Local Finance in Latin America

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Local Government Finance: The Challenges of the 21st Century

Second Global Report on Decentralization and Local Democracy

GOLD II
2010

United Cities and Local Governments
Cités et Gouvernements Locaux Unis
Ciudades y Gobiernos Locales Unidos

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# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>5</td>
</tr>
<tr>
<td>Editorial project</td>
<td>7</td>
</tr>
<tr>
<td>Acknowledgments</td>
<td>9</td>
</tr>
<tr>
<td>1. Introduction</td>
<td>11</td>
</tr>
<tr>
<td>2. Africa</td>
<td>23</td>
</tr>
<tr>
<td>3. Asia-Pacific</td>
<td>61</td>
</tr>
<tr>
<td>4. Eurasia</td>
<td>113</td>
</tr>
<tr>
<td>5. Europe</td>
<td>149</td>
</tr>
<tr>
<td>6. Latin America</td>
<td>189</td>
</tr>
<tr>
<td>7. Middle East and Western Asia</td>
<td>231</td>
</tr>
<tr>
<td>8. North America</td>
<td>255</td>
</tr>
<tr>
<td>9. Financing Metropolitan Areas</td>
<td>285</td>
</tr>
<tr>
<td>10. Conclusion</td>
<td>309</td>
</tr>
<tr>
<td>Annex</td>
<td>331</td>
</tr>
<tr>
<td>Bibliography</td>
<td>357</td>
</tr>
</tbody>
</table>
6. Latin America

Jorge Martínez-Vázquez
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I am thankful to Gustavo Canavire-Bacarreza and Gabriel Leonardo for very able assistance and Harold Vasquez-Ruiz and Mark Curtis for conducting additional background research. I am also thankful to Andrew Nickson, Paul Smoke, Edgardo Bilsky, Claire Frost, Eduardo Stranz, the FLACMA technical team, and many others attending the UCLG regional workshop in San Salvador in February 2010 for helpful comments on previous drafts.
Local governance and the municipality have a long history and tradition in Latin America going back to colonial times. It was only after the 1980s, and for many countries only in the last decade, that genuine decentralization reform efforts have come to invigorate and enhance the role of local governments. However, despite some significant progress to date, many challenges still remain for municipalities to play a vibrant and meaningful role in the delivery of public services and to contribute to improve the daily lives of Latin American citizens.

In the last two decades the Latin American region has seen a general trend toward an increased level of fiscal decentralization. Using the measure of sub-national expenditures as percent of national expenditures, fiscal decentralization increased from an average of 13 percent in 1985 to 19 percent in 2005; using the measure of sub-national expenditures as percent of GDP decentralization increased from 5.5 percent in 2000 to 6.6 percent in 2007. However, there are significant variations in these trends across countries in the region. Overall, increased decentralization can be detected in the devolution of new responsibilities which includes the environment, the fight against poverty, and an increase in decentralized expenditures for education, health, etc. Less progress can be detected in the devolution of autonomous revenue sources.

Recent times have seen a variety of innovations in the region that have attracted interest from all corners of the world, such as ranking systems’ local performance in Brazil and Colombia, per client based transfers for health and education in Chile, or fighting poverty with direct transfers to families administered by municipalities in Brazil. A good number of countries have embarked or are considering significant reforms that that will further strengthen municipal autonomy. For instance, Bolivia has recently approved a new Constitution to allow for better representation of different ethnic groups at the sub-national level; Uruguay lately introduced a third tier of government made up of 89 new municipalities; and Costa Rica only just approved the “Ley General de Transferencia de Competencias y Recursos a los Municipios” which provides the ability to transfer 10 percent of the national budget resources to the municipalities, clearing the way for local governments to assume new competencies and improve the quality of services and infrastructure. In El Salvador the association of municipalities (COMURES) is maintaining an active dialog with central authorities to increase the funding and general stability of the general transfer system (FODES) which represents between 70-80 percent of local budgets, and was expected to reach 9 percent of the national budget in 2009 but because of the crisis it attained only 7.5 percent of the national budget.

On the other hand, there are countries in the region where some trends have moved toward some forms of recentralization. For example, in Argentina the Law of Economic Emergency of 2002 and the Budget Law of 2006 have given central authorities increased discretion to assign federal funds or unilaterally interrupt their disbursement. In the Dominican Republic there have been elements of recentralization with the Municipal Law of 2007 establishing fixed budget shares for different types of expenditures on personnel, services, public infrastructure, and so on; it is also feared that the new constitution will lead to the general transfer fund of 10 percent of the state budget established in 2003 (but never implemented). Similarly, in Peru recent

1. See United Cities and Local Governments 2008 GOLD I report.
2. The effectiveness of decentralization efforts has varied considerably across countries of the Latin America region. In the last decade, decentralization has moved at a fast pace in countries such as Colombia and Peru but it continues to be stagnant after several decades of planning and legal measures in countries such as the Dominican Republic and Haiti. Besides Brazil and all the Spanish-speaking countries of Latin America, this paper covers also Haiti, Jamaica, and Trinidad and Tobago. As shorthand, all the countries will be addressed in this paper as Latin America.
3. See, for example, Daughters and Harper (2007).
4. The focus of this report is on fiscal decentralization. Issues of political and administrative decentralization for the most part are not covered.

5. Naturally, these countries are not usually classified as "Latin" America.

6. In the technical parlance the vertical relationships between different levels of government are bifurcated (central to local and central to regional, separately) as opposed to hierarchical (central to regional to local, all linked).

7. In contrast, for example, the Brazilian Constitution defines its political system as the union of the central government, the states, and the municipalities, thus giving local governments an autonomous standing vis-à-vis the intermediate level governments.

8. Brazilian states also have some limited role in managing the municipalities.

legislation has revoked the municipalities’ prerogative to issue building licenses and rezoning of land use. The regular transfer funds allocated to municipalities have been significantly reduced from 2009 to 2011 (a decline of 22 percent in the last five years). In Colombia, the central government has recently decided to directly allocate resources for water and sanitation that until then had been assigned to municipal governments (through a fiduciary fund administrated by Central Government). Finally, in Venezuela the municipal authorities have been denouncing the continuous curtailment of competencies and resources and the increasing encroachment of the central authorities in local matters.

This report takes an in-depth look at the current state of the local public finances in the Latin America region, identifies and analyzes some of the main challenges for improving efficiency, equity and effectiveness in the delivery of public services and for promoting development and it closes by offering a set of observations concerning policy reform. Although the countries are highly diverse along a number of dimensions: federal versus unitary, size, colonial tradition, etc. This diversity is found first among the four federal countries in the region: Argentina, Brazil, Mexico and Venezuela. Among the countries with a unitary system we can identify clusters of countries with more similar institutions and current challenges, including the Andean countries (Colombia, Ecuador, Peru and Bolivia), the generally smaller countries of Central America, the Island States with non-Iberian traditions, and what we could call the southern cone exceptions (Paraguay, Uruguay and especially Chile) because of their approach to fiscal decentralization. The diversity is also found in population size (from the 196 million of Brazil to the one million of Trinidad and Tobago), in real GDP per capita (from $9,357 in Argentina in 2007 to $884 in Nicaragua and $411 in Haiti), and in other dimensions.

However, there are also many common features in the way municipalities are structured, which enables us to observe all municipal governments in the region from a common perspective. An important feature is that for those countries with more than one tier of sub-national government, the relationship between the central government and the municipalities is for the most part directly between these two levels as opposed to the central government dealing exclusively with the regional and local governments and then the latter dealing exclusively with the municipalities. In most cases, the legal status of the municipalities is clearly stated in the constitution or specialized laws, such as municipal codes. The most important exception to this rule is Argentina where the constitution gives the intermediate level government, the provinces, discretion to structure the fiscal arrangements with the municipalities. To a lesser extent the same story is repeated in Mexico. Thus, the key difference in explaining the different approaches to central-local relations is between "federal" and "unitary" nations. But even in the federal cases, the issues currently facing municipal governments are not essentially different from those being faced by the rest of the municipalities in the region. For this reason, the report will not make a point of identifying the different groups of country experiences but instead we will use a common framework for all countries,
<table>
<thead>
<tr>
<th>Country</th>
<th>Levels of gov.</th>
<th>Govt. level names</th>
<th>Intermediate Level (level 2)</th>
<th>Local Level (level 3)</th>
<th>Average Population Level 2</th>
<th>Average Population Level 3</th>
<th>Population in the largest city (of urban population)</th>
<th>Population in urban agglomerations &gt; 1 million (of total population)</th>
<th>GDP per capita (current US$)</th>
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</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>3</td>
<td>federal, provincial, municipality/department</td>
<td>24</td>
<td>2218</td>
<td>1,654,436</td>
<td>18,804</td>
<td>35</td>
<td>39</td>
<td>6645</td>
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<td>Bolivia*</td>
<td>4</td>
<td>national, department, municipality/canton</td>
<td>9</td>
<td>327</td>
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<td>29,126</td>
<td>26</td>
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<td>3</td>
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<td>27</td>
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<td>34,169</td>
<td>12</td>
<td>39</td>
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<td>Chile</td>
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<td>345</td>
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<td>48,220</td>
<td>39</td>
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<td>national, department, municipality</td>
<td>32</td>
<td>1102</td>
<td>1,386,232</td>
<td>40,253</td>
<td>23</td>
<td>35</td>
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<td>Costa Rica</td>
<td>3</td>
<td>national, canton</td>
<td>[?]</td>
<td>81</td>
<td>636,968</td>
<td>55,046</td>
<td>46</td>
<td>29</td>
<td>5891</td>
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<td>Dominican Republic**</td>
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<td>[32]</td>
<td>155</td>
<td>306,577</td>
<td>63,314</td>
<td>32</td>
<td>22</td>
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<td>40,101</td>
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<td>Haiti</td>
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<td>6,929</td>
<td>45</td>
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<td>298</td>
<td>398,553</td>
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<td>..</td>
<td>..</td>
<td>1671</td>
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<tr>
<td>Jamaica</td>
<td>2</td>
<td>national, parish</td>
<td>14</td>
<td></td>
<td>191,128</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>4802</td>
</tr>
<tr>
<td>Mexico</td>
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<td>national, state, municipality</td>
<td>32</td>
<td>2454</td>
<td>3,290,016</td>
<td>42,902</td>
<td>23</td>
<td>34</td>
<td>9715</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>3</td>
<td>national, department, municipality (+ 2 special regions)</td>
<td>[17]</td>
<td>153</td>
<td>35,003</td>
<td>3,889</td>
<td>..</td>
<td>..</td>
<td>1023</td>
</tr>
<tr>
<td>Panama</td>
<td>3</td>
<td>national, province/comarca, district</td>
<td>14</td>
<td>75</td>
<td>238,810</td>
<td>44,577</td>
<td>53</td>
<td>38</td>
<td>5828</td>
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<tr>
<td>Paraguay</td>
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<td>national, department, canton</td>
<td>17</td>
<td>231</td>
<td>360,390</td>
<td>26,989</td>
<td>51</td>
<td>30</td>
<td>1995</td>
</tr>
<tr>
<td>Peru***</td>
<td>3</td>
<td>national, region/special province, province/district</td>
<td>26</td>
<td>1834</td>
<td>1,096,480</td>
<td>15,544</td>
<td>39</td>
<td>28</td>
<td>3771</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>2</td>
<td>national, region/borough/city</td>
<td>16</td>
<td>83,013</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>16351</td>
</tr>
<tr>
<td>Uruguay****</td>
<td>2</td>
<td>national, department (municipality)</td>
<td>19</td>
<td>89</td>
<td>174,942</td>
<td>37,347</td>
<td>49</td>
<td>45</td>
<td>7297</td>
</tr>
<tr>
<td>Venezuela</td>
<td>3</td>
<td>national, state, municipality</td>
<td>24</td>
<td>335</td>
<td>1,145,125</td>
<td>82,038</td>
<td>12</td>
<td>32</td>
<td>8299</td>
</tr>
</tbody>
</table>

Note: # computed using the number of jurisdictions in level. Between brackets when the authorities are not elected.

* In Bolivia, there are departments, provinces (not elected authorities: 112), municipalities and territories of traditional peoples "territorios indigenas originarios campesinos" (incorporated in the new constitution)

** In the Dominican Republic, recent constitution reforms recognize 229 municipal districts as local governments

*** In Peru, are two kinds of municipalities: provincials and districts.

**** In Uruguay, municipalities were created in 2009 by constitutional reform.

Sources: UCLG data collection, World Bank
identifying particular country experiences as lessons of what needs to be avoided or what may be replicated.

The Structure of Local Governments

As a rule the vertical structure of government in Latin America is organized in three tiers of government (Table 6.1), with the exceptions of Bolivia that has four levels, and Jamaica and Trinidad and Tobago that have two levels9. The focus of this paper will be almost exclusively on the lowest tier of government: the municipalities. The intermediate levels (States, provinces, regions and departments) will be referred to only in issues relevant to the municipalities.

As of 2010, there were over 16,000 municipal governments in Latin America. Their number by country obviously varies with population size and territory, with Brazil counting 5,564 municipalities and at the other extreme 16 municipalities for Trinidad and Tobago. Local governments vary considerably in size in each country (Table 6.1).

Even though a significant share of the Latin American countries’ population live in the largest cities (for example, 53 percent in Panama, 49 percent in Uruguay, 40 percent in Peru, and 35 percent in Argentina), the majority of municipalities in the region remain, for the most part, small in size and of a rural nature. For example, in Peru over 200 municipalities have populations under 1,000 inhabitants, and over 50 percent of all municipalities have fewer than 5,000 inhabitants. Thus the region faces challenges at the two extremes: massive metropolises with high levels of population density, congestion and rings of urban poverty; and very small municipalities in rural areas with low density, little administrative capacity and lacking an appropriate scale for the provision of many basic public services.

In many Latin American countries the structure of local governments continues to be work in progress. In the case of Bolivia, the new 2009 Constitution declares autonomous governments at the regional, municipal, and indigenous community level, with the added facet that indigenous communities may fit in one or more municipalities or regions. The legal norms regulating this structure have not yet been enacted. The proliferation of new local governments, almost always through the fragmentation of existing ones, continues to be quite common in the region. For example in the Dominican Republic, between 1995 and 2006 the number of municipalities rose from 108 to 155.10

Local Expenditures and the Assignment of Competencies

The scope of local government expenditures: The local government share in total public expenditures and in GDP differs significantly by country but they are generally lower than those observed in other regions of the world. However, as shown in Figure 6.1, the share of the public sector in GDP as measured by total expenditures of the general government is rather high, and at levels above those of other countries in the world at similar levels of per capita income. This contrast of proportionately smaller local government sectors in otherwise larger overall public sectors may be explained first, by fewer functional expenditure responsibilities being assigned to local governments in comparison with other regions of the world, and second, by relatively lower levels of expenditure and service provisions in those expenditure

9. In the case of Bolivia, the provincial level may not be interpreted as an additional autonomous level.
10. A recent law in that country has imposed stricter requirements for new potential municipalities requiring that they have 15,000 residents and be able to generate at least 10 percent of the revenue that their previous municipality was raising.
Local Expenditure as a Percentage of GDP and General Government

As shown in Figure 6.1, there are large differences between the share of local governments in total public expenditures and the relative importance of local government expenditures in GDP. Among the most decentralized countries, as measured by the municipal share in total public expenditures are: Brazil, Ecuador, and Colombia at around 20 percent, followed by Peru and Bolivia at about 16 percent and Chile with 12.8 percent. Two large federal countries, Argentina and Mexico stand at 8.8 percent and 6.5 percent, respectively. At the low end we find unitary countries that are still highly centralized such as many Centro-American and Caribbean countries (from 7 percent in Salvador, to 1.7 percent in Panama and 0.9 percent in Jamaica and between them Dominican Republic, Honduras, Guatemala, Costa Rica).

Perhaps a more meaningful measure of local governments' role as providers of public services is the share of local expenditures in overall GDP (Figure 6.1). This variable measures the percentage of national resources channelled through local governments. From this perspective, Brazil at 8.3 percent and Bolivia at 7.3 percent, Colombia at 5.6 percent (see note 14) and Ecuador at 4.4 percent are currently the most municipally decentralized countries in the region, while Argentina, Peru, Chile and Mexico account for between 2 and 3 percent of the GDP. At the bottom stand more centralized countries: Paraguay, Honduras, El Salvador, Dominican Republic, Costa Rica, Panama, Guatemala, and Jamaica, around 1 percent of GDP.

The assignment of expenditure competencies: Several features characterize expenditure assignments in Latin American countries. First, with the exception of Argentina, all countries have explicit responsibilities actually assigned to local governments, as discussed below.

11. For Colombia, if departments as intermediate local governments are added to the municipalities, then in 2008 local expenditures represent as much as 29 percent of general government expenditure and 9.5 of GDP.

12. In Argentina, each province regulates the expenditure responsibilities of municipalities differently. The provinces, in general, tend to enumerate a set of general functions accompanied by a clause that may be used to expand local competencies. Much less frequently the provinces explicitly enumerate the functions that municipalities must fulfill or functions exclusively assigned to them.
13. There are some qualified exceptions to the rule. For example, in the case of Colombia there is no special law assigning expenditure responsibilities at different levels of government, but there are several laws (60 of 1993 and 715 of 2001) that specify certain norms regarding the assignment of competencies.

14. A clear exception to this rule is Chile, where municipalities are circumscribed to a closed list of functions.

15. In El Salvador basic education and primary health are assigned to the local level, but actual service delivery works through special local mechanisms administrated jointly by the State, the communities and the private sector.

16. On the whole these experiences appear to have been positive (Bolivia, Brazil, Mexico and Peru). In the case of Mexico some programs have been critiqued because of partisan interference by central authorities in the deployment of funds.

17. Of significant importance is that just a handful of countries allow for the taxation of both urban and rural property. Those countries allowing only the taxation of urban property leave rural municipalities in a disadvantage. Note that the property tax is still assigned to the El Salvador's central government and that there appears to be no property tax in the Dominican Republic, only a property transfer tax.

18. A good example is the "patente municipal" in Chile which is paid annually at rate based on the declared own capital assets. This tax is further discussed in the next section.

19. In the cases of Brazil's ISS (tax on services) and Colombia's ICA (tax on trade and industry), munidpal collections exceed those from the property tax (IBI, impuesto sobre bienes inmuebles). The two countries' experiences with these taxes are also further discussed in the next section.

Third, in some countries (for example, Bolivia and Chile) the central governments, while retaining the obligation of financing social welfare services (such as social security, unemployment compensation, and welfare payments), have delegated the implementation and management of several social programs (e.g., family welfare services) to local governments in order to exploit the advantage of proximity and better information local governments have. Municipal governments in many Latin American countries play a large role in the public investment of infrastructure at the sub-national level often as equal partners with upper level governments in patterns similar to those observed in European countries. For example, in Brazil local governments in recent years have undertaken close to 45 percent of all public sector investments.

Finally, many countries in Latin America have concurrent or shared expenditure responsibilities, which generally results in less clarity and potentially more conflict than exclusive assignments.

Revenue Assignments

Practically all countries of Latin America assign certain taxes to local governments; some exceptions are Jamaica, and Trinidad and Tobago. As shown in Table 6.2, the most commonly assigned type is the property tax, although it varies in name and scope across countries. Other local taxes include betterment levies, car registration and car permits, real estate and land transfers, different forms of business licenses, taxes on gambling, and in some form of sales tax or business tax. Practically all local governments are allowed to charge fees for particular public services such as building licenses, refuse collection, public utilities, slaughter houses, and public markets.

Revenue assignments are formalized in different ways, usually in the general tax laws or in special municipal laws. The exceptions are Brazil, where it is established in its national constitution, and Argentina and Mexico, where the constitution delegates to the provinces or states the authority to determine local revenue assignments. This arrangement results in
### Table 6.2: Assignment of Taxes and Fees to Local Governments in Latin America

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of Tax</th>
<th>Type of Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>urban/rural property (and its increased value because of public investment)</td>
<td>car registration, turnover tax</td>
</tr>
<tr>
<td>Bolivia</td>
<td>urban/rural property</td>
<td>car registration, car/property transfers, slaughterhouse, construction</td>
</tr>
<tr>
<td>Brazil</td>
<td>urban property (including increased value due to infrastructure improvement)</td>
<td>tax on service sector (ISS), registered goods tax, real estate transaction tax</td>
</tr>
<tr>
<td>Chile</td>
<td>urban property</td>
<td>car registration, alcohol</td>
</tr>
<tr>
<td>Colombia</td>
<td>urban property (and its increased value because of public investment)</td>
<td>surtax on gasoline, tax on industry/commerce, mineral extraction, slaughterhouse, gambling</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>urban property</td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>urban/rural (and its increased value because of public infrastructure investment)</td>
<td>car tags, permits (business, construction),</td>
</tr>
<tr>
<td>El Salvador</td>
<td></td>
<td>Specific taxes for each municipality based on congress approval such as business taxes on industrial, trade, and financial activities</td>
</tr>
<tr>
<td>Guatemala</td>
<td>urban property</td>
<td>tax on wages, advertising (banners), extraction of products/economic activity, alcohol</td>
</tr>
<tr>
<td>Honduras</td>
<td>urban/rural property (and its increased value because of public investment)</td>
<td>tax on turnover of industry and trade, extraction of natural resources (fishing, minerals, oil), slaughterhouses</td>
</tr>
<tr>
<td>Jamaica</td>
<td></td>
<td>Parochial revenue fund</td>
</tr>
<tr>
<td>Mexico</td>
<td>Urban property</td>
<td>Car registration (all other taxes are centralized)</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>Urban/Rural property</td>
<td>Sales tax (recently eliminated); patents and business licenses</td>
</tr>
<tr>
<td>Panama</td>
<td>tax on unused land (urban/rural)</td>
<td>tax on alcohol, economic activity and vehicles</td>
</tr>
<tr>
<td>Paraguay</td>
<td>urban property (and its increased value because of public investment)</td>
<td>car registration, games/gambling, wealth tax (corporate), land transfers/subdivision</td>
</tr>
</tbody>
</table>
a variety of de facto assignments in those two countries.20

The level of autonomy granted to local governments also varies. As summarized in Table 6.3, most countries use a “closed list” approach and do not allow the introduction of new taxes to local governments; some exceptions include Ecuador and Uruguay.21 On the other hand, about two-thirds of the countries in the region allow local governments the ability to set the rates of some taxes; this practice is widely accepted as the most desirable form of tax autonomy that can be granted to local governments. It is interesting that countries such as Bolivia and Peru, where decentralization reforms have advanced rapidly in recent years, still grant no discretion to set tax rates. A reduced number of countries in the region grant local discretion to modify tax base. Most countries in the region allow local government discretion in fixing the levels of fees and user charges for local government services. Nevertheless, an important restriction on the revenue autonomy of local governments is the practice by several countries to require local government revenue budgets (“plan de arbitrios”) to be previously approved by a higher tier of government prior to the start of the fiscal year. Table 6.3 shows this is still practiced in Costa Rica, Nicaragua, Panama, and Paraguay; in Mexico approval comes at the intermediate level from state governments. In terms of fiscal administration (Table 6.3), the general rule is local government is responsible for the administration of local taxes, fees and charges, although in some cases, tax administration responsibility is shared with the central authorities.22

In most countries in the region, the yield from property tax remains far below its potential (Figure 6.2). While on average property taxes raise revenues representing 2.12 percent of GDP in OECD countries, 0.68 percent in transition countries, and 0.60 percent in developing countries, the average yield in Latin America is only 0.37 percent of GDP. The reasons for low performance are multiple, including low political will from national governments, local governments,
<table>
<thead>
<tr>
<th>Country</th>
<th>Ability to introduce new taxes</th>
<th>Ability to set tax rates within legal limits</th>
<th>Ability to change tax base</th>
<th>Control or veto over local govt. budgets by Central/Regional govt.</th>
<th>Country Ability to introduce new taxes</th>
<th>Ability to set tax rates within legal limits</th>
<th>Ability to change tax base</th>
<th>Control or veto over local govt. budgets by Central/Regional govt.</th>
<th>Responsibility for the collection of Fees</th>
<th>Taxes</th>
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<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>L</td>
<td>L</td>
</tr>
</tbody>
</table>

Note*: Costa Rica collects, in some municipalities, through the private sector.

L = local, C = central, R = regional, PS = private sector
Parliament and the disincentive effects of revenue sharing and inter-governmental fiscal transfers (IGFTs), not to mention outdated and poorly equipped tax administrations. These factors translate into generous exemptions and low tax rates, obsolete and infrequent property value assessments, incomplete registries and cadastres and a lack of willingness and means to enforce collections. This lacklustre performance varies little with the different arrangements in the region for discretion on rate setting or administering property tax. 23

Generally, the range of locally raised revenues from own taxes and fees represent a relatively small share of total consolidated revenues in the public sector, although in terms of local budget shares, these revenues are relatively large. 24 Of course there is a large variation in execution from country to country. Figure 6.3 shows that as percent of national GDP, local governments in Brazil raise 8.2 percent, Bolivia 7.7 percent, Colombia 5.2 percent, Ecuador and Peru stay at 3.8 - 3.7 percent followed by Guatemala and Chile 2.8 - 2.7 percent and then Argentina and Mexico 2.5

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23. For a discussion of the issues, see Sepulveda and Martinez-Vazquez (2009) and De Cesare and Lazo Marin (2008).

24. These two effects are compatible if we recall our discussion in the previous section that local government budgets represent a relatively small share of the general government budget.
### Table 6.4: Shares of Local Own Revenues (in percentages)

<table>
<thead>
<tr>
<th>Country (Most recent year)</th>
<th>Own taxes and fees as % of local revenues</th>
<th>Local own taxes and fees as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina (2006)</td>
<td>49.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Bolivia (2008)</td>
<td>11.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Brazil (2007)</td>
<td>20.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Chile (2007)</td>
<td>63.0</td>
<td>0.7</td>
</tr>
<tr>
<td>Colombia (2006)</td>
<td>41.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Dominican Republic (2006)</td>
<td>58.4</td>
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<tr>
<td>Ecuador (2007)</td>
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<td>1.6</td>
</tr>
<tr>
<td>El Salvador (2007)</td>
<td>13.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Haiti (2004)</td>
<td>25.0</td>
<td>0.5</td>
</tr>
<tr>
<td>Honduras (2004)</td>
<td>11.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Jamaica (2008)</td>
<td>100.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Mexico (2007)</td>
<td>15.6</td>
<td>2.4</td>
</tr>
<tr>
<td>Nicaragua (2002)</td>
<td>44.0</td>
<td>0.6</td>
</tr>
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<td>Panama (2005)</td>
<td>49.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Paraguay (2006)</td>
<td>34.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Peru (2008)</td>
<td>43.2</td>
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</tr>
<tr>
<td>Trinidad and Tobago (1995)</td>
<td>52.9</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Sources: UCLG data collection.

- 2.1 respectively. At the lower end stand El Salvador, Paraguay, Costa Rica, Honduras, and Jamaica (less than 2 percent).  

However, on average, municipalities raise a higher percentage of their budgets from their own revenues similar to Africa, Asia and a good portion of European countries. As shown in Table 6.4, the percentage of local budgets financed out of their own taxes and fees is quite high, at or above 25 percent for many countries. However, in Bolivia, Brazil, El Salvador, Honduras, and Mexico the share is much lower in relation to the other countries in the region.

### Intergovernmental Transfers

As a result of limited fiscal autonomy, practically all local governments suffer from vertical imbalances, i.e. the expenditure needs arising from their functional competences exceed their ability to self finance. Although the existence of vertical imbalance is not in dispute, their actual measure is generally a polemical issue because practically no country in the region has introduced explicit methodologies to measure the expenditure needs of local governments in a transparent and objective manner. In order to address the exis-

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25. See Annex 6.2 for the breakdown of revenues collected by each tier of government.

26. See Annex 6.3 in the Appendix for the breakdown of sources for revenues of local governments.
ting vertical imbalances, practically all countries in the region should implement a range of fiscal transfers, often consisting of different forms of revenue sharing, an array of specific or conditional grants, and in some cases, equalization grants.

In addition to vertical imbalances, in practically all countries in the region there are also significant horizontal imbalances between local governments. These imbalances are the result of the different tax capacities and economic development of local governments, and the different expenditure needs arising from disparities in the service delivery costs and the differing resident populations’ needs arising from their diverse characteristics. Horizontal imbalances are most pronounced between urban and rural municipalities and between smaller and larger urban centers. As we see later, different approaches are used in the region to address these horizontal imbalances.

The emphasis throughout the region has been to address the problem of vertical imbalances through different forms of revenue sharing via central government tax collections. There has been less emphasis on the design of explicit equalization grants, although, quite often, revenue sharing formulas contain equalization features. Conditional grants are less common in Latin America than in other regions of the world, but here again there are important exceptions.

Most countries in the region use some form of general revenue sharing. The pool of funds to be shared is most frequently defined by total central government revenues, although in some cases particular taxes are excluded from the pool. This is the case for Bolivia, Colombia, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. In other cases, the pool is based on specific central government taxes; for example, 20 percent of oil production fees derived by the Mexican states must be passed on to their municipalities; Nicaragua’s additional tax sharing with municipalities is based on revenues from natural resources; and in Peru, some of the tax sharing is from portions of the sales tax, and proceeds from gas and oil extractions (canon, sobrecanon, and canon petrolero). In the latter, actual shared revenues are subject to considerable market fluctuations, for example, international price levels for natural resources.

In some cases, shared revenues are distributed on a derivation (i.e. origin) basis, for example, the canon, sobrecanon, and canon petrolero in Peru. This approach (sharing revenues from natural resources on a derivation basis) has become a significant factor for regional horizontal fiscal imbalances. Most often some sort of formula is used for the distribution of resources that includes several variables, some of which, as noted above, may have equalizing features. For example, in Bolivia revenue sharing is based solely on population; in Ecuador it is according to population and relative poverty levels; in El Salvador it is according to population, “equity” (a fixed amount for each municipality), poverty, and land surface area; in Guatemala it is distributed according to a formula that includes equal shares (fixed amounts), population, number of settlements, and per capita income; in Honduras it is according to population and equal amounts for all municipalities; in Nicaragua it is according to population and several other criteria; and in Peru it is according to population and infant mortality rates. Frequently, the formulas are also employed by central governments.

27. In some cases, like in Paraguay, the allocation of funds is still ad-hoc at the discretion of the central authorities.
to pursue several objectives other than equalization. For example, in Ecuador the sharing formula includes elements for rewarding administrative effort and achieving goals in the national development plan, while in Nicaragua the formula provides incentives for increasing revenues from property tax and for achieving more effective budget execution.

Some countries allow unconditional use of shared revenue, including Bolivia, Ecuador, El Salvador, and Honduras. In other cases the use of funds is conditional; Colombia uses revenue sharing funds earmarked for basic education, health, and water and sewerage; Guatemala, for education, health and infrastructure; while in Nicaragua and Paraguay, a share of the funds—80 percent in the latter case—must be spent on infrastructure investment.

Revenue sharing practices in the federal countries also have different features. In Argentina, tax sharing with local governments is carried out exclusively by the provincial governments, which can decide how to distribute their share of federal VAT and income taxes. The Brazilian states also have a tax sharing system funded with 25 percent of their regional VAT revenues, which distributed 75 percent on a derivation basis according to value added in the municipalities, and 25 percent by a formula based on population, land area, and other variables. This same formula is used to distribute federal tax sharing with the states (cooperation funds) to the municipalities. In Mexico, the states are required to distribute to their municipalities at least 20 percent of the income that they receive from revenue sharing in the federal funds (Fondo de Fiscalización and Fondo General...
Conditional or specific transfers are less extensively used in Latin American than in other regions of the world, nevertheless their use is increasing, especially in those countries where central governments count on being associated with local governments as partners for the delivery of certain services and the implementation of national programs. For example, Bolivia has introduced a conditional health transfer for a national program in support of infants and mothers (seguro materno infantil). In Brazil, several conditional grants have been introduced for public transport (funded by the sharing of federal fuel levies), basic education, and health services, including hospitals from the national health system. In Chile several highly conditional grants have for many years funded local governments’ activities in education, health, and other social programs. Some conditional grants are earmarked for certain geographical areas that are deemed to be lagging behind. For example, in Ecuador there is a conditional capital investment grant for the Amazon region.

A particular subgroup of conditional grants is earmarked for investment in local infrastructure. For example, El Salvador offers grants for municipal capital infrastructure based on the presentation of project proposals. In Guatemala one-eighth of VAT revenues go to infrastructure in social and basic services, while a share of vehicle taxes is earmarked for maintenance of roads and drainage. In Mexico, at least 20 percent of the investment grants (Fondo de Compensación) from the federal government must be assigned to the poorest ten states in the country and used by the municipalities of those states.

The practice of explicitly addressing horizontal disparities among local governments through equalization transfers is still not common but it is taking hold in the region. One reason for the slow introduction of explicit equalization grants is that often revenue sharing schemes do incorporate some equalization elements in their allocation formulas. Several examples of existing equalization grants (above and beyond revenue sharing schemes with some equalizing elements in their formulas) are worth mentioning. One is Bolivia’s HIPC (Heavily Indebted Poor Countries Initiative) transfers started in 1997 with funds from international organizations (the World Bank and the IMF) that is distributed by the central government to local governments using a formula based on the poverty level and population of municipalities. In Brazil, there is a federal equalization transfer to the municipalities funded with a share of federal VAT and income tax revenues; the fund is split into two parts, with 10 percent going to state capital municipalities (distributed according to population and the inverse of per capita income) and the other 90 percent to the rest of the municipalities (distributed according to an index that favours municipalities with smaller populations). An interesting approach is that of Chile, where the formula driven equalization grant (the Common Municipal Fund) is funded by the municipalities’ own revenues from different sources in what is known in the technical parlance as a “fraternal” (or Robin Hood) system, in which the relatively richer municipalities finance the transferred amounts to the poorer municipalities. The allocation formula includes population size, poverty levels, exempted real estate property, and past revenue collections. One key positive feature in all these examples is the recognition of the need to introduce a
Table 6.5: Authority to Borrow by Local Governments in Latin America

<table>
<thead>
<tr>
<th>Country</th>
<th>Access to Financial Markets</th>
<th>Municipal Bank</th>
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<tr>
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<tr>
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</tr>
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</table>

Source: UCLG data collection.

Local borrowing can be considered a legitimate, efficient, and equitable source for financing this local infrastructure. However, it is also widely accepted that the local borrowing process must be subject to explicit rules and limitations in order to ensure fiscally responsible behavior by local officials and to guarantee macroeconomic stability in the country. Commonly applied rules include those about expected behavior, such as the "golden rule" that long-term borrowed funds must be used for capital infrastructure only, and not for recurrent

30. The use of a fraternal system to fund the equalization transfers in Chile is a promising innovation. This is a common system to a number of European countries but it is uncertain how easily it will be adopted by other countries in the region.

31. For the available methodologies used in other regions of the world see, for example, Martinez-Vazquez and Searle (2007).

32. Historically this wasn’t always widely accepted in some countries in the region, which in past decades saw an accumulation of macroeconomic difficulties associated with unfettered sub-national borrowing in some of the federations and politicized government-run municipal development banks.
expenditures, and different quantitative budgetary limits on borrowing. Among the latter, there are rules on non-negative current budget balances, limits on the level of total debt and debt-service payments as a percent of budget revenues, as well as restrictions on borrowing abroad.

For a variety of reasons, ranging from fiscal conservatism to negative past experience, not all countries in the world allow their local governments to borrow. Yet in the case of Latin America, as shown in Table 6.5, most countries do allow local governments to borrow. Practically all countries allow such borrowing even though they impose rules and limitations on local borrowing similar to the above-mentioned international “good practice” guidelines. In most cases, foreign borrowing is not allowed, in some cases it is allowed with permission of the higher authorities, and in other cases even domestic borrowing requires administrative approval by higher level authorities. Over time, national systems have adapted to idiosyncrasies. For example, in Nicaragua, municipalities are able to contract short or medium term loans from public and private banks for public works, with long-term loans for large-scale public works approved by the National Assembly. Loans must be repaid within the term of the elected officials; mayors and municipal councils may not leave debts to their successors, except for long-term loans approved by the National Assembly. In Colombia, law 358 from 1997 introduced a system of “semáforos” (traffic light) restricting the level of local debt according to the ability to pay by the local units; if interest payments are below 40 percent of the operational surplus and if the debt level is under 80 percent of current revenues, local governments are free to borrow according to the law; however, they require permission from the Ministry of Finance if any of those limits is exceeded. With law 819, which came into effect in 2003, the need to have a primary surplus sufficient to cover on going debt service was added to the existing indicators. The three indicators must be positive in every year of the loan, and this must be reflected in the medium term fiscal framework of the municipality or department. In El Salvador, municipalities can borrow from commercial banks once they receive the proper quality ranking from the Ministry of Finance and the semi-official organization charged with the physical distribution of the general transfer funds. The municipalities then establish an intercept agreement for those transfers to work as collateral for the loans from the commercial banks. As in other countries around the world, it is common to impose limits on annual debt service as percent of revenues (for example 20 percent in Argentina and Bolivia or 40 percent in Ecuador) and/or the total stock of debt as percent of total revenues (120 percent in Brazil or under 100 percent in Ecuador and Peru).

The actual amount of sub-national debt, which includes local and provincial/state debt, is quite low in most countries, with the exception of Brazil and Argentina, where sub-national debt represents in recent times between 10 and 15 percent of GDP; Mexico, Colombia and Bolivia come behind with sub-national government debt representing less than 2 percent of GDP as of 2007. However, for municipal governments alone in recent years, Bolivia is first in debt service (interest and repayment of principal) at around 9 percent of total municipal expenditures, followed by Ecuador at around 8 percent, and Argentinean and Brazilian municipalities, where debt service stands at around 4 percent.

33. The exceptions include Chile, Dominican Republic, El Salvador, Ecuador, Jamaica and Trinidad and Tobago.
34. For example, foreign borrowing by the municipalities in Argentina requires administrative approval at the provincial level and by the Ministry of Economy at the national level, which it has been argued has been subject to political criteria beyond technical aspects.
Budgeting

The budgeting process at the local level in most Latin American countries is still carried out along traditional lines with heavy emphasis on incremental budgeting and ex-ante financial audit controls for the disbursement of funds. Much less attention is given to the planning of expenditure programs and ex-post evaluation of the effectiveness of funds disbursed on programmatic goals. One positive aspect without exception is, local budgets need to be approved by democratically elected local councils. However, as we have seen above, in a significant number of countries (Bolivia, Costa Rica, Jamaica, Mexico, Nicaragua, Panama, Paraguay) at least some components of the local budgets need to be approved ex-ante by higher level authorities at the central or regional levels. It is questionable whether or not these approvals are really needed; the best practice internationally is to rely on horizontal accountability mechanisms ex-ante, and on the ex-post audit and to grant full budgetary autonomy to local governments.

"Participatory budgeting" is an area of innovation in the region that has attracted much international attention. The specific meaning of this term varies among countries introducing this type of reform, but generally means additional mechanisms for citizens to influence local budgetary decisions beyond the conventional vehicle of democratic elections for municipal councilors. For example, in Bolivia a 1994 law established citizen committees (comités de vigilancia) and community-based organizations (OTBs—organizaciones de base), that are social organizations of peasant communities, the indigenous population, and neighborhood groups. Citizen participation at the local level is also important in Brazil, but varies considerably across states and municipalities.

One experiment involves groups of citizens empowered to address social and political inequalities by influencing the allocation of budget resources through neighbourhood meetings. Even some provinces in Argentina, have formally adopted participatory budgeting. On the other hand, participatory budgeting is generally appropriate for only certain elements of the budget; thus, even in Porto Alegre (Brazil) the share of the budget subject to this process is limited (see Box 6.6). Nevertheless, the implementation of participative budgeting often depends on the will of the Mayor and the City Council since it is not a compulsory or permanent tool.

As for the composition of municipal budgets, our discussion is based on a small number of countries where data availability varies. In terms of the economic classification of local expenditures, the high share of capital infrastructure expenditures in the municipal budgets of a significant number of countries is notable (Figure 6.5). For example, in both Chile and Ecuador, local governments spend 55 percent of their budgets on capital expenditures; in Guatemala this figure is 64 percent and in Peru, 58 percent. Of course, there are large variations for these figures across countries, including the assignment of expenditure responsibilities—what tier of government is responsible for capital infrastructure in the different areas of responsibility: schools, roads, etc—and the legal restrictions imposed on local governments for how to spend revenue sharing and other types of funds—as in Peru, where local governments only can spend funds from the canon and sobrecanon from natural resources on capital investments. There is also the possibility that capital expenditures are over reported. Whatever the explanation, it is clear that many local

36. The strong emphasis on ex-ante treasury controls has not, on the other hand, reduced corruption, which, with some exceptions, still appears to be extensive among local governments (and the rest of the public sector) in the region. The difficulties lie more in poor execution of the ex-ante controls than in a deficient design.

37. In some cases controls for checking the legality of actions, as opposed to changing budget allocation decisions, can be justified when horizontal accountability and audit mechanisms are deficient or not present at all.

38. Somewhat related, citizen participation mechanisms such as referendums, "popular initiatives," and elected representative recalls have been operating in other regions of the world.


40. For a positive assessment in the case of Bolivia, see Faguet (2004). See also Goldfrank (2006) and Shah (2007) for general assessments.

41. There are incentives in many countries in the region to report some current expenditure as capital expenditure. For example, in some cases central legislation restricts the share of budgets that can go to recurrent purposes. In other cases, practically all kinds of current expenditures have been demonized as being inefficient so local authorities actually report some current expenditure as actually being some form of capital expenditure. But, fortunately there does not appear to be a problem in Latin America with the off-budget programs and expenditures that are common in other regions of the world, for example Africa and Asia.
governments in Latin America have been given an important role to play in the task of providing much needed infrastructure. This highlights the importance of finding more stable and potent instruments for infrastructure finance.

As we have seen, the movement toward open and participatory budgeting is spreading, increasing budget efficiency and accountability in general. Although participatory budgeting is not directly about decentralization itself, the movement toward participatory budgeting has tended to reinforce decentralized institutions. There are, however, exceptions; for example, in the Dominican Republic, Law 176 of 2007 goes a long way to introduce participatory budgeting but the actual level of decentralization to local governments in that country remains quite weak.

Even less data are available to obtain a panoramic view of the functional classification of local budgets in the region; for countries where individual municipalities’ data are available, comparisons are hard because of the different classification methods used in each country. As shown in Figure 6.6, education expenditures, deriving from the assignment of expenditure competencies, are important items in the local budgets of Bolivia, Brazil, Chile and Colombia. For the same reason, expenditures on health services are relatively important in the local budgets of Brazil, Colombia, and Peru, with budget shares here ranging between 16 and 22 percent. It is noteworthy that in most of these countries for which disaggregated data are available, not surprisingly “general administration” is the most important expenditure item in terms of budget shares.
Special Issues, Constraints and Opportunities for Local and Intergovernmental Finance in the Region

As shown in the introductory section, the Latin American region offers a vast array of different experiences and approaches to local finance. The kinds of issues facing local governments in large federal countries such as Argentina, Brazil, and Mexico are often very different from those affecting local governments in small countries such as El Salvador, Nicaragua, or Paraguay. Furthermore, there is also significant diversity among the large federal countries as well as among the unitary countries. Hence, the attempt to generalize analysis of local problems and their solutions is neither always possible nor desirable. Nevertheless, some themes common to a significant number of countries in the region clearly emerge from the description of the local finance system presented in Section 1. In this section we identify some of the special issues, constraints and opportunities for the development of local finance in Latin America. It is organized around four major themes: (a) Organizational Structure; (b) Intergovernmental Fiscal System Design; (c) Budget Process and Transparency; and (d) Short Term and Long Term Structural Challenges.

Issues on Organizational Structure

Fragmentation and sub-optimal scale

In many countries there is an ongoing debate on the number and size of local governments related to the issues of economies of scales to deliver public services, which typically improve with size, and citizen representation, which generally deteriorates with size. Citizens that feel marginalized frequently call for the

Source: UCLG data collection (cf. Annex 6.5)
creation of new municipalities. As the current legal frameworks guarantee a minimum amount of funds to each municipality regardless of size, this has promoted the creation of new municipalities. In response to this problem some countries have introduced legislation requiring minimum population size in order to ensure the future fiscal viability of any new local government. This action can be effective in slowing down the process of further fragmentation but it does not help to address the inadequate scale of the already existing municipalities.

Perhaps a more attractive and potentially equally effective approach is the promotion and creation of associations of municipalities into mancomunidades for the delivery of certain public services requiring certain minimum scale. This is an approach still largely unexploited but it is currently being developed in some countries, especially in some provinces of Argentina, southern Brazil, Ecuador, and Peru.

The trade-off between economies of scale and representation

The issue of an optimal scale of local governments presents an inherent tradeoff between the (potential) better political connection in terms of representation and accountability of smaller jurisdictions with the (potential) greater fiscal viability of larger jurisdictions (in particular with regard to population size).

The essence of this trade-off between the greater efficiency of smaller governments that can better match the preferences and needs of local residents in their expenditure allocation and economies of scale in production with lower costs associated with larger governments implies a compromise solution between the two objectives. In particular, it implies that lower cost effectiveness in the delivery of public services may be offset by greater efficiency in responding to the needs and preferences of local residents.

Local administrative capacity

The problem with local governments’ administrative capacity is closely associated with their small size (in number of inhabitants). Central governments (or state or provincial governments in the case of federal countries) spend little time and resources in developing the capacity of local governments. Some of the slack has been taken up by local government associations, which, for example in some of the Andean countries and in Central America, provide their members with assistance and training. However, these associations often lack the resources necessary to address this issue. Central (or provincial–state) governments can do much more.

To summarize, there are no exact answers or methodologies to address the issue of optimal size for municipalities. Several goals need to be pursued including cost efficiency and representation and accountability and several constraints need to be met regarding fiscal viability and administrative capacity. See Box 6.1.

Issues on Intergovernmental Fiscal System Design

Lack of clarity in the assignment of expenditure responsibilities to local governments

One of the weakest points of many decentralization programs in Latin America has been the scant attention given to clear assignment of expenditure responsibilities of sub-national governments, which is a crucial first step in the design of any system of intergovernmental fiscal relations. Instead, the focus has been

43. For example, in El Salvador, the Fund for Economic and Social Development (FODES), which is the main source of local revenues, is distributed according to a formula that distributes 25 percent of the funds evenly to all municipalities.

44. However, these programs can be difficult to implement, for example, in El Salvador, the National Plan for Territorial Development and Organization (PNODT) was supposed to address the communes and general cooperation among local governments. This plan would allow them to lower administrative costs by working together to print jointly needed forms and gathering regularly to share ideas. However, the results are very limited.

45. Other approaches to dealing with the problem of inadequate scale include the contracting out to private companies of some services, so that private companies can benefit from sufficient scale by supplying different municipalities, or the creation of sector specific service governments or districts. The privatization of services is being used in several Latin American countries. See Martinez-Vazquez and Gomez (2008) for a discussion of the issues and solutions.

46. See Martinez-Vazquez and Gomez (2008) and Iman Chahbar-Farivar and Martinez-Vazquez (2009) for a more extensive discussion of this issue.

47. The Latin America region shows a lower prevalence for Ministries of Local Government/Interior/Home Affairs that are more prevalent in other regions of the world and have a higher presence of special agencies designed to exclusively address the needs of local governments, such as ISEDY y FISDL in El Salvador or INFOM in Nicaragua. In general, it is easier for these types of specialized agencies to play a supporting and capacity development role than it is for sectoral ministries; the downside is that the specialized agencies tend to put a lower rank within the government administrations in the bargain for additional resources.
Box 6.1. Four Possible Criteria to Consider for the Minimum Size of Municipalities

Although the desirable minimum size of municipalities is a complex issue that must be addressed in the historical and political contexts of each country, there are four basic criteria that can be followed as guideline for policy decisions:

(1) **The production/cost efficiency/population criterion.** The international experience shows that unit costs for some public services (such as water or public transportation) can be much affected by scale. Depending on the assignment of expenditure responsibilities, in order to arrive at the lowest cost of production it is required to reach a minimum size in terms of population. Yet we must note that there are other ways to provide services in a cost efficient manner, including buying the services from a larger local government, creating an association between several smaller local governments to produce the service, or even buying the services from a large privatized producer. What this means is that this criterion of a minimum population size should be administered intelligently with flexibility to allow for these other service delivery possibilities.

(2) **The representation/political responsiveness/accountability criterion.** The general presumption is that smaller local governments will generally tend to be more representative and accountable to the residing population. But consideration must also be given to the fractionalization of the population and adequate representation of the minority groups’ interest. Population density should also be considered. From an accountability and representative focus it would seem that a simple but useful rule of thumb will be the time required to travel to the location of the municipality building.

(3) **The financial/fiscal capacity criterion.** It seems reasonable to require that any new local government have a minimum level of economic capacity to self finance some of its service needs. Measuring this capacity is not always an easy matter, but it should involve some approximation to the “expenditure needs” and the “fiscal capacity” of each potential municipality and the setting of some threshold for the difference between needs and capacity.

(4) **The administrative capacity criterion.** This can be measured in a number of different ways, but fundamentally qualified personnel available to run the business of the local government efficiently is required.

almost exclusively on putting in place some form of financing scheme. At present, there continues to be too much emphasis in many countries of the region on the decentralization processes simply understood “as the provision of some of revenue sharing and transfers” to local governments, ignoring the fundamental rule that “finance should follow function.” On closer analysis, the assignment of functional responsibilities remains in many cases too general and vague. For example in El Salvador, the municipal code gives authority to municipalities to perform a list of responsibilities that clearly overlap with those also assigned to central government; the same is true in Uruguay. In other cases, the vagueness lies in the
way that legislation is implemented (or not implemented). For example, Law 66 of 1997 in the Dominican Republic added primary and secondary education to the responsibilities of local governments; yet real power and decision-making remain with the regional Education and Culture committees, which may be considered a deconcentrated tier of the central government. 49

Beyond the operational inefficiencies associated with the unclear assignments of functions, an important consequence is the ambiguity in political accountability this situation introduces. The governance implications for attaining the purported benefits of decentralization are quite considerable.

Another problem is that the assignment of expenditure responsibilities in practically all Latin American countries is uniform for all local governments, regardless of their size and administrative capacity. As aforementioned, a good way to address these shortcomings is the creation of associations of local governments into mancomunidades. Alternatively, there may be room for asymmetric assignments for municipalities of different size and administrative capacity.

Nevertheless, the highly asymmetric assignment of expenditure responsibilities can lead to confusion. For example, in Ecuador, the Constitution (Article 226) establishes the obligation of central government to transfer functional competencies at the discretion (by voluntary request) of sub-national governments. This means that any sub-national government can request a full or partial competence in a particular area at their discretion, leading to great heterogeneity in central-local relations, thereby compromising the overall effectiveness of inter-governmental coordination. A better practice could be to design two or at most three different packages of expenditure responsibilities that can be devolved to local governments depending on their administrative capacity. However, an important issue with asymmetric approaches is the need for using verifiable criteria, that is, differential assignments must be grounded in something other than political connections.

Another factor contributing to confusion in the assignment of expenditure responsibilities is the common practice of unfunded mandates. Frequently, line ministries may partially decentralize certain competencies to local governments without providing the required resources to implement them properly. There may also be increased reporting requirements on local governments without adequate coordination among central government agencies or the provision of the technical and financial means to make that reporting possible.

A workable system of expenditure assignments, no matter how specific, is developed in the laws and regulations, which always requires coordination and effective dialog between the different levels of governments. Because of the larger number of municipalities, it is important that the voice of these local governments be represented by associations of municipalities. On this front there has been considerable progress since practically all countries in the region have developed effective municipal associations. 50 However, central authorities have not always recognized these associations as strategic partners in improving policy design in expenditure assignments and the strengthening of other components of the fiscal decentralization systems.

49. Although the trend in the region has been toward more devolution of responsibilities to local governments, there are exceptions. For example, Jamaica has been recentralizing functions previously assigned to the local governments (Parish Councils) through the creation of national entities under the tutelage of the Ministry of Local Government, which is in charge of fire protection services, parks and markets.

50. See, for example, the discussion in Porto (2009).
One final issue in the practice of expenditure assignments is the practically universal lack of effective and transparent methodologies to translate the assignment of functional responsibilities into expenditure needs. Sometimes, historical costs (or levels of expenditures prior to decentralization) are used as a guide. Different methodologies are used in other countries around the world, such as the use per-client spending norms or bottom-up cost estimates that could be successfully implemented in the region. The advantage of having some effective method to calculate expenditure needs is that the discussions on and ultimate design of revenue assignments, whether through own revenue or fiscal transfers, becomes more informed and rational.

Insufficient revenue autonomy

The level of tax revenue autonomy of local governments differs quite significantly across Latin American countries. Countries such as Brazil and Chile have relatively high autonomy and countries such as El Salvador, Mexico and Peru have significantly less. But, in general, as it occurs in some other regions of the world (Africa, Asia and many European countries), local revenue autonomy in Latin America remains below what is desirable.

The lion's share of financing for local governments in the region continues to come from different forms of central government transfers including revenue sharing. Transfers have experienced an increase as the most often used form of newly devolved financing responsibility for local governments. With this in mind, some important and correct policies have been adopted for various countries in the region. For example, many countries in Latin America have taken steps to increase their share of own taxes in local budgets. Most have now assigned the property tax to the local level, which is excellent because there are many features that make it an ideal tax. Unfortunately, the property tax remains highly underutilized for a variety of reasons. Several other taxes have been assigned to local governments, including vehicle tax, betterment levies, and different forms of business taxes and licenses. These positive measures should be imitated by countries that still allow little local tax autonomy. Another practice to emulate is the allowance of a certain degree of discretion for municipalities to set the rates of their local taxes, between some maximum and minimum approved levels.

Nevertheless, it is difficult to make a strong case for policy design that allows for a greater degree of tax autonomy when there is a perception that many local governments in the region do not make effective use of the tax autonomy law granted to them. This is most clear in the case of the property tax for which actual revenues collected are a small fraction of the revenue potential. So the realization of more revenue autonomy for local governments may need to be accompanied by a significant improvement in local tax effort. However, it is important to note that low tax effort (known in the region as "pereza fiscal") is a complex problem. First, there is often confusion between low tax effort ("pereza fiscal") and low tax capacity or economic/fiscal poverty of jurisdictions. Establishing the presence of "pereza fiscal" requires a comparison between actual tax collections and potential tax collections of every particular jurisdiction; this is a complex task in many cases. Second, once the presence of "pereza fiscal" can be established, it is important to understand its multiple roots, from simple political economy issues (local officials may simply be happy spending funds but never raising revenue autonomously) to the low geographical mobility of its base and because property values tend to reflect well in general the quality of local services, the property tax can approximate well the concept of a benefit tax, where residents pay for the services they receive.

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The property tax is highly visible and because of the low geographical mobility of its base and because property values tend to reflect well in general the quality of local services, the property tax can approximate well the concept of a benefit tax, where residents pay for the services they receive (see Sepulveda and Martinez-Vazquez, 2009). All of this is likely to increase political accountability of local officials. The property tax may also have relatively low efficiency losses compared to other local taxes. In terms of administration, there can be flexibility in taking advantage of a mixed local and central administration and enforcement approaches. See Bahl, Martinez-Vazquez and Youngman (2008 and 2010).


52. See Sepulveda and Martinez-Vazquez (2009) for an evaluation of the performance of property taxes in the region.

Box 6.2. A Tale of Two Cities: Bogotá’s Success Story in Raising Local Tax Effort and Lima’s Success with a New Approach to Tax Administration

Bogotá provides an example of a local government that has had success in raising local tax effort (the city was awarded a prize by the United Nations in 2002 for being the most improved local government in the world.) Starting in the late 1980s, The Municipality of Bogotá began a program of civic education during which it emphasized the importance of paying taxes and the accompanying benefit for citizens that derives from a stronger local government. It significantly increased property tax collections through a series of administrative improvements, including enforced business taxes, privatizing certain government run organizations, and successfully issuing own bonds, some times in foreign markets receiving a AAA rating, Particularly noteworthy is that the Municipality of Bogotá in 2006 raised 42 percent of its tax revenues from the local business tax (Impuesto de Industria y Comercio, ICA). Updating the fiscal cadastre in 2009 has also produced significant increases in revenues from the property tax. It is expected that the assessed tax base for this levy will increase by more than 50 percent by 2010, bringing an additional $51 million in revenues or a 13.3 percent increase over collections before the updating of the cadastre.

In 1996 Lima, along with other provincial Peruvian municipalities, introduced a semi-autonomous Tax Administration Service (SAT in Spanish), with the goal of increasing collections for own local taxes. This followed the model of a national-level SAT. The SAT of Lima is autonomous in its financial and human resource management and it is financed through a share of the taxes and fees commission it collects. The shared collections by Peruvian municipalities range from 3 percent to 10 percent. But note that the local authorities are still responsible for regulating and controlling the SATs’ work. There have been some clear benefits for those Peruvian municipalities that, like Lima, adopted a SAT approach. For example, between 1998 and 2007 those municipalities that adopted a SAT increased their own revenue by 80.9 percent, or 9 percent of the annual average, by comparison over the same period the municipalities that did not adopt a SAT saw their revenues increase by 61.2 percent, or 6.8 percent of the annual average. The empirical studies show that the trust in tax administration in Lima and other municipalities where a SAT was adopted has increased. This could be attributed to lower political intervention in administrative processes, higher client focus management, improved public relations, and a reduction of corrupt practices. But not all have been highly regarded for their new local tax administration. The same empirical survey studies identify some issues associated with the SATs: such as a limited link between the revenue collection and public services, and the public perception of tax administration as “insensible.” But some of this is to be expected since the SATs have gone against the conventions and took advantage of not always well defined rules, especially in the SAT of Lima. One of the key characteristics of the SAT agencies has been their innovative drive, including internal processes, the use of modern technologies, human resource development, improved financial management, and the collaboration across tax administrations.

54. See Acosta and Bird (2005).
them), to lack of economic resources (building an updated fiscal cadastre is expensive), to inadequate methodologies for evaluation, to the lack of skilled human resources, or even to the negative incentives for local tax effort provided by the central government’s existing fiscal transfer system. However, the region offers success stories in raising local tax effort, as provided by the recent experiences of Bogotá and Lima (see Box 6.2).

A third issue is the need to explore taxes with significant revenue potential that could possibly be assigned to local governments in order to increase their revenue self-sufficiency, akin to a flat-rate piggy back personal income tax or local surtaxes on some excise duties, such as those on vehicle fuel. Another possibility is a more intense use of betterment levies, which can complement annual real property taxes. Betterment levies are being used quite successfully in Colombia (See Box 6.3). A different option is the adoption of some form of final retail tax such as in the case of Brazil’s ISS (Tax on Services, as discussed in Box 6.4.) Except that this type of tax, although fine within the Brazilian tax system where the federal and state VAT levies exclude many important services from their bases, may be problematic because it would overlap with other countries’ existing VATs.55

An alternative to the ISS that would not present potential conflicts with the existing national VATs, is the broader base local business tax (Impuesto de Industria y Comercio, ICA) in Colombia. This is a

### Box 6.3. Betterment Levies (“Contribución de Valorización”) in Colombia

In general terms, a betterment tax recoups some of the benefits accrued by property owners due to adjacent public investment that increases the value of that property (Bird & Slack 2006). Since most real estate property is significantly affected by public facilities surrounding it, this tax has significant revenue potential. In Colombia, this tax receives the name Contribución de Valorización and it has been in operation for a long time. The constitution gives municipalities and other public entities the right to a share on the added value produced by investments made in urban settings (e.g. infrastructure works). The tax is being looked at with interest by other countries and in the first Latin American conference of Valorization, held in Bogotá (Colombia) in 2009.56 The levying of the tax implies a series of steps including, the determination of the costs and benefits of the project, the geographical area that is expected to benefit, and a method to distribute the costs and benefits of the project among the different properties. This distribution can use an array of “benefit factors” (use of property, closeness, access, etc.) or simply a land area, linear size of lot front, etc.

Bogotá also levies a tax called Participación en Plusvalía57 defined as the contribution owed to owners of real estate property as a result of modifications that increase the value of property. This is similar to the betterment tax except that it captures only changes in urban codes that affect the ways the property can be used or the intensity of its use (how much can be constructed) that may increase its value.

55. For example, in the recent past Nicaragua eliminated a productive local sales tax as part of a policy conditionality given by the International Monetary Fund precisely because of the conflict presented by the existing national VAT.

56. I Congreso Latinoamericano de Valorización; http://www.lonjadebogota.org.co/Portals/0/Docs/

57. Information about this tax may be found at: http://www.shd.gov.co/portal/page/portal/portal_internet/impuestos/impuestos_imp/Plusvalia/INFO%20PLUSVALIA
Box 6.4. The ISS in Brazil

The ISS (Imposto sobre Servicos/Tax on Services) is a municipal level tax levied on those services that are left out of Brazil’s state value added tax (ICMS). The services that may be taxed under ISS are defined by federal law, but the states may decide whether to tax or exempt some of those services. The base covers a wide range of services including, IT services, rental of premises, medical services, veterinary services, personal services (barber shops, etc), professional services (engineering, architecture, law, accounting, etc.), education and training, hotels and tourism, parking, leisure entertainment (movies, shows), repair services, financial services (by banks, etc.), municipal transportation, port, terminal, and airport services. The tax base is the revenue generated from the provision of services. The rate that municipalities may charge for ISS is locally set but cannot exceed 5 percent (in the past, it could go as high as 10 percent). Although the tax rate to be applied is the one charged by the municipality in which the business resides, there are exceptions in which the tax rate is the one belonging to the municipality where the service is rendered (e.g. construction). Producers of services are charged with paying and recordkeeping of the ISS. Buyers of services do not directly see the tax they pay as it is included in the price charged to them by vendors.

Although the ISS collects at the municipal level, its importance varies greatly across local governments; according to the Receita Federal (national tax administration) 1 percent of municipalities (out of more than 5,500) account for 73 percent of the tax collection. The ISS collected approximately 0.5 percent of the GDP in the mid-to-late 1990s and more recently, the tax collections are nearer to 0.8 percent of the GDP. As the maximum tax rates were lowered sometime in the early 2000s, the observed increase in collections as a share of GDP might come either from an expanded tax base and/or better efforts in collecting the tax. There is some evidence of the expansion of the tax base; when the rates were lowered in 2003. The ISS was also extended to services provided by financial institutions, banking services in particular.

The ISS is not without its problems. One issue is the increased tax on the production of products/services for future use, since users of these services cannot identify the ISS balance to be paid against the ISS they would receive; remembering that the price for the services are ISS inclusive. Another issue has been the management of exports. The import of services is subject to this tax, and although it should not apply to exported services, it may become subjected to this tax.

With regard to the future of the ISS, there have recently been calls in Brazil for the simplification of the tax system where—once way or another— the elimination of the ISS was contemplated. This viewpoint supports the integration of the federal-based IPI and state-based ICMS (both value-added type taxes) and the locally-based ISS within a general VAT whose revenues could be shared by all three levels of government. However, the increasing importance of ISS in municipal budgets, with regard to the potential loss in local autonomy and the difficulties of coordination at different levels of government, weigh-in on the other side of the argument.

In terms of revenue collection hierarchy in Latin America, the two sets of taxes that are generally of equal importance are the property taxes (impuesto sobre los bienes inmuebles, IBI) and the different taxes on business activities and services. In a distant third place we find those taxes falling on the use of motor vehicles. Generally, there would appear to be room to increase local revenues for taxes on motor vehicles. This is also the case for local fees and charges in many countries in the region; often the levels of fees and charges are completely out of date.60

Unbundling revenue sharing

Revenue sharing is the most common mechanism for arranging fiscal transfers to sub-national governments in Latin America and in many countries provisions for revenue sharing are enshrined in the constitution. As mentioned in Section 1, fiscal decentralization has often been understood simply as the sharing of central government revenues without relating the additional revenue to any particular local and regional expenditure assignments.

One of the most negative aspects of revenue sharing in other parts of the world is that it can exacerbate the substantial horizontal disparities across local governments when carried out on a derivation (i.e. origin basis). Fortunately, this has generally been avoided in Latin American countries.61 An important exception has been the revenue sharing in natural resources, which in countries such as Peru and Ecuador is fundamentally implemented on a derivation basis. This has led to significant horizontal disparities among municipalities.62 In most Latin American countries fiscal transfers from revenue sharing are distributed according to a set of parameters or formulas that try to achieve several objectives, one of which is some degree of equalization. One of the positive aspects of revenue sharing is that it manages to combine the unconditional use of funds with rather plentiful sources of revenue.

The main problem with general revenue sharing is that there is some confusion over the exact achievement of distribution formulas; pursuing many objectives with essentially one instrument tends to be the source of that confusion. It isn’t always best to give local governments the unconditional

60. For example, reportedly in the case of El Salvador municipal fees and charges date from 1954.

61. Note that this does not mean that there are no significant regional disparities in the region; it simply means that the more frequent use of the derivation would have made things worse. As discussed above, regional fiscal disparities arise from the differences in economic bases and the more tax autonomy provided, the higher the potential for enlarged fiscal disparities which require a higher need equalization grants.

62. In the case of Peru, the evolution of international prices for natural resources had a significant impact on the transfers system. The Ministry of Economy and Finance (MEF) currently shares 50 percent of mining and hydrocarbon revenues with local governments. Transfers from central government to regional/local governments increased exponentially after 2000 but plummeted in 2009. This experience has given rise to very significant horizontal imbalances between municipalities because shares of mining revenues are highly concentrated on seven departments, accounting for close to 80 percent of the total. This has created problems with increased unspent balances during the boom years and it has continued to expose local governments to high volatility in revenue streams.
use of all of these funds. The reforms being introduced or contemplated in some Latin American countries consist fundamentally of the unbundling of the revenue sharing system into two additional separate transfer mechanisms, namely: (i) an equalization transfer with unconditional use of funds and financed from a pool extracted from the shared revenues, which would exclusively pursue the goal of equalization of horizontal fiscal disparities, or (ii) a system of specific or conditional grants for current expenditure and investment purposes, financed with some of the revenue sharing funds. The use of these funds would be earmarked in pursuit of a variety of sectored objectives. Advances in this general direction have been made in countries like Brazil and Chile, while countries like Ecuador, El Salvador and Honduras are still using an unbundled revenue sharing scheme as the main funding source of local governments.

**The need to rationalize the transfer system**

The system of transfers plays a pivotal role in drawing together the other elements of the intergovernmental fiscal system. It makes up for the vertical and horizontal gaps that own source revenues and revenue sharing cannot meet, and when it is designed properly it does not undermine local tax effort or the incentives for creditworthy municipalities to borrow.

With the exception of a few countries, the current system of transfers to local governments in Latin America lacks a clear orientation. Most countries have yet to introduce unconditional equalization grants that incorporate some formula-based measures for expenditure needs and fiscal capacity. When some equalization elements are introduced into the revenue sharing formulas, actual revenue collections are often used instead of measures of tax capacity, thereby creating a negative incentive for tax effort. The current methods used to incorporate different expenditure needs in the revenue sharing formulas are also problematic. For example, population, which is commonly used as a good approximation for some services needs, is not the right factor to be considered for other services. For example, the number of school age children provides a better approximation for basic education needs than population as a whole. The relative share of infants and the elderly in the population provides a better approximation for health care needs than the whole population per se. In some cases, especially in Central American countries like El Salvador and Nicaragua, the existing formulas favor small municipalities, which in turn create problems of fairness and economic viability and regional development.

Even though many countries have some form of conditional grants, they lack structure and consistency, especially in the area of capital grants. When conditional grants are used, the complex system is often a problem. Compliance-administrative costs by local governments which is intricate, in many cases penalizes smaller jurisdictions with low administrative capacity and dilutes the achievement of central government goals. A remedy to these problems, following best international practice, has been to consolidate many of these specific or conditional programs into block grants. While specific conditional grants narrow the use of funds (e.g. funds to buy furniture for primary schools), block grants, while still conditional, have a much broader scope for the use of funds (e.g., the funds must be spent on primary education). The advantages to
using just a few block grants are the simplification and expansion of local government choices, thus aligning the final allocation of public resources more closely to the priorities of individual local governments (e.g., repairing the school building instead of buying new furniture), without unduly compromising the general goals of central government’s policies (e.g., promoting the quality and standards of primary education in the country).

### Increasing fiscally responsible local borrowing

Historically, the Latin American region has suffered some of the worst incidences of fiscally irresponsible sub-national borrowing in the world. The negative experiences of Brazil and Argentina, with uncontrolled sub-national borrowing and hyperinflation during the 1980s and 1990s, are still examples of what can go wrong in this area of sub-national finance. One consequence of those experiences is that the borrowing policy towards local governments in the region has become excessively conservative and restrictive.

For example, in Chile, local governments are—in principle—not allowed to borrow or take out loans of any kind, but either way outright prohibition is unnecessary or effective. In the same country, indirect borrowing through leasing contracts or by delaying the payment of current expenditure makes that norm difficult to enforce. In Uruguay, any domestic or foreign debt issued by a local government needs to be approved by the national congress. Peru also provides an example of legislative conservatism in the matter of local borrowing: The central government has established indebtedness rules to maintain fiscal prudence by two laws (the Law on Fiscal Prudence and Transparency –LPTF– and the Law on Fiscal Responsibility and Transparency –LRTF–). Besides limits on debt service ratios and total debt, the laws also limited the rate of growth for municipal expenditures to a maximum of 3 percent per year. However, this framework has not been fully enforced because of insufficient monitoring, and the lack of effective sanctions. Many local governments in Peru carry large budgetary arrears. At the other extreme, and more like an exception, Paraguay, has practically no restriction on local borrowing.

Thus a pending challenge for several countries in the region is how to set up institutions that effectively regulate borrowing without becoming overly restrictive of local governments. Many countries are still struggling to introduce a credible system of penalties for lack of compliance. The development of information and monitoring systems covering all aspects of borrowing, including budgetary arrears with official institutions and private providers, is urgently needed. But the key ingredient for fiscally responsible behavior of sub-national units remains at the political will of the central government authorities to implement the existing regulatory frameworks.

A second challenge for practically all countries is how to make more credit available to local governments for responsible borrowing. In practice, the level of borrowing by local governments in Latin America is far too low to meet the present large needs for public infrastructure across the sub-continent. The exceptions are large cities, which tend to have ample access to domestic credit markets and in many cases to international markets with accompanying international credit ratings. Thus, the capital cities of La Paz (Bolivia) and Lima (Peru) display a very different picture from that of most other municipalities.

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65. Monitoring systems for local indebtedness have often proved a doubtful utility. In Ecuador and Peru information on debt is taken directly from the financial statements of sub-national governments and is not crosschecked with other sources. In Argentina, the Federal Council for Fiscal Responsibility created by the Fiscal Responsibility Law of 2004 and in charge of monitoring compliance with norms and rules of fiscal and financial behavior does not receive timely information from the majority municipalities as of 2009.

66. Part of the solution can be direct on-lending to municipalities by regional-multinational institutions such as the Confederation Andina de Fomento (CAF) or the Banco Interamericano de Inversiones, or international organizations such as the Inter-American Development Bank (IDB) or the World Bank. However, a large part of the solution needs to be the mobilization of domestic credit sources.
The absence of real access to borrowing by the average municipality in the region is a complex issue. It is explained by a multitude of causes, ranging from the lack of tax autonomy for local governments to the lack of national financial market development. One potential remedy for the scarcity of local credit is the creation of semi-official financial intermediaries or municipal banks. As shown in Box 6.5, several Latin American countries have created this type of institution to facilitate long-term credit to local governments. However, the experience of these institutions has been mixed because of the difficulty of maintaining them at arms' length from central government officials and of operating them with strict banking criteria.

Box 6.5. Practice with Municipal Development Banks and Funds in Latin America

Experience with municipal development banks in Latin America has been mixed, as has been the case in many other countries around the world. Although quite a few countries have introduced some sort of specialized financial intermediaries or municipal development funds to raise capital financing for local governments, few of those institutions have been transformed into financial institutions with market-oriented practices and controls channelling private savings to finance public infrastructure. The following is a summary of experiences with municipal development banks and funds in the Latin America region.

Brazil

The Integrated Program of State Improvements (PIMES) was established as a municipal development fund administered by BADESUL, the development bank of the Rio Grande do Sul, which owns and controls it. The program has two components: institutional and human resource development and infrastructure investments. The first component comprises of about 10 percent of the total project costs and includes technical assistance, training and equipment for municipalities, the State Water Company (CORSAN), and other state sector agencies, etc. The second component represents about 90 percent of the total program budget and includes the financing of projects in water supply and sanitation, street paving and lighting, drainage and erosion control, and so on. The Municipal Action Program (PRAM) was established in 1991 by the Parana state bank BANESTADO, which originally served as the bank's financial agent. PRAM was eventually converted into a revolving State Urban Development Fund (FDU), administered by BANESTADO with technical assistance provided by a legally autonomous organization that in practice functions as a department of the State of Parana Secretariat of Planning.

PARANACIDADE was created in 1996 as a non-profit corporate entity to provide institutional and technical services to municipalities in Parana; this institution also collects and invests financial resources from the state's urban and regional development
significantly in recent times. A noteworthy innovation has been the introduction of participatory budgeting (See Box 6.6). Nevertheless, a variety of issues at different stages of the budget process still need to be addressed in several countries in the region. In terms of budget planning and formulation, there are still countries where local governments must have their budgets, or certain aspects of them, approved on an annual basis by higher levels of government. Ex-ante monitoring and approval of local budgets by higher level authorities is not needed where there are local elected councils and an effective ex-post audit system, and courts to address irregularities. Local budget autonomy is often limited in the case of investment projects. Another issue in the preparation stage is the lack of a link between planning and budgeting. Frequently, it is seen that many development plans at the local, regional, and national levels lack coordination and do not relate to actual budgets in terms of the cost of activities for the fulfillment of strategic objectives.

70. These countries include: Bolivia, Costa Rica, Jamaica, Mexico, Nicaragua, Panama, Paraguay.

71. In Peru all public investment projects must be approved by the National Public Investment System (SNIP) which is managed by the Ministry of Economy and Finance (MEF). Through the General Directorate of Multi-Sector Programming (DGPM), MEF has the power to cancel any approval made by regional and local governments if DGPM consider that SNIP criteria have not been properly applied.

Practice with Municipal Development Banks and Funds in Latin America (cont.)

programs, managing the State Urban Development Fund (FDU), which creates loans for municipalities at maturity ranging from 8 years for urban infrastructure to 10 years for social infrastructure. One of the main explanations for PARANACIDADE's success is its support of capacity building for municipalities.

Colombia

Colombia has been successful in using its Municipal Development Funds to accelerate the development of private credit markets for local government. The Territorial Financing Institution (FINDETER), which began in 1994 as an infrastructure financing window within the National Mortgage Bank, eventually evolved into a development bank for municipalities, working through the commercial banking system. In essence, FINDETER operates as a second-level financing institution which re-discounts commercial bank loans to municipalities. The banks' good credit experience through FINDETER has led them to commit their own resources to municipal lending. Intermediate-sized cities and departments in Colombia now borrow primarily through commercial bank loans, while small cities and towns continue to rely on FINDETER. The largest cities now finance their credit requirements primarily through bonds.

Mexico

The federal public works bank, BANOBRA S, was founded in 1933 as the Banco Nacional Hipotecario Urbano y de Obras Públicas, S.A (National Urban Mortgage and Public Works Bank), and has long had a loan program for municipal development. Its operations, however, became complex and bureaucratic and the allocation of financial resources soon responded more to political than financial criteria. The bank's heavily subsidized loan program used to focus on social housing, water supply systems and the construction of markets and abattoirs. Since 1988, its interest rates have come close to market rates and BANOBRA S has switched its focus to improvements of municipal land registers.
In terms of budget execution, the misappropriation of funds by central government is still a problem in several countries. For example, in Haiti, 90 percent of local government income evidently comes from transfers associated to the Funds for the Operation and Development for the Territorial Collectives (FGDCT), administered by the Department of the Interior. However, recent studies show that these funds are not being distributed as the Department of the Interior claims, and that a significant share is retained by the Department to finance its own projects. The budgets of communes (i.e. the local governments in Haiti) are the most directly hurt, receiving 33 percent less than what they are budgeted to receive. Honduras provides another example, where the law is not respected by the central authorities. In particular, while the Municipal Code establishes that the central government should allocate 5 percent of its tax

Box 6.6. Participatory Budgeting in Porto Alegre (Brazil)

Participatory budgeting has been functioning successfully in the municipality of Porto Alegre, in the state of Rio Grande do Sul (Brazil) for the last two decades. The participatory budget of Porto Alegre, called OPPA, is a process through which ordinary citizens and a team of elected local government officials work together to define a list of projects to be included within the local government budget. Through this mechanism for the shared management of budgetary resources, local residents perform the role of identifying and controlling the implementation of projects. Thus, through the OPPA, local residents are closely associated with the formulation of public policy at the initial stages, including diagnosis and needs assessment, the intermediate phase of monitoring and implementation, and the final phase of control and accountability.

Since its inception the OPPA has contributed to the improvements in the lives of local residents. The number of participants in Porto Alegre has increased year by year, from approximately 1,000 in 1990 to nearly 15,000 in 2004. The process has also brought opportunities to better integrate traditionally marginalized groups of the population in the community’s development. In 2002, there was a predominance of women among the leaders of neighbourhood associations, delegates and counselors. In addition, most of the OPPA participants belong to lower income groups. Other groups, such as the black population or, manual and unskilled workers have also seen higher participation rates in the OPPA process (City, 2003). According to Abers (2000), who studied the profile of OPPA’s participants, contrary to some expectations, the process has not given rise to the influence of an elite field of people with more education or income. In addition, Santos (2003) has shown that OPPA resulted in an increase in the provision of basic public services. In 1999 the volume of garbage collected and the number of additional lights installed nearly doubled from the annual average for the period prior to the existence of OPPA (1985-1988). In 1996, the sewer lines in the municipality were expanded to cover 98 percent of households up from a coverage of about 50 percent in 1989. The World Bank (1999) also attributed to OPPA the paving of half of the municipality streets and the doubling in the number of students enrolled in primary and secondary schools.

72. See http://www.internationalbudget.org/ for other experiences in participatory budgeting and other innovations for more open and transparent budgeting practices.
revenue to the municipalities, in fact, only 3 percent appears to have been allocated in the most recent years. Other countries, like the Dominican Republic, are experimenting with similar situations; 10 percent of their national budget must be allocated to local governments (according to Law 166-03), but actual transfers have never reached this level and recently they have decreased from 8 percent to 6 percent of the national budget.

Deficiencies related to ex-post audit of local budgets still exist. For example, in Paraguay, many municipalities do not comply with the requirement to send their annual financial reports to the Comptroller General of the Republic.

Addressing the Scarcity of Data on Local Finance

The lack of adequate data on local finance is a widespread problem in the region which has major consequences. Only a handful of countries currently make municipal data openly available to the public. Countries, such as Brazil, Peru and Ecuador provide examples for best practice in this area; for further examples in the region see Box 6.7.

Conclusions

The analysis in the above sections has shown that the Latin America region contains a rich variety of experiences and lessons, good and bad, about decentralization and municipal finance. This assortment of experiences and challenges, sometimes quite unique, has made it difficult to draw up a cross-country analysis. Nevertheless, there are many common themes and challenges facing municipal governments in Latin America and each country has been able to address them with varying degrees of success. For example, in Chile, the central government has made use of municipal governments’ ability to increase the effectiveness of social policies and encourage innovation and competition among them. In Colombia,

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Box 6.7. Annual Publication of Executed Budgets in Colombia

Law 617, enacted in 2000, charges the National Planning Department (DNP) in Colombia with the annual publication of budget results (revenues, expenditures and financial indicators) for all departments and municipalities, together with an explanation of where there have been problems and where there has been progress. Included in these records is a detailed recording of the municipalities’ fiscal performance and information on all income and expenditures during the past fiscal year. This annual publication is of high quality. The DNP collects annual data on revenues and expenditures, as well as the debt levels of all local governments. Each local government reports and certifies the accuracy of its executed budgets to the DNP through an automated system, the Sistema de Información para la Captura de la Ejecución Presupuestal de Departamentos y Municipios (SICEP). The DNP also receives information on debt levels from the Controlloría General de la República (CGR). These data are regularly used by government institutions and nongovernmental organizations to monitor the performance of sub-national governments. The comparisons in performance also allow some form of benchmarking competition among local governments; which governments are doing relatively better and which are doing worse.

74. In El Salvador and other countries in the region, municipalities are required to undergo a full independent audit once a year to search for signs of corruption and misuse of public funds. This practice does not eliminate corruption but it goes a long way to keep it under control.
75. For example, the challenges faced by some municipalities in Colombia go beyond fiscal issues. Here, municipalities in the war-torn areas must face the challenge of being on the frontlines against armed actors such as drug traffickers, paramilitaries and the Revolutionary Armed Forces of Colombia (FARC).
central legislation can provide administrative flexibility, with local governments exercising control over staff hiring and salary decisions, and at the same time provide effective accountability mechanisms to maintain fiscally responsible decisions by local officials. In Honduras, a municipal association can successfully provide technical assistance and training for its members. Changes in the attitudes of municipal officials toward broader community participation in budget decisions have taken place in countries such as Bolivia, Brazil, and Peru.

In this concluding section we offer some observations grouped according to the set of issues examined. Yet, there are challenges remaining which need addressing and it will be necessary to continue looking for new orientations in future research about public local finances in the region.

Observations on Organizational Structure

Countries with problems of fragmentation and small municipalities, should introduce legislation and practical support for the creation of associations of municipalities into mancomunidades for the delivery of certain public services requiring a certain minimum scale. Other solutions to the problem of insufficient scale that could be pursued include cooperative services agreements between larger and smaller municipalities, and the contracting of services with private enterprises for the delivery of services. In addition, careful critical study and consideration should be given to the creation of new tiers of vertical government (for example, regional governments) as a solution to some of the weaknesses observed at the existing local governments. A cheaper more efficient solution can be the strengthening of technical assistance and additional funding of existing governments.

In any case, existing potential incentives to further fragmentation should be removed. In particular, those countries with transfer formulas that ensure the same amount of funds to all municipalities independently of their size should discontinue this practice. Where they do not exist now, new legislation with minimum population and fiscal viability requirements should be introduced to prevent any further undesirable fragmentation of local governments.

Most central governments in the region, and provincial or state governments in the case of federal systems, should devote more time and resources to developing administrative capacity, especially in the case of small and rural local governments. Some of this assistance can be provided by working together with and offering support to municipal associations in order to give quantitative and qualitative technical assistance and training to local officials in the most cost-effective manner or by having regional universities and colleges contracted to tutor local governments.

Observations on Intergovernmental Fiscal System Design

Without a clear assignment of expenditure responsibilities to local governments it is not possible to have an informed judgment on whether or not the level of financing of these governments is adequate. Most systems of intergovernmental fiscal relations in the region would benefit from an explicit clarification of the competencies assigned to local governments. First, this will require the clear identification of the exclusive responsibilities of local governments. Second, in
the case of concurrent or shared responsibilities between the local and central (or intermediate level) governments, it will be necessary to identify which attributes of the particular competence (regulation, financing, and implementation) are the responsibility of the local governments and which belong to higher levels of government. There will be no clear assignment of responsibilities, especially in the case of concurrent functions, until it is apparent which level of government is exclusively responsible for the different sub-functions involved. Of course, the implementation of services may be done directly by the local jurisdiction or this unit can make arrangements for its provision, for example by a private company or some other jurisdiction.

If there are significant differences in administrative capacity among local governments it may be desirable to temporarily introduce two or at most three different packages of expenditure responsibilities that can be devolved to local governments depending on their administrative capacities and over time, as capacity is acquired, graduate municipalities to the more complete levels of responsibility.

It would also be desirable to adopt transparent approaches to translate the assignment of local functional responsibilities into expenditure needs in order to have a clear idea of the financing requirements for local governments.

Greater local revenue autonomy is a challenge not yet adequately addressed by most countries in the region. However, there is a need to find a better balance between the decentralization of expenditure responsibilities and the authority to collect local taxes from the residents directly benefiting from local services. This will lead to more fiscally responsible and politically accountable forms of decentralization. Several options are open going forward with this agenda.

- First, countries that have not assigned property tax to local governments should do so. Property tax has several characteristics that make it ideal as a local tax.

- Second, other taxes that should be assigned to local governments are vehicle taxes, business licenses, and betterment levies on real estate for financing basic infrastructure improvements.

- Third, for countries that have not done so, some degree of discretion in setting tax rates should be granted to all local governments so that they can adjust their tax bases, within legislated maximum and minimum rates. Other forms of autonomy beyond rate setting (e.g., adjustments to the tax base or the freedom to introduce new taxes) are not generally desirable.

- Fourth, coordinated efforts of local and central governments should be made to increase the revenue yield of property tax and other taxes assigned to local governments. In the case of property taxes, these should include: regularly updated and improved property cadastres and property value assessment methodologies, increased effectiveness in the collection of tax bills, and removal of disincentives for increases in tax effort by local governments i.e. reductions in transfers when more local revenues are collected.

- Fifth, the introduction of new taxes at the local level should be considered, including wider use of betterment
levies and local business taxation, such as the ICA (impuesto de industria y comercio) in Colombia or Chile’s patente municipal.

Going forward, to improve the direction of increased local tax autonomy, would be the introduction of a local piggy-back personal income tax with a flat rate collection at the same time national income tax is collected. This latter form of local tax is common, in northern and central Europe, but it is yet to be tried in the Latin American region. Finally, there is a possibility of considering the introduction of environmental or “green” taxes enabled by national legislation on the regulation of the environment. This form of taxation has not taken root in many Latin American countries though it provides several important advantages. The first is the so-called “double dividend” since these taxes not only collect needed revenues but also contribute a cleaner environment. These taxes can also fit well in regional and local contexts. Potential levies in this area would include taxes on the emission of solid waste and water contamination.

In those countries where revenue sharing is a major source of local finance, it would be desirable to un-bundle part of the revenue sharing system into separate transfers, including: (i) an equalization transfer with unconditional use of funds and (ii) a system of block conditional grants for current and capital purposes. An explicit unconditional equalization grant is needed to address the important and increasing problem of regional fiscal disparities in many countries in the region—based on differences in tax capacity or economic base, and differences in expenditure needs due to geography or the population structure. Explicit conditional grants are necessary to ensure national standards and objectives in the provision of important services have been decentralized, such as in education and health.

In those countries where local borrowing is not allowed, new legislation should introduce the possibility of responsible local borrowing. In those countries that already allow municipal borrowing, it would be desirable in many cases to review the current status of regulations, streamlining them when necessary so that they are not overly restrictive. This review should also focus on the monitoring capabilities of the central government (including “floating debt” or budgetary arrears with official institutions and private suppliers, and guarantees through municipal enterprises) and the introduction of a credible system of penalties for lack of compliance.

Beyond the regulation and monitoring of local borrowing, an even more important challenge for most countries in the region is to facilitate a significant increase in credit availability to local governments for responsible borrowing, especially for smaller municipalities. The solution may sometimes be the creation of official financial intermediaries or municipal banks. A large amount of information is available within Latin America and other regions of the world regarding the positive features institutions should replicate (e.g., operating with strict banking criteria) and those features that should be avoided (e.g., operating with less than arms’ length distance from political authorities). Policies to encourage the development of private markets for local credit are equally, or even more, desirable. But it must be recognized that local credit from private sources is unlikely to develop without more revenue autonomy and greater transparency of local budgets.
Observations on Budget Process and Transparency

Those countries still requiring ex-ante approval of municipal budgets by higher-level authorities should phase out this practice and increasingly rely on local accountability and effectiveness of ex-post audits and the rule of law in order to keep an eye on the probity of local budget execution. The misappropriation of funds in a selected number of countries is a practice that needs to be stopped and full compliance with ex-post audit rules should be ensured. The ultimate effectiveness of local public expenditures will depend on the adoption of modern budget evaluation practices, which remains a pending assignment for most countries in the region.

The low reliability on municipal finances remains an important problem in the Latin American region, affecting the quality of policy design and of analytical work. Best practice in budget transparency and data dissemination in countries such as Colombia and Peru, for example, should be replicated by all countries in the region where publicly available data on annual budgets and other aspects of the local finances are still missing. An effective way to encourage and sustain good practices in budget reporting and data generation is to make good use of the data, by providing information to experts and ordinary citizens on performance and by publicizing the results in order to create benchmark competition across jurisdictions.

There has been continued progress over the past decade with the institutions that manage finances and with the practice itself of municipal finance in the Latin American region. Nevertheless, there is a long road ahead for further improving the overall efficiency, equity, and accountability of municipal finances in the region.
Latin America Regional Policy Recommendations

Prepared by the technical team of the Federación Latinoamericana de Ciudades, Municipios y Asociaciones (FLACMA), March 2010.

Signs of recentralization in Latin America

In various countries a backward trend has been observed with regard to decisions taken on the handover of responsibilities to local governments, affecting both local autonomy and financing.

National transfers to local governments must be stable and regular

Financial transfers to local government are a mechanism to effectively integrate municipal participation into the national budget and constitute a right for citizens of territories. Universal services such as education and health are nationally designed and financed to ensure equality between territories and, when managed by local governments, merit regular and stable national transfers.

Strengthen collection and take into account the fiscal effort of local governments with regard to local poverty levels

It is often argued that local governments are “fiscally lazy” and invest little in tax collection. These observations do not consider the low yield of economic activity and level of poverty in the majority of Latin American municipalities. As a result, levels of collection in poor areas are often confused with the efforts made to achieve them. To complement these fiscal efforts, systems of income compensation should be favored, such as unconditional transfers from central to local governments that permit a redistribution of resources in favor of more vulnerable, lower income territories.

Increase the participation of local governments in public spending and their autonomy in the management of resources

It is a recurrent theme in Latin America to measure the level of decentralization of diverse countries with indicators such as local expenditure as a percentage of general government spending or local expenditure as a percentage of GDP. Such fiscal observations must be balanced against real levels of local government autonomy in deciding how financial resources will be used, be they collected directly by the local government or transferred from the central level. In addition, access to information on municipal finance must be improved as well as the methodologies for collecting and recording this information.

Promote association and cooperation between municipalities to strengthen municipal capacities

In Latin America and the Caribbean there are more than 16 million local governments. Analyzing, by country, the total number of Latin American municipalities this is not
necessarily excessive to respond to the needs of citizens. However, there are significant differences in both the sizes and characteristics of these entities, depending on the country and type of territory as well as the municipal human and financial resources. The most effective manner to balance municipal capacity – without reorganizing the territorial and institutional structure in each country – is through municipal associative movements, that is to say, to encourage inter-municipal cooperation. "Mancomunidades" allow local governments to mutually support each other, manage services jointly, and undertake local development programs and projects.

**Increase the sources of own revenues for local government**

In Latin America the main sources of municipal income – apart from fees and tariffs for municipal services – are property taxes, business and commercial licenses, vehicle taxes, development charges and transfer systems for equalization purposes to strengthen incomes for less developed municipalities. Property tax is the most common, and is in use across all of Latin America, with some exceptions such as the Dominican Republic, and El Salvador. It is necessary to improve and increase the sources of own revenue for local governments.

**Prioritize strengthening and improved functioning of local governments**

It is very important for the success of the decentralization process that local governments are effectively strengthened, helping them to better exercise their powers and responsibilities and provide good levels of services.

**Improve coordination between ministries and national institutions responsible for sectoral policy and local government; the transfer of responsibilities must be accompanied by corresponding resources**

One of the most common conflicts in public policy is that of aligning the generally sectoral visions of national ministries, with the territorial optic of local governments. Municipalities are often assigned partial responsibilities, from national ministries, without the necessary resources to successfully implement them.

**Recognize and strengthen the role of local government associations**

Local government associations are an important supporting structure for municipal management. The national associations allow for the design and discussion of national policies and regulations on decentralization and local responsibilities, with central government and parliament; the departmental, regional or intermediary municipal associations play a similar role with intermediary governments, and also provide technical support to member governments.