

Intergovernmental Fiscal Cooperation and Subnational Revenue Autonomy

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Abstract

This paper focuses on two distinct but interrelated subjects, intergovernmental fiscal cooperation (IFC) and mobilization of subnational own revenues, arguing that there is a strong case for IFC, especially considering the trend in many countries toward decentralizing responsibilities for the delivery of public goods and services. Well-functioning IFC arrangements can help the different levels of government recognize and attenuate adverse externalities from their policies, avoid or reduce predatory tax competition, and better exploit economies of scale, among other potential benefits. There is no easy recipe to ensure well-functioning IFC, since its effectiveness is influenced by several factors. Models for IFC should therefore be tailored to individual countries' circumstances. Nevertheless, countries can benefit from international experiences with the design and implementation of vertical and horizontal IFC forums. The paper presents a range of such experiences. It also reviews the benefits of subnational revenue autonomy, as well as the various obstacles to it, and discusses the pros and cons of alternative revenue handles for subnational governments in different contexts. It explores how IFC can help subnational governments strengthen their revenue policy and administration capacity, providing several successful examples in this area.

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Table of Contents

Acknowledgements	1
Prologue.....	2
1. Intergovernmental Fiscal Cooperation	3
2. Intergovernmental Fiscal Cooperation in Macro-Fiscal Management.....	5
2.1. Potential Adverse Spillovers from Unilateral Actions by Different Levels of Governments	5
2.2. How can IFC contribute to sound macro-fiscal management?	6
2.2.1. Preventing Subnational Fiscal Crises	6
2.2.2. Resolving Subnational Fiscal Crises.....	9
2.2.3. Promoting Intergovernmental Dialogue on Issues of Common Interest.....	11
3. Promoting Subnational Revenue Autonomy	12
3.1. Subnational Revenue Autonomy	12
3.2. Potential Subnational Revenue Handles	13
3.2.1. Taxes on Income.....	14
3.2.2. Indirect Taxes.....	15
3.2.3. Property Taxes.....	18
3.2.4. Royalties	20
3.2.5. User Fees and other Non-tax Revenues.....	21
4. IFC in Subnational Policy and Management.....	22
4.1. How can IFC contribute to strengthening subnational own revenues?.....	22
4.2. IFC in the Design and Reform of Intergovernmental Transfer Systems	24
4.3. Coordinating and Reforming Expenditure Responsibilities.....	27
4.4. Cooperation in Service Delivery	29
4.5. Cooperation in Strengthening the Management of Subnational Spending.....	31
4.6. Strengthening the Management and Financing of Subnational Investments	33
5. Conclusions.....	36

Boxes

1. Key Issues in the Design and Implementation of Effective Subnational Fiscal Rules.....	8
2. Subnational Insolvency Frameworks	10
3. Brazil's Examples of Problems with a Subnational VAT	14
4. Property Taxation: An Under-exploited Source of Subnational revenue.....	18
5. Avoiding a Race to the Bottom: The Case of the Motor Vehicle Tax in Uruguay.....	20
6. Brazil's Experience with the Electronic Invoices and Other Systems to Track Goods in Transit ..	23
7. Intergovernmental Transfers and Subnational Fiscal Autonomy in Colombia	25
8. Colombia's Contratos Plan.....	28
9. Adopting and Implementing Nationwide Government Accounting Standards.	32
10. Promoting Subnational Access to Efficient and Fiscally Responsible Financing for Investments..	34

Tables

1. Scoring of Potential Subnational Revenue Sources by Different Criteria	14
2. Intergovernmental Distribution of Natural Resource Revenues in Selected Countries.....	21

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Prologue

This paper provides an overview of two distinct but interrelated topics, namely, intergovernmental fiscal cooperation (IFC) and subnational revenue autonomy. These topics were featured at the International Forum “Fiscal Autonomy and Coordination for Effective Decentralization”, held in August of 2017 at the Inter-American Development Bank (IDB) in Washington, DC. This event was organized in the context of IDB’s project RG-T2691 “Decentralization and Subnational Fiscal Management Network of Latin America and the Caribbean” (the Network) led by the IDB’s Fiscal Management Division (FMM).

The general objective of project RG-T2691 was to promote the exchange of knowledge, experiences and innovation—related to decentralization and subnational fiscal management processes—through the creation of a network that provided a platform for regional technical dialogue for its members. Nowadays, this network has 21 member institutions from 15 different countries of the Latin America and Caribbean (LAC) region; primarily, institutions and entities responsible for fiscal decentralization in their home countries.

When the network was created, an action plan was established; this plan included, among other activities, the organization of the previously mentioned international forum. In said event, it was analyzed how subnational fiscal autonomy and intergovernmental fiscal coordination can impact the effectiveness of the decentralization processes in the region. The event was attended by a number of senior government officials from the LAC region, staff of international organizations, and academics, who presented a number of country experiences in the above-mentioned areas. The presentations and related materials can be found at the Network’s website <http://www.descentralizacionfiscal.org/> under the “Resources” section.

Due to the relevance of the presentations -and of the dialogue that arose during the event- the members of the Network agreed in the production of a technical document that synthesized the topics and recommendations derived from the forum. Hence, Teresa Ter-Minassian -senior fiscal consultant and former director of the Fiscal Affairs Department of the International Monetary Fund- was entrusted with the development of the present document. Now, with this paper written, I know we couldn’t have made a better choice.

This paper is organized as follows: Section 1 provides an overview of the benefits of, and impediments to, IFC. It also discusses the different forms of IFC and the economic, socio-political, and institutional factors that can affect the choice of these forms in different types of countries. Section 2 focuses on the role of IFC in macro-fiscal management, including controls on subnational borrowing. Section 3 discusses how to strengthen subnational revenue autonomy, highlighting the advantages and disadvantages of alternative potential subnational revenue handles. Section 4 focuses on the role of IFC in subnational revenue and expenditure policy and management, and in the design and reform of intergovernmental transfers. In each section, relevant experiences of selected countries both inside and outside LAC, in particular several featured in presentations at the forum, are highlighted. Section 5 presents a few concluding thoughts on the political economy of IFC.

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1. Intergovernmental Fiscal Cooperation¹

Cooperation across and within different levels of government may require participant governments to pursue policies that are different from those that would have been selected in the absence of cooperation (Bakvis and Brown, 2010). Therefore, to choose to participate in cooperation arrangements, governments must believe that the benefits of such arrangements outweigh the costs associated with the corresponding loss of decision-making autonomy.

Potential gains from cooperation involve a reduction of adverse externalities/spillovers and a fuller exploitation of positive externalities and synergies from participants' actions and policies, as well as of economies of scale. IFC can be beneficial in the following aspects of policy:

- Macro-fiscal management
- Strengthening subnational revenue autonomy
- The design and reform of intergovernmental fiscal arrangements
- Sectoral policies, including service delivery
- Subnational revenue and expenditure management

A further benefit of IFC is that it facilitates the exchange of relevant information among participant governments, leading to a better understanding of respective objectives and constraint and the identification of viable policy synergies and trade-offs that can be taken into account in the design and implementation of reform packages. This exchange of information and experiences also leads to the identification of good and bad practices of peers who face similar policy challenges.

Despite its potential benefits, IFC typically faces significant obstacles. One is the fragmentation of subnational levels of government (especially the local one), which makes it difficult to manage multi-level cooperation forums effectively. An even more important obstacle is the heterogeneity of subnational governments (SNGs) in terms of size, level of socioeconomic development, production structure, and others. This can make it difficult to identify win-win policy options. The different political affiliations among SNGs can hinder cooperation among them.

These obstacles can be attenuated by the use of horizontal cooperation to facilitate coordination within each subnational level of government, and to ensure its adequate representation in vertical cooperation forums. The disincentives to cooperation stemming from economic, social, or political differences may be alleviated in some cases by agreement to delegate redistributive decisions/recommendations (e.g., on the size and distribution of intergovernmental transfers) to independent institutions (e.g., the Indian Finance Commission or the Australian Commonwealth Grants Commission). IFC can take the following forms:

- It can be vertical (i.e., among levels of government) or horizontal (i.e., within each level, aiming at resolving issues of common interest and intra-level disputes and strengthening the influencing power of the level—the advocacy function). Most countries have both vertical and horizontal cooperation forums.²
- It can be multilateral or bilateral (between the central government (CG) and individual SNGs, or between specific SNGs).
- It can have broader or narrower coverage, encompassing the whole range of intergovernmental issues, or only a subset of them.

¹ This paper draws in part on Ter-Minassian and de Mello (2017).

² Annex I of Ter-Minassian and de Mello (2017) provides examples of both types of forums in selected countries (mostly large federations).

- It can be harder (i.e., when the decisions of the IFC forum are binding on its members, or when one level of government has veto power over certain decisions of the others), or softer (i.e., when policy adjustments are discussed and recommended but not required). Softer forms of cooperation are far more common than harder ones, and can be quite effective, as in the cases of Australia, Canada, and Germany.
- It can take place at the Executive level³ or in the Legislature, most commonly in both.

The choice of forms of IFC reflects a variety of economic, social, institutional, political, and even cultural factors. These include the following:

- The extent of diversity of SNGs. Typically, countries with more pronounced territorial disparities tend to privilege softer forms of cooperation, especially if the influence of the CG is relatively weak.
- The main characteristics of the intergovernmental fiscal system. Intergovernmental cooperation is typically more extensive in countries characterized by a less clear definition, or broader overlap, of spending responsibilities among the different levels of government. The same tends to happen when a level of government has extensive statutory influence over the revenue-raising decisions of the other(s). Austria and Germany exemplify this type of “cooperative federalism.”
- The power balances among and within the different levels of government. In countries characterized by large vertical imbalances (i.e., a strong dependence of SNGs on transfers from higher levels of government), the CG (or the intermediate level of government) can put effective pressure on SNGs (or on local governments) to participate in cooperation forums and to accept the agenda set by them (e.g., Australia). In these countries, the dominant level of government may also have greater power in enforcing decisions reached through multilateral or bilateral cooperation agreements. In contrast, countries in which SNGs have substantial revenue autonomy (e.g., Canada, Switzerland, and the United States) tend to rely more on horizontal and/or bilateral than on vertical cooperation.
- The presidential or parliamentary form of government. Executive federalism, in which intergovernmental cooperation centers on the executive branch of the national and subnational governments, is more frequently found in parliamentary regimes, in which the Executive typically commands a majority in Parliament and can thus effectively drive the cooperation agenda. By contrast, Executive federalism tends to be less prevalent in presidential regimes characterized by strong separation of powers.
- The nature of subnational representation in the national legislature. In many countries, SNGs elect or appoint the members of the upper house of Parliament (the Senate). However, the prerogatives of the latter vary significantly, ranging from a veto power on all legislation (as in the United States) or only on legislation affecting SNGs (as in Germany),

³ Examples of vertical cooperation forums at the Executive level are the Council of Australian Governments (COAG), the Indian Interstate and National Development Councils, the Belgian Comité de Concertation, the German Stability Council, and the Spanish Fiscal and Financial Policy Council. Examples of executive horizontal forums at the regional level are the Austrian Conference of State Governors, the Canadian Council of the Federation, and the US National Association of Governors; at the local level, the Federation of Canadian Municipalities, and other intermunicipal forums in many countries.

to a merely advisory role. A strong role of the Senate can incentivize horizontal cooperation among SNGs to facilitate agreement on issues to be discussed in that body.

2. Intergovernmental Fiscal Cooperation in Macro-Fiscal Management

2.1. Potential Adverse Spillovers from Unilateral Actions by Different Levels of Governments

Unilateral actions by different levels of government can have important adverse spillovers on the other levels. For example, a cyclically inappropriate or unsustainable conduct of fiscal policy by the CG is likely to aggravate economic booms and busts and may eventually lead to fiscal crises, with adverse effects on regional and local economies and on their governments' finances. There are many examples of such spillovers, especially in emerging-market economies. Some examples are Mexico in the aftermath of the tequila crisis of 1995, Russia after the 1998 default, and Argentina following the exit from convertibility in 2001. In all these cases, the fiscal turmoil at the national level was reflected in a spate of subnational debt crises. There is also evidence of significant fiscal stress in many SNGs in advanced countries in the wake of the global financial crisis and the Euro crisis in recent years (see, for example, Ahmad and Brosio, 2016; Ter-Minassian and Fedelino, 2010; and Vammalle et al., 2012).

Moreover, the CG can adversely affect the subnational finances through its tax policies. For example, if to stimulate the economy during a recession the CG cuts a national tax whose revenue is shared with the SNGs without compensating them, the SNGs will be forced to cut spending, if applicable fiscal rules or financing constraints prevent them from accommodating the deterioration in their budget balance. This, in turn, will blunt the overall fiscal stimulus and may adversely affect the provision of important subnational public services. Conversely, increases in SNGs' revenue that result from increases in shared national taxes aiming to cool excess demand or to improve the CG budget can create room for additional subnational spending, thus reducing the effectiveness of the national fiscal contraction.

The CG can also adversely affect subnational finances through its expenditure policies. This is the case, for example, with wage and benefit policies for its civil servants, which frequently put pressure on the SNGs to follow suit; changes in rules for public employment or public pension systems; or decisions on the location of public investments. CGs' expenditure policies can also cause subnational deficits by imposing unfunded spending mandates on SNGs by, for instance, setting minimum standards for the provision of public services in areas like health care, education, or housing, without ensuring that the SNGs have adequate resources to meet the standards at an adequate level of efficiency.

Finally, non-fiscal policy instruments used by the CG can also have a bearing on the subnational finances. For example, income policies set at the national level, in particular changes in nationwide minimum wages, administered price policies, monetary and exchange rate policies, and regulatory policies all can have significant implications for subnational finances.

On the other hand, the fiscal policies of SNGs can also have adverse spillover effects on other jurisdictions, and ultimately on the national finances. A clear example is predatory tax competition (a "race to the bottom"). But, other subnational policies, such as an inadequate exploitation of assigned tax bases ("fiscal laziness") through excessive use of tax expenditures or weak enforcement; inappropriate employment and compensation arrangements, which bloat the

government payroll; and serious inefficiencies and rigidities in current spending and investment can also have adverse externalities, if they lead to the accumulation of significant deficits, and ultimately to debt servicing difficulties.

Unfortunately, there are numerous examples of subnational debt crises in both advanced and developing countries' histories (Waibel and Liu, 2010). For example, in the United States, eight states defaulted in 1842, and nearly one-third of municipal governments did so during the Great Depression of the 1930s. In more recent years, prominent examples of local fiscal crises in the United States include those of New York City in 1975, Orange County in 1994, and the District of Columbia in 1995. Other local crises and bankruptcies have occurred in the United States in the aftermath of the 2008 global financial crisis. There have also been many cases of subnational fiscal distress in Japan and in Western European countries, including Germany, Italy, Portugal, Spain, and Sweden.

Among emerging markets, Argentina experienced repeated subnational debt crises in the 1980s, 1990s, and in the aftermath of the exit from convertibility in 2001 (Artana et al., 2012). Brazil suffered subnational debt crises in the 1980s, 1990s, and in 2014 to 2016. A number of SNGs had debt difficulties in Colombia during the 1990s. In Russia, at least 57 out of 89 regional governments defaulted over the period 1998–2001. In India, many states experienced fiscal stress in the late 1990s to the early 2000s, with a rapid increase in fiscal deficits, debt, and contingent liabilities. Some of South Africa provinces suffered substantial fiscal stress in the late 1990s and in the period 2011–12.

Subnational debt crises typically entail serious consequences, including not only disruptions in the provision of public goods and services to the population of the SNG in crisis, but also adverse externalities for other SNGs, and possibly for the whole nation. Such spillovers are mostly of a financial nature (e.g., increased market perception of financing risks, reflected in rising borrowing costs, and in some cases, propagation of difficulties in refinancing the debt coming due), but may also include social and political costs, especially for other SNGs (or even the CG) that are politically aligned with the jurisdiction in crisis. This fact makes it all the more important to have effective mechanisms in place to both prevent subnational debt crises, and resolve them in an orderly manner, if and when they occur.

2.2. How can IFC contribute to sound macro-fiscal management?

2.2.1. Preventing Subnational Fiscal Crises

There is broad consensus in the fiscal federalism literature that a root cause of unsustainable subnational fiscal policies is the inability of CGs to impose a hard budget constraint on their SNGs. In the absence of a hard budget constraint, an SNG expects to be able to increase spending without carrying the full cost of such an increase. This creates incentives to overspend (run deficits and accumulate debt, in the expectation of an eventual bailout). A soft budget constraint (SBC) also discourages SNGs' efforts to mobilize own revenues, and to be efficient in spending.

SBCs can be the result of various flaws in the design of the intergovernmental fiscal arrangements, including unclear expenditure assignments, or unfunded CG mandates for SNGs; little or no subnational revenue autonomy; and substantial discretion in intergovernmental transfers. A key determinant of SBCs is, however, a lack of effective controls on subnational borrowing.

If a CG relies on financial markets to impose fiscal discipline on its SNGs, but markets expect the CG to eventually support them when they run into financing difficulties, SNGs may increase their debt well beyond their capacity to service it, before they see their borrowing costs rise significantly. Markets expectations about future bailouts are often shaped by past histories of such actions.⁴ Especially, but not exclusively, in developing countries, market discipline is also frequently weakened by a lack of adequate information on subnational finances, or by the existence of privileged channels of access to credit for the SNGs. Therefore, in most countries, market discipline should be a complement to, not a substitute for, other instruments to control subnational borrowing.

SBCs can also emerge in intergovernmental systems where subnational borrowing constraints are defined within the framework of annual or multiyear negotiations (cooperative arrangements). Examples of such arrangements can be found in the so-called Domestic Stability Pacts (DSPs) agreed between central and subnational governments in a number of European countries to promote compliance with the EU's Stability and Growth Pact (SGP) targets, which are formulated in terms of the general government as a whole.

By their very nature, such cooperative arrangements leave ample scope for discretion and negotiation and are very influenced by political power balances. As such, they work best in countries characterized by a well-established culture of fiscal responsibility. A good example in this respect has been the Australian Loan Council, historically an effective forum for dialogue and peer pressure among the federal and the state governments. The above-mentioned DSPs have been in general less effective, and therefore European countries have increasingly moved in recent years to adopt subnational fiscal rules, consistent with the national and supranational (EU) rules.

Administrative control mechanisms on subnational borrowing (essentially requirements of CG's authorization for individual subnational borrowing operations) also suffer from significant shortcomings. First, they are utilized mostly in unitary states.⁵ Second, they can give rise to SBC, if they provide significant scope for discretion, and thus for political bargaining. This is especially likely to be the case in countries where the executive branch is relatively weak, and SNGs have substantial influence on the legislative branch. Third, in the absence of clear and consistently applied criteria for authorizing subnational borrowing, based on objective indicators of ability to service the debt, both the SNGs and financial markets may expect a more accommodating attitude of the CG towards jurisdictions politically aligned with the ruling party or coalition. Finally, it may be difficult for a CG to refuse to bail out an SNG experiencing debt servicing difficulties, if it (or a previous government) had authorized a significant portion of that debt.

The demanding preconditions for effective reliance on market discipline and the weaknesses of negotiated and administrative controls explain the growing popularity of subnational fiscal rules. In recent decades, the number of countries utilizing such rules has grown rapidly to over 90 percent of advanced and emerging countries. However, even fiscal rules are no magic bullet for ensuring adequate subnational fiscal discipline. Their effectiveness depends

⁴ This is illustrated, for instance, by a comparison of the experiences of the United States and Canada with that of Germany. In the first two countries, which are characterized by a long history of no bailouts, interest rates on subnational debt vary significantly across SNGs and over time, reflecting markets' assessments of the evolving creditworthiness of individual SNGs. In contrast, given Germany's history of a bailout of two states in difficulty in 1992, interest rates on states' debt vary little, irrespective of the financial situation of the individual state.

⁵ Few federations (e.g., India) use them, mostly to limit foreign borrowing.

crucially on a sound design, a robust legal basis, adequate implementation tools, and firm enforcement (Box 1). Meeting these prerequisites is not trivial, and significant flaws in this respect can lead to the emergence of SBCs.

Box 1: Key Issues in the Design and Implementation of Effective Subnational Fiscal Rules

Main insights from the literature and international experience on the factors that affect the effectiveness of subnational fiscal rules can be briefly summarized as follows.

- Most countries use a combination of subnational fiscal rules, recognizing that different bases for the rules serve different objectives. Rules that set a ceiling on the ratio of subnational debt to revenues provide a medium-term anchor for SNGs' fiscal conduct, but not an immediate operational guidance for their annual budget formulation, unless the debt ratio is already at, or very close to, the ceiling. Therefore, they need to be complemented by rules based on budget balances or on spending growth that can orient the budget process.
- Rules based on the budget balance unadjusted for the cycle have the disadvantage of facilitating procyclicality in the budget and ideally should be replaced by rules targeting a cyclically adjusted (structural) balance. However, the well-documented technical difficulties in estimating structural balances at the national level (Eyraud and Wu, 2015; Ossowski and Halland, 2016; Ter-Minassian, 2010; Tereanu and others, 2014) are even more significant at the subnational level. Most countries do not have reliable and timely estimates of regional or local output, even less of output gaps. Moreover, short-term financing constraints tend to be more binding for SNGs than for CGs, and can require procyclical subnational budget tightening, unless SNGs have built adequate buffers (rainy day funds) during previous booms.
- Rules limiting the growth of subnational spending to that of trend GDP, while not necessarily avoiding procyclicality during downturns (since they set ceilings, not floors, for public expenditures), help moderate it during upswings and, by promoting subnational savings and asset accumulation during such periods, can help cushion the impact of subsequent recessions on spending.

One drawback of expenditure rules is that they are sensitive to initial conditions. If the initial level of the expenditures is too high, allowing them to grow in line with trend GDP can lead to fiscal unsustainability. If it is too low (or if the country is at the start of a decentralization process) a spending rule can unduly constrain the provision of needed public services or infrastructures. Finally, but importantly, spending rules alone cannot be relied upon to ensure fiscal sustainability because they do not require an adjustment of spending to structural changes in revenues, and therefore should only be used in conjunction with a debt-based rule.

- A key issue in the design of subnational fiscal rules is their coverage. Rules that fail to include SNGs' contingent liabilities arising from non-commercial activities of enterprises they own, or from PPPs they enter into, open scope for the emergence of SBCs.

A question that remains quite controversial in the literature is whether public investments should be excluded from spending rules (or from budget balance targets, so-called golden rules) because they tend to be the first victims of spending cuts, leading to large infrastructure gaps; because they typically have larger multiplier effects; and because, in contrast to current spending, they create assets for the government.

However, several considerations argue against such exclusion. These include the fact that it can disincentivize improvements in public investment management processes; favor spending on new projects, rather than on the maintenance and proper operation of existing ones, as well as on investment in physical, rather than human, capital; and stimulate creative accounting (e.g. the classification of capital transfers to loss-making enterprises as public investments).

- A further important issue in the design of subnational fiscal rules relates to the inclusion of escape clauses. These clauses should specify as clearly as possible the nature and magnitude of the shocks to be accommodated, the length of period during which the rule would be relaxed or put into abeyance, a path of return to full observance of the rule, and the responsibility for activating the clause and monitoring its implementation. Existing rules vary significantly in terms of the degree of discretion afforded to SNGs in utilizing the clause.
- The capacity of SNGs to implement fiscal rules largely depends on the state of their public financial management systems.
- The effectiveness of fiscal rules hinges critically on their enforcement mechanisms. Such mechanisms should have a solid legal basis; their application should be non-discretionary; and the penalties envisaged should be severe enough to act as deterrent to noncompliance, but not unrealistic, which could ultimately lead to their non-application. Penalties are typically of a financial nature, such as in the form of withholding of CG transfers to non-complying jurisdictions, but occasionally also entail the personal responsibility of the relevant officials.
- Several countries have tightened the legal framework for enforcement in recent years, but the actual application of sanctions remains limited to date. The effectiveness of enforcement mechanisms is likely to be greatly enhanced if they are supported by explicit requirements to correct deviations from the rule within a reasonable, pre-specified time period (an example being the “debt-brake” mechanisms adopted by a number of European countries).

Note: See Sutherland et al. (2005), Ter-Minassian (2015), and Kotia and Lledo (2016) for further discussions of the features and effectiveness of subnational fiscal rules.

IFC can contribute to the effectiveness of subnational fiscal rules by facilitating agreement on a sound design, or on needed reforms, of the rules; by promoting compliance through peer pressure; and more generally by fostering progress on reforms of the intergovernmental fiscal system that are needed to improve subnational fiscal sustainability.

2.2.2. Resolving Subnational Fiscal Crises

The fact that subnational debt crises can have serious adverse effects for the affected SNG and for others, or even for the nation as a whole, frequently leads to bailouts of SNGs in distress by higher-level governments, often through gap-filling transfers or through the assumption and restructuring of their debt. Such bailouts are costly, not only because they entail additional financial burdens for the rescuer government, and, when large, they could jeopardize the latter’s creditworthiness and medium-term fiscal sustainability, but also because they give rise to moral hazard, and thus further soften the subnational budget constraint. The degree of such moral hazard depends on the frequency of the bailouts and the severity of the policy conditions and political penalties attached to them. Also crucial is whether or not the bailouts are accompanied by strengthened preventive measures, in particular as institutional reforms such as the adoption or improvement of subnational fiscal rules, measures to increase the transparency and reliability of subnational budgetary information, and steps to reduce discretion in intergovernmental fiscal arrangements.

An increasingly (but so far not sufficiently) used tool to promote an orderly resolution of subnational debt crises is the adoption of insolvency legislation for SNGs facing severe difficulties in servicing their debt. The main characteristics of insolvency laws are outlined in Box 2 below.

Box 2: Subnational Insolvency Frameworks

There is a limited but growing international experience with formal ex-ante frameworks for subnational debt resolution, setting out prespecified rules for the allocation of default costs. Formal insolvency frameworks aim to clarify how, in the event of a subnational default, the debt will be restructured in an orderly manner, which essential public services will be maintained, and how and what structural adjustment measures must be undertaken by the defaulting jurisdiction to restore its solvency. If appropriately designed and implemented, such frameworks can provide the following benefits:

- Help reduce disruption in the provision of public services, and the related political pressures for bailouts
- Facilitate orderly workouts, minimizing problems stemming from holdout creditors
- Facilitate the eventual return of defaulting jurisdictions to credit markets
- Help prevent both SNGs' and lenders' expectations of bailouts, thus reducing the risk of a subnational soft budget constraint

The design of insolvency frameworks must balance the protection of creditor rights with that of core functions of the SNGs involved. It should also create sufficient political costs for leaders of defaulting jurisdiction to minimize moral hazard. It requires consideration and definition of many complex issues (Canuto and Liu, 2013; Herold, 2018; and Waibel and Liu, 2008). These include:

- The role of the judiciary. Brazil, Colombia, and Switzerland have put in place administrative mechanisms in which the central government is in charge of the subnational crisis resolution according to specified procedures and criteria. In the United States and Hungary, resolution is adjudicated in the courts. South Africa's legal framework is a hybrid, envisaging administrative intervention in the early stages of debt distress, followed by judicial intervention if the latter degenerates into insolvency.
- Who can file for bankruptcy. The class of eligible filers differs across countries. In the United States, only the municipality in distress can file for bankruptcy under Chapter 9, conditional on being insolvent, having worked or attempted to work out a plan to deal with its debts, and having been authorized by the state to file for bankruptcy. In South Africa, any creditor can file a claim against the municipality. Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears for more than 60 days. Typically, however, insolvency frameworks apply only to the local level of government, a notable exception being the insolvency framework for the states adopted by Brazil in 2017, which is described in some detail below.
- The specific triggering procedures.
- The creditors' majority required to bail-in holdouts.
- The order of priority of claims (typically wage or pension arrears, followed by secured credits, and lastly by unsecured ones).
- Conditionality. This also varies across countries, with the U.S. Chapter 9 being relatively strict in this respect. Chapter 9 is designed to carry a strong stigma for the distressed municipality to minimize moral hazard. In addition to the financial costs, there are significant political ones. State laws in the United States for distressed municipalities commonly provide for a transfer of control over municipal affairs.

The design of insolvency frameworks must take into account, among other things, relevant characteristics of a country's legal system (including the constitutional status of SNGs and their relations with the higher-level government(s)), the state of the judicial system, and the size and capacity of the jurisdictions involved. Very complex frameworks can result in prohibitive legal costs for smaller jurisdictions. On the other hand, they can also encourage both SNGs in difficulty and their creditors to seek extra-judicial resolution mechanisms such as arbitration.

As an example of a recent, administrative type resolution framework for a federal country in Latin America, the Brazilian experience is outlined briefly in what follows. Faced with severe debt-servicing difficulties in many states in recent years, the federal government took a number of steps in 2016–17 to deal with the crisis, including a restructuring of the debt owed to it by states experiencing short-term

difficulties but ultimately solvent, accompanied by the negotiation with the latter of fiscal adjustment programs tailored to individual states' circumstances; improvements in the system of assessment of states' borrowing capacity; and the adoption of a formal crisis resolution mechanism for states experiencing more acute and long-lasting difficulties (the so-called *Regime de Restruturação Fiscal*, enacted by Complementary Law 159/2017).^a

Access to the program involves a three-year grace period (renewable once) for payments of debt owed by the state to the federal government; a temporary suspension of the debt and payroll limits set by the Law on Fiscal Responsibility, and the possibility for the state to contract new federally guaranteed debt for specified purposes (in particular, financing of voluntary dismissals of personnel and the restructuring of debt owed to financial institutions). Conditions for access are significantly tighter and more specific than those under the general restructuring facility mentioned above. They include, in particular, a number of prior actions.^b Implementation of the program is monitored in each state by an especially appointed committee comprising representatives of both levels of government, which is also responsible for recommending timely corrective actions in cases of threatened noncompliance. The Brazilian experience provides an example of effective intergovernmental cooperation in a process of orderly resolution of subnational debt crises.

^a The resolution framework was initially utilized for the state of Rio de Janeiro, but subsequently also for Rio Grande do Sul. It is open to states that have debts higher than net revenues; combined spending on personnel, interest, and amortizations in excess of 70 percent of such revenues, and liabilities larger than liquid assets.

^b The prior actions include the enactment of legislation to privatize state enterprises, revise tenure privileges for civil servants or adopt an expenditure rule, reduce tax expenditures by at least 10 percent a year, prohibit the raiding of judicial deposits, and extend to the pension system of the state the reforms adopted in 2015 for pensions of federal civil servants and some limits on personnel and other spending (including the granting of new tax benefits) for the duration of the program.

2.2.3. *Promoting Intergovernmental Dialogue on Issues of Common Interest*

IFC can also facilitate the exchange of information on global, national and regional macroeconomic developments and prospects, and on fiscal and other policy variables (e.g., CG transfers to subnational governments, interest rates) needed for the preparation of realistic subnational budgets and medium-term fiscal frameworks. For example, Germany has an intergovernmental Working Party on tax revenue forecasting that is responsible for the forecast and distribution of revenues shared between the federal government and the states. IFC forums in Austria, Belgium, and Mexico, among others, have proven to be effective vehicles for the exchange of relevant macroeconomic and fiscal information among and within different government levels. In Italy, the national annual budget framework law is discussed within the Center-Regions Conference before being submitted to the national Parliament.

Finally, and importantly, IFC forums can provide needed venues for the CG and the SNGs to present, assess, and discuss the repercussions of proposed policy actions of one level of government on the others, for example:

- The scope for the CG to support SNGs during cyclical downturns through increased transfers or financing of subnational investments, as was done by a number of advanced and emerging-market economies in the wake of the global financial crisis, and conversely, the need and ways for SNGs to support counter-cyclical fiscal contractions by the CG in situations of demand overheating;
- The effects of tax policy changes by the higher levels of government on revenues shared with the lower ones;

- The repercussions of national spending policies (e.g., for pensions, subsidies, or civil service) and of spending mandates for SNGs on subnational budgets;
- The implications of income policies (e.g., changes in the minimum wage) decided by the CG for the payroll spending of SNGs, and of the CG's administered price policies and proposed regulatory changes for the subnational finances; and
- The implications of policy changes proposed by one or more SNGs for other SNGs and/or the CG.

3. Promoting Subnational Revenue Autonomy

3.1. Subnational Revenue Autonomy

Both the normative⁶ and the positive⁷ theories of fiscal federalism recognize the benefits of a significant degree of autonomy for SNGs in deciding the level and composition of their revenues. These benefits include the following:

- The potential to increase overall national revenues by tapping sources (such as property taxes and user fees) that would likely be neglected or administered less effectively at CG level
- Providing greater certainty to SNGs about their resource availability, thereby facilitating the preparation of more realistic budgets, and reducing volatility in spending on socially sensitive programs
- Promoting subnational fiscal responsibility. There is substantial empirical evidence that large vertical imbalances, resulting from limited tax autonomy and the related transfer dependence, are associated with larger fiscal deficits⁸
- Making more visible to electorates the cost of subnational spending, thereby increasing local officials' political accountability and incentives to spend efficiently; and
- Facilitating the alignment of tax structure and design with regional and local preferences, and with the incidence of the benefits of subnational spending.

The literature also recognizes, however, that there are significant economic, institutional and political obstacles to subnational own revenue mobilization. The economic obstacles include:

- The greater mobility of potential tax bases (goods and factors of production) within the national territory than across national borders. This increases the scope for tax evasion, and for predatory tax competition (the so-called race to the bottom) among subnational jurisdictions, ultimately undermining SNGs' ability to finance the delivery of the public goods and services they are responsible for; and
- The generally uneven distribution of the tax bases across the national territory. As a consequence, sole reliance on own revenues would result in excessive disparities in individual SNGs' ability to finance the provision of common standards of public services in key areas such as health, education, citizens' security, and basic infrastructures.

⁶ See, for example, Tiebout (1956), Musgrave (1959), and Oates (1972). The normative theory, however, emphasizes that local taxation should be limited to taxes on relatively immobile factors of production, and to benefit taxes on mobile ones. This reflects a view of SNGs as little more than decentralized service providers, with a strictly allocative role (Bird, 2010).

⁷ See, for example, Oates (2005) and Weingast (2009). The positive (second-generation) theory stresses political dimensions of fiscal decentralization, and therefore views significant subnational revenue autonomy as essential to promote both political accountability and fiscal responsibility of local officials.

⁸ See, for example, Eyraud and Moreno Badia (2013), for more information.

The main institutional obstacles include the following:

- The fact that central tax administrations are better positioned than subnational ones to exploit economies of scale in the collection and enforcement of taxes. They also tend to be better equipped in terms of financial and human resources. Moreover, capacities to administer effectively own taxes tend to vary substantially among SNGs, often compounding the above-mentioned differences in tax bases.
- The fact that compliance costs for taxpayers operating in multiple subnational jurisdictions are magnified by the existence of differences in subnational tax legislations and tax administration procedures.

Finally, there are important political economy constraints to revenue decentralization, such as the following:

- CGs tend to prefer maintaining control of the main tax bases, both to facilitate the conduct of revenue-based stabilization policies, and to influence subnational spending decisions.
- SNGs, for their part, often prefer to rely on CG transfers (especially unconditional ones) to avoid the political cost of raising own revenues.

While the economic and administrative factors mainly affect the capacity of SNGs to mobilize own revenues in an efficiency- and equity-friendly manner, the political economy factors mainly impact their willingness to do so (i.e. the extent of their tax effort). The balance between the benefits and costs of revenue decentralization has varied both across countries and over time, reflecting a host of changing economic, institutional, and political conditions. In the LAC region, the obstacles to revenue decentralization have so far played a preponderant role, significantly limiting subnational revenue autonomy and resulting in large vertical imbalances. According to the latest available CIAT-IDB-OECD revenue statistics, the share of subnational tax revenues in total taxes and social contributions ranged from just over 30 percent in Brazil to less than 1 percent in some Caribbean countries, averaging 17 percent in the federal countries and Colombia, and around 3 percent in the unitary countries of the region.

The relatively weak performances of most LAC countries in raising subnational own revenues reflect a number of factors. These include the nature of the tax assignments, which with the exception of Brazil (discussed in some detail in Box 3 below) are especially limited for intermediate-level governments; and the region's socioeconomic characteristics, such as relatively low levels of per capita GDP, still relatively large shares of the difficult to tax agriculture and very fragmented retail sectors, high incidence of poverty and income inequality, and pervasive informality in labor and real estate markets.⁹

3.2. Potential Subnational Revenue Handles

There is a vast literature discussing the criteria that should guide the assignment of specific forms of revenues to subnational governments.¹⁰ Desirable characteristics of such taxes include relatively low mobility of the tax base, avoidance of distortions and of risks of adverse spillovers on other jurisdictions (e.g. tax exporting or predatory tax competition), a relatively even distribution of the tax base across the national territory, significant revenue-raising potential, low sensitivity to

⁹ See Fretes and Ter-Minassian, eds. (2015) for analyses of these factors in selected Latin American countries.

¹⁰ Among the best summaries of this literature are Ambrosanio and Bordignon (2006) and Bird (2010).

cyclical fluctuations and other exogenous shocks, relative ease of administration, low compliance costs, and relative political acceptability.

No potential subnational revenue handle meets all these criteria, as evidenced by Table 1 below.¹¹ Therefore, the choice, design, and reform of subnational own revenue sources must balance the benefits and costs of each potential revenue handle, taking into account the specific relevant economic, institutional, and socio-political circumstances of each country.

Table 1: Scoring of Potential Subnational Revenue Sources by Different Criteria

Revenue source/features	Revenue potential	Mobility of tax base	Potential efficiency costs	Sensitivity to cycle	Even distribution of tax base	Costs of admin.	Compliance costs	Political acceptability
PIT	V	L	L	M/H	L/M	H	M/H	M/L
PIT surcharge	V	L	L	M/H	L/M	L	L	M
CIT	M	H	H	H	L	H	H/M	M
RST	M	L	L	M	M	H	L/M	M
Turnover taxes	H	L	H	M/H	M	M	M	H
VAT	H	L	M	M/L	M	H	M	M
Business VAT	M	L/M	M/H	L	M	M	M/H	M
VAT surcharge	H	L	M	M/L	M	L/M	M	M
Excises	M	M	M/H	L	L	M	L	M/H
Property taxes	V	L	L	L	L	H	M	L
Royalties	H	L	L	H	L	M	M	H
User fees	M	L/M	L	L	M	M	M	M

Notes: H: high; M: medium; L: low; V: varying.

3.2.1. Taxes on Income

Among potential subnational taxes on income, the preferable option is clearly a surcharge on the national personal income tax (PIT), because it combines the advantages of taxing personal incomes (relatively low mobility of the tax base, and, if levied on a residence basis, conformity with the benefit principle and low exportability) with reducing administration and compliance costs. However, subnational PITs or PIT surcharges are unlikely to produce substantial revenue in economies characterized by a high degree of labor informality or by other weaknesses in collection of the PIT at the national level, as is still the case in most LAC countries. A subnational corporate income tax (CIT) or a surcharge on the national CIT are generally not recommendable on efficiency grounds because they can be exported to other jurisdictions and can be used for predatory competition, they are highly sensitive to the cycle, their base tends to be concentrated

¹¹ The scores in the table reflect the author's opinions, although many are supported by relevant literature. See, for example, Bird (2010) and Fretes and Ter-Minassian (2015) for details on their rationale.

in relatively few jurisdictions where most corporations are headquartered,¹² and they entail substantial administration and compliance costs.

3.2.2. Indirect Taxes

Subnational retail sales taxes (RST) are fairly frequent at both the local, and especially the regional, government levels. Compared to income taxes, they have the advantages of less cyclical sensitivity, more even distribution of the base, and possibly less visibility. However, they are difficult to enforce in countries (especially developing ones) where the retail sector is highly fragmented.

Turnover taxes (levied not only on sales to final consumers, but also on inter-enterprise sales) tend to be favored by SNGs for their high revenue potential even at relatively low rates, relative ease of enforcement, and low visibility. However, because of their cascading nature and exportability, these taxes entail high efficiency costs.¹³ Moreover, they tend to be more cyclically sensitive than RSTs because consumption is more stable than total turnover.

A regional, invoice-based value-added tax (VAT) would have in principle the advantages of relatively high revenue potential, and (compared to a turnover tax) lack of cascading and related distortions. It is also more competitiveness-friendly because it can be levied on imports and credited against exports. Compared to the RST, its enforcement is more effective because it is levied on all stages of production with the well-known self-policing mechanism of invoice crediting. If the VAT is levied on consumption (i.e., if it includes an investment credit), its base tends to be more evenly distributed than is the case for income taxes, and less cyclically sensitive.

The costs of regional VAT, however, must be weighed against its advantages. These include: (i) limited subnational capacities to administer a multi-stage tax, especially if levied with multiple rates and multiple exemptions; (ii) high compliance costs for taxpayers (businesses) operating in multiple states, if the regional VATs are levied on differently defined tax bases, or with different administration procedures; and most importantly, (iii) the difficulties connected with the taxation of interstate trade, namely the lack of internal borders which hinders taxation of this trade on a destination base, and the significant distortions, in particular the scope for predatory tax competition, under an origin-based VAT. The problems with administering a subnational VAT are clearly exemplified by the case of Brazil, discussed in Box 3 below. The only country that so far operates efficiently a dual (national and subnational) VAT is Canada¹⁴; it is destination based and hence avoids most of the problems of origin-based taxation. In fact, most VATs around the world are destination based.

¹² Apportionment formula are often used to mitigate such uneven distribution, but they require inter-jurisdictional agreements and may be computationally demanding.

¹³ See Artana et al. (2012) for an analysis of the distortions induced by the provincial turnover tax (*Impuesto a los Ingresos Brutos*) in Argentina.

¹⁴ In Canada, the province of Quebec levies its own VAT (QST) on a base defined independently, but in fact almost identical to that of the federal VAT. By agreement with the federal government, it collects also the federal VAT on behalf of the latter. Five other provinces levy what are essentially surcharges on the federal VAT (at rates ranging between 7 and 10 percent) (the harmonized sales tax, HST), that are collected by the federal tax administration on a "place of supply" basis (essentially an origin basis) but re-distributed on a destination basis. Finally, the other provinces (with the exception of Alberta, which levies no sales tax) impose taxes on retail sales (see Bird and Gendron, 2007, for details).

Box 3: Brazil's Examples of Problems with a Subnational VAT

While Brazil compares well with many countries in the degree of decentralization of revenue responsibilities to its states, the states' own revenues present a rather imbalanced composition. Own-source revenues account on average for over 70 percent of total state revenues. There is heavy concentration on a state-level VAT (the Imposto sobre Circulação de Mercadorias e Serviços, or ICMS) which is fraught with substantial flaws that adversely affect efficiency, horizontal equity, and competitiveness and impose heavy compliance costs on taxpayers.

In contrast with most VATs around the world, which tax domestic consumption (including imports and excluding exports and investments), the ICMS is levied on production plus imports. Exports have been zero-rated since 1996, but in practice, since frequently credits are due to exporters in one state for inputs taxed in other states, there is a general reluctance among states to provide such credits. Delays and other obstacles to refunds undermine export competitiveness. Moreover, while credits are allowed for purchases of capital goods, they can only be used over a period of four years, and they are sometimes delayed beyond that time limit, becoming de facto unrealizable.

The base of the ICMS is value added in the production of goods and selected services, with the taxation of other services assigned to the municipalities. As the services sector has been the most dynamic in the Brazilian economy in recent decades, the exclusion of most services from the ICMS base has significantly dampened the growth of the tax. Moreover, technological changes are increasingly blurring the demarcation line between the production of goods and that of services, further weakening the enforcement of the tax.

The ICMS is levied on a mixed origin-destination basis. Intrastate transactions are taxed at rates that are set by each state and that vary widely across the national territory.^a Interstate transactions are taxed in the state of origin at the rate of 12 percent, which is reduced to 7 percent for exports from the South-Southeast states to the North-Northeast ones. The destination state taxes the imported good at its internal rate and provides a credit for the interstate tax. This mechanism, designed to redistribute part of the revenue of the tax to the poorer states, creates, however, substantial scope for evasion (through fake interstate sales) and for cross-border shopping.

The wide differences in bases, rates, and collection and enforcement procedures across states substantially increase taxpayers' compliance costs, especially for enterprises operating in multiple states. With a view to facilitating collection and improving enforcement, a significant portion of the ICMS is collected through the so-called *substituição tributária*. Under this system, the tax collected at an early stage of the value-added chain includes the estimated tax due on the value added in subsequent stages of the chain. Since the withholding is final, the system, albeit efficient from an administration standpoint, detracts from the neutrality of the tax, to the extent that the value added in the later stages is not correctly estimated.

The predominantly origin-based system also facilitates the use of the ICMS as an instrument of industrial policy, and has indeed led to predatory competition among the states through the granting of incentives, exemptions, and various other non-transparent special benefits, to attract enterprises to the state (the so called *guerra fiscal*, or fiscal war).^b The fiscal war has led to losses of potential ICMS revenues estimated at close to 10 percent on average, but as high as 50 percent in some states, over recent years.

There have been several attempts to reform the ICMS in the last few decades, but all have failed, due to lack of consensus about the distribution of the ensuing gains and losses. Ideally such a reform would involve the merger of the ICMS and the ISS into a subnational VAT, with the revenue shared between the state and local levels of government. The subnational VAT should be destination-based, with a uniform definition of the base and a limited degree of state autonomy in deciding its rate(s).^c

The move to a destination base is widely recognized to be essential to reduce the scope for predatory tax competition, but it would create substantial gains and losses of revenues for individual states, depending on the size and composition of their interstate trade. A reliable quantification of such gains and

losses would be a crucial precondition for any such reform. This task is much facilitated by the now generalized use of the *nota fiscal electronica* for all transactions (see Box 6, below).

A strategy for dealing with the revenue redistribution entailed by the reform could involve a combination of appropriate reforms of the horizontal distribution formulas for revenues shared between the federal and the state governments (the Fundo de Participação dos Estados or FPE) and a transition period during which gains would be returned to the loser states on a progressively declining schedule. Consideration could also be given to providing the states a limited power to levy a surcharge on the federal personal income tax, a practice that is common in advanced federal countries.

If political conditions do not allow a fundamental reform of the ICMS and ISS, improvements in these taxes could be sought through a range of specific changes, including a reduction of the rate on interstate transactions, the creation of mechanisms to monitor and enforce the prohibition of new incentives and the non-renewal of existing ones when they expire, and steps to facilitate the correct working of the credit mechanism for transactions subject to the ICMS.

^a Most common are a standard rate of 17 percent, and reduced rates of 7 percent for staple goods and 12 percent for selected other goods. Higher rates apply to fuels, electricity and telecommunication services, which together account for around 40 percent of ICMS revenue. The heavier burden on these important inputs into production processes further undermines efficiency and competitiveness.

^b In principle, such tax concessions have to be approved by the main current mechanism of intergovernmental coordination, the CONFAZ, a collegiate of the federal deputy minister of finance and the state secretaries of finance. However, the pronouncements of the CONFAZ in this area have traditionally been largely ignored by the states in their race to the bottom. Even a sentence by the Supreme Court declaring such incentives unconstitutional has had limited effect.

^c The incorporation of the ISS into the subnational VAT would significantly boost the longer-term growth potential of the latter, as the share of services in the economy is likely to continue to rise in future years. Local governments would maintain autonomy in their other, mainly property-based, taxes, whose revenue potential is currently underexploited.

An alternative source of revenue based on value-added is a tax levied on the value added of individual enterprises, calculated by the subtraction method (i.e., sales minus the cost of material inputs) (Bird, 2010). This type of tax, the best example of which is the Italian Imposta Regionale sulle Attività Produttive (IRAP), has the advantages of being non-cumulative and avoiding the problems connected with the taxation of interstate trade. Being relatively easy to calculate, it also involves limited compliance and administration costs, albeit lacking the self-policing features of the invoice-crediting method. However, being origin-based, it is not refundable to exports, nor can it be levied on imports, thus affecting adversely external competitiveness. It is also a more visible tax than a proper VAT, and therefore a politically unpopular one, as demonstrated by the repeated attempts to repeal it in Italy.

Subnational taxes are frequently levied on the consumption of specific (generally non-merit) goods and services, either on a stand-alone basis or, more frequently, as surcharges on CG excises. Typical bases for subnational excises are gasoline, tobacco products, alcohol, and soft drinks. Excise taxes are increasingly also being levied, especially in metropolitan and/or touristic areas, on hotel occupancy and restaurant services. Their advantages are a reasonably good revenue-raising potential, low visibility and costs of administration (especially when collected at the point of production). They can also fulfill other (environmental or health policy) goals. However, in some cases (e.g., taxes on soft drinks or tobacco) their incidence may be regressive.

3.2.3. *Property Taxes*

In the traditional fiscal federalism literature, taxes on immovable (urban and rural) properties are generally presented as the ideal source of own revenues for local governments. The pros and cons of such taxes are discussed in Box 4 below.

Box 4: Property Taxation: An Under-Exploited Source of Subnational Revenue

From an economic standpoint, recurrent taxes on property are an ideal source of subnational revenues. They are levied on a relatively immobile base, cannot be exported to other jurisdictions, and finance the provision of local services which benefit local taxpayers. They are also less sensitive to cyclical fluctuations than income or consumption.

However, these taxes tend to be underexploited (in relation to their revenue-generating potential) even in advanced economies, and much more so in emerging ones. Their revenue averaged less than 2 percent of GDP and less than 6 percent of total taxes in the OECD in 2015, albeit with large variance across those countries.^a In LAC, property taxes average around 0.4 percent of GDP, again with significant variance around the mean. Even in the best-performing country (Uruguay), they are equivalent to less than 1 percent of GDP.

This relatively poor performance reflects two, partly interrelated, types of constraints: administrative and political economy ones. An effective administration of property taxes requires first and foremost a comprehensive and regularly updated property registry (cadaster); frequent (preferably annual) and transparent reassessment of property values, based on market indicators; efficient collection and enforcement mechanisms; and speedy resolution of taxpayers' disputes of assessments.

These requirements are rarely met, especially in smaller local jurisdictions, which are frequently plagued by severe shortages of qualified personnel and other administrative capacities. It is not surprising, therefore, that country averages conceal a wide dispersion of performances among municipalities, with large and better-equipped ones typically exploiting more effectively their (larger) property tax bases.

In LAC in particular, available empirical evidence suggests that the performance of property taxes is also affected adversely by the widespread degree of informality, the understatement of property values in registered real estate transactions, and the lack of comprehensive and timely information on market values of properties (Bonet, Munoz, and Pineda Mannheim, 2014).

Even more significant, however, are political economy obstacles to the exploitation of property taxes. These taxes are very visible to taxpayers, especially since they cannot be levied at source and are typically collected in lumpy annual or semi-annual installments. They can create liquidity difficulties for taxpayers who own high-value homes but do not have substantial incomes (e.g., retirees). The lack of up-to-date information on market values of properties can give rise to real or perceived horizontal inequities in assessments, contributing to taxpayers' resistance to the tax. Perceptions of arbitrariness in assessments may be heightened by more or less prevalent cases of favoritism or corruption of assessors. The cyclical insensitivity of property taxes may also be a liability in the eyes of taxpayers who see the tax unchanged when their incomes decline.

Local governments and especially local legislative bodies tend to be highly sensitive to taxpayers' sentiments towards property taxes, a fact demonstrated by the widespread recourse to generous exemptions and a tendency to keep tax rates at the bottom of any permissible band set by higher-level governments. SNGs who have access to alternative sources of tax revenues (such as turnover taxes (Ingresos Brutos in Argentina and ICA in Colombia) or taxes on services (the ISS in Brazil)) have tended to concentrate their revenue-raising efforts on such taxes, at the expense of the Impuesto Predial.

Against this background, the obvious question arises of what could be done to strengthen the role of property taxes in increasing local revenue autonomy. A number of considerations would seem relevant in this respect:

- First, the diversity of performances calls for some differentiation of approaches. For example, larger municipalities can be expected to have the capacity to administer such taxes, while for small ones, it may be preferable to leave their administration to a higher level of government, on an agent basis. Central and/or regional governments could also play a role in supporting large municipalities technically and financially in strengthening the administration of the tax, in particular in modernizing their cadasters, utilizing relevant technological advances (e.g., Geomaps) in this area.
- Second, while local governments should be provided significant autonomy in defining the base and the rate structure of their property taxes, the central government should be able to prevent a race to the bottom by setting boundaries on such autonomy, such as a floor on rates and preferably also a ceiling on exemptions. The central government should also provide incentives to local governments to better exploit their revenue potential by enforcing a hard budget constraint on them and by rewarding local revenue effort (and penalizing fiscal laziness) in the design of its transfer system.
- Third, to reduce popular hostility to property taxes, local governments should improve transparency. In particular, they should provide taxpayers with clear and objective criteria for the assessment of property values, and with fair and efficient procedures for the review and decision of disputes of such assessments. A shift to more frequent (e.g., quarterly) payment installments and the provision of a variety of accessible payment facilities can also help reduce liquidity constraints and taxpayers' compliance costs.

It is especially important for local governments to make more transparent the link between property taxes and their benefits to taxpayers in terms of increased quantity and quality of local services. In this respect, local governments, especially in urban areas, should increase the use of levies to capture gains in property valuations resulting from the construction or improvement of local infrastructures or from regulatory changes (e.g., the re-classification of land tracts from rural to urban). Examples of these innovations (generically dubbed betterment levies) are development impact fees (one-time levies assessed on developers during the permit approval process), and the setting up of tax increment financing (TIF) districts.^b Although comprehensive studies of their effectiveness are not yet available, these innovations are generally seen as promising instruments to improve the acceptability and the yield of property taxes. A recent IDB study (Blanco et al., 2016) provides a useful overview of good practices in this area, particularly in LAC countries.

^a The share of property taxes in total revenues in OECD countries ranges between 12.6 percent of total revenues in the United Kingdom and less than 1 percent in Estonia. These taxes account for more than 10 percent of total tax revenue in six countries (Australia, Canada, Israel, Korea, the United Kingdom and the United States) and for less than 2 percent in five countries, mainly Central and Eastern European ones.

^b Burge (2010) and Brooks and Meltzer (2010) provide extensive discussions of development impact fees and TIFs, respectively. See also Sjoquist and Stephenson (2010) for a comparison of these instruments with other local revenue sources.

Local governments also frequently levy taxes on movable properties, in particular automobiles. These are much easier to administer and less controversial than real estate taxes. In setting rates, often there is a tension between environmental objectives (which argue for taxing more lightly the more recent, less polluting models) and distributional ones (which support taxation based on the value of the car, implying lower taxes on older cars). Because the base of such taxes is relatively

mobile, it is important to prevent a race to the bottom among neighboring municipalities. Box 5 discusses how Uruguay tackled this challenge in recent years.

Box 5: Avoiding a Race to the Bottom: The Case of the Motor Vehicle Tax in Uruguay

Uruguay provides an interesting example of vertical IFC in stemming predatory subnational tax competition. The country experienced a race to the bottom in recent years in the annual tax on motor vehicles, which is one of the main sources of own revenues for the country's regional governments (departments). Some, mainly smaller and less prosperous, departments reduced substantially the rate of this tax, allowing non-residents to register their vehicle in the respective jurisdictions. This put strong downward pressure on the vehicle tax revenues in the other departments, and ultimately on the revenue from the tax nationwide. This revenue fell by a third in real terms between its peak in 2001 to 2011, necessitating a steady rise in transfers from the central government to fill the gap.

To counteract such predatory competition, the central government in 2012 negotiated with the majority of departments support for a national legislation to make uniform across the country the valuation of vehicles and the rate of their registration tax. The adoption by departments of this uniform regime, supported by a nationwide single automobile registry, was kept voluntary, but with the provision that non-complying departments would be subject to a penalty of loss of 40 percent of their transfers from the central government. Not surprisingly, all departments accepted the new regime that took effect in 2013. To facilitate popular support for the measure, the rate of the tax was set initially at a relatively low level, which is being gradually raised in subsequent years. Revenues from the tax have been steadily recovering since the adoption of the new regime.

This case highlights that, in the absence of effective systems of horizontal cooperation among SNGs to avoid a race to the bottom, it may be necessary for the central government to set boundaries on subnational revenue autonomy. This could have been achieved in Uruguay by setting a minimum rate for the vehicle tax, as well as uniform criteria for vehicle valuation nationwide, thereby preserving a degree of departmental autonomy for this tax. The central government privileged, however, administrative efficiency and the minimization of taxpayers' compliance costs by making the tax fully uniform throughout the national territory.

3.2.4. Royalties

Few aspects of inter-governmental fiscal arrangements are as controversial (in practice, albeit not in theory) as the sharing of revenues from non-renewable natural resources (oil, gas and minerals). There is fairly broad consensus in the literature (Ahmad and Mottu, 2003; and Brosio and Jimenez, 2012) that the assignment to SNGs of the bases of such resources, or of their revenues (especially on an origin basis) presents important disadvantages, in particular the following:

- It complicates macro-economic and fiscal management by the central government and imparts excessive volatility to subnational spending.
- It results in the concentration of these revenues in a small set of subnational jurisdictions, often on a scale disproportionate to their spending needs, and with limited local accountability. This in turn can (and frequently does) lead to wasteful spending and corruption.
- Relatedly, it can reduce incentives for the beneficiary governments to mobilize other forms of own revenue.

The literature also recognizes, however, that there is some justification for assigning relatively small shares of resource revenues to the subnational entities where the resources are located, to compensate them for environmental damage resulting from the exploitation of the resources, and for additional infrastructure needs related to the same.

These considerations notwithstanding, political economy realities (sometimes linked to historical or ethnic factors) typically result in the assignment of significant shares of resource revenues to SNGs, often on a combination of origin and redistribution criteria (Table 2).

Table 2. Intergovernmental Distribution of Natural Resource Revenues in Selected Countries

	Full decentralization	Full centralization	Shared revenue basis	Revenue sharing
Unitary countries		Most Middle East oil producers; Azerbaijan; Norway; United Kingdom		Indonesia; Kazakhstan
Federal countries	United Arab Emirates, Argentina		Canada United States	Nigeria, Russia

Source: Ahmad and Mottu (2003).

3.2.5. *User Fees and other Non-tax Revenues*

User charges are a suitable source of revenues for local governments. They can be levied to recover fully or in large part the cost of many services provided by these governments (e.g., water and sewerage, electricity, parking, garbage collection, urban public transport) and to contribute to the financing of other social services (e.g., education and health). They conform to the benefit principle and are largely non-exportable.

Distributional concerns can be addressed by exempting or levying the charge at reduced rates for consumption levels below a minimum threshold. It is not advisable, however, to exempt certain categories of residents from paying the charges because of the risks of leakages and pressures to extend such exemptions to other categories. User charges can also help increase accountability of local officials to their electorate for delivering public services of acceptable quality and minimizing waste.

Despite their potential, user fees are a still relatively unexploited source of revenue for local governments. They range from around 0.6 percent of total local revenues in Greece and Israel to nearly 10 percent in Finland, but cluster in the range of 2 to 5 percent in most other OECD countries. A significant reason is probably their high degree of visibility, which increases also social resistance to sizable discrete hikes in them.

An innovative deployment of user fees involves the setting up of business improvement districts (BIDs), local organizations into which local business and property owners pay additional mandatory fees or taxes, to help fund improved public services in the area. Such innovations have been instrumental in promoting the redevelopment of downtowns or other deteriorated areas in a number of cities.

A promising, but still largely underdeveloped, source of own revenues is green taxes and fees (such as congestion charges and effluent charges). These are desirable from the standpoints of efficiency and environmental sustainability but are costly to administer and, depending on the

ideological bent of local politicians and their constituency, are frequently contentious. Local taxes on gasoline are constrained by the scope for cross-border shopping in neighboring localities. Finally, there is often scope for mobilizing resources for investment through improved management of municipalities' non-financial assets (in particular land and buildings).¹⁵

4. IFC in Subnational Policy and Management

4.1. How can IFC contribute to strengthening subnational own revenues?

IFC can play a useful role in strengthening subnational revenues by facilitating a dialogue among and within the different levels of government on respective revenue assignments, and on their reform over time as circumstances evolve (e.g., as the capacity of SNGs to administer own taxes improves, or in conjunction with reforms of intergovernmental transfers).

Among advanced countries, Australia provides a good example of use of the above-mentioned COAG to build consensus for a major tax reform (introduction of a VAT shared between the Commonwealth and the states). In Germany, proposed reforms of shared taxes are discussed in various cooperation forums, to minimize the risk of their being blocked by the Upper House of Parliament (the Bundesrat), whose members are designated by the states and which has veto power on reforms affecting the states. In Belgium, IFC was instrumental in ensuring agreement on a substantial subnational tax reform in 2001 (the Lambermont Agreement).

In Mexico, the 2013 proposed tax reform package was discussed in the various IFC forums (the Reunión Nacional de Funcionarios Fiscales and the Comisión Permanente de Funcionarios Fiscales) to secure the needed political consensus for its approval by the Congress. In contrast, the absence of effective IFC forums in Brazil is broadly viewed as contributing to the lack of progress to date in the much-needed reform of the ICMS. IFC can also help prevent excessive tax competition among SNGs, as demonstrated by the case of the motor vehicle tax in Uruguay (Box 5).

IFC can also contribute to a more effective administration of subnational taxes. One important example of vertical cooperation in tax administration is represented by “piggy-backing” mechanisms (i.e., the levying of subnational surcharges on national taxes). In these cases, SNGs use the same bases as national taxes, and may delegate to the national tax administration the collection of the surcharges. For example, in Canada this is the case with the provinces that have adopted the Harmonized Sales Tax (HST). This is also the case of VAT in Australia, which is collected by the CG on behalf of the states. In Chile, the national tax administration is responsible for the collection and enforcement of the municipal property tax. Whenever the national tax administration is asked to act as an agent for subnational tax administrations, appropriate compensation for the costs involved should be negotiated (preferably in the form of retaining a portion of the tax) to preserve its incentive to perform the task effectively.

Even when SNGs maintain responsibility for collection of their own taxes, there is generally significant scope for strengthening both national and subnational tax administrations through vertical cooperation, including the following:

¹⁵ Detter and Folster (2017) offer a number of international examples of significant gains in revenues of cities from improved management of their commercial assets.

- A systematic exchange of taxpayer information (e.g., through the sharing of taxpayer registries), use of a common taxpayer ID number, and sharing of income tax returns and/or of electronic VAT invoices, when available
- Joint audit and enforcement efforts
- Sharing of experience, good practices, and know-how

Significant benefits can also be reaped from cooperation among tax administrations at the same level of government. A successful example of such a horizontal cooperation forum is provided by the National Forum of State Tax Coordinators and Administrators (Encontro Nacional de Coordenadores e Administradores Tributarios Estaduais, or ENCAT) in Brazil, which was instrumental in the development and adoption of the electronic VAT invoices in that country (Box 6).

Box 6: Brazil’s Experience with the Electronic Invoices and Other Systems to Track Goods in Transit

Many countries around the world have moved to electronic invoices to track credits and debits under the VAT. Since typically the VAT is a national-level tax, the national tax administration has put in place and maintains the ENCAT-related IT system (for a comprehensive discussion of experiences with electronic invoices in LAC countries, see Barreix and Zambrano, eds., 2017). Brazil offers a distinctive example of use of the electronic invoice system at the subnational level. The creation and maintenance of the system constitutes is well a good example of intergovernmental cooperation in a country that, in other respects, is sorely in need of strengthening such cooperation.

The electronic invoice system was developed in Brazil under the auspices of ENCAT, a horizontal cooperation forum among state-level tax administrators, which acts as technical secretariat for the CONFAZ and promotes dialogue and dissemination of best practices among its members. The development of the system began in 2006 and posed major technical challenges, given the territorial extension of the country and the number of transactions subject to the ICMS. By mid-2017, the system had processed more than 17 billion invoices, emitted by more than 1.4 million taxpayers.

The system links in a network available 24 hours per day, 7 days a week, the IT systems of the 26 states and the Federal District. The seller of a good subject to ICMS inserts into the system of his state of origin the electronic invoice for the transaction in a standardized format, which includes the specification of the buyer and his state. The system of the originating state, following appropriate validity checks, authorizes the transaction and transmits the relevant information to the state of destination. The records of all transactions are stored in a national system operated by the federal tax administration, Receita Federal do Brasil. The electronic invoice accompanies the merchandise throughout its journey to destination. A complementary system using transponders and more recently imbedded electronic chips tracks cargo movements throughout the country.

The system is widely recognized to entail major benefits for both the state tax administrations, by reducing fraud and evasion of the ICMS, and for taxpayers, by reducing risks of cargo losses and theft, and by speeding up controls of interstate trade. Moreover, information about prices of traded commodities can be used in public procurement, and also by private agents, to reduce purchase costs.

4.2. IFC in the Design and Reform of Intergovernmental Transfer Systems

In most countries, intergovernmental transfers constitute the backbone of subnational finances, accounting for the bulk of subnational revenues, especially at the intermediate level of government. They fulfil different objectives: filling the gap between subnational own revenues and spending responsibilities (vertical imbalances), equalizing revenue capacities and spending needs among SNGs, and funding subnational spending programs regarded as national priorities or as having positive externalities. Different types of transfers privilege one or the other objective: revenue sharing is the most commonly used instrument to fill vertical imbalances; equalization transfers aim to reduce horizontal imbalances; and block and special purpose transfers seek to finance subnational spending in priority sectors and programs.

The relative weights of these objectives vary from country to country, reflecting a range of economic, institutional, and socio-political factors. Accordingly, intergovernmental transfer systems differ significantly across countries. For example, shared revenues are very important in Argentina, Australia, Austria, Belgium, Colombia, Germany, Mexico, and Spain, which are all characterized by large vertical imbalances. In other countries (e.g., Canada, India, and the United States), block or special purpose transfers play more important roles. Moreover, the degree of conditionality attached to such transfers varies widely across countries, types of programs, and over time.

Many advanced and some emerging countries (e.g., China and South Africa) have explicit equalization transfers, although the criteria for their distribution vary significantly. For instance, the Canadian equalization transfer system only equalizes revenue capacities, the South African one only spending needs, and the Australian one both revenue capacities and spending needs. Equalization systems also vary widely in terms of the complexity of formulas and indicators used, reflecting in particular countries' preferences for transparency, popular acceptability of the systems, and the availability of relevant data.

As discussed in detail in Munoz, Radics, and Bone (2016), LAC countries do not use explicit equalization transfers, despite large disparities among SNGs in revenues and thus in spending capacities, which are aggravated by the very uneven distribution of royalties. To be sure, some indicators of regional and local disparities (e.g., relative poverty levels) are included in the formulas for horizontal distribution of shared revenues in a number of countries in the region. However, such inclusion is estimated to reduce disparities in subnational revenues by only about one-third on average, compared with about two thirds in advanced countries.

Despite their diversity, sound systems of intergovernmental transfers should ideally display a number of characteristics, namely the following:

- Adequacy (i.e., sufficiency to avoid unfunded mandates for SNGs)
- Minimization of discretion, to avoid soft budget constraints
- Flexibility, to help SNGs avoid pro-cyclicality and cope with exogenous shocks
- Reflection of social preferences for redistribution
- Transparency in design and implementation
- Simplicity, to avoid excessive complexity¹⁶

¹⁶ There is a vast literature on the desirable characteristics of intergovernmental transfer systems (e.g., Ahmad and Brosio, 2006; Boadway and Shah, 2007).

Transfers should also be designed so as to avoid disincentives for recipient governments to exploit own revenue potentials and to deliver efficiently public services of their responsibility. For this purpose, their horizontal distribution formulas should be based on indicators of revenue capacity and of spending needs (calculated assuming an appropriate level of spending efficiency), rather than on current or recent levels of revenues and expenditures. Estimating such capacities and needs is a complex task, requiring massive data availability. Most countries therefore use more easily computable proxy indicators or focus only on revenue capacities. Some delegate this task to independent bodies of technical experts, like the Australian Grants Commission.¹⁷

In practice, actual transfer systems generally fall short of meeting one or more of the desirable criteria, not least because their design or implementation is often shaped more by political economy considerations than by economic principles and fiscal soundness. Moreover, transfer systems tend to be even more the object of reforms, and thus change over time, than other aspects of intergovernmental fiscal systems. As an example of repeated waves of such reforms in a Latin American country, Box 7 discusses the evolution of intergovernmental transfers in Colombia over the last two decades, focusing in particular on the question of how transfers affect incentives to subnational own revenue mobilization in that country.

Box 7: Intergovernmental Transfers and Subnational Fiscal Autonomy in Colombia

Colombia is among the most decentralized unitary states in Latin America in terms of expenditure responsibilities. SNGs are responsible for large areas of social spending, including education, health, water and sanitation, and some infrastructures, as well as the traditional local services. Regional governments (departments) and local ones (municipalities) account for about 18 percent and 21 percent, respectively, of general government expenditures. Total subnational spending is equivalent to around 10 percent of GDP.

However, the fiscal autonomy of SNGs (especially at the regional level) is significantly more limited. Own revenues account for about a third of departmental revenues, and for 40 percent of municipal ones. Departments levy some 10 types of taxes, but over 60 percent of their revenues is accounted for by excises on alcohol and tobacco, and by vehicle registration taxes. Municipalities also levy many different taxes and fees, but more than 90 percent of their revenues is accounted for by three taxes, the property tax (*impuesto predial*), a tax on industrial and commercial activities and an excise on gasoline (Sanchez et al., 2015).

Transfers from the central government play, therefore, a key role in funding the services provided by SNGs in Colombia. The system of intergovernmental transfers can be characterized as one of revenue sharing, but with significant earmarking of the transferred resources. The centerpieces of the system are the General System of Contributions (Sistema General de Participaciones, or SGP) and the National System of Royalties (Sistema General de Regalias, or SGR).

Prior to 2002, the intergovernmental transfer system (including two components, the Situado Fiscal for departments and the Participaciones Municipales for municipalities) involved the allocation to SNGs of a fixed proportion of central government revenues. This was seen as imparting excessive volatility and procyclicality to subnational finances, and was modified in 2002, to ensure a steady growth of the transfers (unified under the SGP) in real terms. The law that created the SGP envisaged, however, a reversion in 2017 to a system of revenue sharing, based on a four-year moving average of central government revenues (Bonet and Galvis, 2017).

The SGP transfers are shared among departments and municipalities on the basis of complex formulas that take into account, among other factors, population, poverty levels, and the urban or rural nature of the locality. Importantly, the law mandates the earmarking of the funds received by the SNGs to

¹⁷ See Ahmad and Searle (2006) for a discussion of the role of the Australian Grants Commission.

their various spending functions in fixed proportions (e.g., 58.5 percent to education and 24.5 percent to health). Such earmarking substantially constrains subnational spending autonomy and hinders the adaptation of the composition of subnational expenditures to local needs and priorities. Various studies of the efficiency of subnational spending in health and education suggest that the system does not provide incentives to improve the quality and cost-effectiveness of such spending (Galvis, 2016).

The past decade witnessed a rapid growth of revenues from natural resources (*regalias*) in Colombia, reflecting both strong commodity prices and increases in mining and petroleum production. Such revenues were initially largely assigned to the SNGs where the resources originated, which have relatively low population levels. On average in 2002–10, 70 percent of the *regalias* were assigned to SNGs whose populations accounted for about a third of the total country's population.

To remedy such disparities, the system of distribution of the *regalias* was drastically changed in 2012, with the creation of the SGR (a notable accomplishment in terms of political economy). The SGR mandates the distribution of the *regalias* in fixed proportion to different funds, including a stabilization one, one to fund future pensions, and various ones to finance investment projects, to be distributed among departments and municipalities, mainly on the basis of relative population and poverty criteria. The projects submitted for financing by these funds have to be approved by special entities, called Órganos Colegiados de Administración y Decisión or OCAD, charged with assessing their quality and feasibility.

The limited fiscal autonomy of Colombian local, and especially regional, governments is widely regarded as a potential source of soft budget constraints on SNGs, a risk that the central government has strived to counteract through a rules-based approval system for subnational borrowing. There have also been various analytical attempts to assess whether the high degree of dependence of SNGs from transfers has promoted fiscal laziness on their part. While specific studies' results vary, there is a fair degree of evidence that on average rising transfers have been accompanied by rising own revenues, although this has varied across the territory and by type of SNGs.

However, there is significant evidence that municipalities and, to a lesser extent, departments under-exploit the revenue potential of their assigned taxes. In the case of departments, to increase significantly their fiscal autonomy, it would be important to assign them some revenue source more income-elastic than excises. Possible candidates would be surcharges on national taxes, such as the personal income tax, and a retail sales tax (Sanchez et al., 2015). At the municipal level, it would be important for the central government to incentivize through appropriate sticks and carrots a strengthened revenue effort, and to support in particular smaller municipalities in improving the administration of the *impuesto predial*.

IFC can facilitate sound reforms of intergovernmental transfer systems by helping the search for win-win solutions to common challenges. For example, in 2001 the Belgian CG was able to pass an initially very contentious intergovernmental fiscal reform by combining increased regional tax autonomy (advocated by the Flemish region) with increased transfers for education (which were important to the Walloon region).

Such win-win outcomes are more likely to materialize when the CG is the driving force of reforms, as was the case with the Lambermont Agreement in Belgium, and with the above-mentioned VAT reform in Australia. The likelihood of success increases if the CG has some fiscal space to increase the overall envelope of transfers or to make them more attractive to the SNGs in some other ways. For example, in both Austria and Switzerland the CG secured consensus among the states/cantons to proposed changes in equalization transfers by shouldering the cost of transitional arrangements designed to ensure that no SNG would see its nominal transfers

reduced by the reform.¹⁸ Likewise, Australia introduced financial incentives for the states as part of a redesign of special purpose transfers to make them more performance-oriented. These changes were agreed under the aegis of the top intergovernmental forum, the COAG, and their implementation is monitored by the independent Reform Council (CRC) established by the COAG in 2006.

4.3. Coordinating and Reforming Expenditure Responsibilities

Clarity in spending assignments to different levels of government is crucial for efficiency and accountability, but it is difficult to achieve fully in practice. International experience shows that the most important spending functions (e.g., education, health care, infrastructure, and social assistance) are frequently concurrent, rather than exclusive. Some clarity can be achieved by unbundling these broad functions, not only those related to service delivery but also standard setting and regulation more broadly, into narrower areas assigned to different levels of government.

Moreover, expenditure assignments are more often shaped by history and motivated by political and social dynamics than by efficiency considerations (i.e., by the principle of subsidiarity). As a result, asymmetric assignments, reflecting different capacities of individual jurisdictions within each level of government to carry them out, would be preferable but may not be politically feasible.¹⁹ Finally, expenditure assignments may also need to be reviewed periodically to reflect evolving economic and socio-political circumstances, as well as subnational capacities.

Vertical IFC can be useful in clarifying and reforming expenditure assignments, as well as in ensuring an effective management of concurrent spending responsibilities in specific sectors. IFC can also help minimize jurisdictional conflicts, which, in the absence of forums for intergovernmental dialogue, frequently end up in time-consuming and costly resort to judicial disputes. The dialogue and analyses in such forums may also facilitate the adoption of asymmetric assignments, when appropriate.

The importance of effective cooperation across levels of government in countries characterized by a high degree of overlap in spending responsibilities is highlighted by a number of country examples. The vertical IFC arrangements in Australia, Austria, Germany, and India provide good examples of such cooperative federalism.

Vertical IFC can also take the form of bilateral arrangements between the CG and individual SNGs to define respective responsibilities in concurrent spending functions. These arrangements are often embodied in performance contracts specifying expectations of both parties regarding financing and results of the spending programs covered by the agreement. For instance, France has Contrats de Plan Etat-Régions between the CG and its deconcentrated regions. These agreements (which are concluded with each region separately) have a duration of seven years and aim at ensuring that evolving broad national priorities are appropriately

¹⁸ Financial incentives have also been used by CGs to promote consensus on other types of intergovernmental reforms, for instance by Denmark and Finland to encourage mergers of small municipalities, and by Canada to promote harmonization of provincial VATs.

¹⁹ Some countries (e.g., Colombia) have introduced a degree of asymmetry in spending assignment by requiring that SNGs wishing to take on given spending responsibilities show evidence of capacity (according to pre-specified criteria) to carry them out. Chile is also planning a gradual and probably asymmetric decentralization of spending responsibilities to its regions (which are currently deconcentrated units of the CG).

reflected in regional investment plans, taking into account relevant regional specificities.²⁰ Colombia introduced in 2012 *Contratos Plan* with some of its departments to coordinate public investment policies, with a view to promoting a more balanced regional development (see Box 8 below). The Chilean CG also uses *contratos-region* to agree investment plans with its regions.

Horizontal IFC tends to play a greater role in countries with lower degrees of spending overlap among the different government levels. This is, for example, the case in Canada (with the inter-provincial Council of the Federation and the Federation of Canadian Municipalities), Switzerland (with the inter-cantonal Presidents' Conference) and the United States (with various associations of state governors, state legislatures, and local governments).

Box 8: Colombia's Contratos Plan

The Contratos Plan, inspired by the French experience with Contrats de Plan Etat-Regions, were first introduced in Colombia in 2010, as an instrument to improve the coordination of public investments across levels of government in areas jointly selected by the signatory governments. The first seven Contratos, framed within the context of the National Development Plan for 2010–14, focused on improvements in road connectivity and in the provision of key public services, such as education, health and water and sanitation. Some covered individual departments, other groups of departments, or municipalities.

An evaluation by the Departamento Nacional de Planeación (DNP) pointed to some weaknesses of the instrument, in particular excessive fragmentation of the projects and lags in their execution, as well as need to better articulate the Contratos with the national and regional development plans.

A new (second-generation) batch of 10 Contratos has been developed in the context of 2014–18 National Development Plan. These focus mainly on areas of the country that were most affected by the conflict with the Revolutionary Armed Forces of Colombia (Fuerzas Armadas Revolucionarias de Colombia, or FARC) and aim to support the post-peace development agenda for those regions (they have been renamed Peace Contracts, or Contratos Paz). To increase the strategic focus of the Contratos and facilitate a speedy access to the agreed financing, a Regional Fund was created, attached to the DNP, to consolidate (in separate sub-accounts for each Contrato) all the sources of financing.

By mid-2017, the Contratos totaled CP\$15.2 billion, some 80 percent of which financed by the central government. Execution rates by that date varied from region to region, and by sectorial area, averaging about 62 percent for the country as a whole. They were estimated to have generated about 60,000 new jobs.

The Contratos have contributed to improving both infrastructures in lagging regions of the country and the subnational capacity to prepare and implement public investment projects. Still, reportedly further progress is needed in coordinating projects within individual contracts, strengthening their quality and speeding up their execution.^a

^a See OECD (2016). Further details on the Contratos Plan can be found at:
<https://www.dnp.gov.co/Contratos-Plan/Paginas/ContratosPlan.aspx>
https://colaboracion.dnp.gov.co/CDT/Contratos%20Plan/Contratos%20Plan%20-%20Vertical_Versi%C3%B3n%20Impresa.pdf

²⁰ For example, for the 2014-20 period the contracts focus, as priority areas, on investments in environment, energy, multi-modal transport, and support to technological research and innovation.

4.4. Cooperation in Service Delivery

IFC has probably the greatest potential payoffs in specific sectoral areas, especially those characterized by extensive concurrent spending responsibilities, and/or by significant negative or positive externalities. Horizontal cooperation can help minimize conflict over scarce resources (e.g. water); reduce adverse spillovers from a jurisdiction to its neighbors; exploit potential economies of scale; and promote favorable demonstration effects and learning from relevant diverse experiences. Vertical cooperation, in addition to facilitating all those outcomes, can also help avoid cost-shifting through the establishment of inappropriate standards and regulations by higher-level governments on their lower-level counterparts. Therefore, it is not surprising that most countries have a variety of intergovernmental sectorial cooperation forums, although the potential for such cooperation is still far from being fully exploited.

Specifically, IFC can be very beneficial in a number of public expenditure areas, in which SNGs are responsible for relatively large shares in many countries. The case for IFC is quite strong in the education area, which accounts for over a quarter of subnational spending on average among OECD countries. Due to citizen's mobility across the national territory, there is a potential for significant spillovers of the benefits of good education provided by one SNG onto the labor market and productivity in others. Similarly, shortcomings in education quality in one jurisdiction can subsequently affect adversely labor productivity in other jurisdictions, and ultimately nationwide. Therefore, there is a strong case for the adoption of common national minimum standards, supported as needed by well-designed equalization transfers.

Specific forums for intergovernmental cooperation in the education area can provide useful venues for the discussion of, and agreement on, standards that are well adapted to economic and social realities. These forums can also promote the sharing of good practices and lessons from failures among subnational education officials, as well as facilitate agreement on needed reforms. Many countries have intergovernmental forums in the education area.

Arrangements for intergovernmental cooperation are also quite frequent in health care, especially in countries in which SNGs have concurrent spending responsibilities with the CG in the delivery of health services. Such arrangements can be especially useful in the prevention and care of contagious diseases, which, by their nature, have spillover effects across local or regional borders, as well as in the dissemination of good practices in the design and implementation of health care programs. Examples in this area include the intergovernmental health forums at the ministerial level in Argentina and Australia, and the health and social issues commission of the National Governors' Association in the United States.

Intergovernmental cooperation forums can also have beneficial effects in various infrastructure areas, including the following:

- Water resource management, to facilitate agreement on building of waterways from water-rich regions to more arid ones, on efficient utilization of scarce water resources among different users, and on the avoidance of upstream pollution. A notable example in this area are the Australian Intergovernmental Agreement of 2004 on the National Water Initiative and the one on the management of the Murray-Darling Basin of 2013, both concluded under the auspices of the above-mentioned COAG.²¹ Brazil's Pact for the Management of

²¹ Details on these agreements can be found on the COAG's website www.coag.gov.au.

Water Resources, which includes the CG, the states and water basin councils, is another case in point.²²

- Environmental management and conservation, given the substantial potential for regional, and even national, spillovers of local activities in this area.
- Energy management, distribution and conservation. Again, Australia offers a good example in this area with a National Partnership Agreement on Energy Efficiency, sponsored by the COAG in 2009.
- Interregional and intermodal transport infrastructures, to maximize synergies between transport projects undertaken at the local and regional level, with a view to improving connectivity.

Intergovernmental cooperation in all the areas above is especially important among the municipalities comprising large metropolitan areas. Indeed, most such areas have created joint institutions (including jointly owned enterprises in some cases) for the management of public transport, water and sanitation, and other major utilities in the area (Bahl, Lynn, and Wetzel, 2013; de Mello and Lago-Peñas, 2013). In New Zealand, the nine municipalities in the Auckland area have formed a joint Council, which now decides on all matters of common interest and constitutes a powerful interlocutor of the CG. In several European countries, local governments have set up specific vehicles for the delivery of local services, ranging from transport to waste-water management and solid waste disposal.²³ France and the United Kingdom provide good examples of inter-jurisdictional cooperation in metropolitan areas.²⁴

However, there is significant scope for further progress in this area. Local governments have in general yet to extend these cooperative arrangements beyond service delivery, to include policy coordination functions, which is particularly challenging at the local level, given the diversity and fragmentation of local governments.

Finally, there can be significant benefits from intergovernmental cooperation in the area of regional economic development. It is increasingly evident from international experience that sustainable and territorially balanced development requires the emergence of development poles/hubs in the less developed area. These hubs can promote the catching up of lagging regions to their more developed counterparts based on their respective comparative advantages (e.g., natural resources, agricultural potential, tourism, or the manufacturing of high value-added goods).

The creation of such hubs requires, in turn, extensive physical and social infrastructure to attract both private investments and skilled labor. For both, a coordinated approach between the CG and the regional and local authorities in the area concerned is essential to maximize synergies, avoid duplications of spending and/or work at cross-purposes. Cooperation is also important with the governments of other localities that are in the region but outside the hub, so as to maximize the connectivity that allows such localities to benefit from the development of the hub. The existence of permanent forums for dialogue among SNGs can also help prevent excessive competition among them in the form of, ultimately self-defeating, attempts to influence

²² See OECD (2015a) for more information and discussion on the Brazilian experience. The Delta Program in the Netherlands is another interesting case, given the status of the Dutch Water Boards as a separate level of administration.

²³ De Mello (2010) provides various examples in this area.

²⁴ See OECD (2015b) for various examples of intergovernmental cooperation in metropolitan areas.

investment location decisions through fiscal or financial subsidies, and/or through overly accommodating regulatory regimes.

4.5. Cooperation in Strengthening the Management of Subnational Spending

Subnational expenditure management is typically fraught with many weaknesses, although there are also examples of sound public financial management systems in many states and cities, especially in advanced countries. These weaknesses include the following:

- Frequently unrealistic budget projections, inadequately developed budget classifications, little or no analysis of fiscal risks
- The lack of medium-term frameworks, and of transparency of future spending obligations (for example pensions of subnational civil servants)
- Limited or non-existent systems of budgeting for results, with adverse effects on the quality of the goods and services provided by most SNGs
- Inadequate systems of selection and execution of public investment
- Lack of single Treasury accounts and modern financial management information systems (IFMIS), as well as inadequate monitoring of the budget execution
- Lack of uniform accounting and reporting standards
- Weak internal and external control and auditing systems²⁵

IFC can contribute significantly to strengthening SNGs' capacities to manage effectively their spending responsibilities. CGs can help SNGs strengthen their systems and procedures for budget preparation and execution, as well as for monitoring and improving the efficiency and effectiveness of spending programs. In particular, CGs can support the adoption by SNGs of improved financial management information systems (IFMIS).²⁶ The CG can also support the growing use by SNGs of electronic provision of public services. The latter can yield significant cost savings to the SNG in question and time savings to the users of the services. For instance, the US state of Utah began providing services to its citizens in electronic form in 1999, and now does so for more than 1000 types of services, including those related to taxes, vehicle registration, professional and business licenses, employment search, and vital event records.

The University of Utah conducted in 2012 a study to assess the benefits of such extensive use of e-government. The study estimated, for the 19 services most utilized by state citizens, the difference between the costs of their online and offline provision. It found that on average the cost of online provision was less than a quarter of offline provision. The study did not quantify the benefits experienced by citizens in terms of ease of access and reduction of time required to use the services. The CG should require whenever legally feasible, and otherwise encourage, the adoption by SNGs of common accounting norms, consistent with the relevant international standards, and of high fiscal transparency standards.²⁷ The increasing emphasis placed by the EU institutions in the aftermath of the Euro crisis on the adoption of common accounting standards for all entities in the general government underscores the importance of this point. Mexico provides a recent good example in this area (Box 9).

²⁵ See, for example, IERAL (2016) for a thorough analysis of the weaknesses of public financial management systems in a number of Argentine provinces.

²⁶ In some cases, especially smaller or poorer SNGs may find it less costly to execute their budgets through the national IFMIS. Such a choice need not involve any loss of budget autonomy by the SNGs in question.

²⁷ The CG can set a useful example in this respect by undertaking a fiscal transparency assessment based on the IMF Transparency Code (IMF, 2014).

Box 9: Adopting and Implementing Nationwide Government Accounting Standards: Selected Examples

The adoption and effective enforcement of accounting standards for all entities comprising the general government is an important precondition for budgetary transparency and for the quality, reliability, and international comparability of fiscal data. For this reason, the IMF's Fiscal Transparency Code recommends that "fiscal reports should cover all entities engaged in public activity according to international standards." In 2011, in its Directive on Budget Frameworks (No. 85), the European Commission stated that EU member states should have in place public accounting systems comprehensively and consistently covering all subsectors of general government, containing the information needed to generate accrual data, with a view to preparing fiscal data based on the European System of Accounts (ESA 95) standard, and subject to internal control and independent audits. Since then, the Commission has been working on developing European Public Accounting Standards (EPSAS), adapting to EU conditions the International Public Accounting Standards (IPSAS). EPSAS are targeted to be implemented by EU members by 2025. In the meantime, the Commission is encouraging member states to move towards implementing the existing IPSAS on a voluntary basis.^a

In LAC, Brazil pioneered the adoption of common accounting standards for all public sector entities in its 2000 Fiscal Responsibility Law (FRL). In subsequent years, the federal government devoted substantial efforts and resources to assisting states and municipalities in implementing the accounting and reporting requirements of the FRL. While these efforts met with considerable success, they failed to ensure full consistency of reported information across the national territory. In particular, states differed in the treatment of certain expenditures in compiling and reporting data on payroll spending (which is subject to a ceiling under the law), a fact noted repeatedly in reports by the Audit Courts. In the last couple of years, the National Treasury has endeavored to enforce uniform accounting standards in the reporting on fiscal adjustment programs negotiated with states that have requested a restructuring of their debt with the federal government.

Mexico promulgated in 2008 a Law on Government Accountability, applicable to all public sector entities (more than 6,000 of them). It also created a National Council of Accounting Harmonization (Consejo Nacional de Armonización Contable, or CONAC), chaired by the federal minister of finance and including representatives of the states and municipalities, responsible for defining and monitoring the implementation of uniform public sector accounting standards. The CONAC does not have its own staff. A Directorate of the Ministry of Finance acts as secretariat for the Council.

Implementation of the law remained weak until more recent years, when it began to be pursued more vigorously in the wake of the adoption of subnational fiscal responsibility legislation (Ley de Disciplina Financiera de las Entidades Federativas y los Municipios) in 2012. Successive reforms were introduced in 2012–16 to make the accounting law more effective. This effort included the creation of state-level Councils on Accounting Harmonization (Consejos de Armonización Contable, or CACEF), charged with monitoring the implementation of CONAC's directives in their respective states and reporting periodically to the CONAC's Secretariat on it. The reports are transmitted through a dedicated IT system (Sistema de Evaluación de la Armonización Contable, or SEVAC). The methodology of assessment of the degree of compliance of individual SNGs is defined by the Supreme Audit Institution of Mexico. The CONAC's Secretariat is empowered to vet the CACEFs' reports and is increasingly doing so. The reports are eventually published on the CONAC's website. The coverage of the reports has been progressively increasing, now covering all states and almost 90 percent of municipalities. Also, the methodology of the assessments of compliance has been refined and nuanced.

^a More information on the current state of play on this issue in EU countries can be found at: <http://ec.europa.eu/eurostat/web/government-financestatistics/government-accounting>

Finally, IFC forums, both vertical and horizontal, can prove to be very useful vehicles for disseminating good practices in public expenditure management, highlighting the costs of bad ones, and promoting positive demonstration effects. Most of the forums mentioned in the previous sections include organizational structures specifically devoted to this function.

4.6. Strengthening the Management and Financing of Subnational Investments

SNGs are responsible for more than half of government investments in many LAC countries, but subnational capacities to plan, budget, and execute efficiently investment projects are on average quite weak, albeit with exceptions in some of the larger and richer regional and local jurisdictions. Available analyses of the state of public investment management in a number of LAC countries²⁸ point to significant shortcomings in existing systems even at the national level. These include: a disarticulation of the National Development Plan with sectorial investment plans; a lack of medium-term expenditure frameworks to integrate planned investments (and their operation and maintenance costs) into the annual budgets; little use of standardized cost-benefit analysis in the assessment and selection of investment projects; inadequate monitoring of project execution; and only sporadic use of independent and transparent ex-post evaluation. To be sure, some countries (e.g., Chile and Colombia²⁹) fare significantly better than average in several or most of these areas.

Lack of coordination between national and subnational investments is also an endemic problem, which further undermines the effectiveness of public investments, not only in LAC but also in advanced countries. A recent survey by the OECD Secretariat (OECD, 2014) found ample evidence of such lack of coordination in OECD members, with over 70 percent of respondents complaining about misalignment of investment priorities across government levels.

Some 80 percent of respondents to the same survey reported lack of a multiyear perspective in investment planning by local governments; 70 percent thought that such plans were not based on clear evidence of local needs. Moreover, most viewed the lack of an integrated cross-sectorial approach as the foremost challenge for subnational investment planning.

Significant weaknesses were also reported in the preparation, procurement, and selection of individual investment projects, in particular a lack in most SNGs of capacity to carry out sound cost-benefit analyses, a fact that limits their ability to qualify for financing from the central government, multilateral agencies, or financial markets, as well as undermining the quality of projects financed with own resources.

Among shortcomings in investment implementation, the survey reported frequent failures to monitor effectively the physical and financial execution of the projects; to take timely action to prevent significant cost overruns; to invest adequate resource in the operation and maintenance of the infrastructures created by the investments; and to ensure reliable ex-post scrutiny of project results through external performance auditing and evaluation.

Similar evidence has been reported for selected Argentine Provinces (IERAL, 2016), Colombian municipalities (Saldarriaga and Eguino), and Chilean municipalities (Pineda and

²⁸ See, for example, reports on PEFA evaluations by the World Bank and the IMF. The same institutions have also conducted specific Public Investment Management Assessments for a number of countries, including some in LAC, but most are not yet published.

²⁹ See OECD (2017) for an analysis of governance of public infrastructure in Chile; and Saldarriaga and Eguino (2017) for a comprehensive discussion of public investment management in Colombia.

others, 2018), among others. In all cases, the studies evidenced a large variance in subnational performances, in most cases related to size, urban or rural nature, and other socioeconomic characteristics of the subnational jurisdictions.

National governments, as well as multilateral development agencies can play important roles in helping SNGs strengthen their public investment management systems through technical and financial assistance. So can horizontal subnational cooperation forums through dissemination of good practices and know-how, and pooling of resources for projects with positive interjurisdictional externalities.

An important motivator for SNGs to improve their public investment management systems should be the fact that weaknesses in such systems are a significant factor in limiting their access to longer-term market financing for the investments. Box 10 discusses key lessons from international experiences on how to improve such access.

Box 10: Promoting Subnational Access to Efficient and Fiscally Responsible Financing for Investments

There is a case on intergenerational equity grounds for financing at least part of public investments through borrowing. Such borrowing needs to be constrained through appropriate and transparent rules, to ensure that it does not lead to eventual debt servicing difficulties.

However, even when such constraints are not binding, access to adequate market financing for investments can constitute a significant challenge for SNGs. This may reflect the state of development of domestic financial markets; factors that discourage domestic or foreign financial agents from investing in subnational infrastructures; or both.

Narrow domestic capital markets, reflecting limited pools of long-term savings or institutional weaknesses that hinder the flow of savings into long-term financial instruments, force subnational governments to rely on bank financing, which tends to be of a shorter maturity than would be desirable to finance infrastructures. This is frequently the case in emerging and developing countries, although some have made substantial progress in developing domestic capital markets in recent decades.^a

But, even when these markets are relatively deep, there can be significant obstacles to local governments' access to them. Among these obstacles, the most important are the following:

- A limited base of own revenues and non-discretionary transfers from higher levels of government, which raises investors' concerns about the SNGs' ability to service the debt
- Perceived weaknesses in the local governments' accounting and reporting systems, which cast doubt on the reliability of data on their finances
- Lack of reliable independent credit ratings for local debt instruments
- Weaknesses in the legal framework for local government borrowing
- Investors' concerns about mechanisms of dispute resolution, including the working of the judicial system
- A lack of ex-ante legislation for the orderly resolution of possible municipal financial crises (see Box 2)

Well-developed financial markets offer creditworthy SNGs a range of instruments to finance investment projects, such as the following:

- General obligation bonds, which are backed by non-earmarked revenues. The choice of characteristics of a bond issue should be guided by a number of considerations related to market conditions and the expected time profile of the benefits from the investment. In general, borrowing in foreign currency should be discouraged, as subnational revenues are typically denominated in domestic currency and therefore do not provide an adequate hedge for foreign exchange risk.

- Revenue bonds, the service of which is met through earmarked revenues from the project financed by the bond issue. These bonds may carry higher interest rates than general obligation bonds, if, as is often the case, they are regarded by investors as less safe, because they are not backed by the local government's taxing power. Nevertheless, the issuance of such bonds may be preferred by the local electorate because the beneficiaries of the infrastructure are seen as paying for its financing.
- Tax-exempt bonds. The exemption may be granted by the issuing government or by a higher-level one. An example in this respect is municipal bonds in the United States, the interest on which is exempt from federal income tax. Tax-exempt bonds can be effective in mobilizing financing, but they have costs in terms of efficiency because they introduce a distortion in capital markets, and of equity, because they favor taxpayers in upper-income brackets.

A number of mechanisms are used to moderate borrowing costs for subnational governments. These include guarantees by higher-level governments, the posting of local marketable assets as collateral, and systems of revenue pre-assignments or intercepts to guarantee the scheduled debt service payments. Some of these mechanisms carry risks. In particular, guarantees can give rise to moral hazard, and revenue pre-commitments or intercepts can impart excessive rigidity to the management of subnational budgets.

As their small size can severely constrain the access of many SNGs (especially local governments) to financial markets (or make its cost prohibitive), some countries have promoted pooling of local bond issues among neighboring municipalities. Some have created special agencies to issue own bonds, whose proceeds are subsequently distributed among different municipalities to finance smaller-scale projects.

While these innovations can be useful to overcome market failures that unduly constrain borrowing, it is important to ensure that SNGs are not put in a privileged borrowers' position that can distort domestic financial markets or soften the subnational budget constraint. Therefore, SNGs' ownership of banks, the requirement that private banks hold a portion of their portfolio in subnational bonds, or an undifferentiated treatment of credit to SNGs for bank prudential requirements purposes regardless of their individual creditworthiness, all should be avoided.

It is noteworthy that the country (the United States) that has the deepest and best-functioning market for municipal bonds has successfully addressed, through a range of reforms over past decades, the obstacles to the development of this market (Martell, 2016; Liu, Tian, and Wallis, 2013). However, the favorable treatment of interest on municipal bonds under the federal income tax has helped this development.

In particular, local governments in the United States are assigned significant sources of own tax and non-tax revenues. Those wanting to issue bonds are subject to strict disclosure requirements. Municipal bonds are rated by major rating agencies. The municipal bond market is under the oversight of a dedicated agency (the Municipal Securities Rulemaking Board), the legal framework for the resolution of disputes related to municipal bonds is well-developed, and the United States regulates the resolution of municipal financial crises through the bankruptcy code (Chapter 9).

In contrast, several factors are likely to hinder the development of markets for subnational bonds in LAC countries, including in particular the generally limited degree of subnational revenue autonomy; past histories of high inflation in some of them, which deter investments in long-term financial assets; significant scope for SNGs to borrow from public sources (the central government or publicly owned banks); legal and regulatory uncertainties; and the lack of clear ex-ante frameworks for the resolution of subnational financial crises. Significant progress on all or most of these fronts is likely to be required before domestic capital markets can become a major source of subnational investment financing in the region.

^a See Canuto and Liu, eds. (2013) for analyses of the development of subnational debt markets in China, the Philippines, Russia, and South Africa, respectively.

Note: This box draws in part on Ter-Minassian (2017).

5. Conclusions

The analysis in the previous sections indicates that there is a strong case for IFC in both federations and unitary states, especially in light of the trend in many countries toward decentralizing the responsibility to deliver important public goods and services. Well-functioning IFC arrangements can help the different levels of government recognize and attenuate adverse externalities from their policies, avoid or reduce predatory tax competition, better exploit economies of scale in providing certain public services, reduce the risk of contagious diseases spreading, improve citizen security and environmental quality and maximize connectivity, and facilitate the formation of consensus on necessary policy reforms, to cite just some potential benefits.

However, there is no easy recipe to ensure well-functioning IFC. The effectiveness of IFC forums is strongly affected by a range of economic, sociopolitical, and institutional factors, including constitutional provisions that reflect the history of decentralization in each country; power balances among the different levels of government; the design and practice of intergovernmental fiscal relations (in particular the degree of spending and revenue autonomy of SNGs); and the extent of regional economic, ethnic, and social disparities which can, and often do, give rise to conflicting attitudes and prevent constructive dialogue among SNGs.

These considerations suggest that effective models for IFC need to be tailored to individual countries' circumstances. Further, though lessons from other countries can be useful in shedding light on the advantages and disadvantages of possible design options, they cannot be imported uncritically. Among the lessons from international experiences, the following seem worth emphasizing.

First, different IFC forums serve different purposes and require different compositions. For example, sectoral forums need to include policymakers and specialists in each specific area. Forums to promote cooperation in strengthening revenue and expenditure management should include tax and treasury officials, respectively, and forums to discuss fiscal policy reforms need to include ministers or secretaries of finance responsible for the national and subnational public finances. However, it is also important that different forums do not work at cross-purposes. Thus, it is desirable to have an overarching forum. Such a forum should involve the chief executives of the national and intermediate levels of government and a suitably high-standing representative of the local level, to promote consensus on the main intergovernmental policy issues.

Second, vertical cooperation is most likely to be successful when the executive branch of the national government is relatively strong and can exercise effective policy leadership. Horizontal cooperation forums can usefully complement vertical forums and are especially needed at the relatively fragmented local level. Horizontal cooperation is likely to be the main form of IFC in federations characterized by substantial revenue and expenditure autonomy of the constituent states vis-à-vis the national government. There is also a potentially useful role for cooperation among relevant subsets of each subnational level of government. For example, neighboring municipalities in a metropolitan area could coordinate services like public transport, roads, and water management, and minimize predatory tax or regulatory competition.

The effectiveness of IFC forums is likely to be reduced by ethnic tensions or arising from very sharp differences in natural resource endowments, levels of development, or economic structures across a national territory, or more generally by a history of perceived unfairness by the national government in the distribution of resources among SNGs. Even in such contexts,

however, it can be argued that dialogue in an institutional IFC forum can be useful in searching for win-win policy reforms. IFC forums can help identify trade-offs and compensations between winners and losers from such reforms.

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