Ministry of Economy and Finance and the OPP, technical advisory assistance will be provided by the IRS technicians to the DGI in the area of tax administration, specifically to develop and institutionalize management systems and procedures for the adequate administration of the IVA, IMPROME and excise taxes. IRS advisors will work with the Director General of Taxes (Head of DGI) and his line officials in the design of management systems and procedures. As the recommendations are approved, the advisors will assist in their implementation and follow-up. The long-term IRS advisor will serve as the project manager for this part of the project and will be responsible directly to the AID Representative. He will also be responsible for coordination with the USAID contract technician who will be working with OPP. The short-term IRS advisor will be programmed for 12 man-months, over the life of the project, the exact timing depending on project progress. Detailed work plans for the short-term advisor will be prepared in advance of each TDY.

The USAID contract advisor will make four trips to Uruguay of approximately one-month duration each to work with and advise OPP on various aspects of GOU fiscal policy. He will assist in revising and refining fiscal policies, including the tax laws, to ensure consistency with other aspects of overall economic policy and to assist in policy studies on fiscal performance as they relate to stabilization development goals. In conjunction with OPP officials and in coordination with the Ministry of Economy and Finance, various studies will be decided upon and undertaken. The USAID advisor will have the major responsibility for completing the study but will work with OPP counterparts in its design, data collection and preparation. The purpose for undertaking the study is not simply to produce the study itself, but to use the preparation of the study as a technique through which OPP technicians can learn how to undertake such studies themselves. An important part of the technical assistance provided will consist of working with the OPP in identifying problem areas which need study. As the studies are being carried out, it is expected there will be ample opportunity for on-the-job training to be provided by the USAID advisor to OPP technicians. The studies, when completed, will be presented to seminars involving OPP and Ministry officials, as well as other officials of the GOU concerned with fiscal matters, perhaps DGI, Central Bank, etc.

3) Evaluation Plan

The project will be evaluated jointly by the USAID and the GOU approximately one year after its initiation. The AID evaluation methodology will be utilized. Approximately one month before the evaluation, representatives of USAID and the GOU will meet to prepare the evaluation, collect the needed data, and prepare a precise evaluation format. The evaluation will be based on the project design as described in this PROP and the attached logical framework.

In preparation for the evaluation, the USAID and GOU representatives will collect and review various GOU fiscal reports, particularly those providing data on the operations and collections of the tax office. Pertinent IBRD and IMF reports will be reviewed, as well as reports and circulars prepared by DGI. Reports prepared by the USAID IRS advisors will be utilized, as well as the completed studies prepared by the USAID short-term fiscal advisor. Any new tax laws which result during the first year of the project will be reviewed for their impact on tax collection.

After all this information has been collected, reviewed and digested, a series of issues will be prepared to serve as a basis of an evaluation meeting to be attended by the Head of DGI, possibly the Sub-Secretary of the Ministry of Economy and Finance, the appropriate division chief in OPP and the AID Representative. As background information, DGI, OPP and the USAID advisors will prepare a progress report indicating the degree of progress achieved. This report will be keyed to the outputs and purpose section of the logical framework.

The evaluation itself will focus on major issues such as: are the goals and purposes still reasonable and valid, will the outputs result in achievement of the project purpose, are the outputs being achieved on time and according to the implementation plan, are any changes in project design needed, are planned inputs being provided, are the necessary changes in legislation, organization, etc. being made, are there other major implementation problems, etc.

It is not expected that outside assistance will be required for the first evaluation. A second evaluation will be held at the end of the project. At that time USAID may wish to request AID/W assistance in preparing a rather complete evaluation and final project report which might be useful to other Missions planning to undertake similar projects.

The results of the evaluations will be communicated to AID/W by PARs, and, if significant information, problems or issues result from the evaluations, AID/W will be informed by the appropriate means -- cable, airgram or separate narrative report.

Public Finance (*)

1. Overall trends

National income data on the operations of the public sector are not available for the past few years, and the information obtained from other sources is not sufficient to produce a consolidation of government accounts. Available data indicate that in the past four years the financial position of the social security funds and other autonomous agencies has weakened and there has been a decline in investment by the large nonfinancial government enterprises. There has been a gradual reduction in social security contributions over the past two years and an increase in delinquent accounts. Revenue accruing to the Social Security funds declined from the equivalent of over 10 per cent of GDP in 1970 to 8 per cent in 1973, and the reduction continued in 1974 Similar trends are shown in the provincial governments.

The frequent adjustments in public sector tariffs and prices in recent years (Table III-B in the Statistical Appendix) provided only the resources required to cover operating costs of the three main public enterprises (alcohol, petroleum, and cement company; electricity and telephone company; and water supply and sewerage company) and left little surplus for investment. Operating costs soared owing to rapid increases in wages and the rise in prices of domestic and imported materials. This effect was particularly strong for the petroleum company in 1974, as domestic inflation and the rate of devaluation of the peso during the year were much larger than projected when its charges were set in January and August. As a result, investment in the petroleum sector in the past two years, as well as in electricity and water, has been limited mainly to the completion of projects in progress, and actually declined in nominal terms.

2. Developments in 1974

a. Central Government

The finances of the Central Government weakened in 1974, reversing the trend of the previous two years. According to preliminary estimates, the overall deficit in central government operations was equivalent to 4.6 per cent of GDP, 3.2 percentage points larger than in 1973 (Table 11). Total revenue declined from 14.5 per cent of GDP in 1973 to 12.8 per cent in 1974; over one half of this decline was in receipts from taxes on international trade, as export taxes were lowered to partially offset the lag in adjusting the exchange rate and falling wool and beef prices. Expenditure, which had declined from close to 20 per cent of GDP in 1971 to 16 per cent in 1973, rose again to 17.4 per cent of GDP in 1974. Forty per cent of the increase in expenditure in 1974 in relation to GDP resulted from price subsidies paid for basic foodstuffs and for fertilizers in an effort to soften the impact of rising international prices.

* This section on Public Finance was excerpted from an IMF report entitled Uruguay - Recent Economic Developments, May 1, 1975 (SM/75/97)

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Table 11. Uruguay: Central Government Operations

	1970	1971	1972	1973	Prel. 1974	Budget 1975
	In billions of Uruguayan pesos					
Revenue	82.9	103.1	167.5	370.2	585.9	1,182.0
Expenditure	91.0	144.7	199.3	406.5	797.6	1,383.0
Overall deficit	-8.1	-41.6	-31.8	-36.3	-211.7	-201.0
(as per cent of expenditure)	(8.9)	(28.7)	(16.0)	(8.9)	(26.5)	(14.5)
Financing, net	8.1	41.6	31.8	36.3	211.7	201.0
Monetary authorities	3.2	36.5	24.8	21.3	101.5	
Treasury notes and bonds	5.8	6.9	4.2	16.8	130.2	
Long-term bonds	-2.5	-1.6	-3.2	-7.0	-12.0	
Development loans	1.1	0.8	2.8	8.1	1.0	
Other	0.5	-1.0	3.1	-2.9	-9.0	
	In per cent of GDP					
Revenue	13.6	14.0	13.5	14.5	12.8	
Income taxes	1.1	1.1	1.1	1.5	1.3	
Property taxes	0.7	0.7	0.8	0.5	0.4	
Taxes on goods and services	5.7	5.9	5.7	7.6	7.9	
Taxes on international trade	2.8	2.0	2.4	3.0	2.0	
Other tax revenue	2.3	2.4	2.3	1.3	1.2	
Nontax revenue	1.1	1.6	0.8	0.9	0.9	
Adjustment	-0.3	0.3	0.4	-0.3	-0.9	
Expenditure	14.9	19.7	16.1	15.9	17.4	
Current expenditure	13.6	18.3	15.0	14.6	15.6	
Wages	(8.4)	(9.4)	(7.2)	(7.0)	(7.3)	
Pensions	(1.1)	(2.6)	(2.8)	(3.0)	(3.6)	
Other goods and services	(2.1)	(3.8)	(2.7)	(2.1)	(1.8)	
Interest	(0.5)	(0.5)	(0.6)	(0.5)	(0.7)	
Subsidies	(0.1)	(0.1)	(0.1)	(0.1)	(0.7)	
Other transfers	(1.4)	(1.9)	(1.6)	(1.9)	(1.5)	
Capital expenditure	1.3	1.4	1.1	1.3	1.8	
Overall deficit	1.3	5.7	2.6	1.4	4.6	

As shown in Table 11, almost 50 per cent of the deficit in 1974 was financed by the monetary authorities, and the remainder was financed by net sales of Treasury notes and bonds. In 1974 the Government placed US$47.7 million (net) of these bonds, mainly with residents. About US$12 million (net) was placed with foreign institutions, including a special purchase by South Africa. Other net foreign borrowing by the Treasury was negative because of repayment of long-term bonds and the minimal use of development loans.

(1) Revenue

As indicated above, in 1974 total revenue of the Central Government rose at a slower rate than nominal GDP. There was a slowdown in almost all tax categories, but it was particularly marked in receipts from taxes on international trade (see Table 11). Cash receipts under individual categories of taxes are somewhat overestimated as they include amounts paid with tax credit certificates granted for certain exports. The value of tax payments made with these certificates reached about 7 per cent of total revenue in 1974. Tax rates on petroleum products were reduced in percentage terms at the beginning of 1974 to partially offset the impact of the increase in international prices.

The slow growth of revenue in 1974 seems to have been due partly to a rise in delinquent accounts, as the penalty for nonpayment of taxes declined relative to other interest rates and expectations increased that the tax amnesty would become an annual practice. According to the present system, there is a 10 per cent discount for any payment on time of taxes or social security contributions. Delinquent accounts lose the discount and are subject also to a 10 per cent penalty and an interest charge, which was 4 per cent per month during 1974.1/ This total financial cost, however, was not very different from bank charges on loans, and the delinquent taxpayer had the additional advantage of a possible future amnesty. Taxpayers may negotiate extended payment schedules of up to 36 months, in which case they are not subject to the 10 per cent penalty; they lose the initial discount but are eligible for a similar discount on each installment, if the payment is made on time.

Table 12 also shows the effects of administrative changes made in the past two years, designed to concentrate tax-collecting efforts in the value-added tax, corporate income tax, and IMPROME (the tax on agricultural activities). The value-added tax was introduced early in 1973 to replace, with higher rates, the existing sales and services taxes, and at the same time a number of excise and other taxes were reduced or eliminated. Late in 1974 the tax on earned income, the inheritance tax, and the substitute inheritance tax were eliminated, and the stamp tax was reduced from 1 per cent to 0.5 per cent. At the same time, the basic rate of the value-added tax was increased from 14 per cent to 18 per cent and the concessionary rate was raised from 5 per cent to 6 per cent. During 1974 productivity indices for individual lots were applied partially for the 1972/73 IMPROME tax liability (payable in

1/ This was raised to 5 per cent per month in February 1975.

1974), and fully with respect to the advanced payment requested also in 1974 for the 1973/74 taxable year. The increase in revenue from this source, however, was lower than expected. Tax rates on income from industry and commerce (included under company taxes) were raised from 15 per cent to 20 per cent for the basic rate and from 10 per cent to 14 per cent for the surcharge, with the changes to be applied to the taxable years ending after September 1974. This will affect revenue only beginning in 1975.

Table 12. Uruguay: Central Government Revenue

(In per cent)

	1970	1971	1972	1973	Prel. 1974
Total revenue	100.0	100.0	100.0	100.0	100.0
Tax revenue	94.0	86.4	90.6	96.3	100.4
Taxes on net income and profits	8.1	7.9	7.8	10.5	10.3
Company taxes	3.3	2.6	2.2	3.6	3.9
Taxes on individual income	2.6	2.8	4.6	5.7	5.1
Individuals	(2.3)	(2.0)	(1.5)	(1.2)	(0.5)
IMPROME	(0.3)	(0.8)	(3.1)	(4.5)	(4.6)
Other	2.2	2.5	1.0	1.2	1.3
Taxes on property	5.6	5.1	5.6	3.6	3.1
Taxes on goods and services	42.4	42.3	42.3	52.0	61.6
Sales and value-added taxes	19.2	16.8	17.1	21.3	27.4
Selective excise on goods	18.0	19.6	18.2	23.2	25.6
Selective taxes on services	3.4	4.1	4.7	5.4	6.3
Other	1.8	1.8	2.3	2.1	2.3
Taxes on international trade and transactions	20.7	14.3	18.0	21.1	16.0
Other	17.2	16.9	16.9	9.1	9.4
Nontax revenue	8.4	11.7	6.3	6.1	6.9
Adjustment1/	-2.4	1.9	3.1	-2.4	-7.3

1/ Ma[illegible]ly for tax[illegible] [illegible]id with tax credit certificates for exports.

(2) Expenditure

As indicated above, total expenditure in 1974 rose much faster than GDP, reflecting mostly the cost of price subsidies introduced late in 1973 and larger transfers to the Pensions Fund to cover its operating deficit. Price subsidies granted in 1974 totaled Ur$33.9 billion, or 4.3 per cent of expenditure (Table 13) with about one half of the cost represented by the purchase of the 1973/74 wheat crop at prices which were about 26 per cent higher than those charged to millers. Similarly, the price of fertilizers was subsidized through refunds given directly to agricultural producers. Sugar, milk, sorghum, and cooking oil were also subsidized during most of 1974, but with the price increases authorized in November 1974 these subsidies were in most cases eliminated.

Table 13. Uruguay: Central Government Expenditure

(In per cent)

	1970	1971	1972	1973	Prel. 1974
Total expenditure	100.0	100.0	100.0	100.0	100.0
Current expenditure	91.3	93.0	93.2	91.6	89.7
Goods and services	77.9	80.4	78.7	75.9	73.2
Wages	56.3	47.9	44.5	43.9	42.1
Pensions	7.2	13.3	17.3	19.0	20.7
Other	14.4	19.2	16.9	13.0	10.4
Transfer payments	10.2	10.0	10.8	12.4	12.8
National Housing Fund	0.3	0.4	0.5	0.7	0.8
Price subsidies	0.8	0.6	0.4	0.6	4.3
Autonomous agencies	2.9	2.3	2.1	2.4	2.3
Provincial governments	0.4	0.8	1.1	0.4	0.2
From earmarked revenue	4.6	5.5	6.5	7.4	5.0
Other	1.2	0.4	0.2	0.9	0.2
Interest payments	3.2	2.6	3.7	3.3	3.7
Capital expenditure	8.7	7.0	6.8	8.4	10.3

Transfers to the Pensions Fund more than doubled in 1974, to the equivalent of close to 21 per cent of total expenditure. This was due to the large adjustment of benefits which averaged 84 per cent, to further reductions in social security contributions, and a reduction in the tax rate on agricultural transactions, which is earmarked for the pensions of rural workers. The latter measures were approved with a view to reducing the high cost of labor. The increase in transfers reflects also the decision to absorb the contribution due by provincial governments to the Pensions Fund, in view of their weakened financial position.

The wage bill rose by 88 per cent in 1974,1/ but declined slightly as a share of total expenditure (see Table 13). The rise in wage payments reflected not only the general wage increases but also other factors such as the increase in the number of national defense personnel and promotions.

Investment outlays in 1974 amounted to about 10 per cent of total expenditure, and were almost totally financed with domestic resources. The shortfall in earmarked revenue from the petroleum tax had to be compensated through special peso-denominated bonds placed with the official Insurance Bank. These funds were used for investments in roads and for work on two large road bridges at the Argentine border. Work was also started on access roads to the site of the proposed Palmar hydroelectric project.

b. Social security system

As noted above, the financial position of the social security system has weakened considerably in the past two years. This resulted, on the revenue side, from the reduction in contributions, elimination of certain earmarked taxes, increased arrears on contributions by public sector entities, and increased use of tax credit certificates for payment of existing debts. On the expenditure side, pensions were adjusted by over 70 per cent in 1973 and by 84 per cent in 1974, in contrast with the two previous years when they were raised by about 30 per cent.

Contributions by employees to the Pensions Fund, which covers most private sector employees and civilian personnel of the public sector, were reduced for private sector workers from 18 per cent at the end of 1972 to 15 per cent at the beginning of 1973, to 12 per cent in July 1973, and to 10 per cent in 1974; for civilian government employees, contributions were reduced from 15 per cent in 1972 and 1973 to 10 per cent in 1974. Also, payments to the Fund by private sector employers were reduced from 20 per cent in 1972 to 15 per cent in 1973.

The employee's contribution to the Family Allowances Fund, which was one half of 1 per cent in 1972, was eliminated at the beginning of 1973 when the employer's contribution was also reduced from 12.8 per cent to 10 per cent. This Fund covers only family allowances (household and dependency allowances, as well as maternity, child care, and education benefits) for private sector employees; in the public sector these benefits are paid directly by the employer and included in the wage bill.

3. Prospects for 1975

In February 1975 the Government announced several measures tending to strengthen the budget for 1975. The interest charge for delinquent accounts, which was 4 per cent per month during 1974, was raised to 5 per cent per month. Prices of several foodstuffs such as milk, bread, flour, sugar, and rice, previously subsidized, were adjusted by between 10 and 45 per cent and the prices of most public services and petroleum products were also raised. The tax rates on petroleum products that had been reduced to 37.5 per cent of the final price during 1974 were increased to 45 per cent of the final price. The rates for consular fees, however, which accounted for 1.4 per cent of revenue during 1974, were reduced by 50 per cent with the provision that they are to be payable in national currency at the Bank of the Republic. In April the Government raised the prices of petroleum products by 17 per cent with immediate effect, and adjusted the tariffs of other public agencies by 10 per cent effective May 1. At the same time consular fees were further reduced (see Section VI).

Official projections for 1975 show an overall budget deficit of Ur$201 billion, equivalent to about 15 per cent of expenditure. Revenue is projected to increase by more than 100 per cent to Ur$1,182 billion, while expenditure is expected to rise at a much slower rate (73 per cent) to Ur$1,383 billion. The gain in revenue is attributed mostly to the tax changes introduced during the second half of 1974 and the first quarter of 1975. A campaign to reduce tax evasion, directed mainly toward the value-added tax, is projected to yield an improvement estimated at 5 per cent of total revenue. There will also be some beneficial effects on the real value of tax collections resulting from the deceleration of inflation. The inflation estimate for calendar 1975 is 41 per cent, compared with 107 per cent in 1974. The relatively slow growth of expenditure is due to the elimination of consumer subsidies, the lower projected rate of inflation and of wage increases.

ANNEX B

AID 1020-28 (7-71)
SUPPLEMENT I

PROJECT DESIGN SUMMARY
LOGICAL FRAMEWORK

ANNEX B

Life of Project:
From FY 76 to FY 77
Total U.S. Funding $240,962
Date Prepared: June 6, 1975

(INSTRUCTION: THIS IS AN OPTIONAL FORM WHICH CAN BE USED AS AN AID TO ORGANIZING DATA FOR THE PAR REPORT. IT NEED NOT BE RETAINED OR SUBMITTED.)

Project Title & Number: FISCAL POLICY AND MANAGEMENT - 528-11-750-98

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal: The broader objective to which this project contributes:	Measures of Goal Achievement:		Assumptions for achieving goal targets:
30 Goal. Upgrade significantly the GOU capacity to analyze and formulate sound economic policies and implement them effectively.	Reduce Central Government's fiscal deficit from 26% of expenditures in 1974 to 15% in 1975 and 10-12% in 1976.	GOU fiscal reports from OPP and Ministry of Economy and Finance.	Continuation of political, economic and social stability. Continuation of strong civilian-military support for GOU's economic stabilization and development program as reflected in IMF Stand By. Agreement.
Sub-Goal. Enhance GOU capability to analyze and formulate fiscal policies and their management in order to improve fiscal performance generally and specifically to reduce fiscal deficits and expand revenue.	Increase total revenue collections from 11% in 1973 to 16-18% of GDP in real terms by end of CY 1977. Reduction of annual rate of inflation to 40-50% for CY 1975 (compared with 107% in 1974) and to around 25-30% by end of CY 1976.	Revenue collection data from DGI. IBRD, IMF, CECIES reports. USAID/Embassy joint assessment of GOU performance.	Satisfactory performance under the IMF Stand-By Agreement. No serious new deterioration in world economic conditions which will further restrict Uruguayan export prospects.

AID 1020-28 (7-71)
SUPPLEMENT I

PROJECT DESIGN SUMMARY
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Project Title & Number: FISCAL POLICY AND MANAGEMENT - 528-11-750-98

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT
Project Purpose:	Conditions that will indicate purpose has been achieved: End of project status.		Assumptions for achieving purpose:
Two sub-purposes: Improve the capacity of the Office of Planning and Budget (OPP) to analyze, formulate and evaluate fiscal policies and programs, including identifying fiscal problems and monitoring fiscal performance.	OPP will have a fully institutionalized capability to undertake technically competent analyses of fiscal policy problems and performance including analyses of the behaviour of various taxes and their effects on macro and sectoral growth, stabilization goals, foreign trade, employment and income distribution. OPP will be capable of continuing analyses of fiscal performance and of anticipating fiscal problems and of formulating strategies and proposals for dealing with them. It will be well equipped to ensure that fiscal policies are consonant with overall economic policies and are flexibly adapting to changes in these policies.	Circulars issued by DGI Revenue collection data Statistics on number of delinquent returns. USAID/IRS professional assessment of DGI operations IBRD, IMF, CECIES reports. Joint USAID/GOU evaluation of project. Examination of new tax laws. Examination and analysis of studies prepared by OPP. Various GOU reports providing info. and data on GOU fiscal performance.	The Office of Fiscal Studies in OPP will provide competent personnel to work with the AID advisor and will organize its Fiscal Policy and Program staff to take maximum advantage of the assistance, and it will organize training seminars to improve the professional capability of its staff. DGI will continue to provide effective leadership in qualitative improvement of tax administration and will provide in a timely fashion personnel, facilities, budgetary support and other contributions essential to project success. Fiscal policy will continue to emphasize IVA, IMPROME and excise taxes as the cornerstone of revenue collections and that an educational campaign to foster improved tax compliance will be undertaken.
Upgrade the capacity of DGI to administer effectively tax collection systems for IVA, IMPROME and excise taxes.	Improved tax administration capabilities will have been evidenced by effectively functioning management systems which will clearly identify non-filers, detect evaders and provide timely and relevant statistical data for enforcement purposes. These systems will ensure maximum possible revenue collections of the IVA, IMPROME, and excise taxes. Time lags between incurring tax liabilities and tax payments will be substantially reduced or eliminated.	Increase in revenues from IVA, IMPROME and excise taxes of 40% by end of CY 1977 as compared with 1975.	

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AID 1020-28 (7-7)
SUPPLEMENT I

PROJECT DESIGN SUMMARY
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Project Title & Number: FISCAL POLICY AND MANAGEMENT - 528-11-750-98

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Outputs:	Magnitude of Outputs:		Assumptions for achieving outputs:
Fiscal Policy			
Studies undertaken, completed and published on various fiscal policy matters, seminars held and on-the-job training provided to OPP.	5 studies on various fiscal matters and seminars held on each study.	Assessment by USAID/AID advisor. Joint USAID/GOU evaluation of project.	

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SUPPLEMENT I

PROJECT DESIGN SUMMARY
LOGICAL FRAMEWORK

Life of Project:
From FY 76 to FY 77
Total U.S. Funding $ 240,962
Date Prepared: June 6, 1975

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Project Title & Number: FISCAL POLICY AND MANAGEMENT - 528-11-750-98

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Outputs: Tax Administration	Magnitude of Outputs:		Assumptions for achieving outputs:
1) Improved, simplified and standardized audit & collection systems and procedures developed, implemented and effectively utilized for IVA, IMPROME and excise taxes.	1. (a) Filing and payment of tax returns reduced from approximately two hours to less than 30 minutes. (b) Internal processing of tax return reduced from approximately 120 days to 45 days. (c) Delinquent taxpayers detected within 30 days after due date of return.	Reports and professional assessment of USAID/IRS tax advisors. Reports and circulars of DGI. Visits to DGI to see first-hand how systems are operating. Joint USAID/GOU evaluations of project.	GOU will continue to assign primary importance to IVA, IMPROME and excise taces as principal source of revenue.
2) Controls effectively used on non-payment of installment accounts and payments of quotas (or estimated tax payments).	2. Accounts in default detected and taxpayers notified within 10 days after due date of payment.		
3) Evasion in payment of IMPROME taxes reduced.	3. Delinquent returns and payments reduced from 30 to 3-5% of universe.		
4) Tax amnesties eliminated.	4. Need for tax amnesties eliminated because of the existence of effective controls on non-filers and other delinquent taxpayers.		
5) Criteria for selection of tax returns for nationwide audit & audit guidelines being used for conducting nationwide audits.	5. Up-to-date criteria developed for the selection of returns for audits by industry, by size, geographical location, etc. Audit coverage extended to interior.		
6) Reorganization of DGI fully completed, is operating effectively, and progress being made towards housing DGI in one location.	6. Functional reorganization completed.		
7) Systems designed for creation, control & maintenance of computerized master file.	7. A computerized master file of taxpayers, each identified by a numerically sequenced number with a check digit for control.		
8) Improved managerial & technical capability throughout the DGI system.	8. Channels of command clearly defined, authority delegated, staff functions identified & a self-improvement capability institutionalized.		
9) Restructured training program to support reorganization and needs of tax system.	9. Relevant and timely training courses provided.		

AID 1020-28 (7-71)
SUPPLEMENT 1

PROJECT DESIGN SUMMARY
LOGICAL FRAMEWORK

Life of Project:
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Total U.S. Funding $240,962
Date Prepared: June 6, 1975

Project Title & Number: FISCAL POLICY AND MANAGEMENT - 528-11-750-98

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Inputs:	Implementation Target (Type and Quantity)		Assumptions for providing inputs:
Fiscal Policy USAID One short-term AID contract advisor in fiscal policy.	4 man months of TDY advisory services provided at spaced intervals over life of project. Timing to be determined later. Probably will involve 4 separate 1 mo.TDYs to Uruguay.	For most part, inputs need no verification. USAID advisors will verify adequacy of GOU contribution, including its continued interest in the project and in receiving technical assistance.	AID can arrange contract with someone to provide the T.A. in fiscal policy. IRS can provide long-term advisors comp. in Spanish by July/August 1975
GOU Adequate facilities, administrative support, secretarial services for AID contract advisor	Provided on time and in quality and quantity needed.		GOU provides adequate counterparts and facilities.
Counterparts to work with AID advisor.	Various, depending on studies being undertaken.		
Tax Administration USAID One long-term IRS tax administration advisor.	July 1975-Sept.1977 (2 yrs.3 mos.)		
One short-term IRS tax advisor on alcohol, tobacco and beverages taxes.	8 m.m. spread out over 2 yr. period at spaced intervals.		
Participant training.	15 m.m. of short-term training.		
GOU Counterparts to work with IRS advisors Adequate facilities, administrative support, and secretarial services for IRS advisors.	Head of DGI plus others as required. Provided on time and in sufficient quality and quantity.		
Adequate budget for DGI including sufficient funds to implement needed changes NOTE: Entire IVA, IMPROME and Excise Tax Divisions of DGI will be working on project. NOTE: OAS will also provide one long-term advisor on data processing.	Over life of project.		

Evaluation Report of the Tax Administration and Reform Project

As provided for in the FY 1975 Tax Administration and Reform Project Agreement, an in-depth project evaluation was carried out to determine the rate of progress and accomplishments to date and to make a determination as to a possible continuation of the tax advisory assistance to the Uruguayan Tax Office.

In preparation for the evaluation, the USAID Mission sent to the Director General of Taxes a letter with a list of relevant questions on the two major areas of work carried out under this project: a) management and organization and b) collection. The written answers served as part of the basis for the evaluation and also afforded Mission an opportunity to pose additional questions at the meeting to expand and clarify points, as required.

Date of Evaluation: June 2, 1975. The evaluation meeting was held at the Ministry of Economy and Finance and the participants were as follows:

Cr. Valentín Arismendi, Sub-Secretary of Economy and Finance,
Cr. Raúl Xavier, Director General of Taxes
Mr. Leonard J. Horwitz, AID Representative
Mr. Jerome Hulehan, Program Officer, and
Mr. Ivan Trabal, Tax Team Leader.

The evaluation results are as follows:

A. Management and Organization

1. A task force was appointed in early February to plan a reorganization, by function, of the Tax Office. The group developed a proposed organization chart with five major functional divisions; audit, collection, planning, legal counsel and administration. The DG approved the plan. Various DGI circulars were issued creating the divisions of audit, collection, planning, legal counsel and administration. With the issuance of these circulars, the first phase of the reorganization has been completed. The implementation phase is already under way. The consolidation of the audit division has been completed and the division is presently operational.

The forthcoming GOU Annual Budget Review (Rendición de Cuentas) will include legislation to legally sanction the administrative steps authorized by the Director General (DG). It will also include the following provisions:

(a) the present functions and responsibilities of the various current directors will be taken away and reassigned to the Director General who will have authority to delegate functions and change personnel as needed.

(b) The Office of Income will become the Office of Collection and the Office of Inspector General will be changed to the Office of Audit. The Offices of Internal and Indirect Taxes will be eliminated and, instead, the Offices of the Legal Counsel and the Office of Systems and Support (Planning) will be created.

According to the Sub-Secretary and the Director General, no problems concerning these measures are anticipated in the Council of State and expeditious approval is expected.

Due to the initiative of Sub-Secretary Arismendi, arrangements have been made to house the Collection Division in newer and larger quarters expected to be available within three months. Long-range plans exist to house all the Tax Office in the premises now occupied by the Central Bank. These are expected to be available within the next twelve months.

2. Another task force was appointed by the DG to study the existing collection system and also the creation of a consolidated master file of taxpayers in line with the needs of the new organization. The work of this commission has been temporarily delayed due to the work on the reorganization.

3. On May 1, the DG appointed a new Director for the Division of Data Processing. The OAS advisor, is working full-time with the new Director to help improve the quality and timely submission of revenue data so as to obtain more accurate and timely statistical information on all taxes, specially on IVA and IMPROME.

4. The design and format of a single-payment document has been approved and implementation is expected by the end of September 1975. Also, as of this date, the Bank of the Republic will no longer receive tax payments. Due to the poor quality of the documents, the delays in processing by the Bank and the late receipt by the Tax Office, a decision has been made for payments to be made directly to the Tax Office.

The adoption of a single-payment document and the direct payment of taxes should help improve the quality and reduce the time required for processing. This in turn will speed up the availability of statistics for management and other purposes.

5. Training courses will be given for approximately 350 employees to familiarize them with the new organization. Additional courses will be given for technical personnel including courses on IVA and IMPROME. Inspectors recently assigned to the enforcement of these two taxes will be given priority for participating in these courses.

6. The study by an IRS technician of the Office of Internal Taxes, which administers the fuels, alcohol, beverages and tobacco taxes, was initiated in March. He has been studying the existing administrative controls and visiting the breweries, wineries and the alcohol and tobacco plants. A report is being prepared and translated which contains recommendations for legislative changes and the tightening of administrative controls.

Implementation of these recommendations is expected to begin immediately after the report is approved by the Tax authorities. The technician has recommended that a group of Uruguayan tax officials visit Venezuela to observe and learn about the controls used in that country for the administration of fuels, alcohol, beverages and tobacco taxes. Arrangements are being made through the Interamerican Center for Tax Administrators (CIAT) for this visit which is now planned for early July.

B. <u>Collection</u>

1. The new organization chart approved by the DG contemplates the creation of a collection division (see DGI Circular N° 92/75, dated May 15, 1975).

The major functions to be performed by this division are: receipt and accounting of revenues, processing of tax payments and returns, creation and maintenance of a computerized, consolidated master file of taxpayers, securing of delinquent returns, controlling installment accounts, etc. Also the division will have a unit to provide information and assistance to taxpayers.

Because of its importance, this division will be the first one to be relocated. The new quarters will be remodeled so as to facilitate better service to the taxpayers.

2. The study of the installment accounts section is practically completed and a report will be issued by the end of July.

Some steps are already being taken to tighten controls and reduce the number of accounts and to shorten the length of the agreements.

The DG has adopted a policy of not granting installment payment privileges upon request but to require complete financial statements to properly determine if an agreement is justified. The amounts to be paid and the length of the agreement will be determined by the financial condition of the taxpayer. A course for employees of this unit on financial analysis and interpretation will begin shortly. A policy of not granting installment privileges, except on hardship cases, on the payment of trust-fund taxes, has also been adopted.

According to Sub-Secretary Arismendi, no tax amnesty is included in the "Rendición" and none is contemplated. Readjustable tax rates on back taxes owed will not be necessary because of the policy of no tax amnesties, the recent increase in the rate of monthly interest due on back taxes from 4 to 5% and the expected improvements in the administration which will, according to the Sub-Secretary, make delinquency more costly, when the anticipated lower rate of inflation is taken into account. These considerations, together with the more stringent requirements on applications for installment payment privileges should make delinquency less and less attractive.

3. Regarding increased enforcement, a unit of 25 inspectors have been created to follow up on non-filers and taxpayers in default of their installment agreements.

In the offices of the interior, excess personnel resulting from the elimination of the stamp tax and the reorganization, will be assigned to enforcement functions. Also, some small offices in the interior will be eliminated and others consolidated. The result should be improved revenues.

4. In the area of public relations and taxpayer education, a monthly bulletin is now being published containing the latest laws, decrees, administrative rulings, etc. The bulletin is given maximum distribution.

Two Directors have had press and TV conferences announcing the policy of increased countrywide enforcement.

Plans are underway to acquaint taxpayers with the reorganization and what it means in terms of contacts, services and attention to them. The establishment of a unit of information and assistance to the taxpayer in the Collection Division was mentioned above.

It was the consensus of the evaluators that the progress achieved thus far speaks for itself and justifies the continuation of technical assistance to the Tax Office. It was agreed that assistance should be concentrated on the key areas of IVA, IMPROME and excise taxes and reorganization.

USAID evaluation of overall GOU economic performance

With the adoption of basic economic reform policies and laws which led to the approval of an IMF Standby Agreement, the GOU has taken the first significant steps to stimulate a stagnant economy and help bring about recovery and development. The adoption of these measures signifies that a GOU economic management capability is being developed which at some future date, given proper assistance and nurturing, will be capable of standing on its own, consequently bringing full recovery and providing a base for a take off.

The various economic measures taken have been reported and need not be detailed here. Suffice it to say that the IMF Stand-By Agreement is evidence that the GOU is headed in the right direction.

An effective tax administration system is one of the essential components of a properly managed economic system because of its overall economic impact on all aspects of economic activity and the GOU is taking steps to improve its system.

Plans to reorganize the Tax Office have been completed and approved and implementation is under way. Personnel have been reassigned and budgetary provisions for implementing these reforms have been included in the GOU forthcoming annual Budget Review.

The Tax Administration and Reform PROP identified improved economic management as the sector goal and an efficient tax administration system as the project purpose. The long string of economic measures reported clearly indicate a significant improvement in the management of the economy. This evaluation of the tax administration project equally indicates a meaningful rate of progress towards achieving a modern and effective tax administration system capable of fulfilling the demands made upon it by the GOU economic managers.

ANNEX D

THE ROLE OF FISCAL FACTORS IN URUGUAY'S INFLATION

Arnold C. Harberger
University of Chicago

This Memorandum attempts to explore the influence of fiscal policy in Uruguay's inflation. It is divided into three main parts. In the first, the notion of a "fiscal inflation" is described, and examples are given, from the experience of other Latin American countries, of both "fiscal" and "non-fiscal" inflations. Then Uruguay's inflationary history up to 1971 is presented, and a diagnosis of its changing degree of fiscal connection is given.

The second part focuses more explicitly on the Uruguayan case. The historical experience of the country with respect to fiscal deficits is reviewed, and the fiscal-monetary connection is traced for the recent past period (1968-73). Out of this examination there emerges a "characterization" of the Uruguayan economy for this period, which in turn provides the point of departure for the series of simulations that constitute Part III.

These simulations explore the likely effectiveness in producing, or helping to bring about, an economic stabilization. The simulations basically explore i) how strong a stabilizing force would be generated by an additional enforcement effort that raised real tax yields by 2 percent per annum above what they might otherwise have been; ii) how much of a fiscal dividend would be produced if the economy started to grow at 6 percent per annum in real terms, with taxes keeping pace and with expenditures being held to a 4 percent per annum real growth; and iii) how much more rapidly economic stabilization would be brought about by the continuation of tax effort and growth-cum-fiscal dividend. The conclusion of this examination is that either one of alternatives (i) and (ii) would by itself essentially eliminate fiscal pressure as a source of inflation within something less than a decade, and the two together would do it in something like three years. Combined with other tools of economic policy, the fiscal moves could be made to contribute even more effectively to a rapid and successful stabilization.

I. Fiscal Inflations in Latin America

A. Characteristics of "Fiscal Inflations"

The notion of a "fiscal inflation" is not a precise technical term. Yet I believe it is the consensus of observers of the Latin American scene that most of that region's serious inflations have been fiscal in origin. This consensus, indeed, was the main result of the confrontation between "structuralists" and "monetarists" at the Conference on Inflation and Growth at Rio de Janeiro in 1963.[1] The general picture of a fiscal inflation is one in which the banking system is "required" to grant substantial increments in credit to the government each year. The impact of these increments on the money supply could be cushioned if the banking system had sufficient assets of foreign exchange to sell (and were willing to sell them), or if it were able (and willing) to go sufficiently into

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[1] See Werner Baer and Isaak Kerstenesky, Inflation and Growth in Latin America (Homewood: Richard D. Irwin, 1964), especially the summary statement of W. Arthur Lewis.

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debt to foreign countries to acquire foreign exchange to sell, or if it were prepared to make drastic cuts in the share of bank credit going to the private sector.

It is within the general notion of a fiscal inflation that some of these cushions might be employed some of the time, but that the degree of fiscal pressure is too strong for the cushions to exert more than a palliative effect on the inflation. Having to finance a significant government deficit, the banking system must expand government credit. Private sector credit then follows, in order to prevent its being eroded away. Characteristically, in a fiscal inflation, the share of private sector credit in total bank credit is allowed to fall to some extent, but after a point, the monetary authorities make serious efforts to prevent its further erosion. Once that point is reached, the relative shares of bank credit going to the public and the private sectors tend to stabilize, fluctuating within a band, but not going outside it.

Another characteristic of fiscal inflations is the absence of large net reserves of foreign exchange in the banking system. Where such reserves are present, they represent a cushion that the authorities tend to draw upon. In this way, any substantial foreign exchange reserves that may appear during a fiscal inflation tend rather rapidly to be eaten away.

B. Some Examples of "Fiscal Inflations"

As was indicated above, the notion of "fiscal inflations" helped resolve the structuralist-monetarist controversy. To the structuralists, the fiscal deficits were a structural failing of the system, and were ultimately responsible for most of the major inflationary pressures

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observed in Latin America. To the monetarists, the mechanism by which inflation worked itself out was through increases in the quantity of money. The theoretical structure connecting monetary expansion with rises in the price level remained intact under the fiscal explanation--which did not deny the monetarist mechanism but only helped to explain <u>why</u> monetary emissions were so large, so persistent, and so resistant to simple "cures." So both sides, each in its own way, could go away from the Rio conference reasonably content with the consensus that was reached.

Since the evidence explored and the judgments reached at the Rio conference were based mainly on the decade of the 1950's, I have attempted to bring later data to bear on the same general question. In examining the history of inflation in Latin America during the 1960's, perhaps the most striking observation is that--in spite of the widespread belief that high inflation is characteristic of most Latin American countries, or at least of most South American countries--only four countries (Argentina, Brazil, Chile, and Uruguay) had inflation rates averaging significantly over 10 percent per annum during the decade. Peru and Colombia averaged right around the 10 percent mark, and all the rest of the countries had average rates significantly less than 10 percent.

Outside of Uruguay, then, the phenomenon of serious inflation was concentrated only in the ABC countries during the 1960's. Their experience is examined in Table I. Most of this experience can be classified under the label of fiscal inflation, of which three rather clear-cut episodes are summarized in Table Ia. In the paragraphs that follow, I shall go through the evidence presented in Table Ia, and try to convey

TABLE Ia

THREE "FISCAL INFLATIONS"

Argentina, 1962-72

	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
FA/M	-.10	-.01	-.01	.02	.01	.11	.11	.06	.10	.001	.03
GC/DC	.32	.38	.42	.42	.42	.46	.39	.35	.34	.33	.33
GC_t/GC_{t-1}	1.18	1.23	1.40	1.26	1.31	1.40	1.28	1.19	1.18	1.44	1.51
CP	90	110	131	179	229	298	326	351	420	575	955

Cumulative annual rates of change: GC = 30.5; M = 29.5; CP = 26.6

Brazil, 1955-64

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
FA/M	-.02	.01	.00	-.02	-.01	-.02	-.00	.00	.04	.06
GC/DC	.27	.31	.34	.32	.32	.33	.35	.40	.37	.37
GC_t/GC_{t-1}	1.15	1.43	1.44	1.15	1.28	1.47	1.51	1.83	1.52	1.77
CP	9	11	13	15	20	27	38	58	100	187

Cumulative annual rates of change: GC = 47.6; M = 45.4; CP = 40.1

Chile, 1961-68

	1961	1962	1963	1964	1965	1966	1967	1968
FA/M	-.40	-.68	-.70	-.57	-.34	-.11	-.16	.07
GC/DC	.33	.40	.43	.45	.49	.49	.52	.49
GC_t/GC_{t-1}	1.75	1.77	1.45	1.53	1.55	1.32	1.48	1.17
CP	63	78	113	161	202	243	291	371

Cumulative annual rates of change: GC = 45.7; M = 39.7; CP = 32.1

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TABLE Ib

A "NON-FISCAL INFLATION"

Brazil, 1967-72

	1967	1968	1969	1970	1971	1972
FA/M	.07	.04	.10	.13	.17	.32
GC/DC	.30	.26	.21	.20	.13	.05
GC_t/GC_{t-1}	1.58	1.33	1.09	1.22	.95	.52
CP	575	714	880	1048	1269	1515

Cumulative annual rates of change: GC = -2.70; M = +34.9; CP = +21.4.

TABLE Ic

THE URUGUAYAN CASE, 1957-71

	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
FA/M	.07	.09	.22	.27	.32	-.06	.09	-.16	-.03	-.24	-.28	-.11	-.02	-.12	-.05
GC/DC	.14	.12	.06	.03	.03	.11	.14	.11	.16	.22	.29	.20	.31	.24	.30
GC_t/GC_{t-1}	1.25	1.02	.57	.78	1.11	4.38	1.66	1.20	2.19	1.50	2.39	.97	2.25	1.04	1.99
CP	26	31	44	61	74	82	100	141	221	384	728	1639	1972	2313	2859

Cumulative rates of growth 1957-61: GC = -14.3; M = +31.4; CP = +29.8
1961-71: GC = -77.6; M = +46.7; CP = +44.1

FA = Foreign Assets of the Consolidated Banking Systems
M = Money Supply
GC = Credit to the Central Government and Official Agencies by the Consolidated Banking System
DC = Total Domestic Credit Outstanding (Consolidated Banking System)
CP = Consumer Price Level.

Source: International Financial Statistics, Supplement, 1972.

to readers a feeling of what a fiscal inflation "looks like."

The case of Argentina (1962-72) is quite typical. The "range" in which the governments' share of banking-system credit was allowed by the monetary authorities to fluctuate was from 32 to 42 percent (with one exception in 1967). Foreign exchange reserves remained low in relation to the money supply throughout the period, offering no plausible possibility of offsetting the fiscal deficits that regularly emerged. The banking system was called upon to increase its holdings of government obligations every single year, at rates ranging upwards of 18 percent, and averaging over 30 percent per year. With that, the money supply grew at nearly 30 percent, and prices at about 27 percent per annum.

Brazil's fiscal inflation is shown for the years 1955-64. Here, too, foreign assets of the banking system remained negligible throughout the period, and the band in which the ratio of government credit to total credit fluctuated was from 30 to 40 percent, rising into this range from an initial position of 27 percent in 1955. In this period the pressure from increases in government credit was indeed severe--apart from two years (1955 and 1958) in which such credit increased by only 15 percent, and one (1959) in which it grew by 28 percent, the growth of government credit was more than 40 percent every year, and averaged over 47 percent for the entire decade. This pressure, and the inability and/or inadvisability of the banking system's squeezing other assets further in the face of it, led to the money supply's increasing at an average rate of over 45 percent, and to a price inflation averaging over 40 percent during the 10 year span here covered.

In Chile, the foreign asset position of the banking system was dramatically (almost incredibly) negative for much of the period covered, and attained a positive value only in the final year (as a result of a surge in copper prices). The band of fluctuation for the ratio of government credit to total domestic credit was in this case 40 to 50 percent--a range which was entered from below after the first year of the period, and which was exceeded only once, with 52 percent in 1967. The pressure on the banking system to grant additional credits to the government was continuous and strong, with such credit growing at an average rate of over 45 percent per year over the period, and falling short of that average only in 1966 and 1968. The 45.7 percent rate of expansion in government credit was partly offset, but still the money supply grew at nearly 40 percent, and the average rate of price inflation was 32 percent.

C. A Case of "Non-Fiscal Inflation"

Brazil's experience in the late 1960's and early 1970's is a rare example of "non-fiscal" inflation. Table Ib summarizes this episode. The differences between it and those reflected in Table Ia are striking. The share of government credit in total banking credit fell from 30 percent to 5 percent. In fact, the absolute amount (in nominal cruzeiros) of such credit was lower in 1972 than it was in 1967. Brazil simply did not resort to banking-system financing of government deficits during the period. The money supply grew at nearly 35 percent per annum, but certainly not as a consequence of fiscal pressure. Massive reserve accumulation--the consequence of a phenomenally successful export-promotion policy plus large inflows of foreign capital--together with significant credit expansion to the private sector were the obvious proximate causes of this particular inflationary experience. And it should also be noted that this

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period in Brazil was the culmination of a dramatic disinflation from an annual rate that reached around 100 percent in 1963-64 to the steady rate of around 20 percent that characterized the period shown in Table Ib.

D. The Historical Setting of Uruguay's Current Inflation

Against the backdrop of the experiences just reviewed--of "fiscal" and "non-fiscal" inflation in other countries, we now proceed to examine the case of Uruguay in the years including and immediately surrounding the decade of the 1960's. The comparable data (drawn from the same source--International Financial Statistics) are presented in Table Ic. As I read the story from that table, the period can be divided neatly into two quite distinct parts. From 1957 through 1961, Uruguay's inflation seems quite clearly to be "non-fiscal" in origin. As was the case in Brazil from 1967 to 1972, even the nominal amount of banking system credit to the government declined over this period. By its close in 1960 and 1961, government credit amounted to only 3 percent of total domestic credit, and there was no serious pressure on the banking system for adding to its total holdings of government obligations. At the same time the country was undergoing a major accumulation of foreign reserves--which moved from 7 to 32 percent of the money supply during this period--precisely the range over which Brazil's reserves moved between 1967 and 1972. There can be no doubt, then, that foreign exchange accumulation and credit to the private sector were the proximate causes of Uruguay's monetary expansion during 1957-61. And, furthermore, the setting was such that these could not be interpreted as some sort of lagged reaction to a prior episode of fiscal pressure. Fiscal pressure was totally absent during this period, which makes it another of the rare cases of significant "non-fiscal" inflation in Latin America (prices almost trebled in four years).

The picture changes drastically as one moves past 1961. Starting from its very low base, government credit multiplied by more than four between 1961 and 1962, and increased thereafter at rates which fell below 50 percent only three times in a decade, averaging over 75 percent per annum over the whole period 1961-71. At the same time, the foreign asset portfolio of the banking system turned abruptly negative in 1962, and stayed that way, with but one exception (1963), throughout the decade under review. This period thus seems to have all the earmarks of a fiscal inflation--the only caveat being the very low base from which government credit started. It is only for this reason that, I am reluctant to call this period in Uruguay one of clearcut fiscal inflation, but there is no doubt that all the signs point in that direction. The move of the government credit/total credit ratio from 3 percent in 1961 to 16 percent in 1965 surely was not in itself a powerful inflationary force. It could, had it not continued further, have easily been cushioned by a modest reduction in private-sector credit. But it did continue, and by the end of the period the ratio of government credit to total credit was approaching 30 percent--the lower range of the bands that characterized this ratio for Argentina's and Brazil's "fiscal inflations." By this point in time the label of fiscal inflation seems to apply reasonably well to the Uruguayan case.

II. The Fiscal Setting of Uruguay's Current Inflation

A. The Central Government Budget

It is incredible how stable has been the macroeconomic budget picture in Uruguay over the past decade or so. In spite of almost annual changes in tax legislation, some of them quite dramatic, and in spite of some quite important changes on the expenditure side, the fractions of GDP accounted for by central government receipts and expenditures, respectively, have remained essentially constant. Table II contains the data supporting this assertion. As can be seen there, central government receipts averaged 13.2 percent of GDP during the period 1961-67, and 13.5 percent during the period 1968-73. Similarly, central government expenditures averaged 16.0 percent of GDP during 1961-67 and 15.9 percent during 1968-73. Though there were transitory variations on both the receipts and the expenditure sides, the basic fiscal structure remained essentially unchanged. This fact will be used in developing simulations of Uruguay's fiscal situation subsequently in this paper.

Table III shows the relationship between the figures for fiscal deficits, as shown in the fiscal statistics, and the financing of such deficits by the banking system, which is what is relevant for our analysis of inflation. Line 1 presents the absolute figures on the deficit as drawn from the fiscal accounts of the central government. Line 2 shows what part of the deficit, thus defined, was financed by sale of government obligations to the monetary authority (in this case Central Bank plus Banco de La República). The third line represents obligations by the banking system. It is drawn from the monetary--not the fiscal--accounts but it represents a quite similar concept to that reflected in line 2.

TABLE II

CENTRAL GOVERNMENT BUDGET, 1961-73

	Receipts/GDP	Expenditures/GDP
1961	15.6	16.6
1962	14.4	18.2
1963	14.4	17.3
1964	14.0	16.1
1965	10.6	15.7
1966	12.5	13.8
1967	10.9	14.1
Average 1961-67	13.2	16.0
1968	13.0	13.2
1969	12.2	14.7
1970	13.5	15.3
1971	14.0	18.7
1972	13.6	16.1
1973	14.8	16.3
Average 1968-73	13.5	15.9

Source: Banco Central del Uruguay, Boletin Estadistico Mensual, No. 13 (Dec. 1973), Table III.1.

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TABLE III

COMPARISON OF ALTERNATIVE DEFICIT MEASURES

	1968	1969	1970	1971	1972	1973
1. Central Government Budget Deficit[a]	754	12,690	10,596	41,666	31,899	36,332
2. Central Government Financing with Monetary Authorities[b]	n.a.	6,883	3,233	36,448	24,780	20,858
3. Banking System - net Central Govt. Credit[c]	610	10,260	3,391	26,110	24,332	18,790
4. Banking System - net Total Govt. Credit[d]	-1,172	12,153	2,574	23,778	36,962	25,487

[a]Source: Banco Central del Uruguay, *Boletín Estadístico Mensual*, No. 13 (Dec. 1973), Table III-1.

[b]*Ibid*., Table III-2.

[c]*Ibid*, Table I-10 (Central Govt. Credit only)

[d]*Ibid*, Table I-10 (Credit to Central Govt. plus Rest of Public Sector plus Development Banks).

The financing of the deficit shown in line 2 represents the net sale of obligations by the central government to the monetary authority. Line 3 shows the acquisition of central government obligations by the entire banking system. There are thus two main ways in which a discrepancy between lines 2 and 3 could be generated. On the one hand, the central government might sell some obligations to some banking entity other than the monetary authority, leading to a different figure being reported from the banking system as a whole than that for government sales to the monetary authority. On the other hand, banks could acquire some government obligations that were held by non-bank institutions (or individuals), thus generating a rise in their portfolio unconnected with the financing of the current year's deficit. Given these sources of possible discrepancies, the degree of agreement between lines 2 and 3 seems reasonably close--indeed, cumulatively, from 1969 through 1973 the difference is only in the order of about 10 percent (92 billion [row 2] versus 83 billion pesos [row 3]).

As we move from row 3 to row 4 we are comparing two sets of statistics from the banking system--the first concerning its holdings of central government obligations, the second dealing with its holdings of obligations of all governmental entities. The possibility of discrepancy is obvious in this case, but once again the relationship between the two sets of figures is reasonably close, with the increase in credit to all governments (100 billion pesos) over the full period 1968 through 1973 exceeding the increase to the central government (83 billion pesos) by about 20 percent.

Finally, we come to the comparison between rows 1 and 4. Row 1 gives us the fiscal deficit concept that is most frequently discussed, and that is most directly under the control of the finance ministry. Row 4 gives us the variable that most directly connects the fiscal with the monetary sector. Here, in addition to the sources of discrepancy already discussed, there is the important one of other sources of financing for the central government deficit. Indeed, the main source of difference between rows 1 and 4 may be said to depend on whether the financing of central government deficits outside the banking system (which appear in row 1 but not row 4) exceeds or falls short of the financing within the banking system of deficits (which appear in row 4 but not row 1) in other agencies of government besides the central government. In this case the latter type of financing appears to fall substantially short of the former, as row 4 averages about 75 percent of row 1. I should emphasize at this point that it is row 4 which is of interest for the analysis of the fiscal-monetary connection, but the data presented in Table III reveal that the deficits measured under other budget concepts were of the same general order of magnitude.

III. Alternative Paths of Disinflation (Simulations)

Tables IV, V, and VI present three alternative scenarios of disinflation in Uruguay. In Table IV it is assumed that the stagnation that has characterized Uruguay's economy for the past two decades will continue. Reliance for combatting inflation is therefore placed on taxes. In the scenario of the table, these are projected to expand at the rate of 2 percent per annum, in real terms. This row 1 of the table shows expenditures constant (in real terms) at 16 percent of GDP (see Table II), while government revenues grow from 13.5 percent of GDP (again see Table II), at the

TABLE IV

DISINFLATION SCENARIO WITH FISCAL EFFORT (2%) BUT NO GDP GROWTH

(GDP constant at 1000)

	Year									
	0	1	2	3	4	5	6	7	8	9
1. Government Expenditure	160	160	160	160	160	160	160	160	160	160
2. Government Revenue	135	138	140	143	146	149	152	155	158	161
3. Deficit	25	22	20	17	14	11	8	5	3	-1
4. Rate of Inflation	89%	76%	67%	54%	42%	32%	22%	13%	8%	–

assumed 2 percent per annum rate. As can be seen, it would take until year 9 for revenues to surpass expenditures. However, long before that the inflationary pressures emanating from the fiscal side would have been brought down to a more manageable range. By the fifth year, for example, the deficit would be only around 1 percent of GDP.

In Table V the assumption is made that the Uruguayan economy will break out of its "traditional" stagnation, hopefully as a result of the general liberalization of economic policies that is now under way. Growth is there postulated at 6 percent per annum in real terms. It is assumed that without additional "fiscal effort" tax revenues can grow in proportion to GDP, though it is recognized that some restructuring of particular revenue sources may be required to achieve this result. The "effort" involved in this particular scenario does not concern taxes, however; rather it entails containing the growth of real fiscal expenditures to 4 percent per annum, in the face of a 6 percent rate of growth of real GDP. Row 3 of Table V shows the deficit implied by these assumptions; it reaches zero in the 9th year of the exercise. But once again the bulk of the reduction of inflationary pressure takes place early in the scenario; as shown in row 4 of the table, the deficit is once again reduced to 1 percent of GDP by the fifth year of the exercise.

In Table VI the assumptions underlying the previous two scenarios are combined. Expenditures are there projected to grow by 4 percent per annum as in Table V, but revenues are projected to grow at 8 rather than 6 percent per year, owing to a combination of GDP growth (at 6 percent) with additional fiscal effort causing a further rise of 2 percent per annum in the tax yield out of a given GDP. The rate of reduction in the

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TABLE V

DISINFLATION SCENARIO WITH REAL GDP AND TAXES GROWING AT 6% PER YEAR WHILE REAL EXPENDITURES GROW AT 4% PER YEAR

	Year									
	0	1	2	3	4	5	6	7	8	9
1. Real Expenditures (4%)	160	166	173	180	187	195	202	211	219	228
2. Real Taxes (6%)	135	143	152	161	170	181	192	203	215	228
3. Real Deficit	25	23	21	19	17	14	10	8	4	0
4. Deficit/GDP	.025	.022	.019	.016	.013	.010	.007	.005	.003	0
5. Rate of Inflation	79%	61%	49%	39%	31%	22%	12%	7%	0%	-

TABLE VI

DISINFLATION SCENARIO WITH REAL GNP GROWTH AT 6%; TAX GROWTH (THROUGH FISCAL EFFORT OF 2%) AT 8%; AND EXPENDITURE GROWTH (THROUGH FISCAL RESTRAINT) AT 4% PER YEAR

	Year					
	0	1	2	3	4	5
1. Real Expenditures (4%)	160	166	173	180	187	195
2. Real Taxes (8%)	135	146	157	170	183	198
3. Real Deficit	25	20	16	10	4	-3
4. Deficit/GDP	.025	.019	.014	.008	.003	-.002
5. Rate of Inflation	79%	50%	34%	16%	2%	-

deficit is consequently faster, with the deficit in absolute terms being eliminated by the fifth year of the scenario, and with the deficit being reduced to below 1 percent of GDP by the third year of the exercise.

Another way of examining the scenarios underlying Tables IV, V, and VI is to inquire how much inflation they imply year by year, or cumulatively. This is difficult to do except on the basis of rigid assumptions. One could always reduce the extent of inflationary impact of a given budgetary situation, for example, by selling gold (something quite feasible in the case of Uruguay), or by borrowing more from abroad (which for Uruguay would probably mean mortgaging a further part of its gold stock). Then, too, there is always the possibility of further squeezing the share of bank credit going to the private sector, though this is hardly a course which responsible monetary authorities would espouse at the present time.

The procedure followed in the tables is a conservative one, which assumes that the total money supply grows in the same proportion as does bank credit to the government. In addition, we assume (again conservatively) that the stock of money will continue to bear the same relationship to nominal income throughout the stabilization process reflected in each of the scenarios. These two assumptions, taken together, mean that nominal bank credit to the government will bear a constant relationship to nominal GDP, and hence that real bank credit to the government will bear a constant relationship to real GDP. Let this relationship be 4 percent--i.e., the level of real bank credit to the government at any point in time is equal to 4 percent of a year's real GDP, centered around the same point in time. (This ratio approximately characterizes Uruguay's recent history.)

For the exercise of Table IV, where real GDP is constant, this means that real bank credit to the government will be constant at 40. Such credit in nominal terms will have to rise, however, as the inflation proceeds. The increment in nominal credit in year zero is 25, which would carry it from a beginning-of-year position of, say, 28 to an end-of-year position of 53. This in turn would imply a within-the-year inflation of 89 percent (= 25/28), and an end-of-year price index of 1.325 (= 53/40), taking the average price level of the year as 1.00.

Subsequent movements in the price level are generated by the formula:

(1) $$B_t + d_t\ [(P_t + P_{t+1})/2] = B_{t+1} = b_{t+1}P_{t+1}\ .$$

Here B_t refers to the nominal amount of bank credit to the government that is outstanding at the beginning of year t; d_t is the real deficit financed by the banking system during year t; $[(P_t + P_{t+1})/2]$ is the average price level during year t; and b_{t+1} is the real amount of credit to the government that is outstanding at the beginning of year t+1. For the exercise of Table IV, $b_t (= b_{t+1})$ is constant at 40, so the price level at the beginning of year 2 can be obtained by solving

$$b_1P_1 + d_1[(P_1 + P_2)/2] = b_2P_2$$

$$40\ P_1 + 22\ [(P_1 + P_2)/2] = 40\ P_2$$

$$51\ P_1 = 29\ P_2$$

$$\frac{P_2}{P_1} = \frac{51}{29} = 1.76$$

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In general, for the case of $b_t = b_{t+1} = 40$, we have

(2) $$(p_{t+1}/p_t) = [40 + (d_t/2)] / [40 - (d_t/2)].$$

This equation was used to generate the rates of inflation shown in row 4 of Table IV.

In the cases of Tables V and VI, the process of generating the implied rate of inflation is similar, except that in these cases the real quantity of money, and hence (under our assumptions) the real amount b_t of banking system credit to the government, grows at the same rate (6 percent per annum) as GDP. In this case the nominal credit of 53 outstanding at the end of period zero corresponds to real credit of 42.4 [= 40(1.06)], so that the price level at the beginning of period 1 is 1.25 (= 53/42.4). Thereafter, successive implied increases in the price level are generated by the formula

(3) $$(p_{t+1}/p_t) = [40(1.06)^t + (d_t/2)] / [40(1.06)^{t+1} - (d_t/2)].$$

As can be seen in the tables, the scenario of Table IV requires nine years to eliminate inflation; that of Table V takes eight years, while under that of Table VI the task is essentially accomplished by the end of year 3. Looked at in another way, and starting the measurement from the average price level of year zero, the overall price level would have risen from 1.00 to 16.74 before the inflation had stopped, under the sequence depicted in Table IV. Under that of Table V the corresponding rise would be from 1.00 to 7.98, while under the scenario of Table VI the rise would only be from 1.00 to 2.97.

These cumulative figures are probably overestimates, as they do not

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take into account the substantial reduction in velocity of circulation that is almost certain to occur as the Uruguayan economy disinflates. Nonetheless, even allowing for velocity to be cut by a third or a half (which, if anything, overstates the likely reduction), one must still look forward to a many-fold increase in prices under either of the scenarios depicted in Tables IV and V. Only that of Table VI can be regarded as giving an optimistic picture. Yet it is not an absurdly unfeasible one. What is required for the picture of Table VI to emerge is a confluence of reasonable efforts, crowned with reasonable success, in several directions at once. And if in addition there is a significant reduction in velocity of circulation, it is quite conceivable that the price level might only have to rise by perhaps 100 or 125 percent cumulatively, from the moment of initiation of a major new economic policy thrust, until the inflation is effectively stopped.

But it is important to realize that this very happy and favorable result depends critically on the reactivation of the process of economic growth, as well as on expenditure restraint and additional tax effort. The "miracle" involved would not be without precedent, but it would not be an easy trick by any means. To my mind the key question is whether the liberalization efforts under way in Uruguay will be powerful enough, and whether they will unleash enough pent-up or repressed forces of growth, so that the private economy will be the major engine of economic progress, permitting the government to take a "conservative" fiscal stance (restraining expenditures while pressing forward on the tax front) without impeding the economy's real growth.

AID 1025-1 (7-71) (FACE SHEET)

NONCAPITAL PROJECT PAPER (PROP) PAGE 1 of 1 PAGES

I. PROJECT IDENTIFICATION

1. PROJECT TITLE

FISCAL POLICY AND MANAGEMENT

APPENDIX ATTACHED ☐ YES ☐ NO

2. PROJECT NO. (M.O. 1025.1)
528-11-750-098

3. RECIPIENT (specify)
☒ COUNTRY URUGUAY
☐ REGIONAL ______ ☐ INTERREGIONAL ______

4. LIFE OF PROJECT
BEGINS FY 1976
ENDS FY 1977

5. SUBMISSION
☐ ORIGINAL ______
☒ REV. NO. 1-5/20/76 DATE
CONTR./PASA NO.

II. FUNDING ($000) AND MAN MONTHS (MM) REQUIREMENTS

A. FUNDING BY FISCAL YEAR	B. TOTAL $	C. PERSONNEL (1) $	C. PERSONNEL (2) MM	D. PARTICIPANTS (1) $	D. PARTICIPANTS (2) MM	E. COMMOD-ITIES $	F. OTHER COSTS $	G. PASA/CONTR. (1) $	G. PASA/CONTR. (2) MM	H. LOCAL EXCHANGE CURRENCY RATE: $ US ___ (U.S. OWNED) (1) U.S. GRANT LOAN	(2) COOP COUNTRY (A) JOINT	(2) COOP COUNTRY (B) BUDGET
1. PRIOR THRU ACTUAL FY												
2. OPRN FY 1976	119	89	16	27	15		3	89	16			51
3. BUDGET FY TQ	24	24	5					24	5			11
4. BUDGET +1 FY 1977	109	109	21					109	21			52
5. BUDGET +2 FY												
6. BUDGET +3 FY												
7. ALL SUBQ. FY												
8. GRAND TOTAL	252	222	42	27	15		3	222	42			114

9. OTHER DONOR CONTRIBUTIONS

(A) NAME OF DONOR	(B) KIND OF GOODS/SERVICES	(C) AMOUNT

III. ORIGINATING OFFICE CLEARANCE

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1. DRAFTER J.Alvarez/C. Austin *C. Austin*	Acting Program Off./Tax Advisor	5/20/76
2. CLEARANCE OFFICER Leonard J. Horwitz *L J Horwitz*	AID Representative	5/20/76

IV. PROJECT AUTHORIZATION

1. CONDITIONS OF APPROVAL

2. CLEARANCES

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3. APPROVAL AAs OR OFFICE DIRECTORS
SIGNATURE | DATE
TITLE

4. APPROVAL A/AID (See M.O. 1025.1 VI C)
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SUBJECT - PROP Revision - Fiscal Policy and Management
Proj. 528-11-750-098

REFERENCE - MONTEVIDEO 1787

Attached is revised PROP facesheet referred to in paragraph 6 reftel.

SIRACUSA

Attachment run with airgram

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DRAFTED BY	OFFICE	PHONE NO.	DATE	APPROVED BY:
J.Alvarez:em Actg.Prog.Off.	PROGRAM		5/21/76	Leonard J. Horwitz, AID Rep.

AID AND OTHER CLEARANCES

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