

# Decentralizing Revenue in Latin America

## Why **and** How

**EXECUTIVE SUMMARY**

**Vicente Fretes Cibils  
Teresa Ter-Minassian**

**EDITORS**





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Inter-American Development Bank

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# Contents

Foreword . . . . .	v
Acknowledgements . . . . .	ix
Contributors . . . . .	xi
Chapter 1 Lackluster Performance: Local Taxes in Latin America . . . .	1
Chapter 2 Two to Tango: Argentina’s Vertical Imbalance and Revenue Mobilization . . . . .	3
Chapter 3 Step on the Gas: Bolivia’s Reliance on Natural Resource Revenue . . . . .	5
Chapter 4 Elusive Goal: Brazil’s Subnational Revenue System Reform	7
Chapter 5 Fiscal Cumbia: Colombia’s Revenue Dynamism . . . . .	9
Chapter 6 Fiscal Surf and Turf: Peru’s Efficiency and Equity in Revenue Mobilization . . . . .	11
Chapter 7 A Mariachi Medley: Mexico’s Long Road to Fiscal Federalism Reform . . . . .	13
Chapter 8: Black Gold Effect: Venezuela’s Natural Resource Dependency . . . . .	15
References . . . . .	17



## Foreword

LATIN AMERICAN COUNTRIES HAVE MADE GREAT STRIDES IN INCREASING TOTAL REVENUE. THE BIGGEST CHALLENGE THEY FACE, HOWEVER, IS REFORMING TAX INSTITUTIONS AND RULES. The importance of taxation as a development tool cannot be emphasized enough, since tax reform has significant implications for sustainable and inclusive growth in the region.

There are two reasons Latin America lags behind in its level of development in terms of taxation. First, most countries are still far from exhausting their revenue potential. Second, taxes are not yet designed to promote development. In particular, subnational governments in the region must generate more own-source revenue because this will enhance budgetary resources for local development and increase the transparency of costs to provide local goods and services, thereby promoting efficiency. Furthermore, it will allow local authorities greater autonomy in choosing and implementing policies that are better tailored to the needs and preferences of the population demanding and receiving them.

The tax situation varies among countries, and the region suffers a clear imbalance in fiscal decentralization, with revenue substantially lagging behind spending. As a result, many subnational governments are highly dependent on transfers from central governments. In addition, this imbalance between own-source revenue and transfers makes subnational government finances more vulnerable and less predictable, hindering the ability of local authorities to prepare more stable and realistic budgets.

Using case studies that span a range of countries of different sizes, levels of development, extent of decentralization, and systems of government, this book demonstrates that there are various factors holding back revenue decentralization in the region. Taking into account the likely economic, institutional, and political constraints on the reform process, the analyses show the following:

- *Revenue assignments at the subnational level need to be revisited to provide more meaningful ways to increase own-source revenue.* Potential tax handles include subnational surcharges on the national personal income tax, retail sales tax, regional excises or surcharges on national excises, and a subtraction-type value-added tax (VAT).
- *Reform efforts have to focus on strengthening capacities for subnational governments that already have appropriate revenue handles (property taxes).* Such reform involves not only investments in building and maintaining effective property cadasters, but also avoiding erosion of the property tax base through exemptions, moving statutory rates toward the upper limit of permissible ranges set by the central government, and strengthening enforcement.
- *Given the political cost to subnational governments of increasing the burden of taxation on their populations, incentives have to be created for them to better exploit their revenue potential.* These incentives depend crucially on the extent of the subnational budget constraint, such as the degree to which intergovernmental transfers are discretionary or formula based, whether borrowing constraints are loose or mostly discretionary, and on the level of transparency of subnational budgetary operations.
- *Reforms to strengthen mobilization of subnational own-source revenue need to be accompanied by introducing or improving transfer systems aimed at equalizing, to the extent feasible, revenue capacities and spending needs.* In order to have a sound intergovernmental relations system, it is important to consider the distribution of revenue capacities within a country, which are typically quite uneven and frequently do not match the distribution of spending needs.
- *Central governments need to support subnational governments in mobilizing own-source revenue through policy and administrative reforms.* Unfortunately, central governments are often a major obstacle to developing own-source revenue because of fear they will lose fiscal control, political bargaining power, and bureaucratic influence.

Subnational revenue mobilization and reform in Latin America are essential, despite the obstacles for proceeding with revenue decentralization. There is no unique approach, and the path to reform will likely be context-specific and highly dependent on the balance struck between differing political and economic factors and interests. Should countries in the region take on this challenge, however, not only will revenue be generated in the future but the changes should contribute to sustained and inclusive growth.



We hope that the analyses and country experiences presented in this book will fuel meaningful debate about the decentralization of revenue and contribute to sensitizing national policymakers and authorities in Latin America to the benefits of sound revenue decentralization.

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# Acknowledgements

THE INSTITUTIONS FOR DEVELOPMENT SECTOR (IFD) OF THE INTER-AMERICAN DEVELOPMENT BANK (IDB) WAS RESPONSIBLE FOR THE PREPARATION OF THIS BOOK.

Vicente Fretes Cibils and Teresa Ter-Minassian coordinated the project and edited the book.

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Chapter 3: Giorgio Brosio

Chapter 4: Teresa Ter-Minassian

Chapter 5: Fabio Sánchez Torres, Irina España Eljaiek, and Jannet Zenteno Gonzalez

Chapter 6: Gustavo Javier Canavire Bacarreza, Cristian F. Sepulveda, and Jorge Martinez-Vazquez; Janet Porras provided research assistance

Chapter 7: Emilio Pineda, Arturo Ramírez Verdugo, and Alejandro Rasteletti authored the chapter with advice from Teresa Ter-Minassian; Hans Georg Schwarz Aguilar provided research assistance

Chapter 8: Germán Ríos, Federico Ortega, and Sebastian Scrofina; Amanda Beaujon, Anderson Gómez, Alejandro Sabarich, and Ricardo Suarez provided research assistance

Several researchers and officials from various public and private entities provided valuable statistical information and documentary sources for the preparation of this book, including the Entrepreneurial Councils of Mendoza (CEM) and Entre Ríos (CEER); Argentine Car Dealers Association (ACARA); Fundación Libertad (Santa Fe); the Exchange Board of Córdoba; the Professional

Council of Economic Sciences of Salta; Price Waterhouse and Coopers Argentina (PWC); Estudio Bottino y Asociados; the Tucumán Foundation; fiscal experts of the Unión Industrial Argentina; Government Administration of Public Revenue of Buenos Aires City (AGIP); Revenue Collection Agency of the Province of Buenos Aires (ARBA); the Ministry of Economics of the provinces of Buenos Aires, Mendoza, and Santa Fe; the Municipal Fiscal Authorities of Rosario City; Eduardo Lora; Ernesto Stein; Rafael de la Cruz; Rolando Ossowski; and participants in several IDB seminars in 2012–13.

Ana Calvo, Natalia Rezaí, and Sarah Schineller oversaw the editing and production of this book, working closely with the principal editors and authors. David Rogers also contributed to the editorial process.

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# Lackluster Performance: Local Taxes in Latin America

1

THIS BOOK ANALYZES THE REASONS FOR THE LACKLUSTER PERFORMANCE OF SELECTED LATIN AMERICAN COUNTRIES IN MOBILIZING SUBNATIONAL OWN-SOURCE revenues and explores policy options to increase these revenues as efficiently and equitably as possible. Seven case studies—Argentina, Bolivia, Brazil, Colombia, Mexico, Peru, and Venezuela—span a wide range of characteristics, including federal and unitary countries, different geographical sizes, levels of economic development, and degrees of revenue decentralization. In this book, subnational governments include both intermediate and local levels of government, which are distinguished in the case studies. Together, the case studies provide a reasonably representative picture of the challenges faced throughout Latin America in mobilizing subnational own-source revenues in a manner that supports equitable growth.

This chapter begins with a theoretical discussion of the objectives and obstacles that subnational governments face in mobilizing own-source revenues. It reviews the main pros and cons of subnational tax handles, and presents an overview of trends in subnational finances in the Latin American region. It concludes with a summary of the main findings of the case studies, as well as a discussion of lessons for future subnational revenue reforms in the region.



# Two to Tango: Argentina's Vertical Imbalance and Revenue Mobilization

# 2

ARGENTINA IS A FEDERAL COUNTRY CHARACTERIZED BY A SUBSTANTIALLY HIGHER DEGREE OF DECENTRALIZATION OF EXPENDITURES THAN OF REVENUES.<sup>1</sup> IN 2011, THE own-source revenue of provinces (intermediate level of government) and municipalities (local governments) was equivalent to 7.5 percent of GDP but covered only half of subnational primary government spending. The resulting vertical imbalance is filled by an automatic revenue-sharing system and by discretionary transfers.<sup>2</sup>

Intergovernmental fiscal arrangements have undergone significant changes over the past decade or so. Particularly important has been a recentralization of revenue as a result of changes in the composition of taxes that favored the federal government and because in every year since 2003 the federal executive has passed a budget underestimating revenue. Using emergency powers granted by Congress to the Executive in 2002, the president was able to allocate the excess revenue at will. Thus, discretionary transfers rose from the equivalent of 0.5 percent of GDP at the end of the 1990s to an average of 2.1 percent of GDP in more recent years.

There have also been important changes in the provinces' own-source revenues. As a result of high international prices of oil, gas, and minerals, provinces rich in such resources have enjoyed a substantial windfall in royalties, which roughly doubled from 0.3 percent of GDP in 1997–99 to 0.5 percent in 2011. Also, most provinces have experienced changes in the composition of their

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<sup>1</sup> This chapter is an abridged and edited version of Artana et al. (2012).

<sup>2</sup> Local governments receive a fraction of their province's own-source and shared-tax revenue. See López Murphy and Moskovits (1998) and Sanguinetti, Sanguinetti, and Tommasi (2001) for an analysis of provincial revenue-sharing schemes.

own-source revenue, with the share of the property tax declining and that of the turnover tax increasing. This change reflects not only the difficulty of keeping up with the rise in property prices, but also the visibility and unpopularity of property taxes.

This chapter aims to provide an up-to-date overview of Argentina's subnational revenue system; of the economic and political determinants of its main features, in particular subnational revenue effort; and of options for its reform. First we review recent developments in subnational revenue and in the vertical imbalance. Then we analyze the income elasticity of subnational revenue as well as the effects of the 2001–02 macroeconomic crisis and of increased federal transfers on the size and composition of provincial taxes. We find that only the discretionary component of transfers discourages the provinces' own-source revenue effort. Next we discuss political economy constraints on subnational revenue reforms in Argentina. Against this background, we explore options to mobilize additional subnational revenue and to reform the distortive provincial turnover tax.

# Step on the Gas: Bolivia's Reliance on Natural Resource Revenue

# 3

THIS CHAPTER FOCUSES ON OPTIONS TO REFORM THE REVENUE SYSTEM OF SUBNATIONAL GOVERNMENTS IN BOLIVIA; IN PARTICULAR, OPTIONS TO REDUCE DEPENDENCE ON natural resources and strengthen own-source revenue.<sup>1</sup> Such reforms would apply especially to prefectures, which depend entirely on natural resource rents and have no tax autonomy.

The 2009 Bolivian constitution confirmed current tax assignments for municipalities (local government), while strengthening their tax regulatory powers. The changes for prefectures (intermediate level government) were minimal, although the central government is empowered to partially or fully devolve tax bases to subnational governments. It is within the context of possible devolution that the options for prefectures presented in this chapter should be viewed. For municipalities, the chapter stresses the importance of expanding collection of existing taxes, which will require not only better tax administration, but also greater efficiency in providing basic services and infrastructure.

Based on a set of widely used criteria, this chapter singles out a number of tax instruments or tax bases that could be assigned exclusively to regional governments or shared with the central government. It assesses the main advantages and disadvantages of these instruments and their impact by simulating the revenue they could generate, and shows that there would be a number of feasible options to increase the tax autonomy of subnational governments in Bolivia.

The chapter describes the current system of intergovernmental relations in Bolivia, particularly emphasizing financing. It later assesses the scope to expand tax collection at the municipal level, with special emphasis on property taxes, and discusses options for new tax instruments for the prefectures.

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<sup>1</sup> This chapter is an abridged and edited version of Brosio (2012).



# Elusive Goal: Brazil's Subnational Revenue System Reform

# 4

COMPARED WITH THE REST OF LATIN AMERICA, AND MANY FEDERAL COUNTRIES AROUND THE WORLD, BRAZIL IS CHARACTERIZED BY A HIGH DEGREE OF REVENUE decentralization at the state level (intermediate level of government), where own-source revenue accounts for over 9 percent of GDP.<sup>1</sup> In contrast, municipalities (local level of government) rely more heavily on transfers from the higher levels of government, with own-source revenue amounting to only about 2 percent of GDP or 6 percent of the total tax burden.

Substantial reliance by subnational governments on own-source revenue has significant advantages in terms of increased accountability to the electorate, closer linkage of subnational taxes to benefits from spending, greater conformity with local preferences as to the size and composition of the tax burden, and greater predictability of resources for the subnational budgets.

The Brazilian subnational tax system, however, is fraught with significant flaws that are widely recognized as adversely affecting efficiency, equity, and competitiveness. The main problem is the heavy reliance of state finances on a mixed-origin/destination-based value-added tax (VAT) (the Imposto sobre a Circulação de Mercadorias e Prestação de Serviços, or ICMS), which has a wide range of effective rates for goods and services across the country. This has led to predatory tax competition (the so-called fiscal war), de facto cascading, and high compliance costs for taxpayers. At the local level, many municipalities do not appear to adequately exploit the important tax bases (services and urban properties) assigned to them.

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<sup>1</sup> This chapter is a revised and updated version of Ter-Minassian (2012).

To date, reform efforts have been stymied by the significant losses for some of the states that would result from a shift to a more neutral, destination-based VAT with a uniform base across the nation. State authorities are recognizing the urgency of such a reform, however, as they see their revenue eroded by the fiscal war. Further, the competitiveness of Brazilian enterprises is being hampered by the cumulative and high compliance costs of the ICMS in an environment with a high real exchange rate and the weak performance of manufacturing exports.

This chapter begins with brief overviews of subnational own-source revenue and the intergovernmental transfer system (including sharing oil revenue), highlighting their critical flaws. Next, reform priorities and options are discussed, and we take stock of the current situation regarding reforms. The chapter ends with some conclusions.



# Fiscal Cumbia: Colombia's Revenue Dynamism

# 5

THE PACE OF FISCAL DECENTRALIZATION AT THE INTERMEDIATE AND LOCAL LEVELS OF GOVERNMENT IN COLOMBIA DURING THE PAST 15 YEARS HAS BEEN DISPARATE.<sup>1</sup>

While the intermediate governments (departments) have generated little in additional own-source revenue (in terms of GDP), local governments (municipalities) have almost doubled theirs. The main explanation for such divergent trajectories lies in the difference between the two tax bases. While the departmental tax base—primarily the consumption of “non-merit” goods—is inelastic, municipalities enjoy a dynamic and growing tax base, encompassing urban and rural properties and urban economic activities.

To mobilize the own-source revenues of the departments, it is important to assign different tax bases. In this chapter, we suggest that the departments introduce a surcharge on the national value-added tax (VAT) or a retail tax. In contrast, increasing municipal own-source revenue requires more efficient exploitation of their existing tax bases. We suggest that municipalities can improve the efficiency of local tax collection by enhancing their administrative capacity and updating the local tax bases. The aim of this chapter is twofold: (i) to explore the changes required to strengthen the generation of own-source revenues in departments and municipalities, and (ii) to determine the effects of such actions on the financing structures and vertical imbalances of both levels of government.

The chapter is divided into four sections. The first section briefly reviews the fiscal decentralization process in Colombia, and its impact on subnational finances. The second discusses the evolution and determinants of departmental revenue and vertical imbalances, and the proposal that departments be allowed

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<sup>1</sup> This chapter is a condensed version of Sánchez Torres, España Eljaiek, and Zenteno (2012).

to levy a VAT surcharge or a retail sales tax. The next section focuses on the evolution of municipal revenue and vertical imbalances, and presents empirical evidence about the scope for increasing such revenue through efficiency gains. The final section summarizes the study's main conclusions.

# Fiscal Surf and Turf: Peru's Efficiency and Equity in Revenue Mobilization

# 6

THE CURRENT FISCAL DECENTRALIZATION PROCESS IN PERU BEGAN IN 2002 WITH AN AMENDMENT TO THE CONSTITUTION AND LEGISLATIVE DECREE NO. 955, THE CURRENT *Fiscal Decentralization Law*.<sup>1</sup> Since then, decentralization reform has been at the center of national and subnational political agendas. After more than 10 years, the process is in some respects relatively advanced: the legal framework covers most aspects of the system of intergovernmental fiscal relations, and, in 2011, each group of subnational governments (intermediate and local) was responsible for more than 18 percent of total public expenditures.

There are still important aspects of the process, however, that remain problematic and will require additional reforms. In this chapter, we focus on the 25 regions and the province of Lima. The regions/departments include 196 provinces and the provinces have 1,850 district/municipalities. Few subnational governments are collecting sizeable amounts of own-source revenue, likely due to the nature of current revenue assignments, the regional distribution of tax bases, lack of administrative and technical capacity, and the economic and political costs of collections. Most subnational governments depend predominantly on intergovernmental transfers. Moreover, the transfer system does not correct the large differences in fiscal capacity among subnational governments, and, in fact, tends to aggravate them.

In this chapter, we attempt to identify the main factors that contribute to the poor own-source revenue performance of subnational governments in Peru, and explore policy reforms to improve revenue mobilization. The institutional

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<sup>1</sup> This chapter is an abridged and edited version of Canavire-Bacarreza, Martínez-Vázquez, and Sepúlveda (2012).

conditions of the government units at the local (municipal) and intermediate (regional) levels are diverse, and thus we use different analytical approaches and propose strategies to improve revenue performance at these two levels of government. At the municipal level, with few exceptions, current tax assignments roughly follow best international practices; thus the analysis focuses on possible reforms to improve efficiency in tax collections. On the other hand, there are still no tax instruments assigned to regional governments. Therefore, we explore options to provide the regions with sources of revenue and create fiscal autonomy and accountability.

# A Mariachi Medley: Mexico's Long Road to Fiscal Federalism Reform

# 7

IN THE 1990S, MEXICO UNDERWENT A RAPID PROCESS OF EXPENDITURE DECENTRALIZATION WHEREBY STATES BECAME RESPONSIBLE FOR EDUCATION AND HEALTH expenditures. The new responsibilities were largely financed through special-purpose transfers, which resulted in strong dependence of the states (intermediate level of government) and municipalities (local government) on transfers from the federal government. The level of fiscal vertical imbalances—defined as transfers as a percentage of total revenue—increased from around 75 percent in 1992 to 90 percent in 2000. Reducing such high levels of fiscal vertical imbalance has been the main aim of a series of reforms over the 2000s, but with meager results to date. In this chapter, we endeavor to contribute to an understanding of the factors behind the persistently high levels of fiscal vertical imbalances. In order to do so, we provide a brief description of the key features of the decentralization process, along with the evolution of subnational revenue between 2000 and 2007. In the first section we summarize the 2007 reform and its impact on each of the main subnational tax handles. We then explore the political economy of subnational revenue mobilization efforts and outline the main hypotheses that may explain the low subnational fiscal effort. Using a panel for the 31 states and the Federal District between 2000 and 2012, we then seek empirical support for our hypotheses. Finally, we provide some thoughts on the 2013 reforms and their likely impact on subnational revenue.



# Black Gold: Venezuela's Natural Resource Dependency



THE INCREASE IN OIL PRICES TO HISTORICAL LEVELS IN THE MID-2000S AND THEIR SUBSEQUENT VOLATILITY IN RECENT YEARS DEMONSTRATES THE DELETERIOUS effects of such volatility on the macroeconomic policies and performance of several major oil-producing countries. Clearly there is a need for policy and institutional reforms to mitigate such effects.<sup>1</sup> Venezuela provides a good illustration of this need because volatility has been a constant feature of its macroeconomic variables, mainly due to its reliance on oil.

Macroeconomic volatility is reflected in national revenue and, given current intergovernmental arrangements, in the revenue of the subnational governments as well. Since about 70 percent of subnational revenue comes from revenue sharing and other transfers from the central government, subnational authorities face problems similar to those of their national counterparts. They are, however, in a worse position to absorb such volatility because they have less access to financing sources, yet they are responsible for delivering essential social services, especially education and health. Thus, reducing the dependence of subnational budgets on the volatile transfers from the center by mobilizing less cyclically sensitive own-source revenues could have significant benefits for fiscal management and the delivery of social services. It would also result in increased accountability of subnational officials to their electorates. Finally, higher own-source revenues at the subnational level would help raise the overall non-oil tax ratio, which in Venezuela is very low compared to countries at a similar level of development.

In Venezuela, decentralization can be viewed as a political response to the loss of legitimacy of the national political system. The weakening of an economic

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<sup>1</sup> This chapter is an edited and abridged version of Rios, Ortega, and Scrofina (2012).

system based almost exclusively on the distribution of oil revenue, and the lack of representativeness of traditional national political parties, paved the way in the late 1980s for local governments to have an increased role. The activation of the federal system, with the direct election of governors and the creation of mayors in 1989, although unintended, was instrumental in reshaping political institutions, particularly political parties. Even after the 1999 constitution was approved—which increased the central government’s powers—the main political features of the decentralization process remained basically unchanged.

This chapter discusses the causes and consequences of the substantial fiscal dependence of states and municipalities in Venezuela, and the political economy process embedded in the interaction between the central and subnational governments. It also explores options to increase states’ and municipalities’ own-source revenues, improve the current intergovernmental transfer system, and reduce horizontal imbalances.



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