Inter-American Development Bank

FISCAL FEDERALISM IN LATIN AMERICA

From Entitlements to Markets

Eduardo Wiesner

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Eduardo Wiesner

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Foreword

This volume emerged from an evaluation commissioned by the IDB Office of Evaluation and Oversight (OVE) to examine the institutional factors that determine the effectiveness of the Bank's decentralization strategy and operations, as well as the specific results achieved by the countries at the sector or project levels. The author, a Colombian economist, was asked to examine the intergovernmental decentralization frameworks and some decentralization-intensive loans in Brazil, Bolivia, Chile and Ecuador. It was felt that these four countries, with their different policy contexts and particular political histories, could provide valuable insights on the factors that shape decentralization results and outcomes. The evaluations were completed in mid-2002.

As the author points out, the Bank's efforts to support decentralization policies and projects have proven to be quite a challenge. After all, while decentralization and fiscal federalism are powerful reform instruments, they also affect a country's key political and institutional pillars. Furthermore, to be successful, decentralization demands compliance with difficult-to-meet conditions at the macroeconomic and fiscal levels, as well as at the micro-institutional and local levels. In short, decentralization demands a whole new set of institutional rules and incentives, which take time and strong political will to develop.

The IDB has been more successful in helping those countries that place great priority on macroeconomic stability, and which have developed strong intergovernmental governance and policy structures. Such is the case of the Fiscal Responsibility Law in Brazil and the National Investment System in Chile. Nevertheless, Ecuador and Bolivia are making laudable efforts to build a more propitious environment for their decentralization policies.

The challenge for multilateral lenders and for the countries themselves is to develop the right set of incentives in loans, intergovernmental transfers, rules and evaluations. Moreover, the intended and unintended consequences of the existing incentive structures as well as of those imbedded in reform pro-

posals must be discerned. To this end, it appears that mainstream decentralization frameworks could benefit by incorporating valuable insights from public choice theory, neo-institutional economics and from "new theory of the firm" findings.

We trust that this publication will help countries of Latin America and the Caribbean make more effective use of decentralization as a powerful instrument to reform the state and the public sector.

Stephen Quick, Director
IDB Office of Evaluation and Oversight

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Introduction

Intertwined processes of fiscal and political decentralization have deeply transformed several Latin American countries over the past two decades. But the transformation has hardly been smooth. At times, macroeconomic stability has suffered as a result of an unbridled expansion of unconditional transfers. On other occasions, principal-agent problems mired in informational asymmetries have resulted in more cumbersome public sector management. Oftentimes, decentralization has engendered special modalities of commons problems and public rent dissipation.

Notwithstanding these vicissitudes, what is really worrisome is that in several countries the results of decentralization have not matched expectations. This has fostered a growing perception that perhaps the initial enthusiasm for decentralization may not have been accompanied by a thorough understanding of what it requires.

And yet there is little disagreement in the region as a whole that fiscal and sectoral decentralization offers great potential as a strategy to improve public sector performance, enhance social development, and strengthen democratic governance. This is particularly true of certain large federal countries in the region. The challenge, then, is to glean from the varied overall picture of decentralization the specific mix of policies that hinder or enhance decentralization processes.

More specifically, Latin American countries interested in using decentralization to reform and modernize their public sectors must:

(i) Have a more rigorous conceptual and analytical framework to guide the detailed design and implementation of specific decentralization frameworks and policies;
(ii) Establish the key conditions at the macroeconomic and fiscal level, as well as at the subnational and sectoral levels, that need to be met for decentralization policies to have a reasonable chance of success;

(iii) Identify the sources of political economy restrictions that conspire against an effective decentralization process;
(iv) Develop the propitious institutional and intergovernmental transfer system within which more specific decentralization objectives can be pursued;
(v) Have a formal institutional arrangement regulating the intergovernmental markets, whether it be a formal or structured legal arrangement like Brazil's Fiscal Responsibility Law (2000), or general and hierarchical rules governing the allocation of public resources, like Chile's National Investment System.

This list of challenges is not random. It involves what amounts to the correct sequence of priorities in terms of what policymakers must optimize when reforming an existing intergovernmental and decentralization framework (or when starting a new one, which is seldom the case).

While it is always difficult to single out one specific condition needed for a successful decentralization framework, tight fiscal budget constraint and explicit rules at the macroeconomic level clearly are critical.[1] Without those conditions in place, it is difficult for the "right" incentives to induce the "right" decentralization process.[2]

Even so, meeting those particular conditions offers no guarantee that decentralization will work. Tight budget constraint alone is a necessary but insufficient condition. It provides the propitious overall environment, but it will be at the micro-institutional and sectoral areas where incentives specifically operate.

Generally speaking, all decentralization schemes should be, in principle, fiscally neutral in their micro-institutional arrangements and financial implications. That is, they should not change the steadiness of fiscal balance. After all, the objective is to identify and exploit potential efficiency and welfare gains by applying the subsidiarity principle to any market that can function better at the closest interjection between supply and demand.[3] As Bird (2000, p. 37) has aptly put it, "money should follow functions, not precede them."

To help Latin American policymakers meet these challenges, this book offers four building blocks towards decentralization.

[1] For Latin America, see Stein, Talvi and Grisanti (1999).

[2] Bird and Vaillancourt (2000) underline the importance of "process."

[3] In Europe, proponents of fiscal decentralization refer to the "principle of subsidiarity." The precept is that public policy and its implementation should be assigned to the lowest level of government with the capacity to achieve the objectives. This principle has been formally adopted as part of the Maastricht Treaty. See Oates (1999, p. 1122).

First, a conceptual framework is needed that incorporates new theoretical developments as well as largely accepted lessons on how government interventions can make use of market proxies to enhance their effectiveness. Hence, the proposed framework departs from the traditional "received view" in Latin America that generally considers that decentralization occurs when unconditional transfers from the national to the subnational level increase, and when expenditure shares at the subnational level increase relative to the total or to GDP.[4] However a system of entitlements based on "social rights" and distributed through transfers to different government levels, organizations or groups of individuals, may not be an efficient way to achieve social or economic objectives.[5]

Instead, the focus of the proposed framework falls on the following two analytical pillars: first, the importance of a macroeconomic and fiscal budget constraint as well as of incentives across the whole spectrum of intergovernmental arrangements; and second, that what matters more than subnational expenditure is subnational tax and fiscal growth relative to the national level. The premise is that it is largely through the growth of state and municipal tax revenue and the expansion of subnational tax authority that most of the benefits of decentralization really accrue, particularly the ever-elusive local institutional development.[6] Unless, that is, subnational expenditures financed through transfers are somehow tied to incentives that reward results. At this stage, one has arrived at the precise and dynamic balance that decentralization requires, i.e., macroeconomic budget constraint combined with the right incentive structures at all levels of government.

Second, the seminal works of Weingast (1993a, 1993b, 1995), McKinnon (1997) and McKinnon and Nechyba (1997) on the importance of federalism to preserve markets in developed countries must be turned around to underline the importance of market-based decentralization approaches that induce better results and outcomes from decentralization in developing countries. In essence, this book posits that a market-based approach to decentralization is probably the

[4] "Received view" is a term popularized by Frederick Suppe in 1977 and refers to what is supposed to be an accepted though not necessarily correct dominant conceptual framework. See Hands (2001, p. 71).

[5] The concept of "entitlement" was developed by Amartya Sen (1981) in relation to the consumption of bundles that a person can legally obtain within a social and economic framework. According to Steiner (1991, p. 220), "much of the philosophical treatment of entitlements is located in discussions of rival theories of justice. These theories differ according to the various norms they propose for determining who owes what to whom."

[6] Contrary to many experts who believe that supply side technical cooperation is the way to build local institutional capacity development, Wiesner (2002, p. 7) deposits that demand-driven local fiscal development will yield more sustainable local institutional development. It will do so through the externalities generated by local taxpayers demanding "better" institutions to manage their fiscal contributions.

most effective way to capitalize on the potential benefits of decentralization, fully sharing the view by Oates (1999, p. 1120) that the "basic issue is one of aligning responsibility and fiscal instruments with the proper levels of government."

Third, several premises must be incorporated into decentralization frameworks and policies, including recent contributions from new institutional economics and its insistence that institutions and incentives matter;[7] public choice theory and its premise that it is naïve to assume that public officials provide public goods and preserve markets;[8] and the "new theory of the firm," which holds that political jurisdictions can be thought of as pseudo-firms that provide services and group together various types of decision-making activities.[9] While incorporating such broad themes is perhaps overly ambitious, the underlying message is that these analytical and operational innovations have much to contribute to decentralization and fiscal federalism theory and practice. This is a message that may prove to be valuable to policymakers in Latin America and to the multilateral institutions supporting development in the region.

The final building block provided in this book is the findings of evaluations of decentralization in Brazil, Bolivia, Chile and Ecuador. The findings ensure a balance of empirical research with theoretical context and have important implications for policymakers interested in enhancing the effectiveness of their decentralization schemes.

In sum, the aim of this book is to provide policymakers in Latin America and elsewhere with the stylized facts of what seems to work and what does not in decentralization policies and schemes. These facts emerge out of the current "received view" of fiscal federalism; out of recent experiences of several Latin American countries, particularly Brazil, Bolivia, Chile, Ecuador and, to some extent, Mexico;[10] and from the incorporation of recent theoretical developments and empirical findings that have enriched fiscal federalism practice and literature.

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[7] It is now widely accepted that institutions and collective rules matter in fundamental ways in explaining long-term economic and social development in countries with different initial factor endowments. See North (1981, 1990, 1993) Buchanan (1991) and Coase (1960). Kenneth Arrow, winner of the Nobel Prize in Economics, has called the study of incentives "the most important development in economics in the last forty years." See Laffont and Martimort (2002).

[8] Public choice or rational politics differs from other approaches to the study of political behavior in that it builds on models in which rational individuals seek to advance their own interests. For an examination of the meaning and ramifications of public choice theory and practice, see Mueller (1997) and Qian and Weingast (1997).

[9] According to Cremer, Estache and Seabright (1994), "the appropriate degree of decentralization depends upon which level of government will have the most incentive to act to bring about the desired outcomes."

[10] An excellent review of Mexico's advances in this area is found in Giugale et al. (2000).

Chapter One

Overview: Conceptual Framework, Findings and Policy Implications

Given the importance of policy frameworks in decentralization schemes, any discussion should begin with an explicit definition of decentralization, as well as its objectives, restrictions and requirements. There are so many varied views and constructs about what decentralization is or should be that many discussions lead nowhere because the conceptual frameworks were not made explicit right from the beginning. More importantly, many flawed policies are adopted as a result of ill-conceived conceptual and analytical frameworks. Often the only way to effectively remedy specific situations is to trace unwanted results back to their original flawed conceptual framework.

Conceptual Framework

The recommendations presented here for a proper conceptual framework may help Latin American policymakers more effectively support decentralization policies and decentralization-intensive projects in the region. The recommended framework emphasizes the use of incentives, competition and structured institutional arrangements. In brief, it is a framework that is largely market-based and that incorporates valuable insights from public choice theory, neo-institutional economics, and "new theory of the firm" findings.

Definition and Objectives

Decentralization is a process whereby a country successfully adopts macroeconomic and sectoral policies to encourage the provision and consumption of public goods and services at the particular level of government—institutional

arrangement or policy area—where it will be most efficient to do so. The underlying objective of decentralization is to improve the overall performance of public sectors. This can be achieved through the appropriate assignment of jurisdiction over public goods, services, tax authority, and user charges. Note that decentralization refers to a process and not to a one-time parceling out of resources.

This ample definition of decentralization extends beyond intergovernmental relations. Under it, the concept of "local good" can mean, for instance, the provision of price stability through a decentralized central bank or the protection of property rights through an independent and decentralized judicial system.[1] The use of regulatory frameworks for public sectors to oversee privatized firms is a modality of decentralization.

Requirements and Incentives

A successful decentralization process requires three components. First, the overall policy framework must be consistent; that is, one in which all policies point in the same direction and complement each other in their results and outcomes. Second, the right incentives must reward the right public choices. Incentives are the crucible of decentralization, because public markets lack autonomous processes of competition and evaluation. Third, institutional rules must provide a propitious regulatory framework within which decentralized choices lead to Pareto improvements.[2] Such rules make some people better off—and no one worse off.

Potential Benefits of Decentralization

The decentralized provision of goods and services allows for the tailoring of outputs to particular preferences and induces an efficiency-generating convergence of supply and demand. Although there are a number of qualifications that could be made to this postulate, in most cases the efficient level of

[1] In a seminal research paper, Weingast (1993, p. 306) found that an independent judiciary establishing local political authority was the key to protecting seventeenth century England's federalist structure. See also Inman and Rubinfeld (1997a, p. 104).

[2] For a review of Pareto optimality conditions and assumptions, see Tideman (1997). A key assumption of optimality is that it is possible to specify the ex ante status quo, so that the effects of the proposed change can be identified. A second even more controversial assumption is that the previous status quo is just, fair or acceptable from a distributive perspective. One way out of this is to separate distributive goals from allocative efficiency ones.

output of a local public good can best be determined locally. The second critical benefit of decentralization is the generation of information and knowledge by those actors more closely interested in benefiting from the potential gains of decentralized markets.[3] Hence decentralization is a process that reduces the degree to which markets are incomplete.

Critical Policy Links

Given that decentralization assumes efficiency and welfare gains from the growing proximity of the supply of and demand for local public goods, the critical policy links to enhance those gains can be found in the fiscal and institutional governance structures connecting decentralized tax revenues and decentralized public expenditures. In principle, the larger the proportion of local public goods financed through local "own-taxes," the higher the efficiency gains obtained from such local public expenditure. This may explain why state and local taxes are relatively more important in many advanced countries than in developing countries. With reference to the United States, Donahue (1997, p. 74) found that the sum of all federal spending other than defense, interest, and transfers dropped from 4.2 percent of GDP in 1980 to just 1.7 percent in 1996. Over the same period, state and local spending funded by state and local tax revenues grew from 8.5 percent to 10.3 percent of GDP.

Measurement of Fiscal Decentralization

If fiscal links are the critical policy determinants of decentralization outcomes at the local level, decentralization can be defined and measured by the sustainable process through which the share of non-national tax revenue grows relative to both gross domestic product (GDP) and total tax revenue.[4] The critical policy instrument to induce effective decentralization is incentives that reward increased local tax authority and collection. This tax revenue criterion is preferable to a transfer-and-expenditure approach, because it induces stronger local institutional development, whereas a transfer-and-expenditure approach says little about the quality of expenditures or local preference.

[3] Economic theory posits that the decentralization of decisions in the private sector to the lowest level of agents (households and firms) enhances efficiency. "Incentives are better, lower level agents are better informed, and property rights are exercised more responsibly. Similar arguments are transplanted to the public sector" through decentralization policies (Boadway, 2001, p. 99).

[4] On the importance of the unit of measurement of decentralization, see Ebel and Sendar (2002).

Sectoral Decentralization

Although for an economy as a whole a growing tax share at the subnational level is a strong indicator of effective decentralization, sectoral decentralization is also possible—and often is a preferred policy choice, even when the national tax share is not declining. Sectors like education and health, which have a high local public good content, can be decentralized in their management, evaluation and institutional arrangements even if their financing continues to come largely from the national or state level. This can be accomplished through the appropriate use of incentives. Chile is a good example of a country that has made large equity and efficiency gains in its education and health sectors through the use of the right incentives and the right institutional arrangements, even though financing and general policymaking are still largely centralized.

Role of Transfers

Transfers are policy instruments that have great potential to correct imbalances in initial conditions, particularly between rich and poor municipalities (that is, between fiscally strong and fiscally weak jurisdictions). The so-called equalizing grants are appropriate policy instruments that countries can use to meet their allocative efficiency and equity goals.[5] The critical importance of transfers lies in the real incentives they contain. It is through those incentives that transfers can either contribute positively to achieving decentralization objectives, or can end up inducing local tax lethargy and rewarding poor public sector performance.

Institutional Framework

A country's institutional and political framework is generally the most important determinant of decentralization processes, results and outcomes.[6] From that institutional framework emerge the rules and incentives that

[5] Stein, Talvi and Grisanti (1997) argue, correctly, that even within tight fiscal restrictions it is possible to mitigate large vertical imbalances by giving less-favored jurisdictions more authority to tax themselves, allowing them to use those additional tax revenues to their own benefit, and rewarding them with incentives when they perform better within their fiscal capacity potential.

[6] According to Boadway (2001, p. 111), "the structure of fiscal relations between the central government and the regions is a critical feature of a decentralized nation."

enhance or hinder specific decentralization objectives at the sectoral or global level. Fiscal results and the quality of local public expenditures are not autonomous. They stem from institutional rules and environments. That is why all evaluations of decentralization proposals have to include the overall intergovernmental institutional framework and attendant institutional factors, such as asymmetric information, contracts, transaction costs, agency problems, incentives, evaluations, and formal or informal regulatory arrangements.

Political Economy Restrictions

Decentralization processes normally involve large transfers of resources and significant policy interventions. They also involve explicit and implicit incentives that may cause both intended and unintended consequences. Such processes are highly susceptible to capture by public and private sector rent seekers. For these reasons, the specifics of decentralization, whether global or sectoral, tend to be endogenously established by those who can profit the most from a given policy framework.[7]

Market-based Decentralization

The organizing policy thread of all of these components is a market-based approach to decentralization.[8] In essence, a market-based approach focuses on the use of incentives, competition and independent evaluations as instruments to induce efficiency in the pursuit of economic or redistributive objectives. Such an approach includes interventions, such as explicit incentives and proxies of markets, to deal with market failures and unbalanced initial conditions. At all management decision levels, a market-based approach assumes new theory of the firm behavior by economic and political actors (Qian and Weingast, 1997, p. 83). That is, it assumes that political jurisdictions can be thought of as pseudo-firms that provide services and group together various types of decision-making activities.

[7] According to Downs (1957), "in almost every policy area, those who stand the most to gain are the men who earn their incomes there."

[8] This is somewhat different from using decentralization and federalism to preserve markets, as underlined by Weingast (1995) in his pathbreaking study.

The Evolution of Decentralization in Latin America

Latin America's decentralization processes can be organized around two periods. The first could be called the "first-generation period," beginning in the early 1980s. The "second-generation period" is still incipient, having likely begun in the late 1990s. It is currently in the process of coalescing in several countries, including Brazil, Colombia and Mexico.

"First-Generation" Decentralization

The first-generation phase was largely characterized by the following features:

- Implementation of constitutional reforms (in Brazil in 1988 and in Colombia in 1991) incorporating automatic and largely unconditioned transfers from the central government to the subnational level.
- Introduction of targeted fiscal transfers through formulas to specific sectors (such as education and health) and to low-income groups.
- An alleged process of devolving resources together with responsibilities.
- Delegation of some limited taxing-and-spending authority.
- A lack, for the most part, of any independent evaluation of results.

A major problem has always been the underestimation of the immense operational and managerial difficulty of "compensating" the transfer of resources with that of responsibilities (Wiesner, 1992). This problem arises because of a sequencing flaw, in which a revenue decentralization target is set first—for example, a given percentage of the national budget, as was the case in Colombia and Ecuador—and only afterwards do officials seek a compensating devolution of responsibilities. This often leads to a duplication of expenditures, a loss of accountability and, ultimately, a deterioration of governance structures at all levels.[9] According to Tanzi (1995, p. 310), "for decentralization to be successful, it must include the decentralization of both spending and revenue, and these decisions must be made at the same time."

As some studies have suggested, the initial Latin American approach contained key conceptual and operational flaws that, in some countries, arose because officials gave priority to the parceling out of free resources instead of looking for a process and assuring the right incentives. Campbell, Peterson

[9] For an excellent review of Latin America's decentralization experience, see Finot (2001).

and Brakarz (1991) expressed concerns about how much could really be expected from local public choice. Aghon (1996, p. 92) correctly warned about "the worrying ascent of transfers" and, in the case of Colombia, about the threat posed to macroeconomic stability by the duplication of expenditures.[10] Similar warnings were expressed by Krause-Junk (1996, p. 199), who also recommended that existing frameworks be more flexible. Wiesner (1992) criticized the lack of significant incentives to reward desirable results in Colombia, and later (1995) recommended structural changes, including the "denationalization" of primary education and health services. The IDB (1994) observed that the transfer system in Latin America, with the exception of Chile, was flawed in several critical aspects. There was particular concern about the inflexibility of such systems and their deleterious effects on countercyclical macroeconomic management.

Some of these comments referred specifically to the risks of public choices that underestimated the findings of new theory of the firm and institutional economics. The fact is that in the 1980s and 1990s, most Latin American countries followed decentralization policies that paid little if any attention to the lessons or principles of neo-institutional economics (incentives), public choice theory, or new theory of the firm (Wiesner, 1997a). With the sole exception of Chile, the systems implemented by Latin American countries were far from market-based.

The application of this policy framework in the 1990s resulted in serious fiscal problems in Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico and Venezuela. Although these problems were not the exclusive result of ill-conceived decentralization policies, in most cases macroeconomic imbalances were aggravated by subnational sectors incurring large fiscal deficits. In several of these countries, such as Brazil, Bolivia and Colombia, these subnational sectors had to be bailed out by the national level.[11]

Although macroeconomic balances were being disrupted by generous transfer systems, it is not certain that significant gains were being made at the sectoral level of decentralization, nor is it clear that the right incentives were being developed at the micro institutional level, such as school and health systems. In other words, the flawed first-generation approach engen-

[10] Restrepo (2000, p. 20) writes: "In the case of Law 60 of 1993 there was no correspondence in the transfer of resources and functions."

[11] Dillinger and Webb (1999a, p. 20) discuss the bailouts of Bogota in 1991 and of metropolitan Medellin in the late 1990s. Regarding more recent bailouts, see Rentería, Echavarría and Steiner (2002). For Brazil, see Bevilaqua (2002) and for Argentina, Dillinger and Webb (1999b, p. 15).

dered a double cost: macroeconomic instability and no gains in sectoral decentralization. In some cases it even resulted in a deepening of sectoral centralization.

Overall, the initial institutional frameworks in Latin America have been largely inflexible. Officials adopted them without adequate information and without incorporating significant independent performance evaluations or incentives to reward results. Although in principle the transfer of responsibilities and resources to other jurisdictions should have been fiscally neutral, the net effect, in most cases, was an increase in total expenditures and a weakening of fiscal balances. In fact, most decentralization initiatives were put in place with little regard to overall macroeconomic policy consistency and without tight budget constraint.[12]

But all this may be beginning to change. The fact that the fiscal performance of some subnational levels is growing relative to national levels augurs well for the second-generation decentralization process in Latin America.

"Second-Generation" Decentralization

In certain countries, including Brazil, Chile and, to some extent, Mexico, a new approach to structuring and implementing decentralization policies seems to be evolving. This second-generation approach is characterized by tighter macroeconomic budget constraint, a strong intergovernmental regulatory framework, and more intensive use of incentives at the sectoral level.

In Brazil, the 2000 Fiscal Responsibility Law provided a de facto strong regulatory institutional framework for intergovernmental fiscal and financial relationships. In Chile, which followed a tight macroeconomic approach well before other countries adopted such a course, the emphasis is on the use of incentives at the regional and sectoral levels. In Mexico, a reform agenda is being developed that emphasizes a stronger subnational taxing autonomy and a rationalization of the transfer system, and it may also involve a new federal-state commission on fiscal federalism and a code of fiscal conduct.[13]

Although it would be premature to affirm that most other countries will follow a more market-based approach to decentralization, it is safe to say that countries like Argentina and Colombia are being forced to revise their existing decentralization frameworks. Such a policy change can come about from

[12] According to Bird (2000, p. 35), "macroeconomic problems arising as a result of increased transfers must then occur because the central government has not reduced its spending proportionally."

[13] See Courchene and Diaz-Cayeros (2000).

fiscal corrections or from a new perceived wisdom as to what works in decentralization and what does not.

In Colombia, two recent developments offer hope for even stronger future corrections in its decentralization framework. First, municipal tax revenues have grown substantially, from 0.8 percent of GDP in 1990 to 1.9 percent in 2000 (see Table 1.1). Such a trend suggests that a critical component of real decentralization is taking place. Second, a series of new laws passed between 1999 and 2001 introduced corrections to limit the rate of growth of transfers and to improve the relevant institutional arrangements. Although Colombian policymakers still have a long way to go in terms of instilling strong incentives to reward decentralized expenditure, it seems that they are inclined to move in that direction.

Table 1.1 also shows that real decentralization is taking place in Brazil, where the subnational GDP tax share went from 9 percent in 1994 to 10.2 percent in 2000. The largest increase took place at the municipal level. The data for Bolivia for 1995 and 2000 suggest that the tax share of municipalities has also grown; however, the quality of the relevant data is uncertain. The quality of the data for Ecuador also does not allow for firm conclusions in this respect. The data suggest that the tax share of its subnational level rose from 0.3 percent of GDP in 1990 to 0.4 percent in 2000.

Mexico's subnational level, measured in terms of its tax revenue, is small (0.53 percent of its 1998 GDP) compared to Colombia, Brazil, Bolivia, Chile and Argentina. Ecuador's share at 0.4 percent of its 2000 GDP is the only smaller one. Mexico's national or "federal" level only collects 10.5 percent of GDP, the lowest share of the seven countries in Table 1.1. Prior to its collapse, Argentina's subnational tax share, at 3.79 percent of its 1997 GDP, was second in relative size only to Brazil. Most of it was concentrated at the provincial level.

Chile is pursuing two tracks of decentralization. One is sectoral (through incentives and changes in institutional arrangements), and the other is fiscal (through growth in the municipal tax share as a percentage of GDP). Table 1.1 shows that this share rose from 1.1 percent in 1990 to 1.6 percent in 2000.

Main Findings

Brazil

Brazil's public sector is highly decentralized from a fiscal and constitutional perspective. Fiscal and political federalism have evolved since the mid-19th

Table 1.1 Tax Shares in Selected Countries in Latin America

	As % of GDP			As % of total		
Country	**1990**	**1995**	**2000**	**1990**	**1995**	**2000**
Argentina	**(1993)**		**(1997)**	**(1993)**		**(1997)**
a. National	18.26	17.15	17.13	82.81	82.59	81.87
b. State	3.72	3.55	3.72	16.87	17.12	17.79
c. Municipal	0.07	0.10	0.07	0.32	0.29	0.34
d. Total subnational (b+c)	3.79	3.65	3.79	17.19	17.40	18.13
Total tax revenue (a+d)	22.05	20.80	20.92	100.00	100.00	100.00
Bolivia						
a. National	na	16.80	17.40	na	96.00	94.10
b. State		na	na		na	na
c. Municipal	na	0.70	1.10	na	4.00	5.90
d. Total subnational (b+c)		0.70	1.10		4.00	5.90
Total tax revenue (a+d)	na	17.50	18.50	100.00	100.00	100.00
Brazil[1]	**(1991)**			**(1991)**		
a. National	16.12	20.01	22.97	65.48	67.24	69.23
b. State	7.32	8.32	8.69	29.73	27.95	26.19
c. Municipal	1.18	1.43	1.52	4.79	4.81	4.59
d. Total subnational (b+c)	8.50	9.75	10.21	34.52	32.76	30.78
Total tax revenue (a+d)	24.62	29.76	33.18	100.00	100.00	100.00
Colombia						
a. National	8.80	9.70	11.60	81.90	81.10	81.00
b. State	1.00	0.80	1.00	8.20	6.50	5.90
c. Municipal	0.80	1.50	1.70	9.90	12.30	13.10
d. Total subnational (b+c)	1.80	2.30	2.70	18.10	18.90	19.00
Total tax revenue (a+d)	10.60	12.00	14.30	100.00	100.00	100.00
Chile						
a. National	14.50	17.00	17.50	92.80	92.60	91.40
b. State	–	–	–	–	–	–
c. Municipal	1.10	1.40	1.60	7.20	7.40	8.60
d. Total subnational (b+c)	1.10	1.40	1.60	7.20	7.40	8.60
Total tax revenue (a+d)	15.60	18.40	19.10	100.00	100.00	100.00
Ecuador						
a. National	8.30	9.30	13.80	96.40	95.90	96.80
b. State	0.00	0.00	0.00	0.10	0.10	0.00
c. Municipal	0.30	0.40	0.40	3.50	4.00	3.20
d. Total subnational (b+c)	0.30	0.40	0.40	3.60	4.10	3.20
Total tax revenue (a+d)	8.60	9.70	14.20	100.00	100.00	100.00
Mexico			**(1998)**			**(1998)**
a. National	11.10	9.30	10.50	96.27	94.51	95.19
b. State	0.26	0.35	0.39	2.25	3.56	3.54
c. Municipal	0.17	0.19	0.14	1.47	1.93	1.27
d. Total subnational (b+c)	0.43	0.54	0.53	3.73	5.49	4.81
Total tax revenue (a+d)	11.53	9.84	11.03	100.00	100.00	100.00

[1] Includes social security budget.

Sources: Argentina and Mexico: World Bank, Latin America and Caribbean Region Country Units; Brazil: BNDES (ECLAC for Brasilia); Chile: Ministry of Finance Budget Office; Colombia: CONFIS and DNP (FEDESARROLLO for 1990); Ecuador: Central Bank.

century, and the 1988 constitution is a reaffirmation of a large degree of state and municipal autonomy. Among other things, the constitution established a municipal third tier of government with the same constitutional status as the states. The constitution and subsequent increases in transfers have changed the fiscal picture dramatically.

Brazil is fast evolving into a truly federal state. Adequate use of macroeconomic incentives and fiscal incentives at the state and municipal levels has produced an effective process of decentralization. In terms of precepts from neo-institutional economics—i.e., that incentives can change economic and political behavior—the Brazilian case is a good example. It is at the municipal level where political and economic markets differ the least and where incentives can be particularly effective in transforming fiscal and political behavior.

After a decade of macroeconomic and exchange rate volatility,[14] Brazil would appear, after several attempts, to have put stable fiscal rules in place.[15] It has done so largely due to the approval in 2000 of the Fiscal Responsibility Law, which:

- Establishes that no permanent expenditure can be created without prior identification of a new permanent source of revenue;
- Sets ceilings on personal expenditures and on public debt by level of government;
- Curtails moral hazard by eliminating the scope for bailouts of subnational governments; and
- Increases transparency and accountability in the management of public finances.

This law represents a major double achievement. First, in a technical and conceptual sense, it implies a broad recognition that without the "right" fiscal rules for the nation as a whole, many other equity and economic policy objectives are compromised. Second, the law implies there is a major political consensus on which to anchor technical and orthodox "positive" macroeconomic

[14] GDP growth in Brazil went from 3.3 percent in 1997 to about 0.2 percent in 1998 and to 4.5 percent in 2000. The consumer price index went from 15.8 percent in 1996 to 3.2 percent in 1998, and the overall fiscal balance was negative from 1996 to 2000, reaching -10 percent of GDP in 1999.

[15] The Real Plan of 1994 successfully tamed inflation and initially boosted the primary surplus. However, the fiscal stance deteriorated over 1995-98, and in early 1999 Brazil had to abandon the crawling-peg exchange regime in favor of a market exchange rate system.

precepts. Paraphrasing Williamson (1996, p. 377), it could be said that a "credible commitment" has been reached at the political level.

While not perfect, the Fiscal Responsibility Law is clearly a "first-order optimizing" constitutional-like rule that sets the stage for a high level of what has been called "cooperative federalism." According to Afonso and de Mello, Jr. (2000, p. 19), it lays the foundation for "rules-based system of decentralized federalism . . . and has been motivated by the recognition that market control over subnational finances should be strengthened by fiscal rules and appropriate legal constraints." Article 35 of the law is the critical one, as it prohibits debt renegotiations amongst intergovernmental levels. The law was the product of a democratic process and intergovernmental negotiations and agreements, and, according to Inman and Rubinfeld (1997b, p. 48), under these circumstances, such processes are likely to be Pareto-improving.

After a highly inflationary period in the first half of the 1990s caused by fiscal deficits and "perverse" indexation mechanisms,[16] Brazil underwent a major macroeconomic and exchange restructuring in 1994 an adopted the Real Plan. A successful structural change, it quickly brought down inflation rates and contributed to a 4.2 percent GDP growth rate in 1995. However, by 1997 the government was forced to raise real interest rates as a result of the Asian Crisis, the exchange rate appreciation of the Brazilian real, and an increase in the current account deficit. The economy collapsed in 1998 (a negative rate of growth of -0.2 percent) and Brazil entered into an arrangement with the IMF in November of that year. Early in 1999, the real was freed and its exchange rate floated in the market.

From the perspective of the critical question of whether Brazil's recent decentralization process has occurred within tight budget constraint, the answer is that from 1994 to 1998, budgeting at all levels of government could hardly be described as tight. According to the IMF, nonfinancial expenditures of the central government increased by 2.8 percent of GDP during those years and the sharp deterioration of the fiscal stance contributed to the abandonment of Brazil's crawling-peg rate regime in 1999.

Up to 1997, the states ran fiscal deficits and largely financed them through their own state banks. The central government restructured the state debts (through Law 9496) and, in exchange, fiscal adjustment programs were imposed on many states. This renegotiation of state debt resulted in a significant subsidy to the states in 1997-98. This was corrected in 1999 and 2000 and Brazil was able to obtain a primary surplus of about 3 percent of GDP during

[16] Brazil's average annual rate of inflation from 1990–93 was 2.47 percent (IDB, 2000, p. 1).

those two years.[17] The correction, however, has come more from raising revenues than from reducing expenditures.

In brief, Brazil's process of decentralization during the first years of the 1990s did not take place under tight fiscal budget constraints. However, during 1999-2002, a sharp correction imposed fiscal discipline at all levels of government.

Bolivia

Bolivia's commendable process of reform since the late 1980s includes a sequence of reform phases during which the country made significant advances in some critical areas. However, Bolivia has been unable to fully complete those reforms, and progress is particularly needed to alleviate extreme levels of poverty. Since 1994, the country has embarked on an intensive decentralization drive through its Popular Participation and National Dialogue Laws and by allocating resources from the Heavily Indebted Poor Nations (HIPC) initiative and other concessional sources to the subnational level of government.[18]

The broad policy question that emerges is whether the basic decentralization framework adopted will yield the expected results in terms of sustainable welfare gains for the majority of the population, particularly those living in the poorest jurisdictions. The short answer is that, to a large extent, the current decentralization process is still excessively oriented towards a straight parceling out of resources, grants and subsidies. It seems that insufficient priority is given to local fiscal performance and to the use of incentives to enhance the effectiveness of decentralized expenditure.

Paradoxically, this situation may partly be the result of the relative abundance of concessional resources available. The free or largely free HIPC resources in 2001 alone were close to 2 percent of GDP. And the concessional content of multilateral and bilateral lending and grants can easily exceed that

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[17] A primary surplus is defined as a fiscal balance in which interests are deducted. This is normally done to exclude the burden of debt and debt service from new policies for the future. "Primary deficit" is different from "operational deficit," which only excludes the inflationary component in interest rates. These accounting acrobatics can help but can also confuse the reading of fiscal situations (see Petrei, 1997, p. 459). For a discussion of the usefulness of a primary surplus to limit borrowing, see World Bank (2000, p. 44).

[18] In 1996, the World Bank and the IMF jointly adopted the HIPC initiative to reduce the debt burden of (41) eligible countries to sustainable levels provided they adopted strong programs of macroeconomic adjustment and structural reform. In 1999, an enhanced HIPC was launched to provide deeper and more rapid debt relief to a larger group of countries. The enhanced HIPC initiative sought tighter integration between debt relief and poverty reduction. See Andrews and Singh (1999).

proportion. This de facto low budget constraint conspires against a rigorous use of resources or incentives to build a long-term sustainable welfare-enhancing decentralization process (IMF, 2002).

Bolivia's transfer system is structured around the following three legal pillars: (i) Law 1551, the Popular Participation Law of 1994; (ii) the Administrative Decentralization Law of 1994; and (iii) the National Dialogue Law of 2001. These are basically mechanisms to transfer national level resources, with insufficient capacity (incentives) to induce improved fiscal performance at the subnational level. Without such incentives, and without much sectoral (educational and health) decentralization, it is difficult to conclude that real decentralization is taking place in Bolivia.

Bolivia's institutional decentralization context is a complex mix of rules and norms containing all sorts of intended and unintended incentives. The net picture that emerges is that political economy restrictions are severe and limit the application of incentives or a market-like approach. The organizations that have emerged from this institutional set of rules have found incentives to become active in pursuing transfers, subsidies and special regional projects. A common pool of resources, comprised basically of debt relief and other resource transfers, has been harvested by a varied mix of agents, rent-seekers and jurisdictions.

The National Dialogue Law offers worrisome examples of the "capture" of earmarked funds by public sector rent-seekers. This law has the potential to create serious fiscal problems and high transaction costs in all management processes dealing with transfers, loans, poverty reduction and decentralization.

Since the jump-start of the Popular Participation Law in 1994, Bolivia has faced the formidable challenge of reconciling the following three objectives:

(i) To develop an institutional framework through which public resources are used more efficiently and effectively across the economy as a whole;
(ii) To continue to deepen the decentralization process in all of its varied modalities of subnational development, privatization and "denationalization" of education and health;
(iii) To continue to make progress in reducing extreme levels of poverty.

Underlying these three interdependent objectives is the even more daunting challenge of utilizing relatively abundant concessional resources currently available to ensure that there will not be a need for another international bailout in the future. In other words, the process needs to ensure that

there is an adequate "bail-in" of corrective policies in exchange for the current bailout, and that, in short, Bolivia ceases to be a country largely dependent on concessional resources.

After all is said and done, the question that remains is if the decentralization process might not be more effective and sustainable if a larger role were given to market-oriented instruments. Although history will likely applaud the Popular Participation Law as momentous and positive, it failed to include a modicum of incentives for enhanced results. Whether this will be judged to have been a missed opportunity is hard to say. After all, the law changed half the political history of Bolivia, and an insistence on incentives may finally have been seen as a technical point that could be taken care of later on.

Chile

Chile has a long tradition of state centralism. Since its birth as a republic in the early 19th century, a strong presidential regime has been the norm. However, over the past 20 years a major process of political and fiscal decentralization has taken place. Chile's decentralization process began in earnest in 1976 when the country was divided into 13 regions, 52 provinces and 325 *comunas.* In 1993, the Regional Government and Administration Law created the institutional entities of "regional government" and "regional council" as the two pillars of subnational government. Today, all municipalities have mayors and municipal councils elected by the local citizens.

Within the context of the decentralization approaches followed by Brazil, Ecuador and Bolivia, Chile is particularly instructive. In contrast with strategies in Ecuador and Bolivia, which emphasize the role of growing and largely unconditional transfers, Chile gives priority to macroeconomic and fiscal restraint as well as to the development of incentives for overall productive resource use. It also favors selective and sectoral decentralization more than wide-open devolution of resources and competencies. On the other hand, Chile's adherence to tight macroeconomic and fiscal constraint is akin to Brazil's recent fiscal correction and to its adoption of the Fiscal Responsibility Law in 2000.

More specifically, Chile's approach to decentralization focuses on building institutions, developing processes and in nurturing the "right" incentives in the rules and norms that flow from such processes and institutions.[19] In the

[19] It should be remembered that institutions "are" rules and that rules are, de facto, incentives. See Wiesner (2003b, p. 20).

education sector, for instance, the policy approach is to decentralize towards the municipalities and even to the school level. In the health sector, Chile seeks decentralization to the markets and to market-like environments. Chile's privatization and divestiture policies are an example of decentralization towards regulation and to the markets. In brief, Chile's strategy towards decentralization is to balance a top-down approach (e.g., national sectoral policies and strong national institutions) with incentives and decentralized choices, management and evaluations.

Notwithstanding the unique characteristics of its decentralization policies, Chile in its distinctive way is probably making more progress with stable and effective decentralization than most others countries in Latin America. This is largely explained by the application of tight fiscal and budget constraint, together with incentives to enhance overall public and private resource allocation efficiency.

Chile has in place the following five major instruments to implement its decentralization processes: (i) the Common Municipal Fund (FCM); (ii) the National Regional Development Fund (FNDR); (3) regionally allocated sectoral investment; (4) locally allocated regional investment; and (5) programming agreements.

The articulation of these five decentralization instruments provides the framework for a large investment pool called Regional Decision-making for Public Investment (IDR). The IDR is a unique configuration of institutions, funds, processes and decision-making under a well-managed institutional web. Its key strength is that nearly all projects have to compete amongst themselves for resources. In other words, there are incentives that reward, with additional resources, the best prepared projects, forcing all the actors to strive to have access to public resources in a competitive public environment.

At the municipal level Chile has a unique system of intra-municipal transfers from fiscally strong *comunas* to fiscally week and poor ones. That transfer finances the Common Municipal Fund. It decentralizes resources and has a legal and institutional framework to assure that they reach the segments of the population in greatest need. A proportion of municipal own-tax revenues is exclusively earmarked to be transferred from rich *comunas* to poorer ones.

The Common Municipal Fund as a percentage of total municipal tax revenue has been inching upwards, from 40.89 percent of total municipal tax revenue in 1990 to 41.02 percent in 2000. It will probably continue to grow, as legislation has recently been put in place to increase local tax authority and raise local tax revenue. This is a significant fiscal decentralization policy trend,

indicating a policy direction strongly advocated in the conceptual framework summarized at the beginning of this chapter—that is, the strengthening of local tax authority and performance.

The tax share of Chile's municipal level has been growing during the 1990s. Municipal tax revenues represented 1.1 percent of GDP in 1990, 1.4 percent in 1995, and 1.6 percent by 2000. A municipal tax share of 1.6 percent of GDP in 2000, similar to Brazil's (1.52 percent) and to Colombia's (1.7 percent), is higher than the respective shares in Ecuador (0.4 percent) and Bolivia (1.1 percent). These numbers point to a very important development, namely, the growing process of "fiscal municipalization" that Chile is currently undergoing. Most likely, the more recent municipal shares in 2002 and 2003 are already higher, as the 2002 Ley de Rentas II is directed to achieving a higher municipal tax performance. In this respect, it could be said that Chile is undergoing a process of "municipalization" just as are Brazil, Colombia and other countries in the region (Table 1-1).[20]

Ecuador

Ecuador's decentralization framework could not be characterized as market-based or consistent with tight macroeconomic fiscal constraint. In effect, during the 1990s and particularly in the second half of that decade, Ecuador had large fiscal deficits that reached 7.2 percent of GDP in 1999. The dollarization plan adopted in early 2000 did not resolve the underlying fiscal imbalances. It merely made it more difficult to use inflation or seignorage as a source of government revenue. But the structural fiscal problems are largely still there, albeit currently clouded by fast GDP growth and an oil-led investment boom.

Ecuador's decentralization process has contributed to its fiscal problems, as transfers from the national government grew from 3.2 percent of GDP in 1996 to 6.6 percent in 2000. Most of these growing transfers were unconditional and were not accompanied by a corresponding transfer of responsibilities. The 15 percent transfer law of 1997 implied a corresponding increase in the fiscal deficit (Wiesner, 2000).

Ecuador's decentralization process has taken place within a highly volatile institutional environment and without a credible regulatory framework.

[20] For a review of the recent decentralization experience of Brazil, Bolivia, Chile and Ecuador, see Wiesner (2003c).

While there has been a plethora of laws, norms and regulations, the decentralization process has been driven by the "wrong" incentives and within an inflexible budget framework. Earmarking is so pervasive that under some estimates, 64 percent of central government revenues were legally preassigned in 2000. Under these circumstances, it is very difficult to have an effective decentralization process.

The paradox is that Ecuador is a highly centralized country where subnational tax revenues do not reach one half of 1 percent of GDP and have hardly grown in the last few years. Given this degree of centralization, a well-designed system of transfers and incentives would have great potential to enhance local tax performance, induce institutional development and increase welfare in general. The country's serious poverty problem could be addressed more effectively within a decentralized framework.

Ecuador's decentralization process also has taken place within a highly volatile macroeconomic environment. GDP growth has fluctuated between a high of 3.4 percent in 1997 to -7.3 percent in 1999. Inflation grew from 30.7 percent in 1997 to over 90 percent in 2000. The combined fiscal deficit of the non-financial public sector grew each year from -2.4 percent of GDP in 1997 to -7.2 percent in 1999. There was a fiscal surplus of 1.6 percent of GDP in 2000.

The severe macroeconomic volatility of the second half of the decade culminated in the dollarization adopted in January 2000. This extreme measure was not the solution to Ecuador's main economic problems, but rather a stopgap measure to provide time and institutional perspective for a beleaguered economy.[21] Whether it will contribute decisively to strengthen Ecuador's development will depend, to a large extent, precisely on whether a "real" decentralization process is put in place. From a decentralization perspective, the main policy implication of all of this is that little budget constraint prevailed in the 1990s.

Compared to other countries in the region, Ecuador is highly centralized. In the 1990s, the national government absorbed more than 95 percent of all tax revenues. An enormous share of government revenue is preassigned to specific sectors, institutions and all sorts of rent-seekers. The IMF (2000, p. 62) estimates that in 2000, 64 percent of central government revenue was earmarked for specific purposes.

[21] For a discussion of the advantages and disadvantages of dollarization in developing countries, see Antinolfi and Keister (2001).

These characteristics are the antithesis of a true process of decentralization. It should be remembered that decentralization is about the search for efficiency through a more market-determined allocation of all public and private resources. If a high share of resources is allocated through discretionary public choices, what room is there for market-influenced choices?

Conclusions

The following conclusions emerge from the country evaluations and should broadly guide policy at the country level:

(i) The most serious problems emerge out of analytical flaws in the conceptual framework at the country level. These frameworks tend to neglect market-based mechanisms and make the capture of large unconditional transfers an easy ride for public sector rent-seekers.

(ii) Most countries tend to underestimate the importance of the integrality of the public sector and the attendant need to have fully consistent policy frameworks. In particular, they underestimate the fiscal implications of whatever happens in every corner of the public sector and in every interstice of public policy. The fiscal imbalances that plagued several Latin American countries in the 1980s and 1990s largely originated in institutional flaws that mask indirect sources of fiscal problems at the subnational level and in other areas of the public sector, such as social security systems.

(iii) While the "right" incentives are the crucible of successful decentralization, it is the "wrong" incentives (earmarking, automatic formula transfers, lack of independent evaluations of results, weak institutional regulatory frameworks) that have had the upper hand in several countries.

(iv) Sectoral decentralization at the education and health levels offers great potential for decentralization.

(v) State and municipal own-tax development is one of the best avenues through which a country or a multilateral institutional can support decentralization. Perhaps the most valuable dividend of this approach is the generation of sustainable fiscal and political institutions at the local level.

(vi) A strong and well-structured institutional framework is necessary to regulate decentralization processes and the interplay amongst intergovernmental levels and markets.

(vii) The issues involved in efficiency-equity tradeoffs pose a daunting challenge for developing countries trying decentralization as a long-term strategy.
(viii) At the multilateral level, there are examples of collective action problems and of misalignment of incentives and interests between the institutions and their borrowers. This is an area that needs to be examined further to determine what adjustments should be made on the "collective" rules governing the existing normative "contract."

Policy Implications and Recommendations

The policy implications and recommendations for countries adopting decentralization policies, and for multilateral institutions supporting those policies, can be grouped around the following five themes:

(i) Policy implications related to the initial conceptual framework from which specific decentralization schemes flow;
(ii) Policy implications related to budgetary and macroeconomic restrictions;
(iii) Policy implications related to the integrality of the public sector;
(iv) Policy implications emerging from the institutional and regulatory frameworks governing the decentralization processes; and
(v) Policy implications of the restrictions that limit the effectiveness of decentralization policies.

Conceptual Framework

While it is never possible to start out ex nihilo to design a country's decentralization framework, policymakers should focus their attention on at least the following three "visions" flowing from their conceptual frameworks:

(i) The main objective of decentralization is to enhance outcomes—all sorts of outcomes, be they of an economic or distributive nature—and to do so through changes in institutional arrangements, incentives and management practices. It is the application of the subsidiarity principle to the delivery of "local" public goods and services.
(ii) Decentralization is a "process" that evolves through time, corrections and learning. It is not a once-and-for-all parceling out of resources.

(iii) The key condition for effective decentralization is that it take place within tight budget constraint at all levels of government, at the sectoral level, and at the project level.

To facilitate the achievement of these objectives, most countries would gain enormously if, before embarking fully on a decentralization process, they conducted evaluations of the pre-existing "order" on whatever policy front they are considering for the thrust of their efforts. Through these evaluations, they can identify the existing "right" and "wrong" incentives and try to correct those situations before they embark on a massive transfer of resources and responsibilities to different levels and jurisdictions of the public sector.

Overall Budget and Macroeconomic Restrictions

Experience and theory confirm that no process of decentralization can achieve its objectives without tight budgetary constraint. In principle, all decentralization schemes should be fiscally neutral and allow for the inherent advantages of decentralized choice to evolve. The overarching policy implication is that a country that wants to capitalize on the benefits of decentralization cannot afford to neglect any major source of fiscal "leakages" in its policy framework. Decentralization processes will likely unravel if there are fiscal deficits at the national, municipal or state levels, public bank lending on the expectation of a bailout, guarantees to creditors, or moral hazard situations.

Brazil is an example of what a major challenge this poses, since the country has confronted several of these problems and is now well ahead of most Latin American countries in dealing adequately with them. Brazil today is a country fully conscious of what could be called the "integrality and policy consistency requirement."

Integrality of the Public Sector

Latin American policymakers need to be more aware of the integrality of public sectors. Markets in general and capital markets in particular do not function in practice on the basis of formal political or institutional arrangements. Rather, capital flows behave according to the "real" incentives governing a given market realm, and to a much lesser extent according to whether a public sector is institutionally structured around a three- or two-tier level.

Markets will pay little attention to budget rules at the national level if those at the subnational level appear more attractive in terms, for instance, of a potential bailout. Under these circumstances, while the national or central fiscal picture may appear sound and well regulated, the subnational sector, if containing different and "bad" incentives, will eventually cause havoc for public finances as a whole.

This has been the experience of Argentina, Bolivia, Brazil, Colombia, Ecuador and others where fiscally costly outcomes have emerged out of flawed privatization schemes, from guarantees in agency contracts, and from alleged adjustment programs to "correct" excessive subnational spending.[22] This has happened mainly because policymakers tend to focus their oversight at the institutional level, where they are more accountable, rather than on an integrated result. This becomes a sort of "collective action problem" within the fiscal and financial public sector in which the real interests of actors are not aligned with incentives to protect the collective welfare. This problem is well recognized by public choice and new theory of the firm findings.

The key policy implication and emerging recommendation is that the unit of fiscal analysis and operational regulation has to be the totality of the public sector through broad encompassing rules and the "right" institutional incentives.[23] This is what the Fiscal Responsibility Law in Brazil is achieving and what Mexico's new subnational regime is directed towards (Giugale, Hernández Trillo and Oliveira, 2000, p. 257). It is also what Chile has accomplished through its hierarchical system and budget rules and procedures.[24]

Regulatory Institutional Framework

All countries have an intergovernmental institutional framework governing transfers, functions and political responsibilities. When "decentralized choice" is taken up as a policy principle, the countries will gain if they

[22] This is the well-known theme of hidden fiscal costs. See Easterly (1999) and Palackova and Schick (2002).

[23] For a review of this approach for Colombia, see Wiesner (2003a).

[24] See Marcel (1999, p. 308) for a discussion of the hierarchical system and Brazen (2000) as to why budget limits and budget procedural rules are the real determinants of fiscal results.

strengthen that institutional framework by adopting explicit regulatory rules for its functioning. Such rules should require that:

(i) There will not be bailouts by the national government;[25]
(ii) All specific sectoral or project decentralization projects be fiscally neutral;
(iii) The subnational level only issue debt for capital expenditures and under tight conditions; and
(iv) The national level provides ample local tax authority and incentives for local jurisdictions to increase their local tax performance.

These rules configure a regulatory framework within which the decentralization process will evolve. The rules can stand alone or be part of a "formal" institution managing their application. There can also be specific regulatory frameworks governing sectoral decentralization processes like education, health, privatization, etc.

Restrictions Affecting Decentralization

Policymakers should be aware that decentralization schemes are particularly vulnerable to "capture" by public and private rent-seekers, who see in automatic transfer formulas and inflexible earmarking of funds an opportunity to access resources with little if any competition. To mitigate this risk, policymakers can:

(i) Build in transfer incentives that reward results and favor demand-driven independent evaluations;
(ii) Make intensive use of the subsidiarity principle to shorten the distance between the demand and supply of any good or service that can be provided "locally" and consumed through a decentralized choice;
(iii) Keep in mind that the objective is to decentralize choice both on the supply and the demand side of "local" markets, and that the principal aim is not to finance local expenditures; and
(iv) Ensure that there are independent evaluations that provide the information needed to gain political support for reforms that benefit large groups.

[25] This is what Mexico has adopted as part of its legislation. See Giugale, Hernández Trillo and Oliveira (2000, p. 250).

Chapter Two

Fiscal Federalism: From Public Choices to Market Processes

The basic ideas and concepts surrounding decentralization have been constantly evolving for well over a century. In the mid-18th century, it was Alexis de Tocqueville with his legendary look at *Democracy in America* who brought out the far-reaching consequences of a decentralized state. More at the theoretical level, Leon Walras argued in 1874 that markets would tend to move on their own towards efficient outcomes and equilibrium, albeit in a somewhat trial-and error process, and that decentralized economies would be an autonomous result of that market process.

In 1956, Charles Tiebout argued that a market process could lead to a Pareto-efficient provision of local public goods and services. Competition between communities[1] and migration—this latter term meaning that people would "vote with their feet" by moving, thus affecting property values and inducing efficient supply responses to their demands—would provide the proper information to markets. In the end, there would be an efficiency-generating convergence of supply and demand. In brief, a neoclassical Walrassian process would drive the local public goods markets towards an efficient equilibrium.

Under certain assumptions, the Tiebout model is a valid one.[2] The challenge has been to find ways in which the conditions or assumptions of this

[1] Competition would lead to efficiency because in deciding how much of a certain good to buy, individuals would equate the marginal (additional) benefit they receive from consuming an extra unit with the marginal (additional) cost of purchasing an extra unit, which is just the price they have to pay. Firms, in deciding how much of a good to sell, would equate the price they receive with the marginal (additional) cost of producing an extra unit. Hence marginal benefits of consuming an additional unit are equated with marginal costs. See Stiglitz (1988, p. 65).

[2] According to Stiglitz (1988, p. 637), "the separate decisions of each community concerning what public goods to provide and how to provide and finance them lead to a Pareto-efficient allocation, just as the separate decisions of firms and individuals concerning private goods lead to Pareto efficiency."

model can be met. An extensive literature has developed since Tiebout towards this end,[3] particularly in terms of welfare distribution across communities that is politically acceptable.[4]

Closer to current times, in the early 1970s, through the seminal work of Oates (1972), fiscal federalism came into full being, emphasizing the potential for economic and welfare gains through the appropriate assignment of jurisdictions over public goods and taxes (Oates, 1996).

According to Oates (1999), industrialized and developing nations are turning to decentralization to improve the performance of their public sectors. Both groups of countries find two basic arguments in their favor. First, decentralized provision of goods and services, whose consumption is limited to specific jurisdictions, allows for the tailoring of outputs to particular preferences and circumstances and increases economic welfare above that which would result from national provision. While there are a number of qualifications that could be made to this postulate—such as the ambiguity of determining what is "a local" good or service—it is difficult to argue against the proposition that, in most cases, the efficient level of output of a "local" public good can best be determined locally.[5]

The second benefit of fiscal federalism is the generation of information (Hayek, 1945) and knowledge. Individual local governments have more information about local preferences and cost conditions and can thus make better decisions. If those decisions have to do with taxation and expenditure, local governments will strive to obtain the most ample information needed to economize on their public policies.[6] Thus, local citizens, will "demand" information as part of the normal process of local government–provided, of course, that they are financing most of their expenditures from their own resources. If the "right" incentives are present, information is demand driven and not supply driven. What will be demanded is "performance information" that will en-

[3] See Stiglitz, (1977, pp. 274-333), Inman (1987, p. 649), and Oates (1999, 1120-49).

[4] The initial Pareto-efficient market outcome says little, if anything, about the resulting distribution of income.

[5] This is the application of the principle of subsidiarity in the sense that "public policy and its implementation should be assigned to the lowest level of government with the capacity to achieve the objectives" (see Oates, 1999, p. 1122). This principle, which is a condensed version of decentralization, is already part of the Maastricht Treaty for the European Union.

[6] The argument here is, of course, a relative one in the sense that at the local level there will tend to more and better information about local issues than at the national level.

hance results, not just accounting numbers or legal compliance of data.[7] It will be information needed to complete a given market.[8] According to Mello, Jr. (1999, p. 6), "because local jurisdictions can identify community preferences more easily, decentralized policymaking tends to reduce information costs."

Countries adopt fiscal federalism and decentralize their public sectors with basic objectives in mind: to improve efficiency, enhance results and make their public policies more effective. This pursuit of efficiency gains is seen as obtainable in all public policies. If countries wish to make social policies more effective, they decentralize; if they wish to gain effectiveness on purely economic grounds, they decentralize; if they want less inflation and more stable macroeconomic behavior, they decentralize the Central Bank; if they want better education for the poorest of children, they decentralize; if they want better-run airports, they decentralize.

But there are important differences in how countries design and implement their decentralization policies. While they may share the theory and principles of decentralization, in the operationalization of those nostrums they are influenced by their institutional approaches to mixing governmental intervention with markets. And there are significant differences in those approaches, differences that may explain the disparity of decentralization results and outcomes between countries.

For example, Boadway (2001, p. 97) points out three main forms of negative fiscal externalities: (i) horizontal fiscal externalities, (ii) vertical fiscal externalities, and (iii) equity effects of decentralization. Horizontal fiscal externalities arise, for instance, from tax exporting, whereby part of the burden of a tax is borne by non-residents. This occurs when taxes are imposed on incomes generated in a region but that accrue to non-residents. Vertical negative externalities may arise from decision-making involving upper and lower levels of government. When they co-share the tax basis or resource use, these may be united incentives leading to resource allocation inefficiencies. Finally, there may be negative equity effects from decentralization when, for

[7] See Binnendijk (2000) for clarifications on the nuances between performance budgeting, performance information and managing for results.

[8] On the importance of information on political processes—and decentralization is largely a political process—Stiglitz (2002, p. 487) insightfully observes that in many political arenas the "wrong" incentives may increase asymmetries of information. "As in the theory of the firm where the current management has an incentive to increase asymmetries of information in order to enhance market power, so too in public life."

instance, equalizing grants perpetuate jurisdictions that have no chance of survival.

Alderman (2001, p.34) warns that "decentralization can create economic inefficiencies if firms or individuals are mobile and make decisions to relocate based on taxation rates or on the magnitude of local grants." Wildasin (1998) calls attention to the fact that jurisdictions may try to mislead national governments about their real needs in the hope of securing greater budget support or a bailout.

One the most interesting recent developments in the theory and practice of decentralization has to do with the evolving nature of the assignment principle. Inman and Rubinfeld (1997a, p. 94) warn that old conclusions may no longer hold. It used to be that for economic efficiency reasons, national public goods were assigned to the national level and local public goods to cities and states. However, as these scholars posit, "Monetary, deficit, and redistribution policies, once considered the sole domain of the central government, are now seen as potentially valid local government activities. Conversely, education policy, once seen as a task for only local governments, arguably now can be added to the national agenda as human capital externalities are identified. If the reach of a given activity's spillover becomes open to dispute, then application of the assignment principle becomes political."

This may well explain why decentralization can turn out to be so complicated, since, in essence, it needs to balance the application of clear-cut economic efficiency principles with political issues when the former fail to provide precise guidelines. Nevertheless, as Ricker (1964, p. 101-3) argues, there is the overarching need for a strong executive to protect the nation's interest in economic efficiency. Since this posture is not risk free and a strong executive or national level of government may end up dominating other jurisdictions, it will be up to the political process to find the right balance.[9]

In brief, these situations and others may lead to economic and welfare problems if the incentives (intended and unintended ones) end up distorting original policy objectives. In the end, there is a tradeoff between the perceived benefits of decentralization and its costs. Much depends on how tight policymakers want to make the equity-efficiency tradeoff, and hence where to place the incentive-intensity priorities.

[9] According to Bardhan (2002, p. 202): "The logic behind decentralization is not just about weakening the central authority, nor is it about preferring local elites to central authority, but it is fundamentally about making governance at the local level more responsive to the felt needs to the large majority of the population."

Market Preserving and Public Choice Approaches to Fiscal Federalism

A powerful alternative approach to classical or traditional federalism has recently emerged principally from the conceptual framework of new institutional economics and from public choice theory.[10] In 1995, Barry Weingast of Stanford University wrote a seminal article arguing that federalism and decentralization were of great importance not only because of allocative efficiency reasons, but because of their capacity, on a larger scale, to sustain market-based economic and political systems. More specifically, he posited that federalism, as the overarching public sector institutional framework, is the way to protect and enhance the role of the markets. His point of departure was that "a government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens" (Weingast 1993b, pp. 287, 305), and that "markets cannot survive without strong political protection from the state."

For a federalist system to protect markets, it must meet the following three conditions: (i) decentralized jurisdictions or levels of government should have the primary regulatory responsibility over the economy;[11] (ii) the system should function as a common market without barriers to trade; and (iii) lower levels of government must practice tough budgetary constraint. According to Oates (1999, p. 1139) Weingast's third condition means that subnational governments have "neither the capacity to create money nor access to unlimited credit. And it implies that the central government does not stand ready to bail them out in instances of fiscal distress."

On a wider historical scope, Weingast (1993b) argued that what largely explains the success of 18th century England and the 19th century United States was the fact that a market-preserving federalism was in place, fostering economic growth and prosperity.

McKinnon (1997) reinforced Weingast's condition of tight budget constraint and emphasized the separation of fiscal and monetary responsibilities.

[10] Public choice or rational politics differs from other approaches to the study of political behavior in that it builds on models in which rational individuals seek to advance their own interests. For a thorough examination of the meaning and ramifications of public choice theory and practice, see Mueller (1997, Chapter 1).

[11] Weingast (1993b, p. 291), explains that "the prohibition on economic regulation at the highest level implies that privately valuable, politically created monopoly rights and restrictions cannot be established for the entire economy all at once."

In a federal system, the central government controls seignorage, while lower-level jurisdictions are limited to their own fiscal resources. However, with the recent development of "decentralized" central banks, not even the national levels of governments or the executive power have the freedom to issue currency. And when lower-level jurisdictions are restricted to their own fiscal capacity and authority, the policy message is that most of their expenditures (excluding those financed by transfers) should be self-financing.

For federalism to really protect markets, McKinnon (1998) recommends the following:

(i) *Monetary separation.* State governments cannot own or control commercial banks.
(ii) *Fiscal separation.* State governments do not have access to discretionary or additional central government financing to cover state deficits.
(iii) *Freedom of interstate commerce.* Goods, services, people, firms and capital are allowed to move freely across state lines.
(iv) *Unrestricted public choice.* States are allowed to design and deliver alternative bundles of public goods and services and to finance them by alternative means of taxation.

As stated by Courchene et al. (2000, pp. 86-87): "The first two principles ensure that there are no bailouts. States can, of course, still borrow on capital markets, but credit-rating agencies and financial markets generally are more vigilant if they realize that the states face hard budget constraints. Unrestricted public choice is possible only if the first three principles are in place. In this market-preserving context, the exercise of competitive federalism enhances efficiency and welfare."

Bringing into the federalism framework the findings from public choice research (Weingast, 1995, Qian and Weingast, 1997, and McKinnon, 1997) raises questions as to why public officials at all levels of government would be interested in assuring the benefits of federalism? According to Qian and Weingast (1997, p. 83), the traditional approach to decentralization "takes for granted that political officials provide public goods and preserve markets."

These arguments are similar to those underlying the new theory of the firm when it questions neoclassical assumptions about firm behavior. Qian and Weingast (1997, p. 83) cite clear parallels: "The first generation approach to federalism and the neoclassical theory both treat the organizations they study—firms and governments—as black boxes run by people who act benevolently, whether for shareholders or for citizens. Both theories provide only a modest

explanation for why managers or government officials would behave in the prescribed manner."

The new theory of the firm offers four concrete critical insights applicable to traditional decentralization theory: (i) the allocation of information and authority directly affects the degree of commitment; (ii) competition can be used as a disciplinary device in the presence of managerial incentive problems; (iii) positive market incentives are needed to reward economic success; and (iv) negative market incentives are needed to punish economic failure.

Some of these implications of modern theory of the firm are beginning to be used in specific instances of federalism. Cremer, Estache and Seabright (1994) have applied it to the case of public services. Their conclusions are clearly relevant to decentralization design and implementation:

- Political jurisdictions can be thought of as pseudo-firms that provide services and group together various types of decision-making activities.
- Questions about decentralization in government are questions about the allocation of rights of control. If contractual relations were complete, it would not matter whether power were decentralized or not, since contracts would specify everything to be done at each level of government and there would be no need for discretion.
- The appropriate degree of decentralization depends upon which level of government will have the most incentive to act to bring about the desired outcomes.
- The organizational design of government affects not only incentives to take decisions but also incentives to gather the information on which those decisions will be based.

While these new theory of the firm nostrums are all useful in understanding decentralization, the last two points deserve special attention, primarily because they focus on incentives as the key criteria to guide the degrees and levels of decentralization as well as the process to gather and use information to evaluate results. Take the case of a decentralized central bank. In such a situation, the national government (responsible for monetary policy and price stability) is the level that has the interest (incentive) to assure low inflation. Hence it gives independence to the central bank, which, in turn, will have the interest (incentive) to see and use the right information on all factors affecting inflation, interest and exchange rates.

Another example is basic education, where it would be the national level of government that has the interest (incentive) to assure that, for equity reasons,

all children, but particularly the poor, have access to education. But it will be the teachers, parents and local schools that need to have the immediate, local interest (incentives) in assuring specific equity and efficiency results. For this reason, the national level decentralizes to the municipal and even to the school level, and lets the school systems seek the right production function to obtain the results that are sought by the national policy. The key conclusion is that incentives are the critical factor, and that those incentives must be strategically placed.[12]

Together with a new theory of fiscal federalism spawned by Weingast and others,[13] there are also new emerging questions about the degree to which decentralization can actually deliver on its promise without friction, conflict and hard choices. Inman and Rubinfeld (1997b, p. 48) have warned that "cooperative federalism" can hardly yield or contribute to the right provision of certain key "national goods" such as macroeconomic stability, social insurance or defense. They maintain that the problems of collective action at lower-tier governments may not yield satisfactory outcomes as a result of a cooperative process. Their point "is not that the levels of central government defense spending, social insurance or macroeconomic stability have always been optimal; rather, it is that if the nation had waited for states to agree unanimously on such policies, economic outcomes would almost surely have been far worse" (Inman and Rubinfeld, 1997b, p. 50).

The Market-Based Approach in Latin America

The market–preserving federalism that has emerged largely in the United States is not so much concerned with decentralization per se as it is with the specific kinds of decentralization and federalism that will protect markets and induce officials to truly commit the state to "sustain a productive and growing market economy" (Oates, 1999, p. 1138). Under this approach, decentralized countries, which are actually the more developed countries in the world, need to use a system of fiscal federalism that is market preserving. Otherwise the state will tend to stifle markets and growth. While this new federalism approach has been conceived primarily to address public sector governance issues in developed countries, the question that arises for Latin America is whether (and to what extent)

[12] Qian and Roland (1998, p. 1151) underline the importance of distinguishing between a commitment to decentralization and a commitment to a hard budget constraint. The key question is which one is more irreversible, or where are the more irreversible incentives.

[13] According to Weingast, these are old problems that were the concern of Hobbes, Locke and Montesquieu. Later on they were treated by Hayek (1939), Riker (1964), Buchanan and Tullock (1962) and Kornai (1986).

the "new" postulates would be applicable to its case. Can the apparently lackluster results of the region's decentralization policies be explained precisely by the fact that not enough attention was given to the very same factors that Weingast and others claim to be so necessary for developed countries?

In principle, it is difficult to argue against the usefulness of framing "new" decentralization policies in a region like Latin America under the broad theoretical model of market preserving federalism. But perhaps it should be called "market creating decentralization" in recognition of the fact that, on the whole, Latin American markets are not the predominant modality of resource allocation in decentralization drives or in the public or even private sectors.

If the more developed countries of the world are also the more decentralized ones, could it not be asked if decentralization is a cause or a result of economic development? According to Bahl and Linn (1992), it looks as if economic development comes first and then decentralization follows. And Weingast may argue it would do so precisely to "protect" markets and sustain growth and employment.

This perspective does not answer the question of where and how development came about in the first place? Could it have been because a decentralized environment was there since the beginning? It would seem that such was the case in some countries. In the late 19th century in the United States, the public sector was small and highly decentralized. It accounted for only 8 percent of GNP, and the central government share of total public expenditure was only about 30 to 35 percent of total expenditure. Yet by 1955, the central government share of public spending had roughly doubled from one-third to two-thirds (Oates, 1999, p. 1142).

What does all this imply for Latin American policymakers working in the field of fiscal federalism and decentralization? What answer can be given to the two-way causal questions? Should decentralization policies be adopted to induce the development of market-like environments at the local level? Should market approaches and proxies of markets be adopted to strengthen decentralization policies?

However interesting these questions may be, the answer offered is that *both* approaches are useful, as it is difficult to separate them.[14] The emphasis should be on the use of market instruments to enhance the probability that

[14] The differences between these two apparent alternatives may be more relevant in countries like the United States, where there is fear that the "central government" may stifle markets. This is not a major issue in Latin America, where the question is how to make governments more effective and how to make all interventions more market-based.

decentralization will actually deliver welfare and economic gains at the local jurisdictional level. So far, in many Latin American countries market principles play a minor role in managing transferred resources, evaluating results and encouraging greater use of local fiscal potential.[15]

Some key sectors like education and health remain highly centralized either because national funds are the main source of financing or because national labor unions actually determine resource use and policy priorities. To a large extent this is the case in Colombia (Wiesner, 1997b) as well as in Ecuador and Bolivia. This is not an argument for reversing the financing from the national to the local or subnational levels. While this is indeed desirable and consistent with decentralization principles, it would be unrealistic to think that the local jurisdictions, particularly poor ones, could adequately finance their basic educational needs. For many years in most countries in Latin America, the national level will need to continue to fund a large (though hopefully declining share) of expenditures for basic education and health.

The argument is for a decentralized institutional and financial arrangement through which what is now supply driven from the finance side (the national level) becomes demand-driven from the user or consumer side.[16] Systems like vouchers would contribute to create a market-like environment in which (local) demand drives the supply input market, although it would be financed largely from the national supply side.[17]

This is a typical situation in which traditional decentralization—transfers to a level or a sector but not to the local consumer in a regional jurisdiction—is anything but market oriented. On the contrary, it is a way to institutionalize monopoly from the supply side.

Definition and Measurement of Decentralization

If decentralization is difficult to define, it is even more difficult to measure. And yet there is an enormous need to measure it, however imperfectly. Otherwise it becomes nearly impossible to assess and evaluate decentralization policies, results and outcomes. How could any given country evaluate its operations or

[15] The managing of resources and discretionary and accountability environments may be critical factors in determining results and outcomes. See Hunter (1997).

[16] Medici (2002, p. 124) observes aptly that incentives should be more demand-intensive than supply-intensive so as to generate the "right" and efficient supply response.

[17] See Calderón (1997) for the Colombian experience with educational vouchers.

its domestic policies without a "satisficing" indicator of what is actually going on.[18] In brief, there is a need for what Ravillon (2001, p. 136) calls "systematic data structure" on the key "explanatory variables" of decentralization outcomes.

While all decentralization measurements are imperfect, the challenge is to find the less imperfect one;[19] that is, the one that has the lowest possible conceptual and operational transaction costs and which focuses on viable alternatives that improve on previous approaches. Generally speaking, there are two approaches to measure decentralization: first, subnational fiscal performance relative to GDP or to the total, and second, efficiency and welfare gains in specific decentralized sectors or institutional arrangements where decentralized choices are facilitated by the proximity of demand and supply factors.

Although this dual and interdependent definition is largely "satisficing," and seems to pass Williamson's test of "remediableness,"[20] there are a number of reasons why the first criterion is particularly attractive. These reasons have to do with the externalities that emerge out of municipal or state fiscal development, the closeness with which demand and supply converge at the local level, and the political process that takes place around the fiscal markets.

One of the most discussed issues in decentralization theory and practice is related to local institutional development. Most authors converge around the idea that local institutional development is a prerequisite for decentralization—or at least has to evolve with the process. But the key question is how to initiate the right circularity between institutions and local development. This is the so-called chicken-and-egg conundrum. Many answer by saying that supply-driven support is needed, and thus they favor technical assistance and institutional building from the top.

Perhaps a better answer can be found by providing incentives to reward additional local tax performance. Through this route, local citizens will feel encouraged to tax themselves at the margin and will want to exercise vigilance over the use of "their" resources. Hence, they will tend to demand the "right" local institutional development.[21] As Shah (1998) has pointed out, "the preservation instincts of taxing authorities also respect accountability, because the strength of

[18] Simon (1982) states that in economics, optimal conceptual and operational solutions are seldom possible, nor necessary, and that progress is achieved gradually by marginal "satisficing" improvements.

[19] On the measurement of fiscal disparities across local jurisdictions, see Ladd (1999).

[20] According to Williamson (2000, p. 601), "an extant mode of organization for which no superior *feasible* alternative can be described and *implemented* with expected net gains is *presumed* to be efficient."

[21] See Feeney (1993) on the demand and supply of institutions as well as their evolution.

their influence depends on economic performance that allows citizens to see their well-being improved."

Finally, there is another externality flowing out of the local fiscal process: the political process involved in collective decisions about collective goods. Stiglitz and Yusuf (2001, p. 246) call this "participatory politics." It contributes to convergence between the economic and the political markets and is a strong attribute of the subnational fiscal dimension of decentralization.

To sum up, fiscal federalism and decentralization are limited concepts when used in reference only to constitutional, legal or political frameworks, instead of in reference to data about the distribution of tax revenues and tax authority between intergovernmental levels. The term "federalism" can often be used as a rhetorical reference to a vision of a country, meant to assuage regional differences or disparities. But without a quantification of the sources of tax revenue, ascertaining whether a country is truly federalized is difficult, for it is tax collection and all that lies underneath that defines the political arrangement (federal or nonfederal) that makes a country.[22] As a result, the local or regional tax revenue approach would seem to be a better unit of analysis of decentralization and of federalism than one focused on transfers or local expenditures.

[22] According to Schumpeter (1954), "the spirit of a people, its cultural level, its social structure, the deeds its policy may prepare, all this and more is written in its fiscal history, stripped of all phrases. He who knows how to listen to its message here discerns the thunder of world history more clearly than anywhere else."

Chapter Three

The Evolution of Fiscal Federalism in Latin America

This chapter will examine the macroeconomic context within which decentralization processes have taken place in Latin America over the past decade. This overview will reveal whether hard or a soft budget constraint was the predominant environment, and will summarize the major challenges decentralization still faces in most countries of the region.

The literature on decentralization and fiscal federalism underscores the importance of a transparent and consistent macroeconomic framework for the smooth implementation of decentralization policy. It also stresses that the decentralization process itself should not adversely affect macroeconomic balance or make the management of economic cycles more difficult. Shah (1998) has pointed out that a "decentralized fiscal system offers greater potential for improved macroeconomic governance . . . because decentralized fiscal systems require greater clarity and transparency." Bird (2000) observes that "decentralization may complicate macroeconomic management but it does not shift the final responsibility from the central government."

These conditions are considered critical for the sustainability of decentralization initiatives. Unfortunately in Latin America, by and large, the macroeconomic context of the 1990s was characterized by rapidly expanding public sector expenditures with which tax revenues could not keep pace, resulting fiscal imbalances, and exchange rate volatility.

Table 3.1 shows that total public sector expenditures in most Latin American countries grew as a percentage of GDP in the 1990s. This trend was particularly pronounced in Brazil, where public sector expenditures increased from 30.7 percent in 1992 to more than 40 percent in 2000, and in Colombia, where expenditures increased from 25.8 to 34.8 percent during the same period.

Table 3.2 shows the growth of tax revenues. However, as Table 3.3 shows, spending outstripped tax revenues, resulting in fiscal imbalances. For the re-

Table 3.1 Latin America: Total Public Sector (Central Government) Expenditures
(Percent of GDP)

Countries	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	18.9	20.3	19.9	20.0	19.5	20.4	20.4	21.9	22.0
Brazil	30.7	33.3	29.3	32.8	32.9	34.1	40.0	44.4	42.7
Colombia	25.8	28.6	27.5	32.3	35.9	36.7	32.9	36.4	34.8
Costa Rica	21.9	22.0	26.0	24.0	25.0	24.0	23.5	31.2	32.5
Ecuador	26.9	25.0	24.6	26.9	27.5	26.3	26.3	30.0	27.9
Guatemala	10.7	10.6	9.2	9.4	9.4	10.7	12.5	13.8	12.8
Mexico	25.4	23.4	23.6	22.9	23.3	23.7	21.6	22.0	22.9
Paraguay	16.3	15.3	16.1	18.3	18.2	20.7	22.2	28.3	31.8
Peru	17.2	16.9	17.9	18.6	17.5	16.7	17.1	17.8	17.5
Uruguay	27.2	29.0	30.6	29.9	29.7	30.8	31.0	33.5	34.1
Simple average	23.6	23.8	24.3	24.3	24.4	24.4	24.8	27.0	27.1

Source: Economic Commission on Latin America and the Caribbean (ECLAC).

Table 3.2 Tax Revenues of Selected Latin American Countries
(Percent of GDP)

Country	1992	1995	1998	1999	2000
Argentina	16.6	17.3	17.6	17.6	18.1
Brazil	20.8	25.0	26.3	26.6	29.8
Colombia	16.7	19.6	18.0	17.8	18.1
Chile	17.3	17.0	17.7	16.9	17.5
Peru	11.6	12.7	13.8	12.4	12.0
Costa Rica	12.0	12.5	12.8	12.4	12.6
Ecuador	7.1	7.9	9.8	10.2	12.3
Bolivia	8.9	11.1	14.1	13.1	13.4
Mexico	12.4	9.2	10.5	11.4	10.6

Source: ECLAC.

Table 3.3 Fiscal Balances in Selected Latin American Countries
(Percent of GDP)

	Total revenue		Total expenditure		Financial balance	
	1998	1999	1998	1999	1998	1999
Latin America	**21.3**	**22.4**	**23.8**	**25.4**	**-2.5**	**-3.0**
Argentina	19.0	20.3	20.4	22.0	-1.4	-1.7
Brazil	32.1	34.4	40.0	43.9	-8.0	-9.5
Bolivia	23.1	30.8	35.0	34.7	-4.0	-3.9
Chile	23.6	23.1	23.2	24.5	0.4	-1.5
Colombia	29.5	32.5	32.9	37.1	-3.4	-4.6
Costa Rica	12.9	13.1	15.4	15.4	-2.5	-2.3
Mexico	20.4	20.7	21.6	21.8	-1.2	-1.1
Peru	14.3	13.0	15.3	15.8	-1.0	-2.7
Venezuela	21.0	24.7	27.6	25.9	-6.6	-1.2
Ecuador	20.3	25.2	26.3	30.0	-6.0	-4.8

Source: ECLAC (2000, Table II.1).

gion as a whole, the fiscal deficit grew from -2.5 percent of GDP in 1998 to -3 percent in 1999.

Underlying the growing fiscal deficits were rapidly growing transfers from the national to the subnational level. Table 3.4 shows that intergovernmental explicit transfers grew in most countries during the second half of the decade.

In Table 3.5, the market-intensive approach is contrasted with the interventionist or market-restricting approach, revealing that, on the whole, the region seems to have followed the latter more than the former.

The macroeconomic conditions that prevailed in the 1980s and 1990s in several Latin American countries were not conducive to producing the potential welfare gains offered by decentralization. Most countries had few budget constraints, and total government expenditures increased substantiality as a

Table 3.4 Relative Share of Intergovernmental Transfers in Selected Latin American Countries, 1994–2000
(Percent of GDP)

Countries	1994	1995	1996	1997	1998	1999	2000
Argentina	8.3	8.3	8.2	8.7	8.7	9.3	9.1
Brazil	4.0	4.0	3.7	3.0	2.8	3.2	3.1
Colombia	6.3	11.1	9.2	9.5	9.8	11.7	10.4
Chile	4.6	4.6	4.9	5.0	5.2	5.9	5.9
Costa Rica	6.8	4.8	5.8	5.3	5.8	5.1	5.4
Ecuador	1.3	1.2	1.4	2.1	2.2	0.6	0.9
Bolivia	3.1	3.1	3.4	4.2	6.4	5.7	6.0
Peru	4.1	4.3	4.2	4.5	4.0	4.4	4.5
Mexico	5.3	4.8	4.8	6.4	6.8	6.9	7.2

Source: ECLAC, except Brazil, for which the source is the federal budget.

Table 3.5 Performance Indicators of Institutional Environments for Decentralization

Decentralization environment	Market enhancing	Market restricting
Automatic formula transfers		X
Tight budget	X	
Independent evaluations	X	
Endogenous or spurious evaluations		X
Transfers with an incentive content	X	
Primary and secondary education financed directly from national level		X
Discretion on expenditure decisions	X	
Earmarked funds tax institution		X
Flexibility of public expenditures framework	X	

proportion of GDP. Total expenditures increased, on average, from 23.5 percent of GDP in 1990 to 27.1 percent in 2000 (see Table 1.1).

In almost all countries, transfers from the national to the subnational level grew at a faster pace than total expenditures. At the same time, tax revenues were not growing as fast, and fiscal deficits increased across the region. Within a volatile macroeconomic environment, it was hardly possible for the authorities to focus on market-enhancing instruments to support the decentralization process.

In the particular case of decentralization, where large vertical imbalances and redistributive issues pose legitimate equity challenges, the inclination of traditional policymakers and the restrictions of political economy end up thwarting the use of incentives[1] and independent evaluations to assure welfare gains among the poorest jurisdictions and income groups. However, this is beginning to change in some countries, sectors and policy areas.

Over the last 10 to 15 years, the decentralization process in many Latin American countries has been characterized more by the application of traditional interventionist approaches than by the use of market principles or proxies of markets to enhance subnational development. Decentralization appears to have been sought more as an outcome of direct intervention and public choices than as a result of the spatial dissemination and application of market principles to make the public sector at all levels more efficient. The key conceptual point—that decentralization is a process rather than a one-time static objective—may have been missed in several countries. The enthusiasm for decentralization may have exceeded the understanding of how it really works.

The conclusion that emerges is that there has been an incomplete process of decentralization in many countries of the region. The backdrop to this is a culture that tends to favor rent seeking and rent giving through public choices over a rent-generating process through market choices.[2] However, the overall positive finding is that there seems to be much greater awareness that the structure of the public sector has to change in order to obtain different results. There appears to be a consensus that local governments will be the driving force for economic and social development in the decades ahead.

[1] For a detailed discussion of why incentives are not more intensively used in reform programs in developing countries, see Wiesner (2003b).

[2] This is the result of complex political economy conditions in which, as the relevant literature has pointed out, losers of reforms are better organized than winners or the public at large. According to Rodrik (2000), this is a distributive problem.

Major Challenges of Decentralization

The many challenges faced by decentralization in Latin America include cultural and historical "path dependency" favoring direct public interventions;[3] achieving of integrality in public policies; incentive to free-ride on transfers, along with the related commons problem; vertical imbalances and equity and poverty issues; subnational borrowing and central government bailouts; institutional development; and political economy restrictions.

Historical Path Dependency

The centralist tradition in Latin America goes back as least as far as Castile, Spain in the 16th century, and perhaps even to pre-Colombian times.[4] Castile, which was the most centralized of all major European governments, conducted the first centuries of Spanish colonization. Even before Columbus sailed to the New World, the governance structures prevailing in Mexico and Peru were highly centralized (Lafaye, 1970). Centralized structures appear to have characterized Latin America for more than 500 years.

This long tradition of political, economic and religious centralism has nurtured a proclivity for direct government intervention and the allocation of rents, privileges and power through public choices. The role of markets, incentives and political and economic competition has had a small and ephemeral role in the history of Latin America. Within this context, decentralization in the region is often perceived as a way of parceling out rents and powers. This contrasts with a process in which additional resources are generated through a change in the institutional structure and the use of policy and market incentives.

Integrality of Public Policies

A major challenge for policymakers is to ensure that their public policies form a consistent framework. This is critical in Latin America, and it represents the most complex challenge for multilateral agencies involved in any partnership for decentralization with countries in the region. Put simply, an integral

[3] North (1990) uses "path dependence" in the following sense: the stock of social capital is immense; it can be changed only at the margin; therefore, the immediate future is largely predetermined.

[4] See Veliz (1980) on the evolution of centralizing and decentralizing processes in Latin America.

policy framework means that all public policies, both macroeconomic and sectoral, contribute to maintaining one consistent policy direction. That direction is to allocate most public and private resources through a market or market-like process.

In the case of decentralization, integrality is needed to assure that markets, on their own and through their inherent incentives, reward efficiency at all levels of government. If, for instance, a given jurisdiction out of public entrepreneurship[5] decides to follow public policies that favor incentives and political participation through the fiscal system, market forces will tend to reward it with all sorts of benefits.[6] Market resources would flow to that jurisdiction. Such an approach by a jurisdiction would greatly alter the incentives of the market. To a large extent this is beginning to happen in Brazil, where some states and municipalities have decided to reform their fiscal institutions to attract private and public investment.

But if there are flaws or loopholes in the global national (or sectoral) policy framework, and other less judicious jurisdictions can get free resources through, for instance, transfers, then the positive market incentives will be overpowered by the negative public choice incentives. The jurisdiction that followed public entrepreneurship would be punished and would tend to abandon its market approach. Instead, it would seek gains from a parceling-out type of decentralization.

Free-Riding and the Commons Problem

Recent research on the relationships between fiscal institutions and fiscal performance suggests that fiscal deficits are largely the result of endogenous policymaking by self-interested political actors. According to Poterba and von Hagen (1999, p. 3), "deficits arise because the government's general tax fund is a 'common property resource' from which projects of public policy are being financed. This induces a 'common-pool problem' in which competing political groups vie for government expenditures that are financed using broad-based tax instruments."[7]

[5] See Kuhnert (2001, p. 26) on the subject of "public entrepreneurship" as part of an evolutionary process of "collective action."

[6] The argument would not change if instead of the word "jurisdiction" the word "country" were used.

[7] Jones, Sanguinetti and Mariano (1999, p. 148), have found that the common-property approach can explain Argentina's fiscal difficulties. In their view, "provincial governments tend to overexploit the common resource of national taxation."

Paraphrasing Olson (1965), it could be said that every jurisdiction and political actor has a strong incentive for free riding in the distribution of a collective good such as unconditional grants. If governments find themselves committed to meeting a transfer target (as was the case with Colombia and Ecuador, among others), a jurisdiction will perceive that pool of resources as common property. As Stein (1998, p. 357) has pointed out, this can lead to "overutilization of the common pool of resources as those who benefit . . . fail to internalize the full costs." The answer to the commons problem lies in a policy framework that focuses on efficiency and welfare gains that can be generated through incentives and a tight budget. Another possibility is to structure "contractarian" arrangements between a "principal" national government and a local "agent."[8]

One of the conclusions reached by Alesina and Perotti (1999, p. 33), after examining budget institutions, is that fragmented budget processes have a lot to do with budget deficits. Fragmentation takes place when, for instance, there are many budget actors, and when decision-making diffuses authority and accountability and the "wrong" incentives lead to higher spending. Fragmentation arises when different government levels and jurisdictions are perceived as independent fiscal boxes in which individual fiscal deficits have little impact on the total consolidated public sector deficit. This often happens when developing countries adopt decentralization frameworks without explicit budget constraints tailored to the characteristics of each public sector level or jurisdiction.

Vertical Imbalances and Equity and Poverty Issues

Poverty alleviation is rapidly becoming a major policy priority in Latin American countries such as Bolivia, Brazil and Ecuador. The challenge is to assist poor jurisdictions that cannot finance even minimum standards of social spending for the poor. This challenge is compounded by the public's perception that decentralization should just parcel out resources to poor jurisdictions. Governments can take a twofold response to this problem. First, they can establish equalizing grants to subsidize those poor jurisdictions while establishing incentives to reward efficiency gains in the achievement of those equity objectives. Second, they can give higher taxing authority to the poor jurisdictions and accompany that enhanced authority with incentives to reward better tax performance and expenditure evaluations.

[8] For a discussion of the "contractarian approach," see Dixit (1996).

Subnational Level Borrowing and Bailouts

The impact of subnational borrowing can be of critical importance, both for macroeconomic stability and for the effectiveness of the decentralization process itself. According to Bird (2000), since subnational governments cannot print money, a systemic problem can only arise if the central government validates subnational deficits by expanding the national deficit to finance them; if the central government explicitly or implicitly subsidizes subnational borrowing (for example, by guaranteeing it); or if subnational governments borrow abroad and spend the money in ways that do not add to the country's capacity to service foreign debt.

The problem is that central governments end up bailing out subnational governments, as happened recently in several countries in Latin America. Some would even argue that multilateral banks might unwittingly be supporting bailouts in Bolivia, Colombia and Ecuador.[9]

This is not an easy matter to resolve. Despite the potential for subnational fiscal indiscipline, there are some instances when borrowing is largely uncontroversial, such as for investment purposes. What to do? How can one find the right balance between jurisdictions that use their borrowing powers carefully and those that bet on future bailouts? There is no clear-cut answer. According to Bird (2000), "inappropriate borrowing by subnational governments should be viewed not as a problem of decentralization but as a symptom of more basic underlying inadequacies with the intergovernmental fiscal system in general." This is a key policy point, but the question remains: How then to correct those inadequacies of the intergovernmental fiscal system as a whole? Mexico's 2000 subnational borrowing regime comprises a varied mix of incentives and regulations embedded in its *Pacto Fiscal* (fiscal pact). Only the future will tell if this is a model to follow.[10]

Institutional Development

It is now widely accepted that institutions and collective rules matter in fundamental ways in explaining long-term economic and social development in countries with different factor endowments.[11] Institutions comprise both for-

[9] For Colombia, see Rentería, Echavarría and Steiner (2002). See also Dillinger and Webb (1999a, p. 20).

[10] For a full discussion of this model, see Giugale, Hernández Trillo and Oliveira (2000).

[11] As argued by several Nobel prize winners in economics. See Coase (1960), Buchanan (1991) and North (1981, 1990, 1993).

mal rules (like those embodied in a constitution) and informal ones (like unwritten norms) that constrain behavior.

North (1981, 1990 and 1991) has stressed that a distinction should be made between "institutions" and the "organizations" that emerge from them to administer and enforce the rules. When the term "institution" is mistakenly understood to refer to an organization, the challenge of institutional reform is incorrectly specified as consisting simply of organizational reform (Schiavo-Campo, 1994, p. 4). The two could coincide, but this is seldom the case. The reform challenge is to achieve both institutional transformation and organizational development. But the real problem is to understand the interplay and causality between institutions and organizations in each country. Considerable analytical and operational prudence should be the guiding principle. It should not be assumed that, if institutional change occurs, organizational development will follow spontaneously.

To complicate matters even more, institutional change does not occur by osmosis. Organizations themselves are the agents of change. When they are successful in changing the institutional rules so that resources are allocated to their most productive uses, institutional development has taken place. Hence institutional development can be defined as a move from a less efficient to a more efficient set of rules.

If institutions were perfect, the "right" organizations would emerge spontaneously. However, this argument can be likened to the neoclassical argument that, with perfect competition and perfect and costless information, divergences between public and private markets would not occur. Reality is different. Neither institutions nor markets are perfect, and organizations often need to become the source of change for both.

Political Economy Restrictions

Within the cultural environment of a historical path dependency favoring a largely nonmarket approach to decentralization, other more specific political economy restrictions also limit decentralization policies in Latin America. These restrictions arise mainly from three sources or processes: public sector rent seeking[12] and endogenous policymaking; losers and winners of reform; and informational restrictions and asymmetries.

[12] Tollison (1997) defines rent seeking as "the socially costly pursuit of wealth transfers." The concept of rent seeking was introduced in economics by Tullock (1967), who describes it as"the welfare cost of tariffs, monopolies, and theft." See also Krueger (1974).

Rent Seeking and Endogenous Policymaking

Downs (1957) observed that "in almost every policy area, those who stand the most to gain are the men who earn their incomes there." This is particularly relevant to decentralization, and can be applied to Latin America, where public sector rent seekers (particularly in the education and health sectors) have been able to capture public rents to their benefit.[13] In most Latin American countries, the central government continues to directly finance primary and secondary education. The resulting earmarked transfers, however, are largely managed and evaluated by an odd partnership between the national government (through the ministry of education) and teachers' labor unions.

The emerging institutional framework is one in which there are generally no independent evaluations, funds are assured to the supply side, consumers have little voice and hardly any options, and competition from the private sector is legally restricted.[14] Clearly these characteristics are far removed from a market-like decentralization process. What the framework amounts to instead is an example of sectoral policy determined endogenously by the vested interests in that particular sector. This also is an example of negative incentives undermining decentralization in a sector that epitomizes the potential advantages of decentralization. In fact, one could argue that the best strategy for advancing real decentralization would be to focus on sectors such as education and health.

Losers, Winners and Free Riding

Institutions are formal structures, and their informal rules and attendant enforcement mechanisms shape the behavior of individuals. By contrast, organizations are entities composed of individuals who act collectively in the pursuit of shared objectives. They do so within an institutional structure defined by formal and informal rules. As Burki and Perry (1998, p. 11) state: "Institutions constitute the incentive structure for the behavior of organizations and individuals."

The key analytical concept here is that institutional frameworks, as sets of rules, constitute de facto a set of incentives. These incentives can be intended or

[13] The concept of "capture" was developed by Stigler (1971, pp. 3–21).

[14] This establishes a monopoly power on the supply side that controls the use of inputs and does not allow competition or market processes to influence the production function for education.

unintended.[15] Within this institutional context, the questions that emerge are: What organizations are encouraged (through incentives) to emerge from the macro institutional decentralization frameworks prevailing in most Latin American countries? Given a particular set of decentralization rules (such as transfers, subsidies, earmarking, bailouts, and property rights), what policies would individuals, such as members of a teachers' association, find it in their interest to support? What incentives would some organized individuals wish to see in the institutional rules?

Olson (1965) held to the view that small organizations would be more capable than larger ones of exploiting the intended and unintended incentives of global institutional rules. When a decentralization program is put in place, it changes, or threatens to change, existing power shares. Those individuals who may be most affected by those policies are the best-informed ones. If they see that they may turn out to be the losers of that reform process, they will organize themselves to protect their interests. However, the potential winners of that reform process, a larger group, would have great difficulty in organizing themselves to protect the potential gains from the reforms or to prevent further loss of their welfare. In brief, the emergence of an organization depends on the critical factors of information, perceived group interests, and effectiveness of other overarching sets of rules.

The real factor behind the apparent passivity of the public at large, or of the potential winners of reforms, is the assumption that the government is focused on protecting the collective interest.[16] This naïve collective posture is exactly what the new theory of the firm questions when, analogously, shareholders in a firm assume that managers are there to protect their interests.

Informational Restrictions and Asymmetries

Part of the reason that markets are imperfect is that information, a key market component, is neither perfect nor without cost. As Stiglitz (1985, 1999, 2002) has pointed out, markets do not function flawlessly and resources may be misallocated when information is scarce. In the case of decentralization, the assumption is that information is most available at the local level, relative to the goods and services transacted there. But there is always an information restriction that limits the effectiveness of intergovernmental contracts and

[15] See Chapter II of Eggertsson (1990).

[16] On the subject of the "intermediation of societal interests," see Graham and Naim (1998).

arrangements. Different agents will have varying degrees of information, increasing the possibility of capture of nonmarket rents. In decentralization processes in which transfers can be the equivalent of nearly 6 percent of GDP, there is ample room for information failures—and hence for market inefficiencies.

Reform of Tax Assignment Distribution

If decentralization has more to do with raising taxes at the subnational than at the national level, then Latin America will be well advised to find ways to make the current distribution of taxing responsibilities among the different levels of government more effective in raising those taxes and taxes in general. The region also must find ways to reduce the "distance" between the tax collected and the expenditures financed. This would be the way to raise the share of "benefit taxation" within the total.

One on the foremost authorities on the subject of the "tax assignment problem," Charles McLure (2001, p. 339), avers that "choices of tax assignment depend crucially on history and both reflect and determine the degree of sovereignty allowed (or enjoyed by) second-tier governments." And Bird (2000) rightly observes that "the tax assignment that actually prevails in any country inevitably reflects more the outcome of political bargaining than the consistent application of any normative principles." But while a centralist history in Latin America explains the current centralist tax assignment, the challenge for the future is to find a better alignment between decentralized expenditures and decentralized taxing authority.

The current system in Latin America is one in which national levels are the dominant receptors and, hence, the major distributors of revenue.[17] This is the result of a long centralist tradition—Veliz (1980) even suggests that such centralism antecedes the discovery of the Indies. However, an effective decentralization process means that the decentralization of spending responsibilities needs to be accompanied by the assignment to subnational governments of significant own-sources of revenue. According Ter-Minassian (1997, p. 22), "this is necessary to promote fiscal responsibility by subnational government officials and their political accountability to the electorate."

Shifting more tax bases to the subnational level will be a major challenge for most Latin American countries, as they now face serious macroeconomic

[17] In other countries like China and Germany there has been a tradition of upward revenue sharing.

restrictions and need to reduce their fiscal imbalances.[18] Hence, policymakers will be weary of devolving or redistributing tax authority to the subnational level. And yet, in countries like Brazil (Afonso and Resende, 2002, p. 39), it appears that a restructuring of the VAT could increase tax revenues for all levels of government and simplify the tax system.[19] Colombia is another country seeking more revenue out of its income tax law as well as a more simple system that will not exclude the subnational level.[20]

To reduce the difficulties of subnational taxation in developing countries, Bird (1999, p. 35) recommends three principles: 1) more attention should be paid to matching expenditure and revenue needs; 2) more effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible; and 3) subnational taxes should not unduly distort the allocation of resources.

These are useful guidelines to tackle one of the most complex problems in any public sector. However, while there is a broad consensus in the literature regarding which level of government should tax what, where and how[21]—the seminal taxonomy proposed by Musgrave (1983)—in actual practice there are enormous political and institutional restrictions conditioning what each country finally ends up with. This is the basic "rumination" offered by McLure (2001).

In brief, it would be difficult to conclude that Latin America's decentralization experience in the 1980s and 1990s was a success or even a mild success. It was not. However, it may have been a learning period.

[18] The assignment of certain taxes to subnational governments need not involve a decentralized administration of these taxes.

[19] According to Slemrod (2002, p. 11), "complexity in tax systems arises when revenue needs increase and the top rate of taxes increases."

[20] See Wiesner (2003a).

[21] See Tanzi (1995) for the specifics of the criteria that could be applied to distribute taxing responsibilities amongst government levels.

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Chapter Four

Brazil

Brazil has been governed as a centralist state throughout its history, dating to 1808, when João VI Regent of Portugal arrived in Rio de Janeiro as head of the Braganza royal family. It is a major historical accomplishment that the country remained unified after independence was declared by Pedro I in 1822, considering the efforts by Portugal and England to undermine that unity and the number of regional insurrections and wars with other countries (Burns, 1970, p. 160). After all, it was a vast country that easily could have easily spawned several republics, as did the neighboring Spanish empire.

After the Brazilian army marched into the Royal Palace under Marshal Deodoro's orders on November 15, 1889 and forced the abdication of Don Pedro II, a new republic was established with a constitution that provided for a federal, republican and presidential form of government. The states were to be governed by popularly elected governors and were given ample taxing authority on state matters.

While federalism and state autonomy were formally adopted, however, the first republican years witnessed political turmoil, which was promptly repressed by Marshal Floriano Peixoto, who assumed the presidency after Deodoro in 1891.[1]

In the decades that followed, administrations successfully managed to balance the centralist needs of a republic with the reality of a huge country with strong tendencies towards decentralization. According to Afonso and Resende (2002), "the conflicts that emerged in the first republic (1889-1930) were due more to social conditions or political divergences than to secession intents." In the end, a flexible centralist tradition that allowed for growing but controlled federalism was maintained by a de facto alliance of the three southeast states, São Paulo, Minas Gerais and Rio de Janeiro.

[1] For a thorough description of the Brazilian revolts during the first 75 years of the republican era, see Carneiro (1965).

In brief, throughout its history, Brazil has been able to balance and respond with collective wisdom to the centrifugal and centripetal forces that from time to time have emerged. At the beginning of the 21st century, Brazil is firmly deepening its federalization process, and remains a solid, unified state.

The 1988 Constitution[2]

Brazil's national territory is divided into 26 states and a Federal District.[3] States in turn are divided into 5,500 municipalities, which as territorial subdivisions of the states include both rural and urban areas. Thus they are analogous to U.S. counties rather than to urban governments. There is a wide variation among jurisdictions at both levels. In terms of population, the states run the gamut from São Paulo (34 million) to Tocantins (250,000). Variations among municipalities are even wider. At the top of the scale are the megacities of São Paulo and Rio de Janeiro (10 million and 8 million inhabitants, respectively). At the opposite end are thousands of largely rural municipalities with populations under 5,000. Despite this variation, common legislation applies to all the jurisdictions within each tier of government.

The relationship between the three tiers of government is regulated by the federal 1988 constitution. In general, the constitution provides for substantial subnational autonomy. Each state has its own constitution and its own directly elected legislature. Governors are also directly elected. The federal government's power to intervene at the subnational level—i.e., to dismiss elected officials—is severely restricted. Like the states, the municipalities have directly elected councils and mayors. The constitution gives municipalities an unusual degree of independence. Unlike most federal constitutions, which define municipal governments as creatures of their respective states, the Brazilian constitution recognizes municipalities as a third tier of government. States therefore cannot compel or prohibit actions by the municipalities within their jurisdictions.

The autonomy of subnational governments is reinforced by the constitutional allocation of revenue sources. State governments have exclusive authority to impose the value-added tax (VAT) *(Imposto sobre a Circulação de*

[2] This summary was taken from World Bank (2000).

[3] In terms of location, the states can be broken down as follows—**Southeast:** Minas Gerais, Espírito Santo, Rio de Janeiro and São Paulo; **North:** Rondônia, Acre, Amazonas, Roraima, Pará, Amapá and Tocantins; **Northeast:** Maranhão, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe and Bahia; **South:** Paraná, Santa Catarina and Rio Grande do Sul; and **Center-West:** Mato Grosso do Sul, Mato Grosso, Goiás and the Federal District.

Mercadorias e Serviços, ICMS), which is the highest yielding non-social security tax in the country. As such, it gives the states an independent power base, particularly in the wealthy southeast, where the VAT is the principal source of state revenues. Poorer states benefit from federal revenue sharing. Sharing arrangements are explicitly defined in the constitution. States therefore regard these transfers as theirs by right, rather than as funds that can be granted or withdrawn at the discretion of the federal government.

The municipalities are assigned exclusive power to impose taxes on urban property *(Imposto sobre Propriedade Predial e Territorial Urbana, IPTU)* and personal and professional services *(Imposto sobre Serviços, ISS).* It is revenue sharing, rather than taxes, that provides the fiscal basis for municipal autonomy, however. Like the states, the municipalities are constitutionally assigned fixed shares of federal revenues, distributed according to formula and exempt from earmarking. In addition, states are constitutionally required to transfer fixed shares of their VAT revenues to municipalities. Except in the largest and most urbanized municipalities, such revenue sharing accounts for the vast majority of municipal revenues.

In contrast to its explicit division of revenues, the constitution is deliberately vague in assigning functions to each tier of government. While it explicitly defines the powers of the federal government, it grants the states "all powers not otherwise prohibited to them by this constitution." Municipalities, in turn, are granted "the power to provide services of local interest." Among the exclusive responsibilities assigned to the federal government are national defense, social security, emission of currency, control of public debt, regulation of interstate and foreign trade, and the power to establish the "general norms of public employment." The constitution also delineates certain concurrent responsibilities of the federal government and the states, including tax legislation, education and social assistance.

Within this general framework, individual jurisdictions are free to define their own scope of activities. Until recently, for example, the federal government owned and operated the suburban railway systems in all of Brazil's major metropolitan areas. These have now been transferred to the states. Variability in the division of responsibilities is particularly marked between the state and municipal levels. Because municipalities are constitutionally recognized as an independent tier of government, state governments cannot impose a division of functions between themselves and their municipalities. As a result, the dividing line between state and municipal responsibilities tends to reflect an accumulation of historical precedents and the relative availability of resources at each level. In the municipality of Rio, for example, most primary education is pro-

vided by the municipal government, while in the municipality of São Paulo, it is largely provided by the state.

Fiscal Institutions[4]

Brazil's 1988 constitution is explicit in dividing up revenues. It assigns specific tax bases to each level of government and creates a system of tax sharing that substantially redistributes revenue among levels of government and regions. The state governments are assigned a value-added tax, which is assessed and collected directly by each state government. Although the senate sets VAT rates, states have some flexibility to set the rates on intrastate sales, subject to a floor and ceiling set by the senate.

The federal constitution requires states to transfer 25 percent of the proceeds of the VAT to the municipalities within their territory, partly on the basis of the "origin" of tax collections and partly according to formulas devised by each state legislature. States can also tax automobiles and property. Municipalities are assigned an urban property tax, a tax on services (the ISS), and a real estate transaction tax. The ISS is assessed and collected by the municipality at rates set by it but subject to a maximum fixed by federal law.

Brazil's transfer system includes transfers from the federal government to states, federal transfers to the municipalities, and constitutionally mandated transfers from the states to the municipalities. The federal component of Brazil's intergovernmental tax sharing consists of fixed shares of the federal government's two principal taxes: the income tax and the industrial products tax. The 1988 constitution requires the federal government to transfer 21.5 percent of the revenues from these two taxes to the states. Of this amount, 85 percent is distributed to the states of the north, northeast, and center-west regions, with the remainder going to the states of the south and southeast. Thus the states with the largest economies and tax bases of their own (south and southeast) rely very little on revenue sharing.

Within each group of states, 95 percent of the funds is distributed among states on the basis of population and per capita income (with poorer states receiving proportionately more). The remaining 5 percent is distributed on the basis of geographic location. Another 22.5 percent of the income and industrial products taxes is distributed to municipalities. Of this, 10 percent is transferred to state capitals on the basis of population and per capita income of the sur-

[4] This summary was taken from Dillinger and Webb (1999b, pp. 8-10).

rounding state. The remaining 90 percent is distributed among all other municipalities on the basis of population and per capita state income.

Compared with previous arrangements, the 1988 constitution shared substantially more taxes with subnational levels, doubling the size of the participation funds (relative to their 1967 shares). The constitution also expanded the base of the state VAT at the expense of the federal government by abolishing federal taxes on fuel, electric power, mining and transport, and incorporating their bases into the VAT. At the same time, the constitution also forced the states to sacrifice revenue in the interest of the municipalities, by increasing the municipal share of the VAT from 20 to 25 percent.

On average, states of the north, northeast, and center-west receive twice the level of participation funds as states of the south and southeast. Because most federal taxes are generated in the south and southeast, the extent of regional redistribution is even greater than this population-based calculation would suggest.

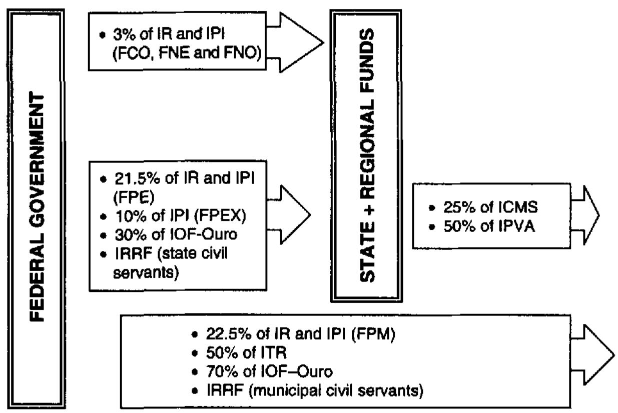
State governors are directly elected for four-year terms (and as of 1998 can succeed themselves once). States have unicameral legislatures, whose members are elected at large by proportional representation and serve four-year terms with no limit on successive terms. This structure is repeated at the municipal level, where mayors are directly elected and council members are elected at large by proportional representations.

In Brazil, the federal government has tried with increasing intensity to control state borrowing. The constitution gives the senate authority to regulate all state borrowing, and it has traditionally set those guidelines based on the state's existing stock of debt, revenues and debt service obligations. But the senate can grant exceptions and has done so. The executive branch imposes a variety of regulations and controls on borrowing according to the sources of credit. Borrowing from the domestic banking sector falls under the purview of the central bank. Figure 4.1 shows the flow of tax-sharing constitutional arrangements.

The Deepening of Federalism

If true decentralization is expressed more by the growth of subnational own-tax shares and intergovernmental revenues than by levels of subnational expenditures, then Brazil's growing decentralization and federalism has been accelerating in the last 40 years. Table 4.1 shows that gross tax revenues and net tax revenues of the states and municipalities grew substantially as a percentage of GDP and of the total.

Figure 4.1 Flow of Constitutional Transfers



Source: ECLAC, Brazil.

FCO: Center-West Finance Fund (*Fundo de Financiamento do Centro-Oeste*)
FNE: Northeast Finance Fund (*Fundo de Financiamento do Nordeste*)
FNO: Northern Finance Fund (*Fundo de Financiamento do Norte*)
FPE: State Participation Fund (*Fundo de Participação dos Estados*)
FPEX: Compensation Fund for the Export of Manufactured Goods (*Fundo de Compensação pela Exportação de Produtos Industrializados*)
FPM: Municipalities' Participation Fund (*Fundo de Participação dos Municípios*)
ICMS: Tax on Merchandise and Services (*Imposto sobre a Circulação de Mercadorias e Serviços*)
IOF-Ouro: Tax on Financial Operations in Gold Transactions (*Imposto sobre Operações Financeiras nas Transações com Ouro*)
IPI: Tax on Manufactured Goods (*Imposto sobre Produtos Industrializados*)
IPVA: Tax on the Property of Self-Propelled Vehicles (*Imposto sobre a Propriedade de Veículos Automotores*)
IR: Income Tax (*Imposto de Renda*)
IRRF: Income Tax Retained at Source (*Imposto de Renda Retido na Fonte*)

Table 4.1 shows that within growing total tax revenue as a percentage of GDP (from 17.4 percent in 1960 to 32.7 percent in 2000), the federal gross tax share of the total fell from 64 percent to 47.2 percent. The state tax share also fell from 31.3 percent to 27.7 percent, but the local share grew from 4.7 percent to 5 percent. Over 1975-2000, social contributions grew immensely, from 4.3 percent of total tax revenues to 20.1 percent. This fast increase somehow mitigated the drop in tax revenues at the federal level, as some of those contributions financed expenditures in the federal budget.

The right hand side of Table 4.1 is even more revealing of Brazil's fast pace of fiscal decentralization. From the total disposable revenue perspective, the federal level saw its share fall from 59.5 percent in 1960 to 56.7 percent in 2000. The federal share of taxes fell much more substantially, from 59.5 percent in 1960 to 36.7 percent in 2000. The states also saw their disposable share fall from 34.1 percent to 26.4 percent. The only increase took place at the municipal level, which registered a huge increase, from 6.4 percent to

Table 4.1 Brazil: Gross and Net Tax Collections by Government Level
(In percent)

	Total tax revenue as % of GDP	Own-tax collections					Disposable tax revenues			
		Federal					Federal			
		Total	Taxes[1]	Social contr.[2]	State	Local	Total	Taxes[1]	State	Local
1960	17.4	64.0	64.0	0.0	31.3	4.7	59.5	59.5	34.1	6.4
1965	19.0	63.6	63.6	0.0	30.8	5.6	54.8	54.8	35.1	10.1
1970	26.0	66.7	66.7	0.0	30.6	2.7	60.8	60.8	29.2	10.0
1975	25.2	73.7	69.4	4.3	23.5	2.8	68.0	63.7	23.3	8.7
1980	24.5	74.7	70.5	4.2	21.6	3.7	68.2	64.0	23.3	8.6
1985	24.1	72.7	66.8	5.9	24.9	2.4	62.7	56.7	26.2	11.1
1990	28.8	67.0	55.8	11.2	29.6	3.4	58.9	47.7	27.6	13.5
1995	29.4	66.0	51.5	14.5	28.6	5.4	56.2	41.7	27.2	16.6
2000	32.7	67.3	47.2	20.1	27.7	5.0	56.7	36.7	26.4	16.9

Sources: Varsano et al. (1998) and Araujo (2001).
[1] Tax receipts, social security contributions and unemployment insurance.
[2] Turnover taxes, tax on financial transactions and net profits tax.

Table 4.2 Brazil: Transfers from the National to Subnational Level
(Percent of GDP)

Constitutional transfers	1994	1995	1996	1997	1998	1999	2000
From federal level to:							
a. States	1.65	1.88	1.79	1.73	1.56	1.77	1.78
b. Municipalities	1.20	1.36	1.30	1.29	1.25	1.38	1.32
Total transfers from national to subnational level (a+b)	2.85	3.24	3.09	3.02	2.81	3.15	3.10

Source: Federal Revenue Service.

16.9 percent of the total. This clearly demonstrates Brazil's process of growing fiscal municipalization. As will be seen, the increase reflects growing transfers from the federal and the state level as well as growth in municipal own-tax collections.

Tables 4.2 and 4.3 show the flow of transfers from the federal level to the states and municipalities over 1994-2000. In 1994, the federal level transferred resources equivalent to 1.65 percent of GDP to the states and 1.2 percent to the municipalities. By 2000, these transfers had grown to 1.78 percent and 1.32 percent, respectively, for a total of 3.1 percent.

Table 4.3 shows that transfers from the states to the municipalities also grew in this period as a percentage of GDP. In net terms, the states had a negative transfer balance, as they received fewer transfers from the federal government than they themselves transferred to the municipal level.

Table 4.4 shows that while Brazil's process of municipalization is evident both in terms of GDP growth and within the total, with a doubling between 1988 and 1999, in terms of "stocks," the states are still very much the bulwark of Brazil's federalism. And these large state revenue shares continue to grow, albeit at a slower pace than those at the local level. From 1980 to 1999, gross tax revenues at the state level, as a percentage of GDP, grew from 5.4 percent to 8.4 percent. Even the states' net tax revenues grew from 5.5 percent to 8.1 percent. In brief, in terms of size, the states are several

Table 4.3 Transfers from Brazilian States to Municipalities
(Percent of GDP)

Constitutional transfers	1994	1995	1996	1997	1998	1999	2000
From state level to municipalities	1.93	2.02	1.99	1.93	1.91	2.00	2.13

Source: Federal Revenue Service.

Table 4.4 Brazil: Tax Revenues by Jurisdictions[1]

Government level	Gross tax revenues[2] 1980	1988	1999p	Net tax revenues[3] 1980	1988	1999p
(Percent of GDP)						
Total	24.6	22.5	31.8	24.6	22.4	31.8
Federal	18.5	15.8	21.7	17.0	14.0	18.2
States	5.4	6.0	8.4	5.5	6.0	8.1
Municipalities	0.7	0.7	1.7	2.1	2.4	5.5
(Percent of total revenues)						
Total	100	100	100	100	100	100
Federal	75.1	70.6	68.2	69.2	62.3	57.2
States	22.0	26.5	26.3	22.2	26.9	25.4
Municipalities	2.9	2.9	5.5	8.6	10.8	17.4

Sources: IBGE, FGV, STN (Balanço Geral da União, Finanças do Brasil, SFR, Ministry of Social Security and Assistance, CEF, CONFAZ and ABRASF).
[1] For 1980, from IBGE, with revisions added. For 1980-88, from IBGE. For 1999, estimated by SF/BNDES.
[2] Refers to tax revenues collected by each jurisdiction.
[3] Excludes constitutional revenue-sharing transfers.
p = preliminary.

times larger that the local governments, but the latter are growing at a much faster pace.

Table 4.5 shows that the federal level increased its share of gross tax revenue from 16.12 percent of GDP in 1991 to 23.62 percent in 2001. At the same time, the subnational level grew from 8.5 percent to 10.75 percent of GDP.

This data would suggest that Brazil's process of "real decentralization" could be somewhat questioned, as it is the federal level that appears to have

Table 4.5 Brazil: Relative Shares of Gross Tax Revenue by Level of Government, 1991-2000
(Percent of GDP)

	Tax revenue by level of government	1991	1995	2000	2001
A	Federal or union[1]	16.12	19.38	22.75	23.62
B	State	7.32	7.77	8.71	9.21
C	Municipal	1.18	1.32	1.48	1.54
D	Subnational (B+C)	8.50	9.09	10.19	10.75
E	Total tax gross revenue by non-financial public sector	24.62	28.47	32.94	34.37

Source: Federal Revenue Service.
Note: The title refers to gross tax revenues collected by each level of government, excluding constitutional transfers among the states or levels. This is what could be called "own taxes" by each level of government before transfers are incurred.
[1] Includes social security budget and others.

Table 4.6 Brazil: Intergovernmental Shares of Gross Tax Revenues as a Percent of Total

	Tax revenue collected by level of government	1991	1995	2000	2001
A	Federal or union[1]	65.48	68.07	69.07	68.73
B	State	29.73	27.29	26.44	26.80
C	Municipal	4.79	4.64	4.49	4.48
D	Subnational (B+C)	34.52	31.93	30.93	31.28
E	Total	100.00	100.00	100.00	100.00

Source: Federal Revenue Service.
Note: The title refers to gross tax revenues collected by each level of government, excluding constitutional transfers among the states or levels. This is what could be called "own taxes" by each level of government before transfers are incurred.
[1] Includes social security budget.

grown the most. And yet it could also be argued that the growth at the state and municipal level is even more remarkable, having taken place while the federal government was absorbing growing shares of resources in terms of GDP.

Table 4.6 shows the intergovernmental revenues shares as a percentage of the total. Over 1991-2001, the federal share of the total was the only one that grew, going from 65.48 percent to 68.73 percent. The subnational share decreased from 34.52 percent to 31.28 percent. Would this data again cast doubt of a "real process" of decentralization taking place in Brazil?

Before answering this question, the data for 1999-2001 should be taken into account, particularly in terms of the components considered to be federal revenue. Table 4.7 shows that the specific GDP share of the federal budget

Table 4.7 Brazil: Relative Shares of Gross Tax Revenue by Level Of Government, 1999-2001
(Percent of GDP)

	Tax revenue by level of government	1999	2000	2001
A	Federal or union[1]			
	a. Fiscal budget	8.82	8.32	8.56
	b. Social security budget	11.12	12.12	12.64
	c. Others	2.53	2.31	2.42
	d. (b+c)	13.65	14.43	15.06
	e. Total federal (a+d)	22.47	22.75	23.62
B	State	8.17	8.71	9.21
C	Municipal	1.51	1.48	1.54
D	Subnational (B+C)	9.68	10.19	10.75
E	Total tax gross revenue by non-financial public sector	32.15	32.94	34.37

Source: Federal budget.
Note: The title refers to gross tax revenues collected by each level of government, excluding constitutional transfers among the states or levels. This is what could be called "own taxes" by each level of government before transfers are incurred.
[1] Includes social security budget and others.

decreased from 8.82 percent of GDP to 8.56 percent. What grew were the shares of the "social security" portion, which went from 13.65 percent to 15.06 percent. The shares of the state and municipal level also grew by over one percentage point of GDP.

Of the total increase in tax revenues at the federal level—which went from 22.47 percent to 23.62 percent, an increase of 1.15 percent—1.41 percent corresponded to the social security budget. In other words, the fiscal budget of the federal level actually decreased. A large portion of the social contributions goes to finance decentralization processes at the state and municipal level, such as the SUS in health, the FUNDEF in education, and other expenditures of the Alvorada Program.

Table 4.8 shows other data that should be examined before reaching any conclusion as to whether the subnational tax shares have grown relative to the federal level. The table shows the amounts of all taxes and social security revenues collected in Brazil in 2000 and 2001 by specific source at each level of government. Gross tax shares of the states were 8.71 percent and 9.21 percent of GDP for the respective years, larger than the federal shares, which were 8.32 percent and 8.56 percent. The shares of the social security budget were above 12 percent of GDP, considerably higher than at the federal level. The shares at the municipal level—1.48 percent in 2000 and 1.54 percent in 2001—were lower than those of the "others" category of social security.

Table 4.8 Brazil: Gross Tax Burden
(Millions of reais)

	2000		2001	
	GDP: 1,086,700		GDP: 1,184,000	
	Value (R$)	% GDP	Value (R$)	% GDP
FEDERAL GOVERNMENT	**247,276**	**22.75**	**279,581**	**23.61**
Fiscal budget	**90,448**	**8.32**	**101,316**	**8.56**
– Income tax	59,696	5.49	68,803	5.81
Individual	3,383	0.31	3,724	0.31
Legal entity	16,634	1.53	16,232	1.37
Retained at source	39,679	3.65	48,847	4.13
– Employment	18,224	1.68	21,552	1.82
– Overseas residents	3,273	0.30	4,514	0.38
– Capital gains	10,723	0.99	15,205	1.28
– Other revenue	7,460	0.69	7,577	0.64
– Tax on manufactured goods	18,689	1.72	19,317	1.63
– Tax on financial operations	3,096	0.28	3,559	0.30
– Tax on foreign trade	8,443	0.78	9,104	0.77
– Tax on rural land ownership	231	0.02	191	0.02
– Federal fees	292	0.03	342	0.03

(continued)

Table 4.8 Brazil: Gross Tax Burden *(continued)*
(Millions of reais)

	2000		2001	
	GDP: 1,086,700		GDP: 1,184,000	
	Value (R$)	% GDP	Value (R$)	% GDP
Social security budget	**131,744**	**12.12**	**149,657**	**12.64**
– Contribution to social welfare	55,715	5.13	61,060	5.16
– Contribution to social security financing (COFINS)	38,494	3.54	45,436	3.84
– Provisory contribution on financial movements (CPMF)	14,395	1.32	17,157	1.45
– Social contribution on net profits (CSLL)	8,716	0.80	8,985	0.76
– Social Integration Program (PIS) and Civil Servant Patrimony Formation Program (PASEP)	9,531	0.88	11,148	0.94
– Contr. public social security	3,619	0.33	3,813	0.32
– Other social contributions	1,273	0.12	2,058	0.17
Other	**25,084**	**2.31**	**28,609**	**2.42**
– Length of Service Guarantee Fund (FGTS)	18,709	1.72	21,074	1.78
– Economic contributions	939	0.09	1,176	0.10
– Education salary	2,791	0.26	3,123	0.26
– "S" System	2,646	0.24	3,235	0.27
STATES	**94,678**	**8.71**	**109,039**	**9.21**
– Tax on merchandise and service (ICMS)	82,279	7.57	94,267	7.96
– Tax on ownership of self-propelled vehicles (IPVA)	5,294	0.49	6,287	0.53
– Tax on *causa mortis* transmissions and on donations (ITCD)	329	0.03	339	0.03
– State fees	1,569	0.14	1,659	0.14
– State social welfare	4,886	0.45	6,112	0.52
– Other (AIR, ICM, ETC)	322	0.03	375	0.03
MUNICIPALITIES	**16,063**	**1.48**	**18,244**	**1.54**
– Tax on services (ISS)	5,923	0.55	6,786	0.57
– Tax on urban land and building property (IPTU)	4,519	0.42	5,367	0.45
– Tax on inter vivos transmissions of real estate (ITBI)	950	0.09	981	0.08
– Municipal fees	3,239	0.30	3,426	0.29
– Municipal social welfare	1,055	0.10	1,253	0.11
– Other	377	0.03	432	0.04
TOTAL	**358,017**	**32.95**	**406,865**	**34.36**

Source: Federal Revenue Service.

Table 4.9 shows the tax and "contribution" shares per each source of income at each one of the three levels of government for 2000 in GDP terms and as a percentage of the totals. This table, as well as Table 4.5, desegregate the 33.18 percent points of GDP of "gross tax burden" for Brazil in 2000.

In brief, even while the national level has been making a major fiscal effort in the last three years to regain control over its macroeconomic variables, a process of real decentralization has continued to take place in Brazil. The subnational level as well as the social security level have continued to grow vis-à-vis the federal level.

Intergovernmental Transfers

Constitutional transfers are important in Brazil and are a growing share of GDP. Tables 4.2 and 4.3 showed that in 2000, the federal level transferred 3.1 percent of GDP to the subnational level, while the state level transferred 2.13 percent of GDP to the municipalities.

Table 4.10 shows that transfers from the federal to the subnational level represented 37.3 percent of total federal tax revenue.

Table 4.11 shows that transfers from the state to the municipal level represented 24.4 percent of state tax revenues.

Perhaps more important than the relative weight of transfers out of a given level of government is the significance of transfers at another level of government. Table 4.12 shows the importance of transfers at the state and municipal levels relative to their own-tax revenues. At the state level in 2000, transfers amounted to 20.48 percent of own-tax revenues. This ratio flips over when looking at the municipal level. There, transfers received from the federal and state levels were 126.9 percent of municipal own-tax revenue. Own-tax revenue at the municipal level was 44.05 percent of transfers received from "above" in 2000. This proportion was 42.3 percent in 1995.

The policy conclusion is that in spite of growing tax collection at the municipal level, transfers from the national and state level continue to account for a substantial and growing proportion of municipal revenues.

The Process of Municipalization

The stability of the process of "municipalization" in Brazil can be appreciated through Table 4.13. It shows that over 1994-2000, the federal government's

Table 4.9 Brazil: Yield of Main Taxes, 2000

Tax	Classification		Gross yield		
	Type	Level	R$MIL	% of total	% of GDP
1 ICMS	Tax	State	82,279,381.00	22.76	7.55
2 Income tax	Tax	Federal	59,695,994.94	16.51	5.48
3 Contribution to social welfare	Contribution	Federal	55,715,135.19	15.41	5.11
4 CONFIS	Contribution	Federal	38,494,077.84	10.65	3.53
5 FGTS	Contribution	Federal	18,708,530.53	5.17	1.72
6 IPI	Tax	Federal	18,688,720.65	5.17	1.72
7 CPMF	Contribution	Federal	14,394,827.67	3.98	1.32
8 PIS/PASEP	Contribution	Federal	9,531,251.91	2.64	0.87
9 CSLL	Contribution	Federal	8,716,336.73	2.41	0.80
10 IPEX	Tax	Federal	8,443,213.79	2.34	0.77
11 ISS	Tax	Municipal	6,354,653.90	1.76	0.58
12 IPVA	Tax	State	5,293,672.00	1.46	0.49
13 IPTU	Tax	Municipal	5,086,659.82	1.41	0.47
14 State social welfare	Contribution	State	4,885,516.08	1.35	0.45
15 Contribution of civil servants to social welfare	Contribution	Federal	3,618,760.19	1.00	0.33
16 Municipal fees	Fee	Municipal	3,096,632.35	0.86	0.28
17 IOF	Tax	Federal	3,096,091.72	0.86	0.28
18 COTA-PARTE COMP. FINANCE	Contribution	Federal	3,026,983.09	0.84	0.28
19 Education-Salary	Contribution	Federal	2,791,251.21	0.77	0.26
20 Systems	Contribution	Federal	2,645,557.63	0.73	0.24
21 State fees	Fee	State	1,568,634.00	0.43	0.14
22 Other social contributions	Contribution	Federal	1,273,427.75	0.35	0.12
23 Municipal social welfare	Contribution	Municipal	1,042,737.78	0.29	0.10
24 ITBI	Tax	Municipal	878,335.04	0.24	0.08
25 Merchant Navy AFR	Contribution	Federal	483,009.43	0.13	0.04
26 ITCD	Tax	State	328,560.00	0.09	0.03
27 Other State Revenues	Tax	State	322,333.00	0.09	0.03
28 Federal Fees	Fee	Federal	292,274.66	0.08	0.03
29 FUNDAF	Contribution	Federal	289,183.99	0.08	0.03
30 ITR	Tax	Federal	230,884.08	0.06	0.02
31 Other Economic contributions	Contribution	Federal	166,346.77	0.05	0.02
32 Other municipal contributions	Tax	Municipal	131,148.49	0.04	0.01
31 IPMF	Tax	Federal	633.50	0.00	0.00
TOTAL			**361,570,756.73**	**100.00**	**33.18**

Note: GDP 2000 (R$ millions): 1,089,688.14

Table 4.10 Brazil: Transfers as a Proportion of Federal Tax Revenue
(Percent of GDP)

	Transfers	2000
A	Federal fiscal budget	8.31
B	Transfer to subnational level	3.10
	B/A	37.30

Source: Tables 4.2, 4.3 and 4.8.

Table 4.11 Brazil: Transfers as a Proportion of State Tax Revenue
(Percent of GDP)

	Transfers	2000
A	States tax revenue	8.71
B	Transfers to municipalities	2.13
C	B/C	24.40

Source: Tables 4.3 to 4.8.

Table 4.12 Brazil: Transfers as a Proportion of Subnational Tax Revenues
(Percent of GDP)

	Transfers and own-tax revenues	1995	2000
A	Own-tax revenue of states	8.32	8.69
B	Net transfers received by states from federal government	1.88	1.78
C	State transfers received as % of state own-tax revenue (B/A) = C	22.60	20.48
D	Municipal own-tax revenue	1.43	1.52
E	Transfers received by municipalities from federal and state levels	3.38	3.45
F	Transfers received as % of municipal own-tax revenue (E/D) = F	236.36	126.97
G	Municipal own-tax revenue as % of transfers received from the federal and state levels (D/E) = G	42.30	44.05

Source: Federal Revenue Service.
Note: Refers only to constitutional transfers.

tax share before transfers remained stable at around 69 percent. Once transfers are deducted, that share becomes 59.88 percent in 2000. The state share comes down both before and after transfers. The municipal share grows from 3.45 percent before transfers to 4.59 percent, and grows slightly after transfers from 14.07 percent to 14.99 percent.

Table 4.14 shows the flow of transfers to and from different levels of government. The federal as well as the state level transferred increasing amounts

Table 4.13 Brazil: Federal and Subnational Shares of Tax Revenues, Before and After Transfers
(In percent)

	Share before transfers				Share after transfers			
Year	Federal	State	Municipal	Total	Federal	State	Municipal	Total
1994	69.45	27.10	3.45	100.00	59.79	26.14	14.07	100.00
1995	62.24	27.95	4.81	100.00	56.34	27.50	16.16	100.00
1996	66.79	28.30	4.91	100.00	56.14	27.61	16.24	100.00
1997	67.67	27.27	5.06	100.00	57.26	26.57	16.17	100.00
1998	68.65	26.18	5.17	100.00	59.20	25.02	15.78	100.00
1999	69.89	25.42	4.69	100.00	60.11	24.70	15.19	100.00
2000	69.23	26.19	4.59	100.00	59.88	25.13	14.99	100.00

Source: Federal Revenue Service.
Note: Refers only to constitutional transfers.

to other jurisdictions. The municipal level made no transfers and received shares from other jurisdictions that increased from 3.59 percent of GDP in 1995 to 4.26 percent in 2000.

This data suggest that a policy and a process are in place to strengthen the fiscal growth of the municipal sector. This sector receives substantial and growing shares from the federal as well as the state level. It has also seen its "own" share grow as a percentage of GDP, even when the other levels were also increased their own shares (Table 4.8).

The fiscal municipalization process is taking place within a country that is also experiencing long-term structural changes in the spatial distribution of its economic development. Table 4.15 shows that while the southeast and south, long the dominant regions of the country, are gaining some relative GDP participation, the northeast and center-west are pretty much maintaining their combined share. The north's participation is declining.

Although these numbers are not final, it may be said that an incipient process of regional recomposition is taking place as a result of two processes:

Table 4.14 Brazil: Revenue Sharing Transfers
(Percent of GDP)

Origin and destination	Federal		State		Municipal		Total	
of transfer	1995	2000	1995	2000	1995	2000	1995	2000
To other jurisdictions	3.72	4.28	2.02	2.13			5.74	6.42
From other jurisdictions			2.15	2.16	3.59	4.26	5.74	5.74

Source: Federal budget and the Banco Federativo (BNDES).
Note: Refers to constitutional revenue-sharing transfers plus other current transfers.

Table 4.15 Brazil: Gross Domestic Product by Region
(Percent of national total)

Year	Southeast	South	Northeast	Center-west	North
1985	59.1	17.4	13.9	5.3	4.4
1990	58.4	16.0	14.0	6.6	5.0
1995	56.5	16.5	13.8	7.0	6.2
1996	57.9	15.7	13.4	7.0	6.0
2000	58.3	17.7	13.1	6.4	4.4

Source: Country Profile 2001, Brazil, The Economist Intelligence Unit. For 2000, BNDES.

first, specific governmental interventions, and second, the underlying structural change led by long-term market forces.[5] The northeast, a huge territory of 1.5 million km^2 and a population of nearly 50 million people, is still struggling to overcome extreme poverty, particularly in the rural areas.

Table 4.15 shows an incipient loss of relative importance by the traditionally dominant southeast region. By 1996, the north, which was the less developed region, had gained about 1.6 percent of GDP share. The center-west also appears to be growing relative to other regions.

This process of regional recomposition is surely the result of specific interventions and decentralization policies. But these alone could not sustain what regional development and market forces would not support in the long term. Fortunately, such regional policies are well anchored in carefully designed strategies such as those contained in the *Plano Plurianual* (PPA), and in studies such as the *Estudo dos Eixos Nacionais de Integração e Desenvolvimento.*

Macroeconomic Context of Decentralization in the 1990s

There was a close and intricate relationship between macroeconomic developments and decentralization processes in Brazil during the 1990s. These two sets of policies and variables affected and aggravated each other in several complex ways.[6] The high inflationary period in the first half of the 1990s (reaching 2,708 percent in 1993), the large fiscal deficits, the indexation problems, and the bailout of the state banks by the federal government in 1996-97,

[5] For an examination of Brazil's medium-term planning framework, see World Bank (2001a). For a summary of Brazil's long-term strategic priorities, see Cardoso (2002) and Tavares (2002).

[6] For a discussion of Brazil's policies during this period, see Baer and Paiva (2001).

were inputs and outputs of fiscal and financial imbalances at the federal, state and municipal levels.[7]

The question that emerges is whether Brazil has overcome these pernicious interactions and has restructured its fiscal and institutional framework in a way in which macroeconomic stability is preserved and decentralization is enhanced. The answer appears to be that Brazil is close to achieving this goal.

The imbalances began to be corrected with the successful launching of the Real Plan in 1994.[8] The immediate effect of the plan was to reduce the rate of inflation from 1,093 percent in 1994 to 14.78 percent in 1995. The economy grew by 4.2 percent in 1995 but the current account deficit continued to widen to -2.9 percent in 1996 and to -3.8 percent in 1997 (Table 4.16). It surpassed 4 percent in 1998 and remained above that level into 2002.

However, in the years that followed, the government incurred large fiscal deficits. From 1996-99, the overall balance of the consolidated public sector grew from -5.9 percent of GDP to -10 percent. Tax revenue for the public sector as a whole dropped from 24.3 percent in 1995 to 23.6 percent in 1997. In the meantime, expenditures of the central government grew by 5 percent of GDP between 1996 and 1998. Table 4.17 shows a calculation of the fiscal deterioration between 1991-94 and 1995-98.

With regard to fiscal management from 1994 to 2002, Giambiagi (2002, p. 1) offers two far-reaching conclusions. First, that "the most relevant cause for the fiscal worsening during the first Cardoso administration was the deterioration of the primary result and not the increase in the interest burden;" and second, that "the total primary federal public expenditure grew in real terms in all the eight years—with no exceptions—of the two administrations, at an yearly average of 6 percent, more than doubling the average of yearly GDP growth rate of 2.4 percent."

The concern is that the counterpart of this less than tight fiscal budget constraint has been a fast growing debt that has reached critical levels. Since public sector taxes and social security contributions have reached levels above 33 percent of GDP, higher taxes are hardly possible.[9]

[7] On indexation problems, see Bacha (1995) and Franco (1995). On bailouts, see Bevilaqua (2002). For details on how the stabilization plan was formulated, see Arida and Resende (1985).

[8] According to Giambiagi (2001, p. 14), the 1994 Real Plan "can be seen as the logical macroeconomic counterpart to the market-oriented reforms carried out in the 1990s, both in the sense of magnifying their impact on growth and of generating the political conditions to pursue them."

[9] See Netto (2001, p. 20).

Table 4.16 Brazil: Key Economic Indicators
(Percent of GDP)

Indicator	1995	1996	1997	1998	1999	2000	2001	2002p
Real GDP growth rates	4.2	2.7	3.3	0.2	0.8	4.5	2.0	2.5
Current account balance	-2.6	-2.9	-3.8	-4.2	-4.6	-4.2	-4.5	-4.2
Central government[1]								
Total revenues	19.2	17.8	18.4	20.1	22.0	21.9	23.0	23.7
Total expenditures		20.4	21.0	25.5	28.8	25.1	28.9	26.8
Of which: Interest		3.0	2.3	6.0	9.3	5.1	7.7	5.4
Primary balance		0.4	-0.3	0.6	2.4	1.9	1.8	2.3
Overall balance		-2.6	-2.6	-5.4	-6.9	-3.2	-5.9	-3.1
Tax revenue[2]	17.0	16.7	17.2	17.8	19.6			
Net interest payments[3]	2.2	2.0	1.4	5.7	5.5			
Tax revenue of public sector[5]	24.3	21.9	23.2	23.6	27.6			
Consolidated public sector[4]								
Tax revenue	24.3	21.9	23.2	23.6	27.6			
Primary balance		-0.1	-1.0	0.0	3.2	3.5	3.4	3.5
Overall balance		-5.9	-6.1	-7.9	-10.0	-4.6	-7.9	-3.9
Outstanding external debt[4]		23.2	24.8	30.7	45.6	39.9	42.1	44.7
Public		12.1	10.6	12.1	19.0	15.6	18.6	19.9
Private		11.1	14.1	18.6	26.6	24.3	23.6	24.8

[1] Includes the federal government, the central bank and the Social Security System (INSS). Source: IMF.
[2] Source: World Bank
[3] Comprises interest payments on external debt, plus the real component of interest payments on the domestic debt. Source: World Bank.
[4] Includes the federal government (including the operational result of the central bank), state and municipal governments, and public sector enterprises. Source: IMF Brazil: Selected Issues and Statistical Appendix, 2000, 2001, 2002.
[5] Includes earmarked social taxes and social security contributions. Source: World Bank.

Table 4.17 Brazil: Fiscal Results

	Annual average (% of GDP)	
Items	**1991-94**	**1995-98**
Operational deficit	**0.4**	**5.2**
Federal	-0.1	2.6
State & municipal	0.2	2.1
State companies	0.2	0.5
Real interest expenses	**3.3**	**5.0**
Federal	1.5	2.9
State & municipal	0.9	1.7
State companies	0.9	0.4
Primary deficit	**-2.9**	**0.2**
Federal	-1.6	-0.3
State & municipal	-0.7	0.4
State companies	-0.7	0.1

Source: Giambiagi and Rigolon (1999).

Table 4.18 Brazil: Public Sector Debt
(Percent of GDP)

Type of debt	1995	1998	2001
A Domestic debt			
Central government	6.6	17.2	20.5
State and municipal level	10.3	14.0	17.5
Public sector entities	4.9	1.3	0.4
Subtotal	**21.8**	**32.5**	**38.4**
B External debt			
Central government	3.5	4.3	8.4
State and municipal level	0.3	0.7	1.0
Public sector entities	1.7	1.4	1.2
Subtotal	**5.5**	**6.4**	**10.6**
Total debt[1] (A+B)	**27.3**	**38.9**	**49.0**

Source: Banco Federativo (BNDES) (2002, Table V.5).

The counterpart of fiscal imbalances is the generation of debt. From 1995 to 1998, the internal debt of the central government grew from 6.6 percent to 20.5 percent of GDP and that of the states and municipalities from 10.3 percent to 17.5 percent. Table 4.18 shows that total debt is now approaching 50 percent of GDP, a huge increase in just five years (Bevilaqua and Garcia, 1999).

During this period of precarious fiscal conditions, the Asian crisis in late 1997 caught Brazil fiscally unprepared. Trying to protect the nation's exchange rate, the authorities devalued the currency in real terms by 8 percent in 1998, raised interest rates, and began a strong process of fiscal correction. The "primary result" of the consolidated public sector improved by 1 percent that year compared to 1997. However, as Giambiagi (2001, p. 17) observed, "this was too little and too late." Between August and the end of September 1998, Brazil lost $30 billion in international reserves.

In October 1998, Brazil approached the IMF and events calmed somewhat. However, when Congress rejected additional tax corrections, and the state of Minas Gerais announced a moratorium on federal debt, the authorities had no recourse but to allow the exchange rate to float freely. On January 15, 1999, the "band" was abandoned and by the end of that year the real had depreciated by 34.5 percent in real terms.

Over 1999-2002, authorities largely regained control of events. The consolidated primary balance was 3.4 percent of GDP by the end of 2001 and was expected to be 3.5 percent in 2002.[10] Inflation remained low, but so did

[10] See Malan (2002).

growth, at just around 2.5 percent for 2001–2002. The country seems to have achieved a macroeconomic equilibrium. However, it is a precarious equilibrium, highly vulnerable to inter alia external developments.

Regulatory Institutional Framework

A key component of Brazil's process of fiscal correction has been the strengthening of the institutional framework within which the finances of the public sector are disciplined and regulated. The framework is a result in part of the Fiscal Responsibility Law passed in 2000. The law establishes that no permanent expenditure can be created without prior identification of a new permanent source of revenue; sets ceilings on personal expenditures and on public debt by level of government; curtails moral hazard by eliminating the scope for bailouts of subnational governments; and increases transparency and accountability in the management of public finances.[11]

The law represents a major double achievement. First, it is a technical and conceptual achievement in the sense that it constitutes broad recognition that without the "right" fiscal rules for the nation as a whole, many other equity and economic policy objectives are compromised. Second, the law implies that a profound political agreement has finally been reached that can serve as the basis for technical and orthodox "positive" macroeconomic precepts.[12] Paraphrasing Williamson (1996), it could be said that a "credible commitment" has been reached at the political level.[13]

While far from perfect, the Fiscal Responsibility Law is clearly a "first-order optimizing" constitutional-like rule that sets the stage for a high level of "cooperative federalism." Afonso and Mello, Jr. (2000) believe it lays the foundation for a "rules-based system of decentralized federalism . . . and has been motivated by the recognition that market control over subnational finances should be strengthened by fiscal rules and appropriate legal constraints." The law's critically important Article 35 prohibits debt renegotiations among intergovernmental levels. The law was the product of a democratic process and in-

[11] See IMF (2001, p. 33).

[12] Congress has approved an ancillary piece of legislation that stipulates that judicial and administrative sanctions will be imposed on those that violate the precepts of this law.

[13] A "credible commitment" is defined as "a contract in which a promise is reliably compensated should the promisor prematurely terminate or otherwise alter the agreement. This should be contrasted with noncredible commitments, which are empty promises, and semicredible commitments, in which there is a residual hazard. Credible commitments are pertinent to contracts in which one or both parties invest in specific assets." See Williamson (1996, p. 377).

tergovernmental negotiations and agreements, and, according to Inman and Rubinfeld (1997b, p. 48), under these circumstances, such processes are likely to be Pareto-improving.[14]

In brief, within the context of the conceptual framework developed earlier in this book, Brazil now appears to be fully aligned with the overarching institutional rule of tight fiscal budget constraint. Within this new institutional context, the challenge now is to put in place and constantly evaluate specific decentralization policies, projects and programs. For although macroeconomic stability is a necessary condition for efficient decentralization, it is insufficient for decentralization to evolve spontaneously in the right direction.

Decentralization in a Restrictive Macroeconomic Context

For several reasons, Brazil's decentralization is a special case featuring particular policy and institutional characteristics. What currently warrants attention is the "integrality" of its efforts and results in the following four interdependent processes: (i) fiscal decentralization at the state and municipal level; (ii) decentralization towards the markets (e.g., privatization and regulation); (iii) sectoral decentralization (e.g., in education and health); and (iv) the response to macroeconomic restrictions in a globalized environment.

What is remarkable is that Brazil—together with Chile and to some extent Mexico—increasingly is putting together an integrated institutional framework to give policy consistency to all these interrelated and demanding processes. This is a major challenge indeed.

Decentralization vis-à-vis Federalism

Decentralization and federalization are not the same thing. Decentralization appears to be a larger concept that would in most cases involve or contain a process of federalization. After all, decentralization is the search for potential efficiency gains in public policies and public goods. In essence, it is the search for the support of market-based conditions that can help attain certain public policy objectives. This is why privatization, for instance, is part of a decentralization strategy, and it also why having a "decentralized" central bank is also part of decentralization policy. But it would be difficult to call these two

[14] Welfare economics holds that if a change (like a transfer) makes someone better off (like a decentralized local jurisdiction) and nobody worse off (like a national level of government), then that change has triggered a Pareto-improving process.

processes components of a federalization process. This latter process has more to do with subnational development.

The process through which a country becomes increasingly "federal" will involve the fiscal growth of its subnational level, together with large transfers accompanied by real delegated discretionary authority for the use of local resources. Federalism will also need to contain regional and local institution building as an input and output of subnational fiscal development.

Sectoral Decentralization

Fiscal and sectoral decentralization—in education and health, for example—are policies that would be part of federalization. In a federal country, education and health are largely financed through local or regional own-tax revenues. This is not yet the case in Brazil, nor for that matter in any country in Latin America.

In Latin America, even in Brazil and Chile, where decentralization is most advanced, most of the financing of education and health still comes from the national level. But there is increasing devolution and delegation of discretionary spending powers and accountability to the state and municipal levels.

Macroeconomic Restrictions and Remaining Challenges

Although Brazil has successfully adopted much needed reforms—including trade liberalization, privatization, deregulation, elimination of formal indexation, development of a new currency, adoption of the Fiscal Responsibility Law, and the successful flotation of its currency—its main remaining challenge now is to complete the process of macroeconomic and institutional reforms initiated in the mid-1990s. This will imply (i) obtaining and maintaining a fiscal primary surplus in the consolidated public sector of around 3.5 percent of GDP; (ii) achieving a fiscal correction more through expenditure reductions than tax increases; (iii) restructuring its tax law;[15] (iv) increasing the effectiveness of public expenditures in general and of social expenditures in particular; and (v) bringing its social security system into a self-sustainable financial position.

All of the above constitute an enormous challenge involving the key policy linkages of the overall policy framework. The pillar of the response has to be

[15] According to Ter-Minassian (1997b, p. 454), "the coexistence of a broad-based state VAT with a more narrowly based multirate federal VAT is awkward and has given rise to cascading and distortions in the tax burden across sectors and localities. Also, the state VAT is plagued by erosion of the base and by substantial difficulties in administration."

of a fiscal nature. After all, the root problem continues to be excessive spending. Over the past eight years, public expenditures, even after excluding interest payments, have grown at double the rate of GDP growth. This has been financed by a very high level of taxation (33 percent of GDP), social security contributions, and a growing internal and external debt.

The current precarious macroeconomic equilibrium is "supported" by very high real interest rates, a floating exchange rate without a strong fiscal anchor, the constant risk of elusive external rollover of amortizations, and a growing internal and external debt. Fortunately, the reform experience of the last eight years and the evident growing maturity of Brazilian authorities and policymakers, at all levels of government, augurs well for the future.

Integrality of Policymaking

Brazilian policymakers are fully aware of the integrality and interdependency of these four processes and are learning fast how to cope with the challenges that emerge from them. Resende and Afonso (2002, p. 38) provide a full discussion of the effects of macroeconomic restrictions on decentralization and federal growth. Their conclusion is that "in the process of emphasizing a stable currency, economic development and federal autonomy were negatively affected." Their message seems to be that the overarching need to keep macroeconomic developments under control has forced authorities to treat some key regional policy issues with benign neglect.

The priority since the late 1990s has been the sustainability of a macroeconomic balance. To this effect the authorities have worked hard to obtain a primary surplus above 3 percent of GDP. Through very high real rates of interest they have "protected" the exchange rate. Even the much needed reform of the tax law has been delayed somewhat in order to respond in the short run to the fiscal and macroeconomic challenge. The authorities appear to have made the right call, despite the call for a "proper balance among competition and cooperation in the federation" (Resende and Afonso, 2002, p. 38).

Findings, Conclusions and Policy Implications

This evaluation of Brazil's process of decentralization and fiscal federalism offers the following three main findings and conclusions:

- Brazil's process of decentralization during much of the 1990s took place under a permissive macroeconomic stance. Even after the Real Plan was

launched in 1994, there was not strong macroeconomic and fiscal budget constraint. In this respect, Brazil did not fully comply with the key condition of having tight fiscal constraint as the underlying policy framework for successful decentralization.

- Since the real was floated in January 1999, there has been a strong process of fiscal correction at all levels of government, so much so that Brazil now has one of the highest gross tax revenues in the world as a percentage of GDP (34.36 percent in 2001).
- The fiscal losses of 1995-97 did not affect the long-term direction of Brazil's decentralization process. Even before the tight fiscal correction began at the federal level in 1998, many states and cities on their own had already begun to put in place local financial and fiscal adjustment programs. The measures were a result of local political demand for improved public goods.

Brazil's experience during the 1990s, and particularly since the strong fiscal correction began in 1998, offers four key policy implications. First, fiscal imbalances and profligate expenditure in any sector or at any level of government can be deleterious to macroeconomic sustainability, decentralization and a federalization processes. This may sound like a somewhat anodyne observation, but it has substantive policy implications, i.e., it is always much better and less traumatic to maintain tight fiscal budget constraint at all levels and sectors.

Second, a strong regulatory institutional framework is needed to put order in all fiscal and financial flows among intergovernmental agencies and levels. In Brazil, that framework was the result the (i) Fiscal Responsibility Law, (ii) the oversight role played by the Ministry of Finance over the adjustment processes of the states, and (iii) the local and international capital markets, which have demanded high real rates of interest when fiscal frugality is not the norm. The cost of this high rate of interest in terms of growth and employment can be immense.

The third key policy implications has to do with the unparalleled importance of incentives and information. Underlying the costly processes engendered by fiscal profligacy are the "wrong" incentives and the lack of adequate information. The key policy challenge is to discern the wrong incentives already built into the decentralization framework and change them to the right ones.

Finally, experience and theory confirm that no process of decentralization can achieve its objectives if there is not tight budget constraint. In principle, all decentralization schemes should be fiscally neutral and allow for the inherent advantages of decentralized choice to evolve. The overarching policy implication is that a country that wants to capitalize on the benefits of decentralization

cannot afford to neglect any major source of fiscal "leakages" in its policy framework. Decentralization will eventually unravel if there is a fiscal deficit at the national, state or municipal levels; public bank lending on the expectation of a bailout; guarantees to creditors; or moral hazard situations.

Brazil is a prime example of just how difficult but attainable this challenge can be, since the country has confronted several of these problems and is now well ahead of most Latin American countries in dealing adequately with them. It is a country now fully aware of what could be called the "integrality and policy consistency requirement."

Chapter Five

Bolivia

Bolivia's commendable process of reform since the late 1980s and 1990s includes a sequence of reform phases during which the country made significant advances in some critical areas. However, Bolivia has been unable to fully complete those reforms and still needs to make further progress, particularly in alleviating extreme levels of poverty. Since 1994, Bolivia has embarked on an intensive decentralization drive through its Popular Participation and National Dialogue Laws and by allocating resources from the Heavily Indebted Poor Countries (HIPC) initiative and other concessional sources to the subnational level of government.[1]

The broad policy question that emerges is whether the basic decentralization framework that Bolivia has adopted will yield the expected results in terms of sustainable welfare gains for the majority of the population, and particularly for those living in the poorest jurisdictions. The short answer is that, to a large extent, the current decentralization process is still excessively oriented towards a straight parceling out of resources, grants and subsidies. It seems that insufficient priority is given to local fiscal performance and to the use of incentives to enhance the effectiveness of decentralized expenditure.

Paradoxically, this situation may partly be the result of the relative abundance of concessional resources available. The free or largely free HIPC resources amounted to close to 2 percent of GDP in 2001. And the concessional content of multilateral and bilateral lending and grants can easily exceed that proportion. This de facto low budget constraint conspires against a rigorous use of resources or incentives to build a long-term, sustainable decentralization process that enhances overall public welfare.[2]

[1] See footnote 18 in Chapter One for a description of HIPC. See also Andrews, and Singh (1999).

[2] See IMF (2002) for a discussion of Bolivia's efforts to obtain HIPC resources to reduce poverty.

Table 5.1 Bolivia: Key Economic Indicators

Indicator	1997	1998	1999	2000	2001
Growth of GDP	4.9	5.2	0.4	2.3	2.0
Current account (% of GDP)	-7.0	-7.9	-5.9	-5.5	-5.4
Total public sector revenues (% of GDP)	30.5	31.1	31.6	32.7	34.1
Total public sector expenditures (% of GDP)	33.7	35.8	35.4	36.7	37.0
Overall public sector balance (% of GDP)	-3.3	-4.6	-3.4	-3.7	-3.9
Current revenue (% of GDP)	27.9	29.7	29.8	30.5	31.1
Current expenditure (% of GDP)	22.9	24.7	23.4		
Inflation, CPI, end of period	6.7	4.4	3.1	3.4	

Source: IMF (2001a).

Table 5.2 Bolivia: Tax Revenue by Origin

Tax revenues	1997	1998	1999	2000	2001
Taxes	17.6	19.6	18.4	18.5	19.3
Hydrocarbons	4.4	5.4	5.2	5.0	5.5
Other	13.2	14.2	13.2	13.4	13.9

Source: IMF (2001a, Article IV Consultation, Table 2).

Macroeconomic and Fiscal Context

After enjoying rates of growth well over 4 percent in 1997 and 1998, Bolivia's growth fell to 0.4 percent in 1999.[3] There was some recovery in the year 2000 (2.3 percent) but for 2001 a further slowing down was likely. The current account deficit has remained high, at over 5 percent of GDP, and the overall public sector balance has remained at between -3 and -4 percent over the last four years. Inflation is under control at the single digit level. Total public sector expenditures, which were large to begin with early in the decade, have continued to grow and were estimated at 37 percent of GDP for 2001. (Table 5.1).

With regard to the fiscal context (Table 5.2), while overall tax revenue in terms of GDP appears relatively high—close to 20 percent in the last four years—more than 25 percent of it comes from taxes on hydrocarbons. "Other" tax revenues have remained stagnant at around 13 percent of GDP, a rather low percentage compared to similar data in other Latin American countries.

[3] The IMF (2001a) estimates that "the virtual elimination of illicit coca cultivation over the last two to three years may have lowered incomes by 3 percent or more of annual GDP."

Table 5.3 Bolivia: Tax Revenues by Government Level
(Percent of GDP)

Tax revenues	1994	1995	1996	1997	1998	1999	2000
National	17.2	16.8	16.9	16.8	18.7	17.3	17.4
Municipal	0.0	0.7	0.8	0.8	0.9	1.2	1.1
Total	17.2	17.5	17.7	17.6	19.6	18.4	18.5

Source: Fiscal Programming Unit, Ministry of Finance.

The relevance of this point for decentralization policy is that those hydrocarbon tax revenues are analogous to an unconditional transfer, and some of the policy implications usually ascribed to transfers in general are applicable to this particular type of grant or of transfer. Among other things, an unconditional transfer seldom carries with it the political process behind a normal tax or the accountability implications of its expenditure. Within the context of a market-like approach to decentralization, a hydrocarbons tax transfer does not make it easy for the authorities to use incentives within those transfers to reward a particular result. Political actors will regard those resources as a sort of common pool.

If national governments at their macroeconomic and fiscal level are regarded as a common pool—as is so often the case of decentralization frameworks in Latin America[4]—a "commons problem" evolves.[5] If there are no exclusive property rights, rent dissipation will take place and organizations competing for the use of the perceived "common property" will reduce, through inflationary effects, that asset (represented by price stability) to zero (Cheun, 1991, p. 83, and Demsetz, 1964).

With regard to the intergovernmental composition of tax revenue, Table 5.3 shows that in 1994 there were no tax revenues from the municipal level. But in 1995 those revenues represented 0.7 percent of GDP and went on to grow in subsequent years to reach 1.1 percent of GDP in 2000.

Can this be judged to demonstrate that a true process of decentralization is taking place in Bolivia? In principle, the answer should be yes. However, it is curious to observe that the jump in municipal taxation in 1995 occurred exactly one year after the Popular Participation Law granted municipalities 20 percent of national budget resources. In the same year, the national share

[4] This is what happened in Ecuador when in 2000 it had to adopt the U.S. dollar as its currency.

[5] For a summary of the implications of the "commons problem" in fiscal federalism, see Mello, Jr. (2000).

Table 5.4 Bolivia: Tax Revenues by Government Level

Tax revenues	1994	1995	1996	1997	1998	1999	2000
National	100.0	96.0	95.7	95.5	95.4	93.8	94.1
Municipal	0.0	4.0	4.3	4.5	4.6	6.2	5.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Fiscal Programming Unit, Ministry of Finance.

of taxes declined from 17.2 to 16.8 percent—suggesting a statistical problem in which transfers through the Popular Participation Law are now simply being categorized as municipal own-tax revenue.

Table 5.4 shows the intergovernmental tax percentage shares within the total tax revenues of the public sector for 1994-2000. It is consistent with Table 5.3 in revealing the same relative changes between the two levels of tax revenue sources.

From the perspective of intergovernmental expenditures (a limited measurement of real decentralization according to the conceptual framework followed in this book), Table 5.5 shows that the subnational share has been growing since 1994. The share was equivalent to 4.8 percent of GDP that year and was 6.4 percent of GDP in 2000. Line C of Table 5.5 shows that the increase in the subnational expenditure share took place mainly at the municipal level, with a relative increase of over 60 percent. The regional level (line B) has remained stable for the last five years at about 2.5 percent of GDP.

However, the national level share also grew from 10.9 percent in 1994 to 15.7 percent in 2000, a large relative increase of 44 percent. From this perspective, it may be concluded that a modicum of real decentralization has taken place.

Table 5.6 shows the relative share of intergovernmental expenditures not as a percentage of GDP but in terms of total expenditure of the public sector as a whole. This data is consistent with that of Table 5.5. While the regional and municipal level shares were about 15 percent each in 1994, by 2000 these shares had changed substantially. The municipal share had grown to 17.6 percent of

Table 5.5 Bolivia: Expenditures by Government Level
(Percent of GDP)

Intergovernmental level	1994	1995	1996	1997	1998	1999	2000
A National	10.9	11.7	11.1	14.9	16.1	14.8	15.7
B Regional	2.3	1.8	2.4	2.8	3.0	2.5	2.5
C Municipal	2.4	3.5	3.9	4.1	4.0	4.5	3.9
D Total subnational (B+C)	4.8	5.3	6.3	6.8	7.0	7.0	6.4
Total expenditures (A+D)	15.7	17.0	17.4	21.7	23.1	21.8	22.1

Source: Fiscal Programming Unit, Ministry of Finance.

Table 5.6 Bolivia: Expenditure Shares by Government Level
(In percent)

Government level	1994	1995	1996	1997	1998	1999	2000
A National	69.5	68.8	63.9	68.6	69.5	67.9	71.1
B Regional	15.0	10.7	14.0	12.7	13.1	11.4	11.2
C Municipal	15.5	20.5	22.1	18.7	17.3	20.7	17.6
D Total subnational (B+C)	30.5	31.2	36.1	31.4	30.5	32.1	28.9
Total expenditures (A+D)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Fiscal Programming Unit, Ministry of Finance.

total expenditure while the regional one had declined to 11.2 percent. The national share stood at 71.1 percent.

Table 5.7 shows the destination of transfers over 1994-2000. Transfers from the national treasury remained stable at around 3.5 percent of GDP, while transfers to other entities decreased from 5.2 percent of GDP in 1994 to 2.8 percent in 2000. The share of universities remained at around 0.6 of GDP, but that of public sector enterprises and others declined significantly. As a result, transfers from the national level to institutions other than those at the subnational level decreased from 5.2 percent of GDP in 1994 to 2.8 percent in 2000. The drop was concentrated in transfers to public enterprises, which have seen their share decline from 1.4 percent to 0.5 percent. This suggests that the priorities of the national government have focused on the municipal level, which is consistent with the overall strategy adopted since 1994 through the Popular Participation Law.

Table 5.7 Bolivia: Intergovernmental Transfers
(Percent of GDP)

Transfers	1994	1995	1996	1997	1998	1999	2000
A Transfers from national to subnational level:							
Tax transfers	2.4	2.1	2.6	2.8	2.9	2.7	2.7
Budget transfers	0.9	0.3	0.5	0.5	0.2	0.2	0.7
B Total transfers to subnational level (A+B)	3.4	2.4	2.9	3.4	3.1	2.9	3.5
C Other transfers from national level to:							
Universities	0.5	0.5	0.6	0.6	0.6	0.5	0.6
Public entities	1.4	0.4	0.3	0.3	0.1	0.7	0.5
Others	3.3	2.5	3.0	2.1	2.0	1.5	1.8
D National transfers to other levels of government (A+B+C)	5.2	3.4	3.8	3.0	2.6	2.7	2.8
E Total transfers (B+D)	8.6	5.8	6.7	6.4	5.7	5.6	6.3

Source: Fiscal Programming Unit, Ministry of Finance.

Table 5.8 Bolivia: Relative Importance Of Transfers
(In percent)

Transfers	1994	1995	1996	1997	1998	1999	2000
A Royalties	0.6	0.7	0.7	0.7	0.5	0.5	0.8
B Current transfers	3.4	2.4	2.9	3.4	3.1	2.9	3.5
C Other transfers (1)	0.4	0.3	0.6	0.3	0.6	0.6	0.6
D Total transfers (A+B+C)	4.4	3.4	4.2	4.4	4.2	4.0	4.9

Source: Fiscal Programming Unit, Ministry of Finance.

Table 5.9 Bolivia: Total Tax Revenues and Revenues in Selected Municipalities
(Percent of GDP)

Government level	1994	1995	1996	1997	1998	1999	2000
Tax revenue							
A National	17.2	16.8	16.9	16.8	18.7	17.3	17.4
B Municipal	0.0	0.7	0.8	0.8	0.9	1.2	1.1
C Total tax revenues (A+B)	17.2	17.5	17.7	17.6	19.6	18.5	18.5
D Tax revenue, La Paz	0.0	0.3	0.3	0.3	0.3	0.3	0.3
E Tax revenue, Santa Cruz	0.0	0.2	0.2	0.2	0.2	0.3	0.2
F Tax revenue, Cochabamba	0.0	0.1	0.1	0.1	0.2	0.1	
G Tax revenues (D+E+F)	0.0	0.6	0.6	0.6	0.6	0.8	0.6
H Tax revenue in other municipalities	0.0	0.1	0.1	0.1	0.2	0.4	0.4
I Total municipal tax revenue (G+H) = I	0.0	0.7	0.8	0.8	0.9	1.2	1.1

Source: Fiscal Programming Unit, Ministry of Finance.

What is intriguing from this data is that the total transfers (line E in Table 5.7) would seem to decline from 8.6 percent of GDP in 1994 to 6.3 percent in 2000. However, if one considers Table 5.8, which includes royalties, transfers appear to be growing from 4.4 percent of GDP in 1994 to 4.9 percent in 2000.

Inter-Municipal Tax Decentralization

Table 5.9 examines the question of where the rise in relative municipal tax revenue has occurred. Has it been in the large cities? The intermediate ones? While a final answer is still pending, the table suggests that the tax revenue increase, relative to GDP, has not taken place in La Paz, Santa Cruz or Cochabamba.[6]

[6] For an evaluation of institutional and fiscal conditions in the municipalities of Colombi, Punata and Villa Tunary, see Goodman and Rodríguez (2001).

The respective own-tax shares of revenue in these three cities remained rather stable between 1994 and 2000, while the share of other municipalities grew from 0.1 percent in 1995 to 0.4 percent in 2000. If this preliminary data were to be confirmed, it would suggest that a wide process of real decentralization may have been initiated in Bolivia covering the relatively less populous municipalities. Tables 5.10, 5.11 and 5.12 show the budgets for 2001 for El Alto, Santa Cruz and La Paz.

Table 5.10 El Alto: Share of Transfers in the 2001 Budget
(Millions of bolivianos)

Concept	Bolivianos	%
A Own-tax revenues	38.60	10.46
B Non-tax revenues	24.20	6.55
C Transfers from Popular Participation Law	86.40	23.41
D Other transfers from World Bank, IDB, Japan, DFID and other bilaterals and multilaterals	169.11	45.83
E HIPC II	14.00	3.79
F Other revenues	36.68	9.94
G Total budget (A+B+C+D+E+F) = G	369.00	100.00
H Total transfers (C+D+E) = H	270.00	
I Transfers as % of total budget (H/G) = I		73.17
J Transfers as % of own-tax revenue (H/A) = J		700.00
K Own-taxes as a % of transfers and donations (A/H) = K		14.29

Source: El Alto 2001 budget.

Table 5.11 Santa Cruz: Share of Transfers in the 2001 Budget
(Millions of bolivianos)

Concept	Bolivianos	%
A Own-tax revenues	228.80	36.72
B Transfers from Popular Participation Law	151.20	24.26
C Donation and transfers from the Dutch government, World Bank, Belgian government, Universidad Católica Boliviana	10.00	1.60
D HIPC II	15.00	2.40
E Other current and capital revenues	192.80	30.94
F Other revenues	24.90	3.99
G Total budget (A+B+C+D+E+F) = G	623.00	100.00
H Total transfers and donations (B+C+D) = H	176.00	
I Transfers and donations (H) as % of own-tax revenues (H/A) = I		76.92
J Transfers and donations (H) as % of total budget (H/G) = J		28.25

Source: Santa Cruz 2001 budget.

Table 5.12 La Paz: Share of Transfers in the 2001 Budget
(Millions of bolivianos)

Concept		Bolivianos	%
A	Own-tax revenues	210.80	28.11
B	Sale of public services	86.80	11.57
C	Current transfers (Popular Participation Law)	152.50	20.33
D	Transfers and donations from bilateral and multilateral institutions	52.30	6.97
E	Transfers from HIPC II	20.00	2.66
F	Other current and capital revenues	227.60	30.34
G	Total budget (A+B+C+D+E+F) = G	750.00	100.00
H	Total transfers and donations (C+D+E) = H	225.00	
I	Transfers and donations as % of total budget (H/G) = I		30.00
J	Transfers and donations as % of own-tax revenues (F/A) = J		107.14

Source: La Paz 2001 budget.

Of a total 2001 budget of 369 million bolivianos for the municipality of El Alto, transfers amounted to 270 million, and tax revenues (38.6 million) were only 14.3 percent of those transfers (line K). Given these numbers, it is difficult not to conclude that this municipality—with a population now reaching one million—is financed largely by transfers. The question is whether this level of own-tax performance can be considered satisfactory relative to the fiscal or tax base of this community.

In Santa Cruz, transfers and donations constituted 28.25 percent of the total budget, while own-tax revenues made up 36.72 percent. This is a completely different fiscal picture than that of El Alto. But the some question emerges: Is the own-tax performance satisfactory relative to the city's fiscal and economic base?

In La Paz, transfers and donations constituted 30 percent of the total municipal budget. Own-tax revenue (210.8 million bolivianos) was below total transfers of 225 million bolivianos. On the assumption that La Paz has the strongest fiscal or local tax base, the fact that its own-tax revenues are lower than transfers suggests that there may be ample margin for raising local tax revenues.

Table 5.13 summarizes transfers vis-à-vis own-tax revenues for La Paz, El Alto and Santa Cruz. In all three, transfers and donations are a relatively important source of funds for their respective budgets. In El Alto, those transfers constitute 73.17 percent of the total budget, while in La Paz and Santa Cruz their share is less than a third of the total.

Table 5.13 Share of Transfers and Donations in the 2001 Budgets of La Paz, El Alto and Santa Cruz

	La Paz	El Alto	Santa Cruz
Transfers and donations as % of total budget	30.00	73.17	28.25
Transfers and donations as % of own-tax revenue	107.14	700.00	76.92

Source: Tables 5.10, 5.11 and 5.12.

Only in Santa Cruz are transfers and donations less than own-tax revenues. In El Alto, transfers and donations are a multiple of seven of own-tax revenues, and in La Paz they make up 107.14 percent of those revenues.

These ratios are very suggestive and could correspond, in the case of El Alto, to a lower fiscal capacity compared to the other two cities. But it is intriguing to observe that in La Paz, the nation's capital, own-tax revenues do not exceed transfers and donations by a wide margin.

Overall Inter-Municipal Picture

While it is difficult to arrive at firm conclusions from this varied and not always consistent municipal data, it appears that:

- Judging by the growth of the overall public sector deficit, as well as of public sector debt, there has not been tight macroeconomic and fiscal budget constraint in Bolivia during the last five years.
- While data are somewhat ambiguous, it could be argued that some degree of real decentralization has been taking place, as the share of municipal own-tax revenue appears to be growing.
- Measured by the growing share of expenditures at the subnational level, there would appear to have been nominal decentralization there.
- The intergovernmental transfer picture is mixed, as different estimates appear to show different trends. This strongly suggests that there is a serious problem with the quality of the data. Fortunately, the government is fully aware of this situation, and may be able to redress this situation through expansion of the Financial Management Information System (SIGMA) to the municipal level.

Institutional Context

Bolivia's current institutional decentralization framework is the product of a major constitutional reform in 1993 at the start of the administration of

President Sanchez de Losada. In the following year, two key laws came into effect: the Popular Participation Law (Law 1551), and the Decentralization Law.

The Popular Participation Law established that 20 percent of the national budget had to be distributed to the municipalities on the basis of their respective population. The Decentralization Law came into effect after the Popular Participation Law and redistributed a number of functions, particularly to the second level of government (the *prefectura*).[7] Subsequently the Municipal Institutional Development Strategy was formulated to strengthen coordination between municipalities and the *ambito comunitario.*

The current institutional context for decentralization is largely framed by two interdependent parameters: the National Dialogue Law passed on July 31, 2001 and the new role of the Single Directory of Funds.

The 2001 National Dialogue Law

This law has three basic purposes: (i) to establish the terms of reference for the government's strategy for poverty reduction; (ii) to specify the criteria for the distribution of multilateral debt-forgiven resources destined to reduce poverty; and (iii) to organize the national dialogue as a permanent instrument of social participation in the oversight of poverty reduction programs.

According to Article 3, a technical entity will be created to monitor all key aspects of the Bolivian Poverty Reduction Strategy. However, this process is not directly linked with the decentralization framework. If there were to be a disconnect here, inconsistent policies and processes could emerge. In principle, it might have been preferable to have a "decentralization regulatory body" under a broad policy framework, within which the specifics of poverty reduction would be implemented. This would better assure full consistency in the complementary purposes of achieving a sustainable process of poverty reduction within a broad framework of decentralization to enhance that process.

A worrisome development in the National Dialogue Law is the earmarking (Article 7) of a significant amount ($27 million) over the next 15 years to cover deficits in education and health services. This is clearly an example of "capture" by rent seekers of public resources. When policymakers within the government were asked to explain this curious incen-

[7] Avila Navajas and Rengel (2000) suggest that the Decentralization Law was meant to reestablish some balance of power back from the municipalities to the higher level of the *prefectura*.

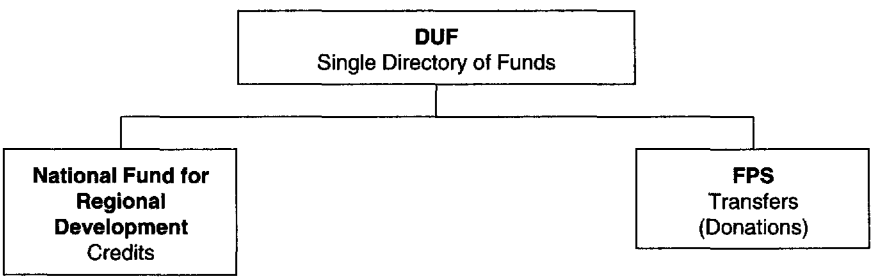
tive for expenditures, they said that this concession to the unions represented the "transaction costs" that had to be paid to get the law approved by Congress.

Furthermore, Chapter V of the same Article 7 establishes that future salary increases and other costs will be financed through the Municipal Solidarity Fund for Basic Education and Public Health. It is difficult not to see here an example of the "wrong incentives" that will lead to excessive expenditures, little evaluation, and inefficient results—clearly not a market-oriented approach in a critical equity sector.

This law's alleged emphasis on poverty reduction establishes (in Article 9) that the Municipal Solidarity Fund for Basic Education and Public Health will be financed before the municipalities receive resources from a "2000 Special Dialogue Account." The question that emerges is which poverty priority prevails: that of an organization made up basically of teachers, or that of poor households that need the funds to have access to education?

Single Directory of Funds (DUF)

Under the National Dialogue Law and its compensation policy (Article 17) the following structure is created:



Under the National Fund for Regional Development (FNDR), loans will be granted for investment purposes at the municipal and *prefectura* levels. Under the National Fund for Productive and Social Investment (FPS), co-financing (as grants) will be provided to municipalities for poverty reduction programs and for local institutional development.

The available resources (from HIPC) are distributed through a formula that favors those municipalities with the most severe poverty conditions. The FPS was to have distributed $100 million by December 2002.

Grants and donations from international cooperation must go to investment projects.

Under the FNDR, local governments have to develop an institutional adjustment program (PAI) and may also need to agree with the Ministry of Finance on a financial collection plan (PRF) to strengthen their fiscal prospects.

Summary: Institutional Framework

- Bolivia's institutional decentralization context is a complex mix of less than tight fiscal constraint and a labyrinth of rules and norms containing all sort of intended and unintended incentives. The net picture that emerges is that political economy restrictions limit, to a large degree, the application of incentives or a market-like approach.
- The organizations that have emerged from that institutional set of rules have found incentives to become active in pursuing transfers, subsidies and special regional projects. A common pool of resources, comprised basically from debt relief and other resource transfers, has been harvested by a varied mix of agents, rent seekers and jurisdictions.
- The National Dialogue Law offers worrisome examples of "capture" of earmarked funds by public sector rent seekers. This law has the potential capacity to create serious fiscal problems and high transaction costs in all management processes dealing with transfers, loans, poverty reduction and decentralization.
- A possible redeeming feature of the National Dialogue Law could be the functioning of the DUF. However, it will be quite a challenge to prevent serious policy and management problems arising from the interplay of its two funds.

After all is said and done, the question that remains is if the process of decentralization underlying the different reforms in progress would not be more effective and sustainable if a larger role were given to market-oriented instruments. The 1994 Popular Participation Law, which history will applaud as momentous and positive, failed to include a modicum of incentives for enhanced results in whatever welfare-enhancing objectives could have been agreed to politically. Whether this will be judged to have been a missed opportunity is hard to say. After all, this law changed half the political history of Bolivia, and an insistence on incentives may end up being viewed as a relatively minor technical point.

Main Decentralization Challenges

The laudable progress of decentralization in Bolivia since the Popular Participation Law in 1994 is judged more in terms of the particular characteristics of the subnational public sector prior to the law than on higher municipal tax revenue or performance. Furthermore, the country now faces the formidable challenge of reconciling the following three objectives:

(i) To develop an institutional framework through which public resources are used more efficiently and effectively across the economy as a whole.
(ii) To continue to deepen the decentralization process in all of its varied forms of subnational development, privatization and "denationalization" of education and health.
(iii) To continue to make progress in reducing extreme levels of poverty.

Perhaps the more daunting challenge for Bolivia is to assure that the relatively abundant concessional resources (they could be as large as 5 percent of GDP annually over 2001-2003) are well utilized and preempt the emergence of a new bailout in the future. To this effect Bolivia will need to meet the following five policy objectives:

(i) Maintain a stable macroeconomic environment and strengthen the fiscal institutions at all levels of government.
(ii) Effectively decentralize some key sectors like education, health and social security.
(iii) Build "contractarian" incentives into the transfer system and, generally speaking, in all interactions between the government and markets.
(iv) Enhance an incipient evaluation capacity, particularly at the central government level and in some key jurisdictions. This should be done in conjunction with the development of incentive systems in the areas of poverty reduction and decentralization.
(v) Create incentives for the development of an "information market" on the decentralization process.

Meeting those objectives under a consistent policy framework will imply that Bolivia will have left behind the previous conditions that led to the current international bailout. In other words, the overarching challenge is to ensure that the conditions that in the past led to the virtual dissipation of the assets, grants and concessional lending do not reappear within a few years.

Maintaining a Stable Macroeconomic Framework

According to the IMF's Article IV consultation (IMF, 2001a), "all quantitative financial performance criteria and benchmarks for 2000 were met, except for the end-year financed benchmarks on the fiscal deficits and its domestic financing . . . In these latter two cases, the modified limit agreed with the staff were met by a narrow margin."[8]

As for 2001, the report stated: "The authorities' macroeconomic strategy for 2001 is appropriate. Many of the factors that led to the current slowdown are transitory, and the decision to avoid a large fiscal stimulus merits support. The planned fiscal stance reflects a balance between the need for economic recovery and higher levels of poverty-related spending, on the one hand, and further progress in ensuring fiscal and external sustainability, on the other" (page 24).

On the basis of these assessments it would seem safe to conclude that Bolivia is responding relatively well to the macroeconomic component of its global challenge. However, this does not mean that there is no urgent need for further reform at this level. In fact, the government is committed to its multilateral lenders to deepen tax reform. Under the Poverty Reduction and Growth Facility (PRGF) with the IMF, the structured reforms will focus on tax and customs administration, budget management and fiscal decentralization, with the aim of enhancing transparency, improving the monitoring of expenditure, particularly for local governments, and increasing tax revenue.[9]

Effective Decentralization in Key Areas such as Education and Health

Meeting macroeconomic conditionality has proven to be a less difficult challenge for Bolivia than has effectively decentralizing micro-institutional conditions in key sectors such as basic education and health. So far, Bolivia's main decentralization thrust has been directed towards increases in transfers and ad hoc bailouts of specific subnational situations. It would be difficult to argue that significant decentralization has taken place in the primary education area, considering that Article 7 of the National Dialogue Law guaranteed earmarking funds for those with interests in the sector. This earmarking in

[8] Some experts like Horst Grebe, Director of the PRISMA Institute, warn that the task of making Bolivia's public sector more efficient may become even more difficult if, in fact, the country finds itself "blessed" with additional large amounts of "free" resources from new large findings of gas and oil.

[9] See IMF (2001b).

effect ensures significant control of expenditures by the teachers' union, with nominal supervision by the Ministry of Education.

The draft text of this law did not give so many privileges to the union. Apparently, additional concessions had to be made by Congress to ensure approval. This is an example of "capture" by public sector rent seeking, made possible by the wrong institutional and incentive structure (Wiesner, 1998).

The "denationalization" of education, which is reducing the share of such expenditures by the central government, does not mean that municipalities will have to use their own-tax resources for education, which is not feasible in the short term. "Denationalization" means reconfiguring the institutional sectoral framework within which basic education is delivered, managed and evaluated. It aims to introduce, inter alia, market proxies and accountabilities at the local, municipal and even school level.

Building "Contractarian Incentives" into the Transfer System

Under its new structure, the Single Directory of Funds (DUF) will have two main windows through which municipalities will have access to resources. Through the National Fund for Regional Development, the DUR will provide loans with a large degree of market conditionality; and through the National Fund for Productive and Social Investment, it will make concessional transfers to low-income municipalities.

This new DUF structure is certainly a major institutional improvement and demonstrates commitment on the part of the government to turn the focus to incentives and the long-term sustainability of subnational development. However, money is fungible, and it will not be easy to manage two separate funds under the same roof for the same debtors.

While the Ministry of Finance is rightly insisting on implementation of its Institutional Adjustment Program (PAI) as a condition for municipalities to have access to DUF funds, there is still a risk that such an adjustment program may turn out to be a disguised bailout. After all, more resources are being provided to jurisdictions that, ex ante, gambled that this was going to be the government's response to their financial profligacy. Giving them funds to "adjust" may well prove to be the wrong incentive if it largely validates local policies that had assumed that the government, or a multilateral or bilateral institution, would bail them out.

It should be noted, however, that the financial collection plans require, as a condition, implementation of SIGMA to improve fiscal data at the municipal level.

Some degree of nominal conditionality is aimed at ensuring that corrective policies are put in place. The question remains, however, if giving municipalities additional resources will really induce adjustment or rather simply cultivate a future bailout. After all, if the municipalities that are now in deep fiscal problems did not have the bailout-cum-adjustment at hand, what would they do?

Building an Evaluation System around Principal Social Priorities

Bolivia has focused to date on transfers to the subnational public sector level, particularly municipalities, but it has not given significant attention to evaluating the results of such transfers. The apparent presumption is that what is scarce are the resources and not the institutional and management systems to assure effectiveness from those expenditures. The fact is that what is wanting here are all the appurtenances of a results-based management system.

The key strategic link is the connection between weak institutions at the municipal level, on the one hand, and the absence of incentives, on the other. As long as the "right" incentives are not there, institutional capacity will most likely remain weak. Supply-driven attempts by the national government or donors to strengthen local institutional capacity have limited and transitory effects. Demand-driven institutional development based on incentives is the durable solution. On this point, the World Bank (2001b, p. 5) observes: "While the weak institutional capacity of municipalities is an important reason for the sub-optimal performance of Bolivia's decentralized public administration, another cause of the under-utilization of municipalities' potential capacity lies in the confusing incentives framework that guides intergovernmental relations today."

The current situation offers a great opportunity for evaluation capacity development at the national and subnational levels, since the authorities are in the process of negotiating rules through which incentives could figure into certain transfers in exchange for improved results. This is the right sequencing to negotiate the incentives and the evaluations, i.e., at the moment when transfers like the HIPC II are being distributed and implemented.

Incentives and Information

Underlying the incentive problem is the dearth of data on public finances, particularly data related to intergovernmental operations. In terms of institutional economics, which places great importance on information, the problem is that the incentives in Bolivia's decentralization process are generally wrong in the

sense that they do not sufficiently penalize municipalities for failing to supply and use adequate information as part of their programs. Nor do they make it attractive for municipalities to work on the demand side of information.

According to the IMF (2001a, p. 55), "it is currently impossible to track poverty related spending at all levels of government and the quality of the available data is poor." This information issue is closely related to what was said above about incentives and evaluations. Hence, an integrated and consistent strategy is needed to deal with these interdependent problems.

Bolivia's main decentralization and poverty reduction challenge is to use current concessional resources to assure that there will not be a need for another bailout in the near future. At this juncture, progress could be substantially strengthened by more intensive use of incentives in decentralization and poverty reduction programs.

Main Findings and Conclusions

No two processes of decentralization are alike, and Bolivia is no exception to this rule. Its decentralization process, which began in earnest with the passage of the Popular Participation Law in 1994, was based on the idea that the first priority was to strengthen a state entity at the municipal level. The key policy objective was to convert dozens, if not hundreds, of isolated municipalities into *effective political units and valid interlocutors for the national and central government*. There was no place in that initial jump-start of the process for establishing incentives or other proper conditions that most decentralization processes require. It was an almost exclusively political process, and hardly an inspired one in terms of economic efficiency or even equity considerations. From this unique but limited perspective, Bolivia's process of decentralization may have begun successfully.

The challenge now is to structure a decentralization process that uses market-like instruments and develops within tight fiscal and macroeconomic constraint. This is not happening in a significant way. Bolivia is receiving substantial concessional funds (about 6 to 7 percent of GDP per year), but the institutional framework under which these and other budget resources are allocated is far from market-oriented. It is basically a parceling out of resources through unconditional and automatic transfers. In this process the "right" incentives have a minor role, while the "wrong" incentives end up being predominant. Under this interventionist public choice institutional framework, the "wrong" organizations have emerged to become a major source of severe political economy restrictions.

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Chapter Six

Chile

In contrast with decentralization strategies in Ecuador and Bolivia, which emphasize the role of growing and largely unconditional transfers, Chile gives priority to macroeconomic and fiscal restraint as well as to the development of incentives for overall productive resource use. It also favors selective and sectoral decentralization more than wide-open devolution of resources and competencies. However, Chile's adherence to tight macroeconomic and fiscal constraint—the country had consolidated fiscal surpluses for most of the period from 1985-97[1]—is akin to Brazil's recent fiscal correction and its Fiscal Responsibility Law.

Chile's approach to decentralization focuses on building institutions, developing processes and nurturing the "right" incentives in the rules and norms that flow from such processes and institutions. In the educational sector, the policy approach is to decentralize towards the municipalities and even to the school level.[2] For example, the Montegrande Project established a national competition system for 1,200 state-funded secondary schools to select models of school excellence. Participating schools managed their own funds as they saw fit in order to enhance academic performance.[3]

In the health sector, Chile decentralizes to markets and market-like environments. The country has a private system of competitive health insurance and a public scheme organized on the basis of a social security system that permits subsidized care to its beneficiaries. According to Larrañaga (1999, p. 223), while "the overall record of the Chilean health system is mixed, it has achieved universal coverage, high life expectancy and low child mortality relative to other countries at a similar stage of development."

Chile's privatization and divestiture policies are an example of decentralization towards markets. Bitran, Guash and Serra (1999, p. 228) write that

[1] See Perry and Leipzinger (1999).

[2] See Molina (2000) for the specifics of educational reform and in particular the emphasis on quality.

[3] See Cox and Lemaitre (1999, p. 171).

although Chile "has not succeeded in distributing the efficiency gains fairly between investors and users," it is proceeding in the right direction, i.e., placing more reliance on incentive-based regulatory schemes than on cost-plus models. Galal et al. (1994, p. 17) report that while divestiture of public enterprises is widely referred to in Chile as privatization, "in recent years the latter term has been expanded to include everything from mixed public-private hybrids (for example, management contracts or leasing) to anything that makes public entities behave more like private ones (for example, incentive systems), to anything that makes private enterprises behave in practice more like they are supposed to behave in theory (for example, liberalization)."

Notwithstanding the unique characteristics of Chile's decentralization policies, the country in its distinctive way is probably making more stable and effective decentralization progress than many others in Latin America. This is largely explained by the application of tight fiscal and budget constraint together with incentives to enhance the efficiency of overall public and private resource allocation.

In brief, Chile's decentralization strategy balances a top-down approach (e.g., national sectoral policies and strong national institutions) with incentives and decentralized choices, management and evaluations.[4]

Chilean decentralization stands in striking contrast to the experiences of Brazil, Ecuador and Bolivia. For Latin American countries as a whole, the Chilean case offers guidance and best practices as to how to deal with specific problems.[5] While all countries are different and most reforms depend on historical and situational political contexts, some of Chile's lessons may shed light on how to actually take advantage of the potential welfare gains offered by decentralization.

This chapter examines various aspects of Chile's decentralization experience based on a series of interdependent questions. Is Chile's a "centralist" country? Does it have a "unique" approach to decentralization? If so, what are its special features? What macroeconomic framework and institutional arrangements underpin Chile's decentralization process?

Macroeconomic Context

The importance of a stable macroeconomic environment to decentralization has been underlined throughout this book. Neither Ecuador nor Bolivia has

[4] For an examination of how well balanced this approach is, see Raczynski and Serrano (2001, p. 21).

[5] For a review of Chile's reforms since 1973 and how they relate to those of nine Latin American countries, see Stallings and Ffrench-Davis (2001).

been able to fully meet this condition for decentralization, while Brazil, on the other hand, is rapidly moving in the direction of meeting it.

Chile maintained a consolidated fiscal surplus for most of the years between 1985 and 1997, and its positive outcomes have been attributed to "sound policies as well as sound fiscal institutions" (Perry and Leipzinger, 1999, p. 4). By 1997, the Chilean economy had completed 14 years of continuous high growth that averaged 7.8 percent annually in the 1990s (Eyzaguirre and Lefort, 1999, p. 109).

Table 6.1 (Line I) shows that Chile's overall combined public sector balance remained positive until 1998, when the economy was hit by recession. This situation was brought under control, and the combined public sector deficit was reduced to -0.3 percent by 2001. Since 1996, inflation has been below 6 percent. The current account deficit declined to -1.9 percent of GDP in 2001 from -5.1 percent in 1998. Interest payments on public debt have been below 1 percent of GDP over the past seven years.

For 2002, Chile agreed with the IMF to seek a central government "structural" surplus of 1 percent of GDP following a surplus of 0.2 percent in 2000. According to the IMF (2001a), "this new fiscal balance measure and target is defined with respect to the accounts of the central government, its derivation involving first a number of significant accounting adjustments to the traditional official measure, then the extraction of two estimated temporary components, both on the revenue side. One such component, standard in structural balance estimates, is the revenue effect of the deviation of output from its potential level. The other is an adaptation, which recognizes the significance of copper exports to government income in Chile and is based on the deviation of the copper export price from a specified reference price. The government announced that it would target a surplus of 1 percent of GDP of the resulting structural balance in each of the budget years 2001 through 2005."[6]

Table 6.2 shows Chile's macroeconomic performance over the past decade relative to other Latin American countries. Chile had the fastest GDP growth rate (6.5 percent) and, with the exception of Bolivia, the lowest inflation rate. It was the only country in the group to register a positive public sector balance (1.4 percent of GDP), and it had the highest investment ratio.

In brief, Chile's macroeconomic management has probably been the best in the region over the past decade. Beyond these laudable figures, however, three questions emerge: 1) What policies explain these results? 2) Was decentraliza-

[6] Structural surplus or deficit is the one that takes into consideration, among other things, the economic cycle.

Table 6.1 Chile: Key Economic Indicators
(Percent of GDP)

Indicators	1995	1996	1997	1998	1999	2000	2001
A GDP real growth rate[1]	10.6	7.4	6.6	3.2	-1.0	4.4	2.8
B Current account balance[1]	-1.9	-4.1	-4.4	-5.1	-0.4	-1.4	-1.9
C Tax revenue (central government)[2]	15.5	16.7	16.3	16.3	15.6	16.4	17.2
D Pension contributions[3]	1.2	1.3	1.3	1.4	1.4	1.4	1.5
E Total revenue (combined public sector)[4]	22.5	23.3	23.4	23.4	23.2	24.4	25.1
F Total revenue (central government)[3]	20.9	21.7	21.7	21.6	21.3	22.5	23.2
G Total expenditure (combined public sector)[4]	20.0	21.3	21.6	23.1	24.5	24.3	25.4
H Total expenditure (central government)[3]	18.6	19.6	19.9	21.3	22.6	22.4	23.5
I Overall surplus or deficit (combined public sector)[5]	2.4	2.1	1.8	0.4	-1.3	0.1	-0.3
J Overall surplus or deficit (central government)[3]	2.4	2.1	1.8	0.4	-1.4	0.1	-0.3
K Transfers and subsidies from central government to private recipients[1]	4.2	4.5	4.6	4.8	5.5	5.5	5.9
L Pension payments[3]	5.2	5.4	5.5	5.9	6.6	6.6	6.9
M Interest on public debt[3]	0.7	0.5	0.4	0.6	0.3	0.4	0.5
N Transfers under Law 13, 196[1]	0.5	0.4	0.3	0.3	0.3	0.4	0.4
O Education, health, social provision[6]	12.1	12.9	13.1	14.0	15.4	15.6	16.4
P CPI (end of period)[1]	8.2	6.6	6.0	4.7	2.3	4.5	2.6
Q Total revenue, public enterprises (combined public sector)[7]	13.5	12.2	11.7	10.4	10.8	13.1	14.4
R Unemployment rate[8]	7.3	6.3	6.1	6.3	9.8	9.2	9.1

Source: IMF (2001c) and Central Bank estimates.
[1] Source: Central Bank.
[2] Data as of 2001. Includes net tax inflows (including deductions for devolution of taxes). Source: Public financial statistics.
[3] Data as of 2001. Source: Public financial statistics.
[4] Central government. Source: Public financial statistics.
[5] General government. Source: Public financial statistics.
[6] Includes social expenditures. Source: Public financial statistics for 2001 and the Budget Law for 2002.
[7] Nonfinancial public entities (including CODELCO). Source: Public financial statistics.
[8] Average for January–March, April–June, July–September and October–December for each year.

Table 6.2 Chile in the Regional Context, 1990–99
(Averages for the period)

Country	GDP growth (%)	Inflation (%)	Public sector balance (% of GDP)	Current account (% of GDP)	Savings (% of GDP)	Investment (% of GDP)
Argentina	4.6	252.9	-0.8	-2.5	15.2	17.7
Bolivia	3.9	10.5	-2.3	-6.0	10.8	16.3
Brazil	1.8	843.6	-5.2	-1.8	18.8	20.8
Chile	6.5	11.7	1.4	-3.1	21.4	25.3
Colombia	2.8	22.3	-1.7	-2.3	23.3	21.6
Mexico	3.4	20.0	0.1	-3.7	19.1	22.9
Peru	3.8	807.9	-1.4	-5.3	16.0	21.3
Venezuela	2.2	47.1	-1.3	3.5	21.2	17.4

Source: IDB (2001).

tion a major priority within this overall policy framework? 3) What specific social gains were obtained from tight macroeconomic and fiscal environment?

With regard to the first question, Eyzaguirre and Lefort (1999, p. 120) report that "since the mid-1980s, Chile has sought a sustainable rate of growth through continuous control of internal demand expansion and an increasingly flexible exchange rate regime. It also has addressed traditional sources of macroeconomic instability, such as fluctuations in export receipts and capital inflows, as well as in the money supply. The positive results of this macroeconomic policy have fostered healthy capital market development, especially of the banking sector. In turn, the regulatory and supervisory efforts undertaken in both the banking sector and the bond and stock markets have contributed enormously to sound macroeconomic evolution. It is precisely the interaction between these policy areas that explains, in our view, the emergence of synergy between growth and capital markets."

The strongest explanatory variable of Chile's macroeconomic and fiscal success is the stability of the economic model over the past 20 years. Key structural reforms adopted in the 1980s—fiscal correction, central bank independence, privatization, financial reform, trade liberalization and regulatory reform—were maintained in the 1990s.[7] Today those reforms remain as largely shared principles of economic policy. The democratic governments of Presidents Patricio Aylwin and Eduardo Frei committed themselves in word and deed to not altering the essential elements of the economic model (Corbo, Lüders and Spiller, 2002, p. 81).

[7] Stallings (2001, p. 55) posits that "reforms, by themselves do not engender positive or negative results. They have to be considered within the broader context of international economics and other policies."

As for the second question, decentralization was indeed part of the overall policy framework, but with a key caveat: it did not include a significant process of revenue sharing or large transfers from the national to the subnational level. In 1993, the Regional Government and Administration Law, inter alia, established the regional governments and decreed that mayors could be directly elected by citizens. However, the administration of *la concertación* decided to duplicate investment resources allocated by regional decision mechanisms. Over 1992–97, regionally decided investments grew by an average of 28 percent annually (Serrano, 2001, p. 59).

With regard to the third question regarding social gains, it should be noted that reductions in levels of poverty and inequality are not one and the same. As Solimano (2000) has pointed out, achieving distributive justice involves much more than poverty reduction.[8] Chile has been more successful in reducing poverty than inequality (Valdez, 1999). Still, Table 6.1 shows that Chile increased social spending from 10.8 percent of GDP in 1990 to 14 percent in 2000, and the UN Human Development Index classifies Chile as a "high human development country" just below Argentina, Costa Rica and Uruguay.

"Chile has made remarkable progress in reducing poverty, both through macro policies which have produced a sustained rate of rapid growth, and well directed social programs," notes a study by the World Bank (2001c, p. 9). "Few countries can match Chile's record of cutting its poverty rate in half over a period of 20 years. However, problems do remain. Unemployment is high, particularly among the young."

In sum, maintaining budget constraint and following prudent fiscal policy over two decades has compromised social and welfare gains in Chile. Most likely, it is the other way around: the country has substantially improved social welfare precisely *because* it followed such an approach, along with deliberate incentive-intensive policies that enhanced the effectiveness of social expenditures.

As summarized by Cowan and De Gregorio (2000, p. 148): "The income distribution in Chile today, is the fruit not so much of current social policies as of a combination of social policy, education strategy, health programs, and other initiatives put in place over the past two or three decades, if not longer."

This point has also been underlined by Rodrik (2000) in his observation that "income distribution tends to be stable and fairly unresponsive to policy

[8] Solimano (2000, p. 32) writes: "The modern theory of distributive justice distinguishes between 'outside' (or morally arbitrary) factors (gender, race, initial assets, talent) and 'personal responsibility' elements (effort, risk-taking attitudes) in shaping the level of income, wealth, and welfare of the individual in society. Social inequality is a reflection of individual differences in these two sets of wealth-creating factors."

changes." This does not mean that income distribution does not matter; it matters perhaps more than anything else. Rather, as Solimano (2000) posits, it means that redistributive justice needs to be well understood in order for policies aimed at improving income distribution to be effective.

Intergovernmental Decentralization Framework

Chile has a long tradition of state centralism. From its birth as a republic in the early 19th century, a strong president regime was the norm. However, according to Marcel (1999, p. 294) "over the past 20 years, major processes of decentralization have been undertaken, significantly changing the structure and operation of the public sector. These processes have had a political impact. For the first time all the municipalities in the country have mayors and municipal councils elected by local citizens; regional governments have been established with their own bodies, powers, and participatory arrangements."

Chile's decentralization process began in earnest in 1976, when the country was divided into 13 regions, 52 provinces and 325 *comunas*. In 1975, the National Fund for Regional Development (FNDR) was created to provide financing for investment in local infrastructure through a system of decentralized project identification. During the 1980s, the "municipalization" of primary education and health took place.

The 1991 constitutional reform introduced mechanisms to transfer more decision-making power from the central to the regional level and new formulas were devised for the allocation of resources to investment projects. Marcel (1999, p. 296) notes that with the increase in resources mobilized by the FNDR and other supplementary systems, regionally allocated public investment grew at an average annual rate of 21.4 percent from 1990 to 1997, increasing its share of total public investment from 13.7 percent to 26.6 percent.

Currently, "the municipalities and regional governments are endowed with specific responsibilities and powers in the areas of administration, delivery of social services, and investment in infrastructure. Most of these functions have been transferred from the central government, which has thus narrowed its scope of activity. This transfer of responsibilities has gone hand in hand with the transfer of considerable resources, varying from taxes and fees exclusively earmarked for municipalities to conditional transfers from the central government. Altogether, these resources represent some 5 percent of GDP, which is the equivalent of one-fifth of general government resources" (Marcel, 1999, p. 294).

Finally, in 1993 the Regional Government and Administration Law created the institutional entities of the "regional government" and the "regional council" as the two pillars of the subnational level of government.[9]

Main Decentralization Instruments

Chile has in place the following five major instruments to implement its decentralization processes: 1) the Common Municipal Fund (FCM); 2) the National Fund for Regional Development (FNDR); 3) regionally allocated sectoral investment (ISAR); 4) locally allocated regional investment (IRAL); and 5) programming agreements.

Common Municipal Fund

The Common Municipal Fund was created to redistribute resources from the fiscally strong municipalities to those with lower fiscal capacity. Hence, it has clear redistributive and equity purposes. The fund decentralizes resources and has a legal and institutional framework to assure that those resources reach the segments of the population in greatest need of public support. A proportion of municipal own-tax revenues was exclusively earmarked to be transferred from wealthy *comunas* to poorer ones.[10]

The Common Municipal Fund is a major instrument of decentralization. According to Schilling (1999, p. 6), its resources grew by 126 percent in real terms between 1992 and 1998.

National Fund for Regional Development (FNDR)

Since its establishment in 1975, the FNDR has been a key decentralization instrument in Chile. During the 1982-83 crisis, it declined in importance, but in 1985, its spending tripled and new operational mechanisms were developed. The fund grew at a cumulative real growth rate of 80 percent between 1986 and 1991 (Marcel, 1999, p. 295).

[9] See Serrano (2001, p. 33).

[10] The main municipal bases that are "taxed" by this transfer are the property tax, vehicles, and fees (patents) on commercial activities. The resources are then distributed according to a formula that favors low-income groups.

The FNDR receives resources from the Inter-American Development Bank, directly from the national budget, and from the sectoral investment programs of line ministries.

According to a CIEPLAN study, the FNDR is one of the principal instruments of decentralized public investment, channeling about 40 percent of all regionally decided investment. The fund is popular because it is flexible and receptive to local and regional needs. In general terms, it focuses its operations in education and transportation (Serrano, 2001, p. 80).

The FNDR's participation in public investment over 1991-97 was stable at around 10 percent of total public investment, which grew by an average of 16 percent per year during that period (see Table 6.3) (Serrano, 2001, p. 50).

While FNDR now shares its influence with other fast growing instruments, (e.g., ISAR, IRAL) it remains critical to Chile's decentralization process, particularly because of its flexibility and capacity to finance small but strategic projects at the local level.

Regionally Allocated Sectoral Investment (ISAR)

Regionally allocated sectoral investment corresponds to those resources that line ministries distribute among the 13 regions. These resources grew significantly between 1992-97. Table 6.4 shows their relative participation in Chile's total public investment.

Locally Allocated Regional Investment (IRAL)

Regional investment resources are allocated locally through a program (IRAL) that began in 1996 to provide special support to municipal projects in the poor-

Table 6.3 FNDR Participation in Chilean Public Investment
(In percent)

	1991	1992	1993	1994	1995	1996	1997
All 13 regions	11.3	10.1	11.1	11.2	9.1	10.1	10.1

Source: Serrano (2001) and MIDEPLAN (2001, Table 5c, p. 157).

Table 6.4 Relative Percent Share of ISAR Resources in Total Public Investment

All 13 regions	1992	1993	1994	1995	1996
ISAR share	1.6	7.2	8.2	8.4	7.1

Source: Serrano (2001, p. 167).

Table 6.5 Chile: Relative Shares of Programming Agreements between Regions and Ministries
(In percent)

Level of government	1996	1997	1998
Regional	37.31	33.19	31.37
Ministries	61.75	66.54	68.63
Other	0.94	0.27	–
Total	100.00	100.00	100.00

est income groups. In terms of resources, IRAL is the smallest of the decentralization instruments. However, it grew by 32 percent in real terms between 1996 and 1999.

Programming Agreements

These agreements began in earnest in 1996, when the Ministries of Public Works and Housing developed joint programs with regional governments to develop specific investment projects. In general terms, the largest share of the financing comes from the line ministries (Table 6.5).

Findings

The articulation of these five decentralization instruments provides the framework for a large investment pool called regionally decided public investment (IDR), a unique configuration of institutions, funds, processes, and decision-making under a well-managed institutional web. The key strength is that most projects must compete with one another for resources. In other words, there are incentives that reward the best-prepared projects with additional resources, and all actors strive to access public resources in a competitive public environment.[11]

Redistributive Framework

At the municipal level, Chile has a unique system of intra-municipal transfers from fiscally strong *comunas* to fiscally weak and poorer ones. The transfer finances the Common Municipal Fund. In 1990, this fund redistributed 40.9 percent of all municipal tax revenues (Table 6.6). While this share has grown only

[11] MIDEPLAN administers the National Investment System (SNI) according to well-known methodologies and procedures. The Integrated Project Bank (BIP) is part of the system.

Table 6.6 Chile: Relative Share of the Common Municipal Fund (FCM)
(Millions of current Chilean pesos)

Resources	1990	1995	2000
Total national tax revenues	1,448.251	4,750.119	7,237.238
Total municipal tax revenues	104.684	349.520	621.180
Common Municipal Fund	42.807	147.129	254.864
FCM as % of total municipal revenues	40.9	42.1	41.0

Source: Ministry of Finance Budget Office.

nominally to 41 percent in 2000, it will probably grow at a faster pace in the near future, as recent legislation authorizes municipalities to raise local taxes.[12]

Intergovernmental Tax Structure

The characteristics of Chile's recent intergovernmental tax and financial flows make the country a special case. However, the important question is not so much whether Chile has a particular "model," but whether those characteristics are conducive to effective decentralization.

Table 6.7 shows that as a percentage of GDP, the tax share of Chile's municipal level grew during the 1990s. Municipal tax revenues represented 1.1 percent of GDP in 1990, grew to 1.4 percent in 1995 and reached 1.6 percent by 2000.

This growth of municipal tax revenues occurred while the national level share was also increasing from 14.5 percent of GDP in 1990 to 17.5 percent in 2000. This is similar to Brazil, where subnational tax performance grew as a percentage of GDP while the total for the federal government also grew (see Chapter Four).

Table 6.8 shows that municipal tax revenue as a percentage of total revenue grew from 7.2 percent in 1990 to 8.6 percent in 2000. A municipal tax share of 8.6 percent of the total is higher than the respective shares in Brazil, Colombia, Ecuador, Argentina, Mexico and Bolivia (Table 6.9). But this comparison may be misleading. After all, Chile has no significant "state" or "regional" level. For this reason, the comparison would have to be made between subnational sectors.

Table 6.9 shows that for the year 2000, Chile's "subnational" share (8.6 percent) of the total is much lower than those of Brazil (30.78 percent) and Colombia (19 percent) and higher than those of Ecuador (3.2 percent) and

[12] These are the revenue laws "Ley de Rentas I" in 2000 and "Ley de Rentas II" in 2002. The latter is still in progress.

Table 6.7 Chile: Relative Shares of Tax Revenue by Level of Government
(Percent of GNP)

Level of government	1990	1995	1996	1997	1998	1999	2000
National	14.5	17.0	18.4	18.0	17.8	16.9	17.5
Municipal	1.1	1.4	1.5	1.5	1.6	1.7	1.6
Total national and municipal tax revenue	15.7	18.4	19.9	19.5	19.4	18.6	19.2

Source: Ministry of Finance Budget Office.
Note: This table refers to tax revenues collected by each level of government. That is, it excludes transfers among the states or levels. This is what could be called "own-taxes" by each level of government.

Bolivia (5.9 percent). But the interesting policy message is that Chile's municipal tax share is growing and will probably continue to do so, since new revenue laws (*Ley de Rentas I* in 2000 and *Ley de Rentas II* in 2002) are directed towards boosting municipal tax performance. In this respect, it could be said that Chile is moving towards a process of fiscal "municipalization," as is Brazil, Colombia and other countries in the region.

Table 6.10 shows a breakdown of the sources of tax revenues by level of government. At the municipal level, the largest increase in GDP terms (0.3 percent) took place between 1990 and 2000 in the territorial tax, which is the real

Table 6.8 Chile: Tax Revenues by Level of Government
(Percent of total tax revenues)

Government level	1990	1995	2000
National	92.8	92.6	91.4
Municipalities	7.2	7.4	8.6
Total	100.0	100.0	100.0

Source: Ministry of Finance Budget Office.
Note: This table refers to gross tax revenues collected by each jurisdiction or level of government.

Table 6.9 Subnational Tax Shares and Transfers in Selected Latin America Countries in 2000

	Subnational tax shares	
Country	% GDP	% of total
Colombia	2.60	19.00
Brazil	10.21	30.78
Bolivia	1.10	5.90
Chile	1.60	8.60
Ecuador	0.50	3.20

Source: Table 1.1.
Note: Subnational tax revenues refers to municipal and state or regional own-tax shares.

Table 6.10 Chile: Sources of Tax Revenues by Level of Government

	1990		1995		2000	
Tax revenue by government level	**% of GDP**	**% of total**	**% of GDP**	**% of total**	**% of GDP**	**% of total**
National						
Income tax	2.6	16.4	3.9	21.0	4.4	22.8
Value added	7.0	44.9	8.2	44.8	8.5	44.3
Customs	2.4	15.4	2.1	11.3	1.5	7.6
Others	2.5	16.1	2.8	15.6	3.1	16.8
Total national level	14.5	92.8	17.0	92.6	17.5	91.4
Municipal						
Territorial tax	0.5	3.4	0.6	3.3	0.8	4.1
Municipal contributions	0.5	3.0	0.6	3.1	0.6	3.3
Municipal rights	0.1	0.9	0.2	1.1	0.3	1.5
Debtor fluctuations	0.0	-0.1	0.0	-0.1	-0.1	-0.3
Total municipal level	1.1	7.2	1.4	7.4	1.6	8.6
Total tax revenues (national and municipal)	15.7	100.0	18.4	100.0	19.2	100.0

Source: Ministry of Finance Budget Office.

state urban tax. Also in GDP terms, all major municipal taxes grew in the last decade.

Tables 6.11 and 6.12 provide another indication of Chile's gradual process of converging to a more conventional decentralization model that focuses on subnational shares of expenditure. While the subnational share in 2000 (2.6 percent of GDP) was low compared to most other Latin American countries, that share continues to grow. What is more relevant, however, is that in Chile, national expenditures and investment at the subnational level may provide for a more intense process of local participation. As stated earlier, all subnational projects in provinces and *comunas* have to compete for resources. In the end, a large portion of the benefits of decentralization is generated through this competitive and incentive-based process.

Table 6.11 Chile: Intergovernmental Shares of Expenditures Net of Transfers
(Percent of GDP)

Expenditures by level of government	1990	1995	2000
National	18.1	18.7	22.4
Regional	0.2	0.3	0.4
Municipal	1.5	1.7	2.2
Total expenditures	19.8	20.7	25.0

Source: Ministry of Finance Budget Office.
Note: Excludes interest payments and financial investment.

Table 6.12 Chile: Intergovernmental Shares of Total Expenditures Net of Transfers
(Percent of total)

Expenditures by level of government	1990	1995	2000
National	91.4	90.4	89.6
Regional	1.1	1.4	1.5
Municipal	7.5	8.2	8.9
Total	100.0	100.0	100.0

Source: Ministry of Finance Budget Office.

Whether these benefits are larger than those that could be engendered by a higher share of directly subnational-financed expenditures is hard to say. In any case, Chile is moving into a policy framework in which it will be able to reap the benefits of an approach that will combine the two incentive environments—one that comes from the current competition for access to national resources, and the emerging one in which municipal or subnational tax revenues gain ascendancy and provide the incentives for effectiveness.

Chile is particularly different from other Latin American countries in terms of transfers from the national to the subnational level. While these transfers can be as high as 5 percent of GDP in Colombia, 3.5 percent in Bolivia and 3.1 percent in Brazil, they amount to only 0.7 percent of GDP in Chile (see Tables 6.13 and 6.14).

Table 6.13 Chile: National Transfers to Subnational Level
(Percent of GDP)

Country	National transfers to subnational level
Colombia	5.0
Brazil	3.1
Bolivia	3.5
Chile	0.7
Ecuador	6.6

Note: Subnational tax revenues refer to municipal and state or regional own-tax shares.

Table 6.14 Chile: Relative Share of Transfers from the National to Subnational Level
(Percent of GDP)

Transfers	1990	1995	2000
National transfers to:[1]			
Regions	0.2	0.3	0.3
Municipalities	0.1	0.2	0.2
Total transfers	0.3	0.5	0.5

Source: Ministry of Finance Budget Office.
[1] These transfers are basically those related to the National Fund for Regional Development.

Table 6.15 Chile: Relative Share of Municipal Revenues
(Millions of Chilean pesos for the respective year)

Resources	1990	1995	2000
A Total municipal tax revenues	104.684	349.520	621.180
B Common Municipal Fund	42.807	147.129	254.864
C Total national tax revenues	1,448.251	4,750.119	7,237.238
D A/C (%)	7.20	7.40	8.60
E B/A (%)	40.90	42.10	41.00
F A as a % of GDP	1.10	1.40	1.60
G C as a % of GDP	16.00	18.00	19.00
H B as a % of GDP	0.46	0.56	0.67
I GDP	9,245,504	25,875,727	37,774,743

Source: Ministry of Finance Budget Department.

However, the relevant question is, why would larger transfers automatically imply more effective decentralization? Can it be said that when in Ecuador, Bolivia, Colombia and other countries the national government makes transfers to the subnational level, these countries are really inducing significant economic and social gains just from doing this?[13]

As was argued earlier in this book, the simple growth of transfers provides little indication that "real" and effective decentralization is taking place. Chile seems to abide by this nostrum, which is the correct approach. In most cases, unless transfers have an incentive to reward some desirable local fiscal and institutional behavior, they add little to effectiveness or to long-term subnational development.

Although Chile does not have a large system of national transfers to the subnational level, it has a unique mechanism through which wealthy *comunas* transfer, as a group, about 41 percent of their own-tax revenues to poor *comunas.* Table 6.15 shows that these intra-municipal transfers have been growing since 1990 and were equivalent to 0.67 percent of GDP in 2000.[14]

In brief, Chile's transfers, while low in comparison to other countries, have been growing during the past decade. What matters is this policy trend.

Beyond the point of growing transfers lies the more important one of ultimate priorities. According to Arellano (2000, p. 166), "Chile has opted to

[13] In an insightful reversal of the transfer effectiveness argument between public intergovernmental levels, Ocampo (1999, p. 11) asks why transfers from the public to the private sector in the 1980s and 1990s under privatization schemes or foreign debt swaps are not considered as subsidies. Furthermore, he asks why they are not scrutinized as rigorously as other transfers.

[14] Regarding the evolution of transfers in Chile, see Marcel and Espinoza (1994, p. 58). These authors posit that between 1987 and 1992, national transfers excluding payments for education and health grew in real terms by 73.4 percent and absorbed up to 70 percent of permanent current revenues.

stress education rather than significantly increasing monetary transfers—as is shown in the figures for the past few years."

Findings and Conclusions

Does Chile have a unique approach to decentralization? If so, what are its special features? And, even more important, is it achieving in its own way decentralization results and attendant gains in welfare and efficiency? The answers to these questions are all affirmative. Yes, Chile has a unique way of capitalizing the potential benefits offered by decentralization. It anchors its model on tight budget constraint and incentive-intensive sectoral environment. And yes, the country is consolidating significant social and economic gains across income groups and regions.

Of particular note is that although Chile's approach is different, it does not contradict fundamental principles of mainstream public economics or fiscal federalism. On the contrary, in terms of these conceptual frameworks, Chile is moving towards more intensive use of hitherto low-profile decentralization instruments and channels, slowing moving towards the enhancement of local tax authority and performance.

While still incipient, data clearly suggest that Chile is moving towards "municipalization" in terms of growing tax and expenditure shares at this level of government. While it is difficult to predict how Chile's special model will evolve, the country is certainly well poised to capitalize on the benefits of the two incentive environments it is currently nurturing—one that comes from competition for access to public resources, and an emerging one in which municipal or subnational tax revenues increase and provide incentives for local institutional development and enhanced effectiveness.

Chile's global approach to decentralization and subnational development is centered on the key premise that they are an integral part of overall public policy. That is, decentralization is not considered an independent process taking place apart from other public policies. Just as overall public policy is framed by market principles and by market-based operational approaches, so is decentralization policy.

Policymakers in Chile know all too well how imperfect markets can be and how costly it is for a country if it fails to make the right choices when confronted with the dilemmas of discerning market failures from strict market solutions. So far, Chilean policymakers appear to have made good choices

most of the time. The result for close to 20 years is a largely consistent policy framework.[15]

The point to underline about Chile's tight macroeconomic fiscal constraint is that it is based on a political consensus that practically dictates to all administrations that fiscal prudence must be the norm. This is the necessary pre-condition for the success of consistent macroeconomic policy. It is not a sufficient condition itself, since beyond that political restriction there is always the tough question of deciphering data, processes and transmission mechanisms to determine current fiscal results and those evolving underneath the surface of ordinary data.[16] Fortunately, Chile has the institutional and technical capacity to also meet this sufficient condition.

At the sectoral level, policy consistency is largely assured as a result of macroeconomic budget constraint. Once this constraint is a principle shared by all ministries, managers and heads of decentralized institutions will generally not try to stealthily subvert that macroeconomic order. Such constraint is not the rule in most Latin American countries, where ministries often promote programs that will adversely affect sectoral consistency and the common good of macroeconomic prudence.

Intersectoral policy consistency in Chile is also largely achieved through well-coordinated economic governance at the top. There is a sort of Executive Committee at the presidential level where key coordination is agreed to.

A key contributing factor leading to policy, project and program coordination is the National Investment System (SNI) and its Integrated Project Bank (BIP) managed by the Ministry of Planning (MIDEPLAN). This well established institutional arrangement selects the projects that deserve to be financed and exercises global surveillance to assure overall consistency.

In addition, Chile now has in place an ex post evaluation system to assess results of policies, projects and programs.

Given Chile's successful results with what amounts to a unique decentralization strategy, the question may arise as to the replicability of this model. In this regard, the usual caveat that all countries are different and have distinct institutional traditions is applicable. Hence, it is doubtful that Chile's approach is either replicable in its entirety or even advisable for most countries. What in principle does appear replicable, independent of historical idiosyncrasies, is the application of tight macroeconomic budget constraint. In fact, it would seem

[15] See Moguillansky (1999) for an analysis of Chile's experience with high market-based periods as well as with more interventionist ones.

[16] For a discussion of these complexities, see Easterly (1999).

that this feature must be a common denominator in all decentralization modalities, regardless of different country contexts.

However, this is only true in principle. What will be most difficult replicate is not so much macroeconomic budget constraint but the underlying political consensus that in Chile has established fiscal profligacy as a norm. Without prior political agreement on this condition, it is difficult to have tight budget policy.

On the replicability of Chile's model, Foxley and Saporelli (1999, p. 421), warn that "the country's historical development and context, the weight of its political institutions throughout its history, and the framework within which the transition process has taken place are, to say the least, uncommon." In brief, it would appear that while each country can and often must choose its own path in terms of a specific approach to decentralization, it may not be able to choose the underlying budgetary or macroeconomic policies. The benefits of decentralization will accrue only if macroeconomic budget constraint is tight.

Chapter Seven

Ecuador

Few countries offer more of an interesting example of the need for decentralization and the difficulties of meetings its conditions than Ecuador. The country is highly centralized, yet awash in rhetoric about decentralization. It clearly could benefit from an organized and transparent process of decentralization, and yet, as will be seen, there is still much technical and political homework to be done in Ecuador before a real decentralization process can get underway.

Since the mid-1990s, decentralization in Ecuador has taken place within a highly volatile macroeconomic environment (Table 7.1). GDP growth has fluctuated widely, ranging from a high of 3.4 percent in 1997 to a low of -7.3 percent in 1999. Inflation grew from 30.7 percent in 1997 to over 90 percent in 2000. The combined fiscal deficit of the non-financial public sector grew each year from -2.4 percent of GDP in 1997 to -7.2 percent in 1999. There was a fiscal surplus of 1.6 percent of GDP in 2000.

The petroleum sector, which earlier in the decade had been a main source of growth, contracted over 1997-99 by -29.1 percent. Total public sector expenditures went from 26.2 percent of GDP in 1997 to 31.7 percent in 1999. Interest payments as a percentage of GDP went from 4.7 percent in 1997 to 9.3 percent in 1999.

Severe macroeconomic volatility during the second half of the 1990s culminated in the adoption of dollarization in January 2000. This extreme measure was not the solution to Ecuador's main economic problems, but rather a stopgap action to provide time and institutional perspective for a beleaguered economy.[1] Whether it will contribute decisively to strengthen Ecuador's development will depend, to a large extent, precisely on whether a "real" decentralization process is put in place. From a decentralization perspective, the main policy implication of all of this is that little budget constraint prevailed in the 1990s.

[1] For a discussion of the advantages and disadvantages of dollarization in developing countries, see Antinolfi and Keister (2001).

Table 7.1 Ecuador: Key Economic Indicators

Indicator	1997	1998	1999	2000	2001e
Growth of GDP	3.4	0.4	-7.3	2.3	3.6 to 4.0
Current account (% of GDP)	-3.6	-11.0	7.1	7.4	-2.8
Central government: total revenues (% of GDP)	17.4	16.2	19.7	23.8	22.5
Central government: total expenditures (% of GDP)	18.8	21.1	24.3	23.7	24.4
Expenditures: total public sector (% of GDP)	26.2	26.4	31.7	28.9	29.9
Public sector total interest payments (% of GDP)	4.7	4.7	9.3	6.3	4.3
External debt (% of GDP)	76.9	82.2	118.8	83.0	64.9
Consumer price index (end of period)	30.7	43.4	60.7	91.0	20 to 22
Unemployment	9.3	11.8	15.1	10.3	10.51
Combined surplus or deficit (-)	-2.4	-5.9	-7.2	1.6	-0.3
Participation of petroleum sector in GDP		-29.1		14.2	14.7
Government revenue from petroleum sector (% of total)		28.0		35.3	33.1
Government revenue from petroleum sector (% of GDP)		4.5		10.7	9.7
Taxes from nonpetroleum sources (% of GDP)	9.3	11.8	11.3	13.7	13.2
Social security contributions (% of GDP)	2.3	2.2	1.7	3.3	2.9
Earmarked revenues (% of central government revenues)				64.0	

Source: IMF (2000) and updated by Ecuador's Central Bank.
e = estimate.

Tight budget constraint is an indispensable condition for a well-developed decentralization framework. If expenditures can expand and fiscal deficits occur, it is difficult to establish incentives that can then reward performance. If access to resources is relatively easy, there is little demand for evaluation, further undermining any prospects for the success of incentives. To make matters worse in Ecuador, the decentralization process itself contributed to the weakening of the fiscal position of the public sector. Table 7.2 shows that the fiscal deficit grew from -2.4 to -7.9 between 1997 and 1999.

Table 7.2 Ecuador: Combined Fiscal Surplus or Deficit
(Percent of GDP)

	1997	1998	1999	2000	2001
Fiscal balance	-2.4	-5.9	-7.9	1.6	-0.3

Source: Central Bank of Ecuador.

Table 7.3 Ecuador: Intergovernmental Transfers
(Percent of GDP)

	1996	1997	1998	1999	2000
Transfers	3.2	2.9	3.7	4.5	6.6

Source: Central Bank of Ecuador.

Table 7.4 Intergovernmental Transfers in Selected Latin American Countries
(Percent of GDP)

Country	1996	1997	1998	1999	2000
Argentina	8.2	8.7	9.3	9.3	9.1
Colombia	9.2	9.5	9.8	11.7	10.4
Mexico	4.8	6.4	6.8	6.9	7.2
Bolivia	3.4	4.2	6.4	5.7	6.0

Source: ECLAC and author's estimates.

Table 7.3 shows that transfers from the national to the subnational level grew from 3.2 percent of GDP in 1996 to 6.6 percent in 2000.

In the case of the "15 percent transfer"—a 1997 law that requires the national level to increase transfers to the subnational level by up to 15 percent of its budget without conditionality—there was no compensating reduction through a corresponding transfer of responsibilities. Such transfers, ceteris paribus, either increased the fiscal deficit or lowered a potential fiscal surplus.[2]

Although transfers from the national government have been growing rapidly, they are still small compared to other countries. In Colombia and Argentina, for instance, transfers can reach levels close to 10 percent of GDP (Table 7.4).

The conclusion that emerges is that fiscal policy was lax during the second half of the decade and that a largely unconditioned transfer system aggravated the macroeconomic imbalance. Under these circumstances the political and administrative struggle between those seeking to correct macroeconomic imbalances (i.e., the economic authorities at the Ministry of Finance) and those seeking to capture gains from transfers, (i.e., jurisdictions, institutions, labor unions, public banks) proved to be highly deleterious to macroeconomic stability and to real decentralization.

[2] On the fiscal implications of the "15 percent transfer," see Wiesner (2000).

Institutional Framework

The institutional framework and the rules supporting Ecuador's decentralization process do not appear to be delivering the expected results. There is, for sure, an abundance of institutions as rules (e.g., the 1998 constitution) and several laws directed towards maintaining a favorable macroeconomic environment as well as delivering efficient and equity-enhancing decentralization (Table 7.5). But neither objective seems to be firmly anchored. How can this be?

Table 7.5 Ecuador: Legal and Institutional, Framework for the Decentralization Process

Dated	Norm or institutional arrangement	Policy objective
March 20, 1997	Special 15% Law	The national level has to increase transfers to the subnational level by up to 15% of its budget. There is no conditionality for this transfer.
October 1997	Application procedure for the Special 15% Law (Official Registry 183)	Establishes the destination of the 15% transfers
October 8, 1997	Chapter XI of the constitution	Establishes that there will be decentralization of functions and resources
August 10, 1998	Special Decentralization Law	Specifies the process of decentralization
December 3, 1997 (Decree 1567)	The National Decentralization Commission created with 21 members	A body to advice the president on decentralization issues. It is supposed to prepare a comprehensive decentralization framework
October 2, 2000	Draft Law for Status Autonomy prepared by CONAM	Established the legal framework for autonomous provinces
January 2001	New guidelines issued for the Decentralization Law	To put order in the decentralization process
2001	Decentralization Plan	Decree no. 1616
June 18, 2001	Guidelines for the State Decentralization and Social Participation Law	Decree no. 1581
June 26, 2001	National Decentralization Plan, which will be published in the Official Register along with current decree to ensure compliance by ministries and executive agencies.	Decree no. 1616
2002	Fiscal Responsibility Law	To establish macroeconomic rules leading to tight budget constraint

The answer lies in the critical distinction that institutional economics makes between nominal and effective rules with their own enforcement capacity. What may be happening in Ecuador is that the nominal (legal) rules are not yet the effective rules. The real underlying interests of the organizations that have sprung up under the nominal institutional framework are following other set of rules. That set would be the markets, as the supreme overarching institutional framework. In brief, what could be happening is that the nominal institutional effective rules are in fact the institutions and their emerging organizations.

This proliferation of rules could hardly be a fortuitous result. Rather, it reflects the complex political maneuvering underlying any change in existing power relationships. In Ecuador, this intense political struggle between losers and winners (Fisher and Sahay, 2000) is particularly acute because of the century-long rivalry between Quito and Guayaquil.[3] This "binary struggle" for gains from decentralization may have polarized and politicized the debate much more than in other countries.

Reflecting this political fragmentation is the fact that between 1995 and 2001, Ecuador had five presidents: Sixto Duran Ballen (1995), Fabio Alarcon (1996), Abdala Bucaran (1997), Janil Mahuad (1999) and Gustavo Noboa (2001–02). And reflecting the area where the political struggle is most intense, and where decentralization interests converge and conflict, is the fact that since 1995 Ecuador has had 14 ministers of finance: Mauricio Pinto and Iván Andrade (1995), Pablo Concha Ledergerber (1996), Carlos Dávalos Rodas and Marco Flores (1997), Fidel Jaramillo (1998), Ana Lucía Armijos, Guillermo Lasso and Alfredo Arizana (1999), Jorge Guzmán and Luis Iturralde (2000), Jorge Gallardo and Carlos Julio Emanuel (2001), and Francisco Arosemena Robles (2002).

The interpretation that emerges is that in Ecuador, decentralization is perceived more as a static product to be distributed by political muscle than as a process through which collective welfare gains can be shared by political consensus.[4] Underlying this situation is an enormous lack of transparency in fiscal and financial transactions. Under a game theory perspective, political actors are prisoners of themselves and think decentralization is a negative win or loose game. They are prisoners of this "incomplete" and asymmetric information bind. Political actors are thus moved by the "negative incentives"

[3] See Wiesner (2000).

[4] See Zimmerman (2000).

hidden in numerous modalities of explicit and surreptitious transfers. The short-term rationale is, why bet on potential gains from decentralization when discretionary power can yield concrete and immediate gains?[5]

Of course, the reality is much more complex that this perception. In the final analysis, most political actors perceive their own immediate gains as a legitimate interpretation of a social welfare function. Proposals based on "neutral" incentives to enhance total welfare have uncertain outcomes and are thus suspect.[6]

This is precisely what public choice is all about and why, without a public choice perspective, it would be difficult to use decentralization to modernize many Latin American countries.

Fiscal and Policy Consistency Framework

The fiscal and policy framework within which decentralization has been attempted in Ecuador is characterized by an inconsistent macroeconomic policy setting where incentives and independent evaluations cannot prosper; fiscal centralization and low fiscal performance; fiscal rigidity and intensive earmarking; and fiscal obscurity and surreptitious transfers.

Policy consistency—defined as a framework in which different rules complement each other in the pursuit of global objectives—did not prevail in Ecuador during the 1990s. Large fiscal deficits and exchange rate crisis were the ultimate outcome of an inconsistent policy framework. From the perspective of decentralization, the increase in public sector expenditure at all levels was not supported by instruments (incentives) to enhance the quality of expenditures. Within that environment, incentives encouraged further spending instead of rewarding greater effectiveness.[7]

Compared with other countries in the region, Ecuador is highly centralized. Table 7.6 shows that in the mid-1990s, the national level absorbed on average about 11 percent of GDP in taxes, while the subnational level only absorbed about 0.4 percent. As a percentage of all tax revenues, the national level absorbed 97 percent in 1999 compared to 3 percent by the subnational level.

[5] The "second invisible hand" alluded to be Mancur Olson (2000) is not yet in the picture.

[6] On the relationship between governments, politicians and the maximization of social welfare, the classical work is by Downs (1957).

[7] In the *Fondo de Desarrollo Seccional* (FODESEC) transfer (2 percent of budget resources), there is a miniscule share supposedly assigned to reward administrative efficiency.

Table 7.6 Ecuador: Intergovernmental Tax Shares
(In percent)

Tax revenues	1995	1996	1997	1998	1999	2000
National (% of GDP)	9.7	8.6	10.6	11.0	12.2	13.8
Subnational (% of GDP)	0.4	0.3	0.4	0.4	0.4	0.4
National (% of total)	96.7	96.1	96.7	96.7	97.0	96.8
Subnational (% of total)	3.8	3.8	3.3	3.2	3.0	3.2

Source: Central Bank of Ecuador.

If the decentralization evaluation criteria suggested in Chapter Two are applied to Ecuador, it would be difficult to argue that significant true decentralization has taken place. After all, how could that have happened when the share of taxes collected at the subnational level has practically remained below one half of one percent over the last decade?

Table 7.7 shows that subnational tax shares in other countries are larger than in Ecuador and have been growing in the last few years.

In Ecuador, fiscal revenues are not only highly centralized, they are also very low compared to others countries in the region. Table 7.8 shows that in several countries, total tax revenue is around 15 percent of GDP, while in Ecuador it was about two-thirds that through the 1990s. Together with the low subnational tax share, this suggests that there may be ample room to use incentives to enhance total tax revenue, reduce vertical imbalance, and

Table 7.7 Subnational Tax Shares as a Percentage of GDP in Selected Latin American Countries

Country	1995	1996	1997	1998	1999	2000
Colombia	2.17	2.36	2.47	2.48	2.69	
Brazil	9.75	9.62	9.39	9.33	9.68	10.21
Bolivia	0.70	0.80	0.80	0.90	1.20	1.10
Ecuador	0.40	0.30	0.40	0.40	0.40	0.40
Chile	1.40	1.50	1.50	1.60	1.70	1.60

Table 7.8 Tax Revenues as a Percentage of GDP in Selected Latin American Countries

Country	1995	1996	1997	1998	1999	2000
Bolivia	17.5	17.7	17.6	19.6	18.4	18.5
Brazil	26.0	23.8	26.7	25.9	27.8	33.1
Ecuador	9.7	8.6	10.6	11.0	12.2	14.2
Chile	18.4	19.9	19.5	19.4	18.6	19.2
Colombia	12.0					14.3

Table 7.9 Ecuador: Intergovernmental Tax Shares

	1990		1995		2000	
Tax revenues	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
National	8.3	96.4	9.3	95.9	13.8	96.8
Municipal	0.3	3.5	0.4	4.0	0.4	3.1
Regional	0.0	0.1	0.0	0.1	0.0	0.0
Total municipal and regional	0.3	3.6	0.4	4.1	0.4	3.1
Total national and subnational	8.6	100.0	9.7	100.0	14.2	100.0

Source: Central Bank of Ecuador.

improve the quality of total expenditures. Table 7.9 summarizes Ecuador's tax shares for the last 10 years as a percentage of GDP and as percentage of total tax revenues.

Fiscal Obscurity and Surreptitious Transfers

The simple growth of transfers alone is a poor indicator of decentralization, since it says little about incentives or the achievement of policy objectives. However, the existence of surreptitious transfers conspires against a sustainable decentralization process. The first condition in a well-designed decentralization system is that transfers should be transparent. Even "formulas" that are automatic and lack an incentive content are not as harmful as surreptitious transfers. Yet it appears that there are significant numbers of such surreptitious transfers in Ecuador, including bailouts of public or private banks, default on national debt (Table 7.10), entitlements of monopolies to public or private institutions (e.g., *Transportes Aereos Militares Ecuatorianos,* TAME), and government guarantees.

Fiscal Rigidity and Earmarking

Ecuador is not only high centralized because the national government absorbs 97 percent of all tax revenue, but also because a huge share of government revenue is "pre-assigned" to specific sectors, institutions and all sorts of rent seekers.[8] The IMF (2000, p. 62) estimates that in 2000, 64 percent of central government revenue was earmarked for specific purposes.

[8] Rent seeking is the socially costly pursuit of wealth transfers. This concept was introduced in the economic literature by Tullock (1967, pp. 224-32).

Table 7.10 Ecuador: Territorial Default on National External Debt
(Millions of U.S. dollars)

Year	Beneficiary	Amount	Balance to be paid
1992	Guayas Territorial Commission	43.568	43.568
1993	Municipality of Quito	249.863	249.863
1996	Municipality of Guayaquil	1,052.204	

Source: Ministry of the Economy and Finance (2000, pp. 169-73).

Table 7.11 Ecuador: Earmarking of Selected Government Revenues
(Millions of U.S. dollars)

Beneficiary of earmarking	Source of revenue	1999
University officials	10% of income tax, petroleum sector	45.654
6% Guayas Transit Commission	Income tax	9.244
Fundaci6n Melecom 2000	Income tax	14.399
Other beneficiaries	Several tax sources	
Total US$		226.724
Total % of GDP		1.650
% of total tax revenue		16.700

Source: Ministry of the Economy and Finance (2000, pp. 25-27).

Table 7.11 shows examples of tax revenues earmarked for official universities, municipal infrastructure, local administration and other beneficiaries in 1999. These are small amounts, equivalent to 1.65 percent of GDP and 16.7 percent of all tax revenue.

These characteristics of the fiscal framework in Ecuador are the antithesis of a true process of decentralization. It should be remembered that decentralization is about the search for efficiency through a more market-determined allocation of all public and private resources. If a high share of resources is allocated through discretionary public choices, what room is there for market-influenced choices?

The argument, of course, is not about the size of earmarking funds (although that is important), but about the negative incentives that are thus created.[9] Therefore, what is deleterious for decentralization is that the existence of earmarking and of surreptitious transfers inhibit the use of incentives. Most political actors will perceive that the "real" (negative) incentive is to gain access to those subterfuges rather than to try to meet national or local policy goals.

[9] Wiesner (1998a) has observed that the problem is not getting the right institutions in, but in getting the wrong institutions out.

Table 7.12 Ecuador: Performance Indicators of Decentralization Institutional Environments

Decentralization environment	Market enhancing	Market restricting
Automatic formula transfers		X
Tight budget constraint	X	
Independent evaluations	X	
Endogenous or spurious evaluations		X
Transfers with an incentive content	X	
Primary and secondary education financed directly from national level		X
Discretion on expenditure decisions	X	
Earmarked funds		X
Flexibility of public expenditure framework	X	
Surreptitious transfers		X

Table 7.12 summarizes the restrictive structure of the fiscal and decentralization framework in Ecuador.

In brief, a consistent policy framework is virtually impossible when hidden transfers and earmarking exist to the extent that they do in Ecuador. And within an inconsistent policy framework, positive incentives for sectors, programs and even projects may well prove to be ineffectual.

Decentralization Challenges

If one lesson emerges out of Ecuador's attempt at decentralization over the past five years, it is that not all policy fronts are equally important. What really matters, beyond all the rhetoric and elbowing below the "fiscal piñata," is to focus on the key strategic conditions and linkages that determine concrete results in the economic and political markets.[10] Those strategic linkages are found in "vertical imbalance" and equity issues; a political economy accord on a "win-win" decentralization scenario; the regulatory framework of the decentralization process; and binding fiscal constraint and the Fiscal Responsibility Law.

[10] In Ecuador, these two markets are both incomplete and hardly converging towards each other. The "solution" to the more acute problems will only come from progress in both markets.

"Vertical Imbalance" and Regional Equity

Given Ecuador's acute poverty and vertical imbalance between jurisdictions,[11] the decentralization process might be perceived as the solution to that skewed income distribution. To some extent this perception is right. Decentralization should deal with poverty issues. However, insistence on the role of incentives may also be perceived as excessively market-oriented and neglectful of different "initial conditions" in the poorest jurisdictions.

While this is relevant to the discussion about decentralization, it does not follow that one should give up incentives as a key instrument. On the contrary, the challenge is to use incentives for policy purposes both for redistribution as well as purely economic objectives. This can be done, inter alia, by combining "equalizing grants" with rewards and incentives for improved local tax performance.[12] No matter how poor a jurisdiction may be—and thus deserving of "equalizing" grants to correct for adverse "initial conditions"—a decentralization policy can simultaneously have an equalizing component as well as incentives to encourage, for instance, greater local tax performance.[13]

Stein and Talvi (1997) argue, correctly, that even within tight fiscal restrictions it is possible to mitigate large vertical imbalances by giving less favored jurisdictions more authority to tax themselves, allowing them to use those additional tax revenues to their own benefit, and rewarding them with incentives when they perform better within their fiscal capacity potential.

This is clearly a strategy that has great potential in Ecuador. Certainly it is major challenge to policymakers, since transfer systems are always a complex compromise between equity and economic considerations. Nevertheless, practically all transfer systems in Latin America have ample room for improvement.

[11] Even before the economic crisis, Ecuador was a country with high levels of poverty. In 1995, an estimated 33 percent of the population lived in poverty and 10-12 percent in extreme poverty (IMF, 2000, p. 9). By 1999, these percentages had increased dramatically to 40 and 15 percent, respectively, with the incidence of extreme poverty reaching 30 percent in rural areas. Much of this increase was the direct result of higher unemployment and compression of real wages and pensions. Poverty in coastal areas was also exacerbated by weather-related damage to housing and infrastructure.

[12] It should be remembered that the issue is one of relative tax performance compared to fiscal capacity.

[13] At a more general public policy level, the discussion between policies to redistribute income and policies to enhance economic efficiency has a long academic tradition. More than a hundred years ago, Knut Wicksell posited that the two policies had to be seen independently in their design and interdependent in their global consideration. Mueller (1989) insisted that conceptual separation and even institutional implementation has to be separated. The point here is that both need the proper incentives to deliver their respective welfare or economic results. See Wiesner (1996).

Political Compromise on a "Win-Win" Decentralization Strategy

Decentralization is more about generating additional revenue through a different institutional structure than about distributing a static stock of resources. It is a "process" over time and not a "win or lose" game for its protagonists. The challenge for Ecuador's political leadership is to realize that if—and this is a big if—political accord could be reached on a true decentralization framework that is fiscally neutral, Ecuador would have established the conditions for economic prosperity over the long term.

A Regulatory Body for Decentralization

Any decentralization process involves a complex mix of markets, institutions, hierarchies and organizations that can be defined as follows:

- *Markets* are a set of institutions, rules and their enforcement mechanisms that set the stage for conducting discrete and impersonal transactions without requiring a continuous contractual relationship.
- *Institutions* are formal and informal rules and their enforcement mechanisms that shape the behavior of individuals and organizations in society.
- *Hierarchies* are sets of rules for making transactions based on vertical lines of decision-making authority.
- *Organizations* are entities composed of people who act collectively in pursuit of shared objectives.

The main component within the conceptual framework is markets. But markets can be highly imperfect and incomplete,[14] as can be institutions, organizations and hierarchies. If the combined institutional arrangement that emerges disregards fiscal restrictions, incentives and independent evaluations, it will probably fail. But if the right combination of these components is arrived at, decentralization can be a powerful force in fighting poverty and sustaining long-term growth.

As aptly stated in a recent national decentralization commission,[15] the process of decentralization in Ecuador "needs specific instruments and

[14] The term "incomplete markets" is generally applied to markets in which there are some basic flaws in terms of information asymmetries, property rights and competitive conditions. See Stiglitz (1995, p. 197).

[15] The *Comisión para la Descentralización, las Autonomías y las Circunscripciones Territoriales.* See Presidencia de la República (2000, p. 75).

institutional capacity for its development." The commission went on to propose the creation of a permanent decentralization commission as a guarantor of the process. While there are still many details that would need to be worked out regarding the specific objectives and authority of such a commission, the idea of a regulatory commission for decentralization is an attractive one and deserves to be explored further. In any case, its overall mandate would need to be framed within these three key postulates: (i) market principles and proxies must be the guiding conceptual framework; (ii) incentives should support redistributive and economic goals; and (iii) the macroeconomic consequences of any decentralization proposal should be the first test to evaluate its adequacy.[16]

One possibility is to have the current commission further explore the details of having a decentralization regulatory body that, mutatis mutandi, would follow the same precepts of a traditional regulatory commission in such sectors as energy or telecommunications.

Binding Fiscal Constraint and the Fiscal Discipline and Prudence Law

Given Ecuador's recent history, the tendency may be to use the Fiscal Responsibility Law to "distribute" rents, albeit through a very labyrinthine process. And yet, there is the need is to have constitution-like "rules behind a veil of ignorance"[17] that will be welfare enhancing for the population as a whole.

The political accord that needs to precede the design of this law has to establish that Ecuador will not incur fiscal imbalances. This is easier said than done, considering that the current distribution of budget rents will be seen as already unfair, and attempts to change that through expenditure will be more politically popular than doing it through further restrictions on expenditures. This is the crux of the fiscal dilemma in which Ecuador has found itself in recent years.

Fiscal restraint must include the abandonment of surreptitious transfers and the establishment of a policy framework in which these types of negative incentives are ruled out. Without an environment free from surreptitious transfers, market incentives and incentives built into the transfer system cannot work.[18]

[16] See Caballero and Hammour (2000).

[17] See Rawls (1971, p. 61).

[18] Market incentives would allow, for instance, for well run jurisdictions to borrow at low competitive interest rates in the capital markets.

While difficult, fiscal and institutional reforms are not impossible. Dollarization in Ecuador is a good example of an institutional reform that, although still insufficient, proves that the government and Congress can adopt complex measures. The general public appears to have already perceived the beneficial consequences of dollarization in terms of lower inflation. This may be the opportunity to "sell" radical fiscal reform. Without it, dollarization may well fail.[19]

Main Findings and Conclusions

Ecuador is a highly centralized country with enormous fiscal rigidity on the revenue and expenditure sides. Few countries have more earmarking, intensive use of surreptitious transfers, lower tax performance at all levels of government, and persistent financial turbulence in the banking sector. In brief, a large proportion of rents, public and private, are more the result of public choices than of market choices.

Structural rigidities are the main reason behind Ecuador's steady decline in GDP growth. Total factor productivity (TFP)—a measure of the flexibility of an economy and its capacity to allocate productive resources to their most efficient use—seems to have been declining since the late 1970s. This has enormous decentralization implications, since decentralization is about the search for efficiency through resource allocation flexibility.

Ecuador's fiscal problems are structural and are its main problem. The dollarization reform adopted in January 2000 did not solve this problem. It only revealed how deep and pervasive the fiscal imbalance was (and still is). The hope is that dollarization has provided a damage control period during which time political forces may agree to deal in earnest with fiscal and financial structural imbalances.

Ecuador's economy is rapidly losing competitiveness, with inflation in 2000 expected to have run at about 20 percent. Without recourse to exchange rate downward flexibility, factors of production will need to become flexible. Otherwise, serious growth and employment problems will arise.

If decentralization is measured by a rise in the GDP share of subnational own-tax revenue, Ecuador has not accomplished much in this area over the past decade. Subnational tax revenue is still below 1 percent of GDP and has remained largely static over at least the last five years.

[19] On the timing of institutional reform, see Graham and Naim (1998). Chang and Velasco (2000) argue that dollarization might decrease the incentives for fiscal discipline.

The decentralization modality adopted by Ecuador is more about the redistribution of public resources than about the creation of conditions to generate additional public and private resources. It has been seen as a static redistribution of resources rather than an incentive-led process with large potential welfare gains for the majority of the population.

The country's institutional framework is plagued by a proliferation of rules and norms that seldom deal with the fundamental requirements of decentralization. The use of market instruments or proxies of markets—such as incentives, contracts, principal-agent arrangements, and independent evaluation—is very limited.

Developing a true decentralization process will be extremely difficult in Ecuador unless an integral and fully consistent policy framework is established. This would mean, inter alia, the abandonment of surreptitious transfers, and more intensive use of incentives to reward policy objectives. Without an integral and policy-consistent framework, neither market incentives nor chosen incentives in the transfer system will work.

Decentralization may well be the best strategy to deal with poverty, particularly in rural areas. A well-structured system of equalizing grants, together with incentives to reward local fiscal enhancement, could reduce vertical imbalances and significantly improve the welfare of a large segment of the population.

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