"Intergovernmental fiscal relations in Latin America: regional disparities and fiscal sustainability"[1]

Preliminary version for comments

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"Intergovernmental fiscal relations in Latin America: regional disparities and fiscal sustainability"

1. Introduction

In the last two decades, many Latin American governments have embarked upon reform processes which modify the degree of power and the responsibilities granted to different levels of government. Though these kinds of reforms are collectively characterized as 'decentralization', they have followed different paths in different countries.

In Latin America, preexisting institutional, economic, and social features have strongly influenced both the design and the results of the different decentralization processes. These features include: high institutional heterogeneity; unequal personal income distribution; unequal regional distribution of income; high specialization in natural resources; high density of urban populations, and the high importance of informal economy. The impact of said features is evident in public policy. For example, excessive territorial heterogeneity in the supply of goods and services, such as infrastructure, education, health, and social assistance, can make it difficult to achieve national equity objectives. In some countries, the assignment of revenues from natural resources raises a number of issues, from political economy to macro stabilization, and often generates rivalries between the constituent units of the same nation.

This paper analyzes the intergovernmental fiscal relations in Latin America, with special attention to the relationship between those structural characteristics and macroeconomic factors, such as solvency problems, high volatility and pro-cyclical behavior, that have characterized regional fiscal policy. Further, it argues that the structural characteristics of Latin America countries and the volatile performance of macrofiscal policy have created the following dilemma: despite the need for the central government to play a critical role in coordination, there is a lack of tools and resources to meet this obligation. Consequently, there is a strong necessity to redefine the role of the central government. From a multilevel governance approach, more emphasis should be placed on the Central Government's coordination role. Accordingly, a successful decentralization process should have an institutional framework based on three pillars:

1. a distribution of responsibilities among the various levels of government and a system of intergovernmental transfer, within a sustainable macroeconomic environment;
2. a public sector management system endowed with a number of common principles, rules, and procedures, which is complemented by a set of mechanisms for the coordination of aspects of public expenditure, such as sectorial policies and political accountability;
3. a set of procedures, principles and institutions necessary to achieve macrofiscal coordination in the public sector as a whole.

In Latin America, macro fiscal volatility, public sector size, and low taxation have limited the capability of central government to fulfill these objectives. Consequently, central governments are not currently capable of fulfilling the basics roles of coordinator: to coordinate macro fiscal policy, to compensate differences, and to articulate sectorial policies.

In this document we present data about the structural characteristics and the common features of the macrofiscal policies that are relevant to the analysis of the intergovernmental relations. Then, the analysis of both the decentralization of expenditure responsibilities and the assignment of tax responsibilities between levels of government will permit a discussion about the decentralization policies and the role of the central government in the region.

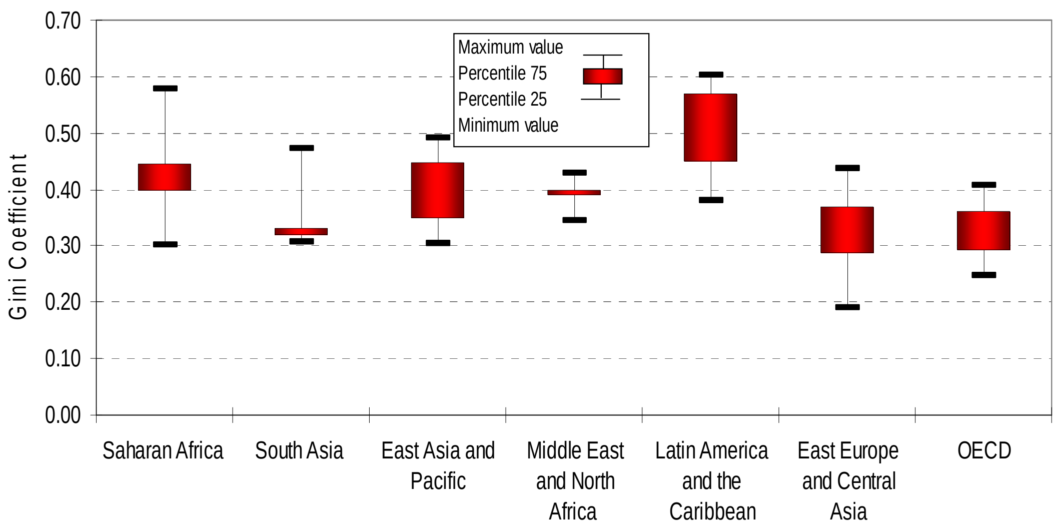
2. Structural Characteristics of the Region

This paper will show that the characteristics of the decentralization process and the resulting system of intergovernmental relations in each country vary considerably. However, despite this heterogeneity, there is a group of common structural characteristics, present in a greater or lesser extent, in all of the countries of the region. In particular, we want to highlight that these common features create serious challenges for central governments trying to adequately provide and coordinate public goods and services.

2.1. Inequality of income distribution

In terms of personal income distribution, Latin America's level of inequality is substantially higher than in other regions of the world.

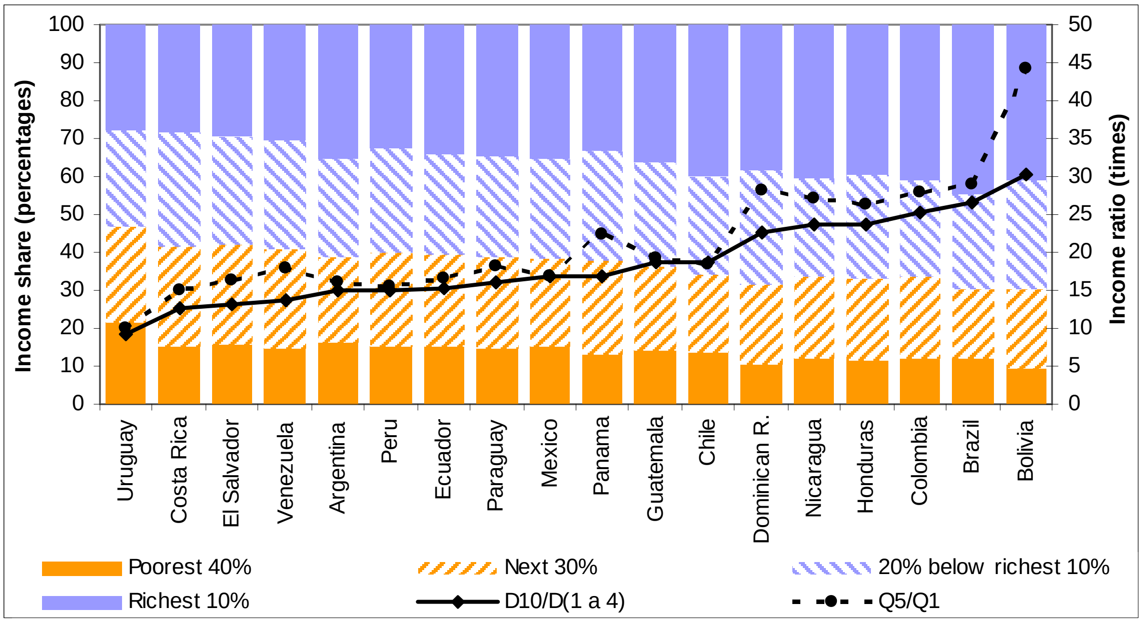
Figure 1: Gini coefficients for groups of countries, 1997/2004



Source: ECLAC on the basis of World Bank, World Development Indicators 2007.

One noteworthy characteristic of inequality in the region is the proportion of income held by the highest percentile (richest 10%). Whereas the differences between the intermediate percentiles are less pronounced, the gap between the highest income earners and the rest is significant. In European countries, the income of the tenth decile is 20% to 30% greater than the ninth decile. However, in Latin America, this difference is typically 100% greater, and in some cases, closer to 200%.

Figure 2: Structure of income distribution by deciles



Source: ECLAC

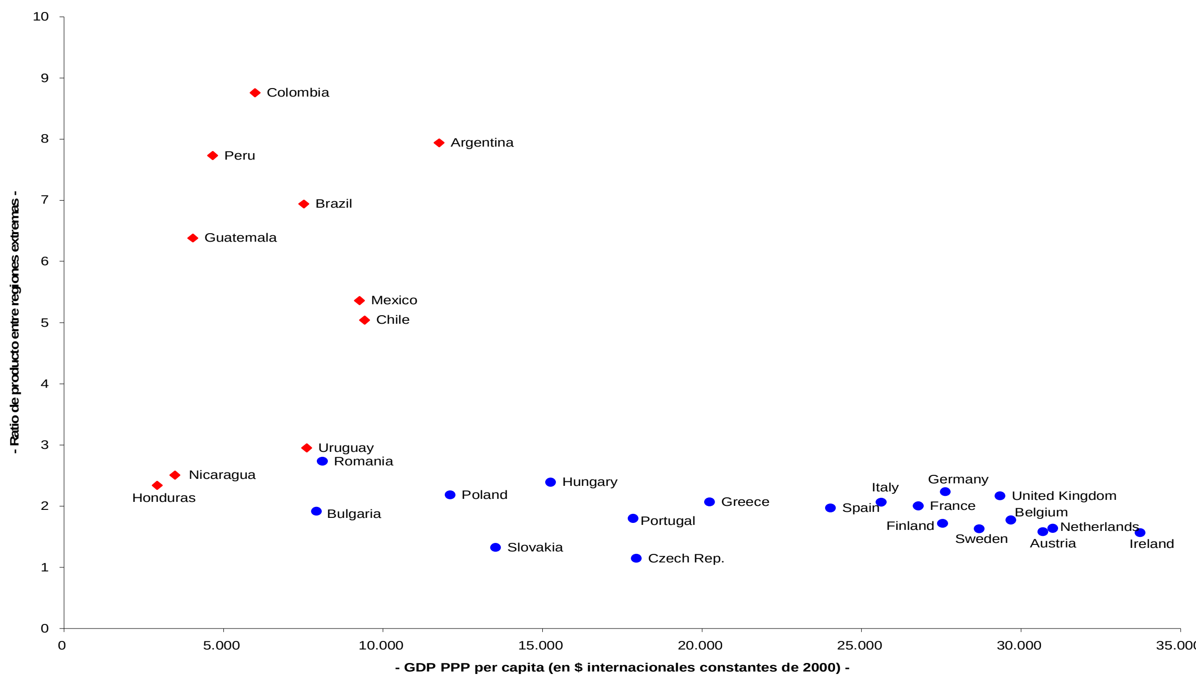
This has important consequences for public finances and increases the need of redistributive public policies, not only on the expenditure side but also on the tax system. Countries of the region need to enhance progressive tax systems in order to strength the “capacity to pay” principle.

2.2. Regional inequality within the country

Regional inequality is of particular importance when considering how to design and fund decentralization policy. In Latin America, unlike other regions in the world, there are significant differences in the level of development between regions within an individual country. The gap in per capita output between the highest and lowest jurisdictions for a sub-group of countries in the region illustrates this disparity. The ratio between the GDP per capita of the richest province in Argentina (Santa Cruz) is more than eight times the GDP per capita of the poorest province (Formosa) . In the case of Mexico the difference between the GDP per capita of Mexico DF and Chiapas is 6.2 times and in the case of Brazil 5.5 times[2].

Figure 3 shows the relationship between this indicator and the GDP per capita for European and Latin American countries. With the exception of smaller Central American countries and Uruguay (a country with better indicators of equity and strong unitary government), the gap between rich and poor jurisdictions is extreme and much higher than any European case. This indicates the complexity of a decentralized policy providing adequate, effective and equitable public services. Simply, this means that the poorest regions do not have a sufficient tax base to obtain the necessary fiscal resources to finance local expenditure. In a decentralized environment, the different subnational governments have varying degrees of capacity to finance those services (in many cases, infrastructure, health and education) that have been decentralized.

Figure 3: Comparison of the per capita GDP between the highest and lowest income jurisdictions in Latin American and Caribbean countries and European Countries



Source: Cetrángolo (2007a).

[2] Unfortunately, the indicator used is not ideal, and shows the difficulties inherent in the national accounts of countries in the region. Not all countries have regional product data (very few have income estimates), so the methodologies are varied and of varying reliability. Moreover, in each case, the jurisdictional units on which the calculations are based both vary and depend on the institutional organization.

2.3. High urbanization

The region's high percentage of urban population (in the case of Uruguay, Argentina, Chile and Brazil exceeding 80%) must be considered when designing public policies. This is especially relevant when determining allocation of these policies between different governmental levels. The challenges for urban and rural areas are very different. The provision of public services for rural areas is more demanding of fiscal resources. Additionally, in some countries of the region, the population is concentrated in only a very few municipalities. For example, in Argentina, Brazil, Colombia and Honduras, more than half the population is contained in 5% of the municipalities.

Table 1: Urban Population, 2003

(Percentage of total population)

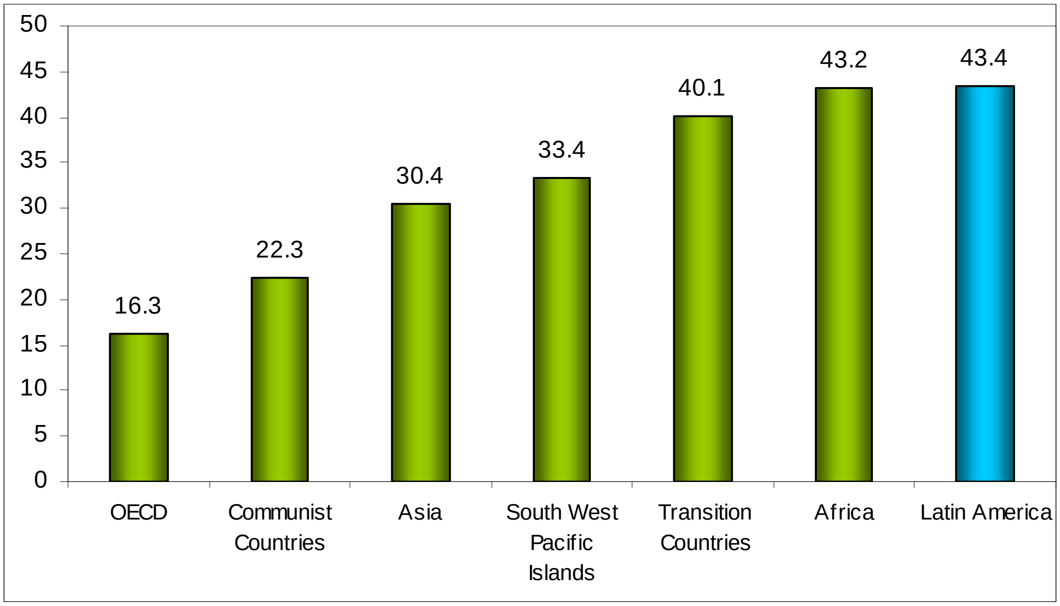
Region	% of Urban Population
Latin America and the Caribbean	77
Caribbean	64
Central America	69
South America	81
North America	80
Europe	73
Oceania	73
Arab States	55
Africa	39
Asia	39

Source: UN Population Fund

2.4. Informal sector

Latin America has both the greatest income inequality and the largest informal economy in the world. Figure 4 shows Latin American countries have the largest informal economies in relation to GDP, reaching an average of 43.4%. OECD countries on the other hand, have the lowest informal economy, which reaches an average of 16.3% of GDP.

Figure 4: The informal economy in the world - Average 2002/2003



Source: own based on Schneider (2006)

Since 1990, the informal economy has been growing in all regions of the world. As can be seen in Table 2, Latin America is no exception.

Table 2: Size of the informal economy in Latin America

As Percentage of GDP (according to DYMIMIC and Currency Demand Methods)

Country	1990/91	1994/95	1999/2000	2001/02	2002/03
Argentina	22.1	24.8	25.4	27.1	28.9
Bolivia	55.4	60.4	67.1	68.1	68.3
Brasil	32.5	36.4	39.8	40.9	42.3
Chile	13.6	16.4	19.8	20.3	20.9
Colombia	33.4	36.2	39.1	41.3	43.4
Costa Rica	22.0	24.2	26.2	27	27.8
R. Dominicana	28.4	30.4	32.1	33.4	34.1
Ecuador	28.9	31.4	34.4	35.1	36.7
El Salvador	…	…	46.3	47.1	48.3
Guatemala	41.4	45.9	51.5	51.9	52.4
Haiti	…	…	55.4	57.1	58.6
Honduras	40.7	44.3	49.6	50.8	51.6
Jamaica	31.4	33.2	36.4	37.8	38.9
México	24.1	27.1	30.1	31.8	33.2
Nicaragua	40.1	43.2	45.2	46.9	48.2
Panamá	51.4	58.2	64.1	65.1	65.3
Paraguay	…	…	27.4	29.2	31.4
Perú	47.1	52.3	59.9	60.3	60.9
Puerto Rico	…	…	28.4	29.4	30.7
Uruguay	41.3	45.3	51.1	51.4	51.9
Venezuela	27.4	30.4	33.6	35.1	36.7
Unweighted Average	**34.2**	**37.7**	**41.1**	**42.2**	**43.4**

Source: Schneider (2004 y 2006)

These high levels of informality have important implications for public policies impacting both fiscal expenditures and revenue by weakening fiscal revenues and increasing tax evasion.

2.5. Institutional heterogeneity

Both federal and unitary institutional organizational structures can be found in the region. Countries such as Argentina, Brazil, Mexico and Venezuela have a federal structure, whereas the others are characterized by a more unitary organization. However, under the umbrella of these two broad categories, there are different types of federal and unitary organization. This obviously amplifies the complexity of the region.

Federal organizational structures tend to coincide with the largest territorial countries. In Mexico and Argentina, federalism emerged as a way to unite states that had previously enjoyed autonomy. In Brazil, on the other hand, this type of organization emerged from the center. Despite these differences, in each case, federalism is a legacy of the colonial organization. Venezuela has a federal organization structure that also arose from the center, but it seems to be more nominal than real.

The remaining cases can be differentiated from more traditional unitary organization like Uruguay, or cases such as Colombia which is a decentralized unitary republic, with territorial autonomy.

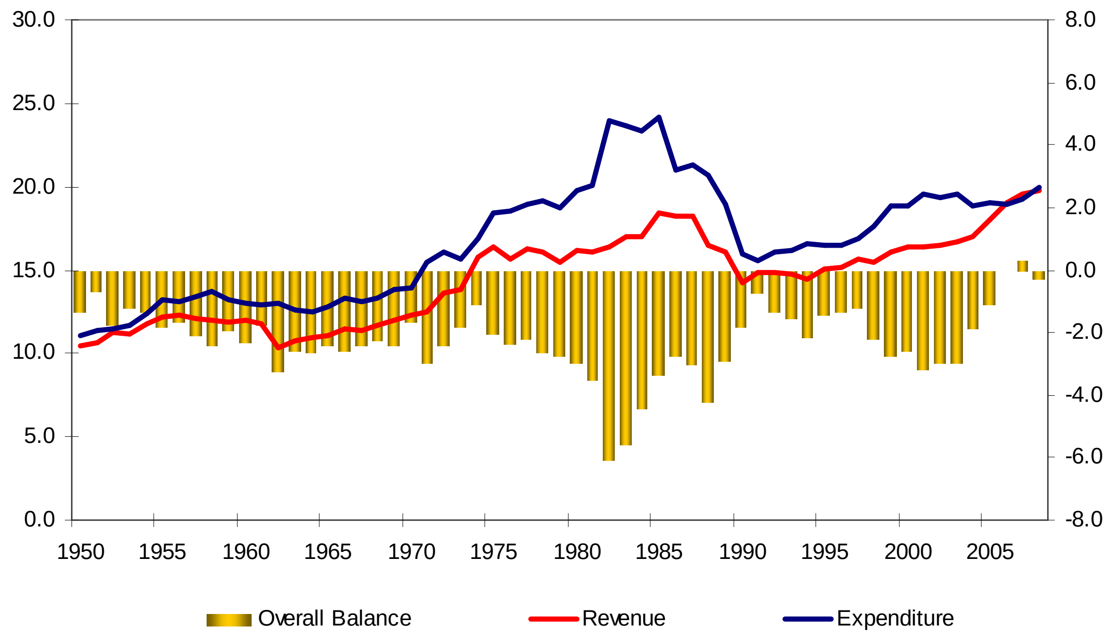
Additionally, the temporal dynamics must be considered: the unitary governments were not always unitary, nor were the federal always federal. This is reflected, in part, in the varying Constitutions written in different countries throughout the nineteenth century. For example, in Colombia the Constitutions of 1853, 1858 and 1863 defined the state as federal, while the 1821, 1830, 1832, 1843 and 1886 Constitutions defined it as unitary. In Mexico, the first federal constitution of 1824 was followed by several attempts, both federal and unitary, until the final ratification of federalism in the constitution of 1857.

3. Basic features of fiscal policy: problems of solvency and volatility

On a consolidated basis (i.e. adding the central government to subnational governments), all of the aforementioned characteristics have necessitated different policies. Policies such as those related to income redistribution, territorial compensation, and inclusion of the informal sector for example, have been very demanding of public resources. The problem is that several times these policies have reached the limit of the lack of fiscal solvency of the public sectors in Latin America.

Solvency problems are related to the difficulty experienced by the region’s governments in financing goods and services provided by their public sectors in a sustainable way. As an illustration of this concern, for the 19 countries in the ECLAC database, only 66 of the 349 overall fiscal balances observed from 1990 to 2008 were positive. If these indicators are disaggregated by decade, the 1990-1994 period included 22 positive overall fiscal balances, whereas there were only nine between 1995 and 1999, 5 between 2000 and 2004, and 30 in the 2005-2008 period. Extending the time coverage to 1950-2007 (figure 5), only 198 of 1058 observations show overall fiscal surpluses, which is less than 20% of the total.

Figure 5: Latin America and the Caribbean: Fiscal revenue and expenditure, 1950-2007. *(Percentages of gross domestic product)*

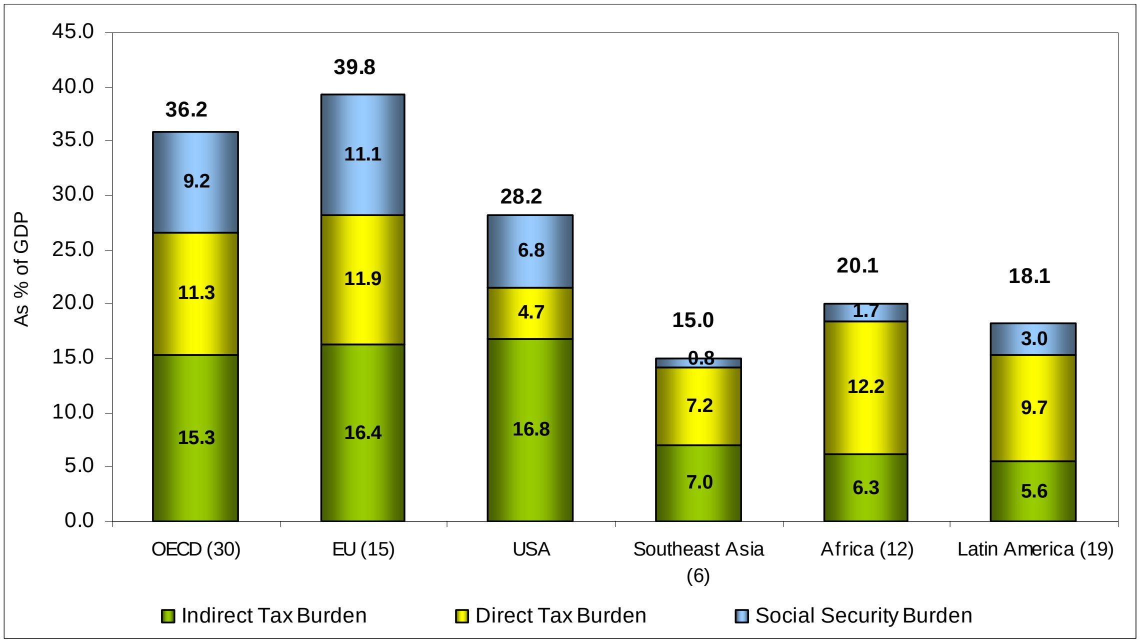


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Solvency problems are related to the difficulty faced collecting taxes in the region. Furthermore, it is necessary to emphasize that the revenue collected by countries in the region has been paltry, both in comparison to other regions of the planet and in relation to their needs or relative to their level of development.

If one compares the situation in Latin America with other regions, it is evident that, in aggregate terms, the tax burden is very low and that there is a significant dependence on indirect taxes. Moreover, these fall disproportionately on the most disadvantaged strata of the population. As shown in Figure 6, the average tax burden for Latin America accounts for 18.2% of GDP in the region, of which 54% is indirect taxation.

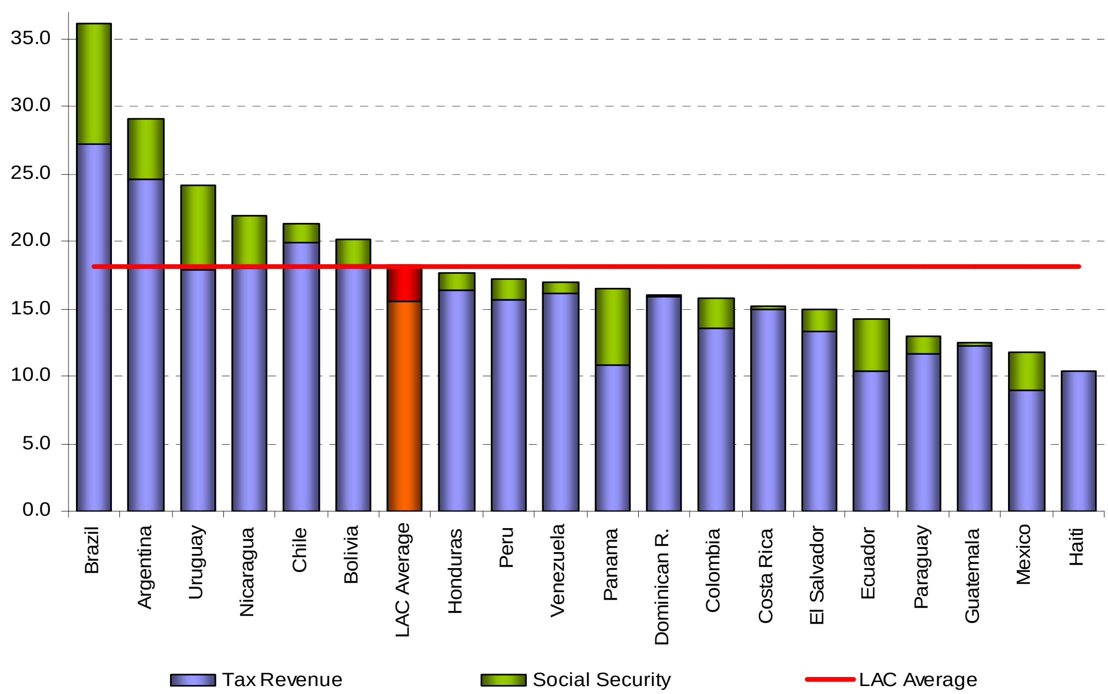
Figure 6: Tax burden and structure compared between regions
(As percentage of gross domestic product)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures

Viewed in disaggregated terms, the tax burden is very uneven across countries. Figure 7 illustrates the level of tax revenues as a percentage of GDP in 2007.

Figure 7: Latin America (19 countries): tax burden, 2007
(Percentages of GDP)

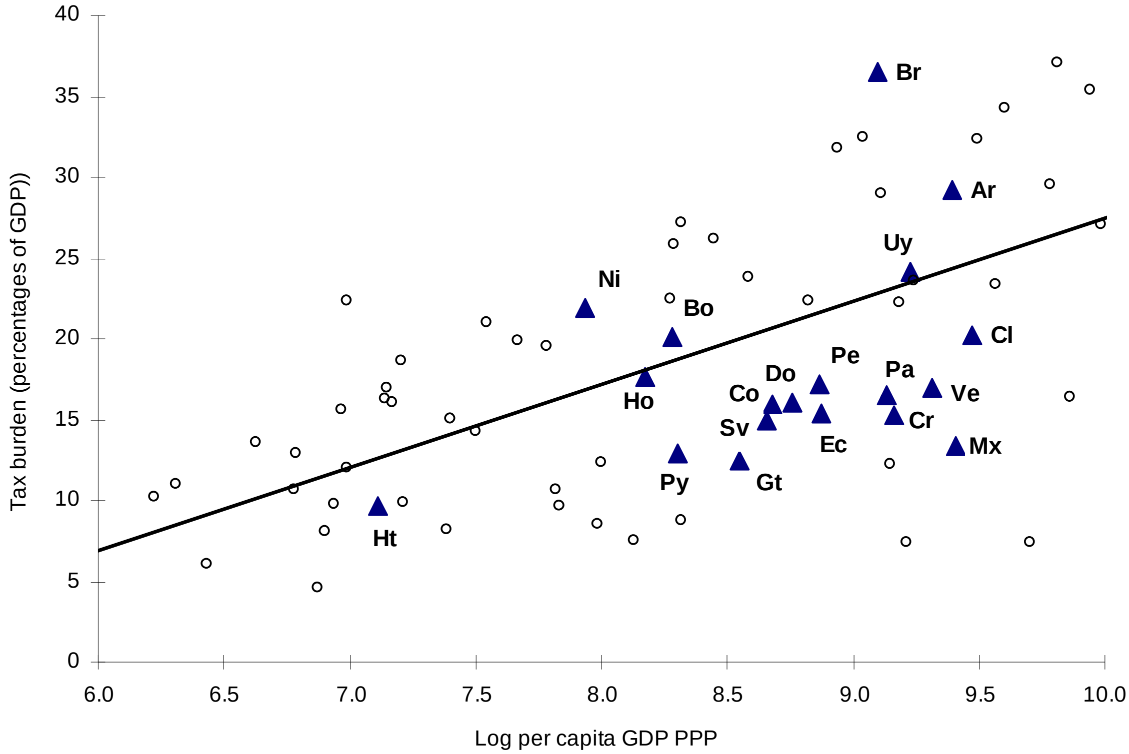


Source: Calculations based on figures from the Economic Commission for Latin America and the Caribbean (ECLAC).

In terms of the relation between tax burden and level of development, Figure 8 shows that only five of 19 Latin American countries have a tax compatible with their level of development. In the other 14 countries, the tax burden is below what it should be based on their per capita GDP.

Figure 8: Latin America and the Caribbean: Tax Burden compared to GDP per capita, values of purchasing power parity (PPP)

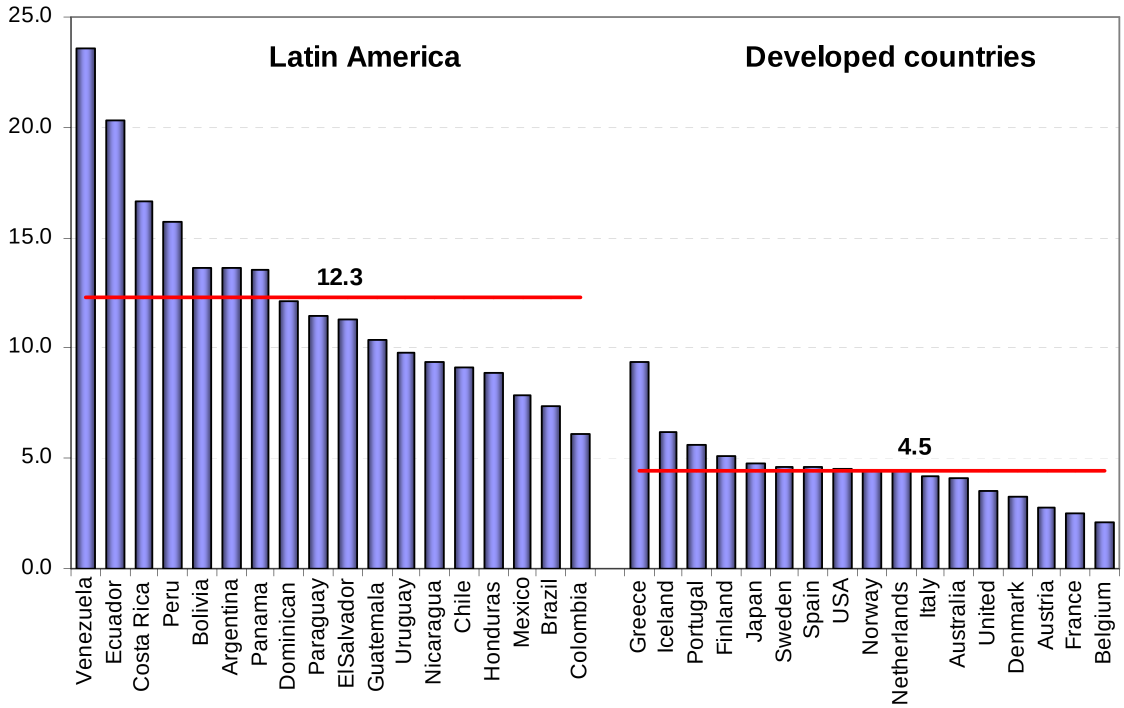
(Percentages of GDP and logarithms)



Source: J.P. Jimenez and A. Podestá, "Taxation and Equity: Challenges for Latin America", Santiago de Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2008, unpublished.

In addition to problems related to solvency and tax burdens, the high volatility of tax revenues is another factor affecting fiscal policy in the region. Measured by its standard deviation, the average volatility is almost three times higher than in developed countries. This has important consequences in regards to the public sector's capacity to play a stabilizing role. Additionally, the excessive volatility of tax revenue mainly affects the most vulnerable segments of the population as it creates fluctuations in social spending.

Figure 9: Latin America and developed countries: Volatility of income tax
(Standard Deviation)



Fuente: R. López Monti, "Real volatility and cyclical fiscal policy in Latin America and developed countries", Santiago de Chile, Comisión Económica para América Latina y el Caribe (CEPAL), 2009, inédito.

Strongly related to the low burden and highly volatile taxation, it should be mention that Latin America has traditionally been a key source of natural resources for the world. Consequently, commodities represent a significant share of total exports for the region. Table 3 shows the commodities that accounted for more than 10% of the exports from their respective countries in 2007.

Table 3: Latin America and the Caribbean: Countries dependent on exports of commodities, 2007 (Percentages of total exports of the country concerned)

Commodity	Over 50% of total exports	Between 20% and 49% of total exports	Between 10% and 19% of total exports
Energy goods			
Crude oil and oil products	Venezuela (92.55), 2006 Ecuador (59.26)	Barbados (31.18) 2006 Colombia (26.77), 2006 Santa Lucia (21.62), 2006 Trinidad and Tobago (42.32), 2006	Argentina (11.09), 2006 Bahamas (18.33), 2006 Belice (16.17), 2006 Mexico (15.54) Jamaica (14.69)
Natural gas		Bolivia (Plurin. St. of) (40.75), 2006 Trinidad and Tobago (34.15), 2006	
Mineral goods			
Coal			Colombia (11.08)
Copper	Chile (56.90)	Peru (36.12)	
Gold			Peru (14.87)*
Zinc			Bolivia (13.39), 2006
Agricultural goods			
Coffee		Honduras (20.91)	Nicaragua (17.25)
Bananas		Dominica (21.27) 2006 Saint Vincent and the Grenadines (29.29), 2006	Panama (10.12) Santa Lucia (18.95), 2006
Soya		Paraguay (30.22), 2006	Argentina (13.55), 2006
Suger			Belice (18.23), 2006
Rice			Saint Vincent and the Grenadines (9.88), 2006
Crustaceans and molluscs			Bahamas (18.26), 2006 Belice (15.45), 2006 Panama (10.18)
Beef (cattle and meat)			Nicaragua (12.06) Paraguay (21.49), 2006

Source: Own compilation based on Tromben and Jimenez (2006), Comtrade (United Nations) and Banco Central de Reserva Peru

Such resources are distributed unevenly within a given country, exacerbating differences in wealth between regions. In addition, as Jiménez and Tromben (2006) emphasize, those countries whose production structure is concentrated in natural products often face fiscal policy challenges resulting directly from the inherent characteristics of such goods. For example, price unpredictability and volatility (as expressed dramatically in recent months) complicates tax policy, by making it difficult to determine the appropriate and sustainable levels of expenditure that can be assumed by the public sector. Moreover, insofar as they constitute non renewable resources (ex: energy, mineral etc.), it is necessary to incorporate considerations of equity across generations into the design of fiscal policy.

The fiscal balance of Latin America and the Caribbean have been much more variable than those of the countries in the Organization for Economic Co-operation and Development (OECD), whether measured as a percentage of GDP, as a share of total fiscal resources, or in relation to the size of the domestic financial system (Gavin, Hausmann and others, 1996; Alesina and Tabellini, 2005). This high volatility is a feature both of overall fiscal balances and of revenues and expenditure separately (Jiménez and Tromben, 2006).

This high degree of volatility is associated with the third feature of fiscal policy in the region: its relation to the economic cycle. Several authors have demonstrated that the fiscal policy of Latin America and the Caribbean has behaved in a way which can be described as procyclical: public spending expands in upturns and declines during recessions, whereas public accounts in the OECD countries have shown the opposite tendency.[3]

4. The process of reallocation of functions between levels of government in Latin America

4.1. Some conceptual issues needed for the evaluation of Latin American decentralization

Over the past few years, various reforms to the organization of public policies have been discussed and implemented. They have affected the shape and scope of state intervention and, in particular, the actions of the welfare state in each country. Reforms such as the decentralization of the process of provisioning goods and services from the central to subnational governments should be understood as part of this wave of reforms. These trends have been quite widespread, covering both developed and developing countries as well as both unitary and federal types of political organization.

Even if there is consensus among fiscal experts on the dominant importance of political factors in the processes of decentralization, in general, the advantages and disadvantages of further decentralization in both the provisioning as well as the financing of public expenditure have been analyzed in the field of fiscal federalism. Different kinds of questions have generally been included within the idea of decentralization. First, one should not confuse the decentralization of public service with its deconcentration, i.e. merely delegating bureaucratic functions from the central government to local governments. Second, decentralization may be only administrative and financial, which implies relative autonomy for local governments; or it may assume a character of political decentralization if there is an integral transfer of normative power to local governments.

The specific characteristics of each of the services that are subject to these processes are very important when defining strategies. Other aspects to be taken into account include the degree of urbanization of society, which has important implications in terms of unit costs of services.

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[3] For more details see Bello y Jiménez (2008)

For example, the public provision of education is based on the well-known arguments of distributional impact and social cohesion, including those benefits related to national integration that arise from having a better educated population. Government intervention provides for a service with more uniform characteristics: this uniformity can be seen as a cost in terms of efficiency – those most capable do not receive as much education as they could receive - which should be contrasted with the benefits of greater equality of opportunity to succeed for those who have no resources for education. In this way, education policy occupies a central role in the establishment and consolidation of the democratic system. That is why access to some basic level of education is now considered a right and an obligation of citizenship; a principle that in almost all countries in the region has achieved constitutional status.

Given the above arguments, the public provision of basic education (like social programs with distributional impact) should respond to the dictates of national policy. Full decentralization, without even the minimum ingredients of coordination, would lead to an excessive fragmentation of the patterns of provision. In turn, local governments can have an uneven idea about what is an adequate provision financed with their own public funds. Ultimately, the need to achieve a more equitable society is a goal that exceeds the powers of local governments and should be a national concern. That is why it is accepted that any decentralized design that impacts the provision of social services must incorporate further criteria for coordination and for the achievement of minimum levels of education for all people. This is independent of location or cost.

The decentralization of health services and other components of social spending, in essence, must be assessed with similar arguments. However, the existence of social health insurance, more or less developed in accordance with each case, is required to follow specific consideration, depending on the more centralized organization of these schemes.

In Latin America, the discussion about the merits and disadvantages of decentralizing the public sector has historically been influenced by ideas related to the historical development of the region. In one perspective, there are authors that understand that the centralism that has historically characterized Latin American countries is due to the region's colonial heritage and this heritage has created barriers to the development of certain regions and caused uneven regional development. Decentralization, according to this perspective, is a necessary reform to improve the situation of inequality in the region. A second perspective sees the decentralization of functions from central to local governments as a policy reform that must be sustained. They allege that it both relieves the central government of responsabilities and, more importantly, brings decisions closer to beneficiaries; consequently, the efficiency of interventions improves.

Great expectations have been placed on the potential of decentralization processes. It is seen as the vehicle for strengthening development, energizing the democratic process, improving equity, improving efficiency in public spending, and/or limiting the uncontrolled growth of public spending. Additionally, it should be noted that much of the discussion is colored by the fact that that the theory does not come with a set of universally applicable instructions. By contrast, the theory of fiscal federalism is has adopted a subsidiary role for the historical institutional elements that mark the parameters of its recommendations.

The challenge is, however, to achieve a balanced position that takes into account the particular circumstances of each case and tries to find pragmatic answers. Moreover, one that encourages the search for solutions that can/will improve the provision of goods and services from the State so as to achieve the most significant results for the welfare of citizens.

In this sense, we should emphasize regional disparities as an aspect often neglected or not treated with the importance it deserves. Both the high degree of personal inequality and the high degree of disparity in regional production within each country impose serious limits on the operation and financing of decentralized services. Further, this limitation necessitates an important central governmental role in order to coordinate and compensate for the disparities between regions or subnational jurisdictions in the public service delivery.

If it is assumed that much of the merit of decentralization depends on fiscal correspondence, the existence of strong regional productive disparities suggest the difficulty in making compatible a completely decentralized provision with overall efficient and equitable results in terms of public provision. Therefore, in this environment, a balanced operation of an intergovernmental relations system will depend on the strong role that central governments plays in defining policies and compensating for of regional differences.

Even when Central Governments have the financial resources required for compensation, the aforementioned disparities still affect substantially the availability of human resources and, in general, the management capacities between jurisdictions.

In particular, it is crucial to recognize that when these problems exist, the basic dilemma of decentralization of social policies is to find a formula for the compatibility between the objectives of the decentralization policy and redistribution. However, it should not be assumed that both groups' objectives can necessarily be fulfilled simultaneously. This requires establishing mechanisms for coordination and cooperation between different levels of government and its financing. This is the case for Latin American countries.

4.2. Latin America experience with reallocation of functions

The diversity and heterogeneity of situations is the hallmark of the process of decentralizing public services in the region. This heterogeneity refers to aspects ranging from institutional characteristics of the countries -that have been discussed in previous sections- to the relevant elements of the subnational governments. These may include the various motivations, institutional frameworks, dynamics of the process, stakeholders and degrees of autonomy of subnational governments.

Different motivations have led countries to undertake reassignment of responsibilities processes. These include cases where decentralization is at the heart of policy reforms (Bolivia, Colombia, Peru), where the process is dominated by sectorial reforms (Chile), and in extreme situations, where it is motivated exclusively by fiscal and financial consideration(Argentina).

According to Di Gropello and Cominetti (1998), there is a predominance of fiscal motivations in the "first generation" of decentralization reforms under non-democratic political contexts (Argentina, Chile, Brazil). Later reforms implemented during the second half of the eighties and nineties were politically motivated and driven by the need to legitimize the new democratic governments. Reforms aimed at improving the efficiency of the services, however, were put off until the late nineties.

When analyzing the reforms to intergovernmental relations in Argentina and Brazil, the motivations for those processes can be interpreted as extreme and opposite cases. In Argentina, decentralization of health, basic education, and other social services was designed by the central government to appropriate provincial resources in order to alter the balance of responsibilities between levels of government without recognition of specific financial transfer. Accordingly, the Argentinean case can be regarded as the paradigm for a process that looks only at fiscal sustainability without worrying about its impact on efficiency and equity. Brazil, however, presents a political process where the transfer of resources to subnational governments was a way to end the centralized management of the dictatorship and promote the development of democracy.

Although perhaps similar to the Argentinean case in terms of motivation, the Chilean case may be, in some sense, considered special. The process was accelerated in the early eighties by the military government for political and fiscal reasons principally, (decentralization as privatization and public sector reduction). The process combined modifications in the micro organization of services and the introduction of financing modalities related to demand subsidies.

Related to this, some aspects of the dynamics of the processes must be taken into account. In general, despite differences between the cases, the processes were originally prompted by the central government, no matter if they were political or fiscal motivated.

In Brazil, however, the political option in favor of decentralization was included in the Constitution drafted in 1988.

The shifting political winds in Peru have greatly affected the process of decentralization in the country. In 1979, in support of the democratic process, the process began. This restored the election of municipal authorities and established new responsibilities and powers. In the late eighties, however, the process lost favor, and during the nineties, with a return to a centrally inclined government, regional governments were abolished and the autonomy of municipalities restricted. After 2001, once again, the decentralization impulse reemerged.

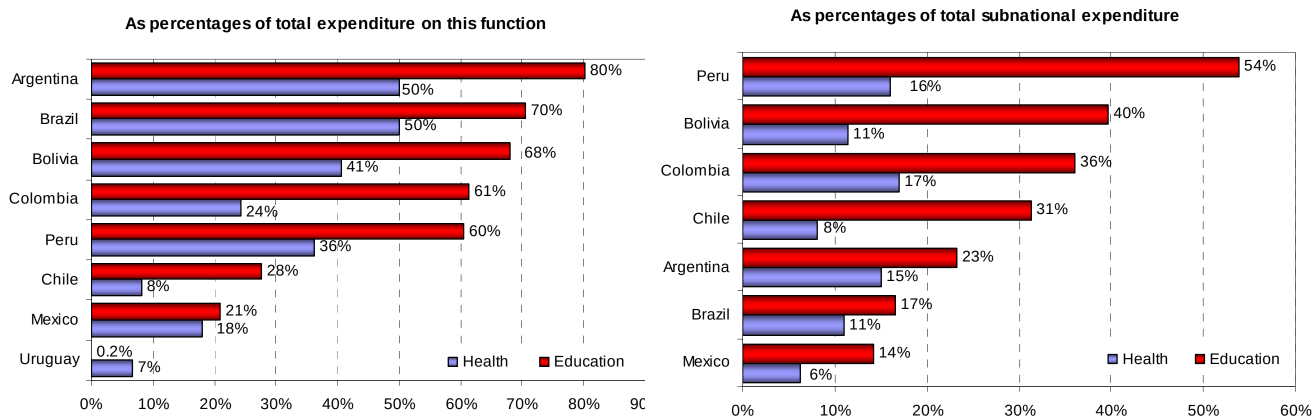
Across the region, the reallocation of responsibilities to subnational governments has initiated a sharp increase in public spending at the subnational level. This increased expenditure has been funneled into education and health, which comprises a significant amount of subnational expenditure of the most decentralized countries in the region (see Gropello and Cominetti 1998; Cetrángolo 2007).

Table 4: Expenditures of Subnational Governments
(As percentages of GDP)

	1985-1990	1991-1995	1996-2000	2001-2007
ARGENTINA	8.7	11.0	11.9	12.5
BOLIVIA	2.8	5.7	7.0	8.9
BRAZIL	14.4	17.3	13.9	12.9
CHILE	2.3	2.3	3.0	2.9
COLOMBIA*	5.2	5.0	7.3	8.0
COSTA RICA	0.8	0.6	0.7	0.8
ECUADOR	…	1.8	2.2	3.8
MEXICO**	3.7	4.0	5.5	7.2
PARAGUAY	0.4	0.3	0.3	0.4
PERU	…	1.8	2.0	2.3

* Average 1985-1990 belongs to 1986-1990
** Average 2001-2007 belongs to 2001-2006
Source: ECLAC

Figure 10: Health and Education
Expenditures of Subnational Governments
(As percentages of total expenditure on this function and as percentages of total subnational expenditure)



Source: ECLAC

However, the crises in the late nineties and early part of this decade resulted in a partial reallocation of functions to the central government. This policy shift was reflected characterized by two functions: to coordinate the macro problems arising from the high indebtedness of subnational governments (a theme which will be addressed in greater detail in the next chapter) and to design programs to confront poverty and serve those most vulnerable to the crisis. The central governments were largely responsible for funding these anti-poverty initiatives.

Typical central governmental programs designed to address poverty are those that aim to directly transfer income to needy households. Examples include the Chile Solidario program, the Argentinean Plan Jefes y Jefas de Hogar Desocupado implemented as a response to the economic crisis of 2001, and the Colombian Desarrollo de Zonas Deprimidas y de Conflicto.

In addition, recognizing the importance of employment and national and social cohesion, central governments devised programs to confront unemployment. The Programa Manos a la Obra promoted both job creation and community participation in Argentina. Others central government led initiatives included the Programa de Erradicación del Trabajo Infantil (PETI) in Brasil and the Programa de Empleo y Capacitación Laboral in Colombia.

Certain central government initiatives tried to cover the shortcomings of local policies. They include the distribution of goods complementary to decentralized functions, such as programs to distribute books in Brazil, and drugs in Brazil and Argentina (Programa Remedying). Another program where the central governments acted to complement the local governments was the Brazilian el Fondo de Mantenimiento y Desarrollo de la Enseñanza Fundamental y Valorización del Magisterio (FUNDEF), which insured a minimum expenditure per pupil in the public school network.

In other cases, the need for compensation is solved by supporting local capacity instead of decentralization processes. One example, found in Honduras, is the initiative Descentralización Fiscal y Gestión Financiera Municipal and the Descentralización de los Servicios Públicos. The federal government has similar intitatives linked to welfare programs. For instance, the Programa de Emergencia Habitacional in Argentina works with labor cooperatives formed by beneficiaries of the Plan Jefes y Jefas de Hogares Desocupados.

Ultimately, under emergency situation the reallocation of roles required a partial redefinition of the role of the central government, either as coordinator of the decentralized sectoral policies or as a supplier of new anti-poverty programs.

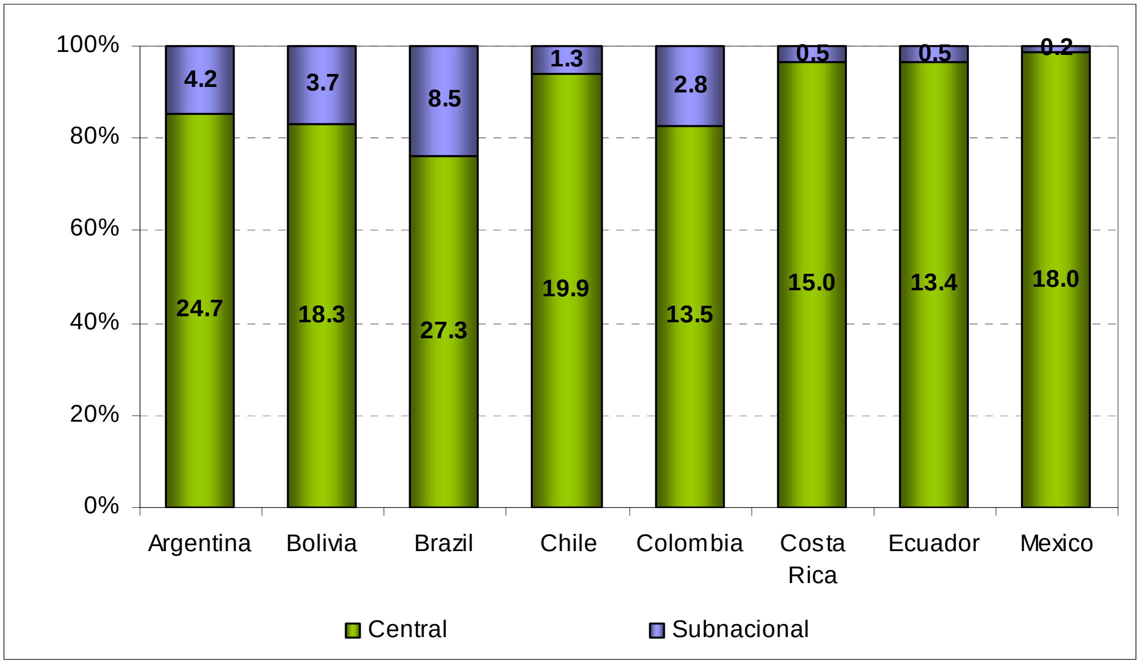
5. Allocation of fiscal revenues

A distinctive feature of the region is the serious problem the public sectors has financing its various activities. This restriction, as noted above is not new, has affected all of the activities of the region's governments, and has important consequences on the final impact of decentralized public policies.

The main source of funding for the public sector is tax revenues. In each country, tax collection is mostly concentrated in the central levels of government (Figure 11). This happens not only because of the Constitutional definition(s) of the powers governing each level, but also due to the benefits of centralized administration of wide base taxes on consumption, foreign trade, income, and payroll.

Figure 11: Structure of tax revenues by level of government

As percentages and percentage of total GDP



Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on official figures.

Note: sub-provincial governments data corresponds to the provinces in Argentina, to regional governments in Bolivia, to states and municipalities in Brasil, to municipalities in Chile, to departments and municipalities in Colombia, to local government in Costa Rica, to provincial councils in Ecuador, and state governments in Mexico.

The tax concentration in the central government has assumed greater significance after the developments of 1) a tax on the incomes of businesses and individuals, 2)a centrally funded social security financed with payroll taxes, 3) and especially since the late sixties, the development of the VAT as the best solution to the taxation on consumption. For subnational governments (intermediate and local), they collect primarily tax assets (land and automotive) and in some more decentralized countries, consumption taxes, mainly through their intermediate governments (Table 5) .

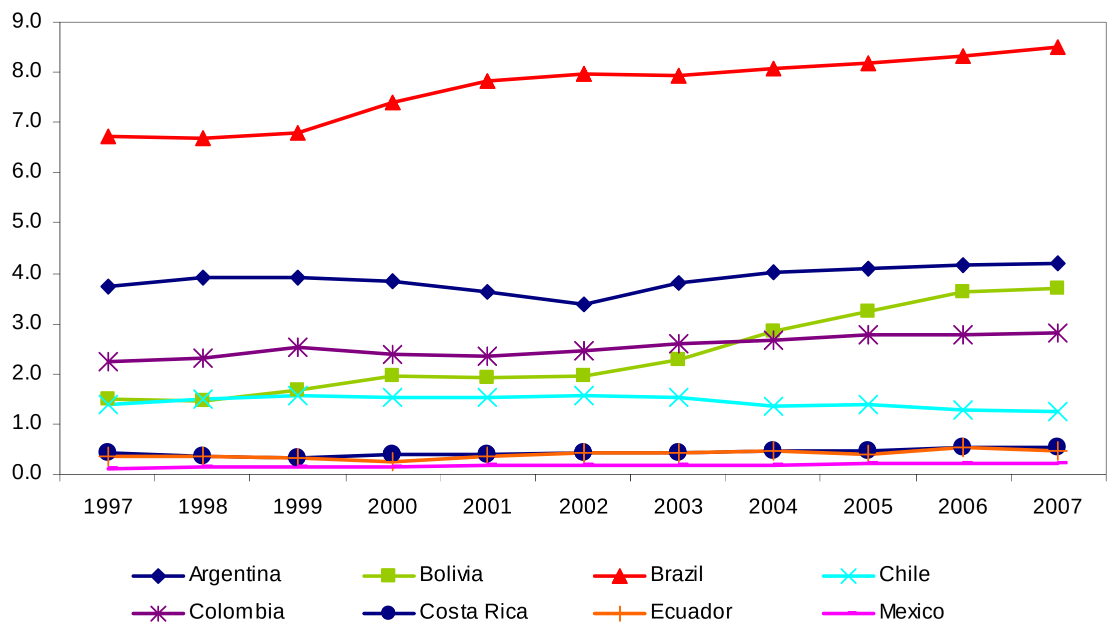
Table 5: Subnational Taxes

	Intermediate government	Local government
Argentina	Turnover tax, property tax, automobile tax, stamp	Non tax revenues, services contribution
Brazil	VAT, fix amount on income tax, consumption tax	Services and property tax
Colombia	Excise taxes (beer, tobacco, liquor and gasoline)	Property tax, Industry and commerce tax, Gasoline (over rate)
Ecuador	"Alcabalas", improvement contributions	Property tax, asset tax, "alcabalas"
Mexico	Automobile and partial payroll tax	Property tax, "patentes de giro"
Peru	Automobile tax, "patentes de giro"	Property tax
Venezuela		Property and automobile tax

Source: Own compilation based on official legislation.

The positive trend observed in national taxes is not reflected in the sub-national taxes as shown in figure 12. Rather, they have remained largely stagnant. Only those related to the exploitation of nonrenewable resources, such as Bolivia, have increased.

Figure 12: Revenue Tax of subnational governments in select countries in Latin America and the Caribbean (1990-2007)-*Percentage of GDP*



Source: ECLAC

The subnational tax par excellence has traditionally been the property tax. However, low collection has characterized Latin American countries. Property tax revenues have been on average about 0.4 points of the product, i.e. one-fifth of what is collected by the developed countries. The situation varies between countries. In some, such as Ecuador, Mexico and Peru, this indicator is less than 0.2% of GDP. On the other hand, in Argentina, Bolivia, Chile, Colombia and Uruguay, the collection of property tax is between 0.5 and 0.7% of the product (see table 6).

Table 6: The property tax in three representative groups of countries and in Latin American countries

(Percentages of GDP)

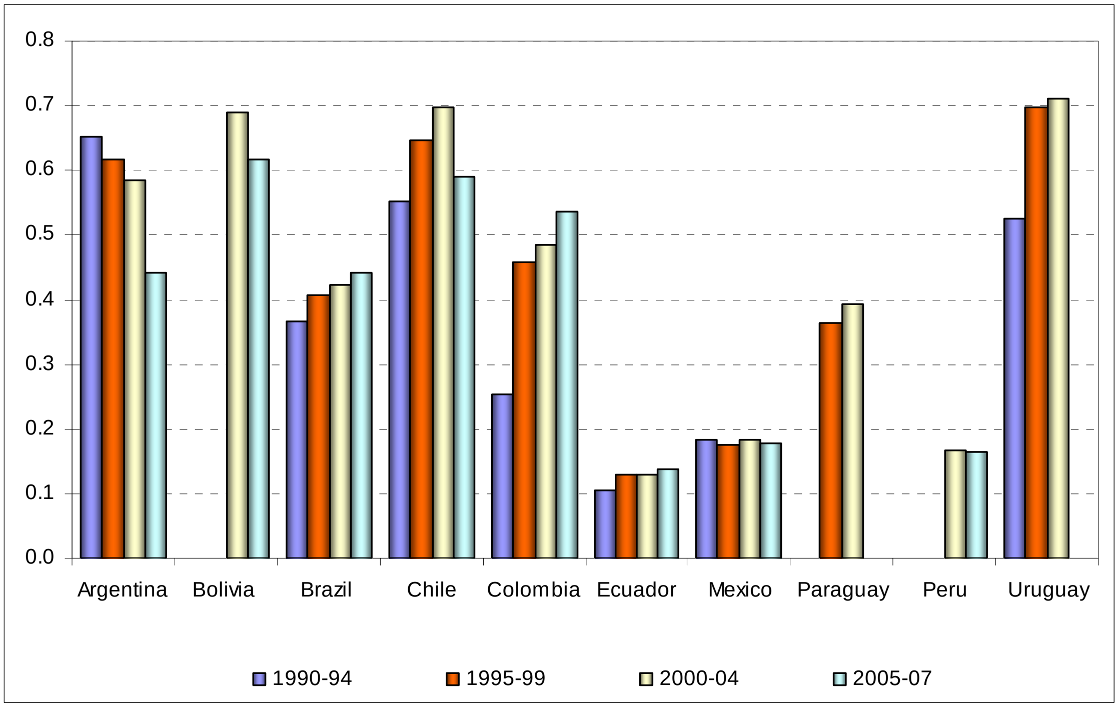
	1970s	1980s	1990s	2000s*
All countries	0.77	0.73	0.75	1.04
(number of countries)	(37)	(49)	(59)	(65)
OECD countries	1.24	1.31	1.44	2.12
(number of countries)	(16)	(18)	(16)	(18)
Transition countries	0.34	0.59	0.54	0.68
(number of countries)	(1)	(4)	(20)	(18)
Developing countries	0.42	0.36	0.42	0.6
(number of countries)	(20)	(27)	(23)	(29)
Latin American countries	…	…	0.40	0.40
(number of countries)	…	…	(8)	(10)
Argentina	…	…	0.63	0.53
Bolivia	…	…	…	0.65
Brazil	…	…	0.32	0.43
Chile	…	…	0.60	0.66
Colombia	…	…	0.36	0.50
Ecuador	…	…	0.12	0.13
Mexico	…	…	0.18	0.18
Paraguay	…	…	0.36	0.39
Peru	…	…	…	0.17
Uruguay	…	…	0.61	0.71

* The data for 2000s is for five years from 2000 to 2004, except to Latin American countries where the data is from 2000 to 2007.

Source: Bahl and Martinez-Vazquez (2008) and ECLAC for Latin American countries.

The performance of the property tax revenues in the period under analysis showed significant improvement in Colombia and Uruguay and a smaller increase in Brazil, Ecuador and Paraguay. In Mexico and Peru, collection remained stagnant at very low levels, while Argentina, Bolivia and Chile experienced a decline from 2005. In contrast, in OECD countries, the tax burden of property taxes has increased considerably, from an average of 1.44% of GDP in the nineties to 2.12% in the first half of 2000. In countries in transition and developing countries, there has been a positive evolution of this indicator over the same period.

Figure 13: The evolution of the property tax in Latin American countries
(Percentages of GDP)



Source: ECLAC.

In the countries concerned, property taxes comprise approximately 40% of the total taxes collected by local governments. However, the relative importance of this tax in local tax revenue varies considerably across countries. For example, in Bolivia, Mexico and Peru, half or more of municipalities total revenues originates from this tax, while at the other extreme, it accounts for only 14% in the Argentinean provinces. It represents approximately 30% in the municipalities in Brazil, Colombia, and Ecuador[4]. However, across the region, the level of collection of predial taxes is very low. The low collection capacity of subnational governments in the region impacts revenues, and, as will be discussed below, creates high dependence on transfers from the central levels of government.

[4] In these countries with low relative importance of property tax, there are other taxes at the subnational level that are more relevant. For example, in Argentina, there is a provincial turnover tax on gross income. In Brazil, the municipalities level a tax on services (ISS) . In Colombia, there is a tax on industry and commerce, and in Ecuador Ecuadorian municipalities tax on total assets and "alcabalas"

Table 7: Reliance on the property tax in Latin American countries
(Percentages of subnational governments tax revenue)

	1990s	2000s*
Latin American countries (number of countries)	36.5 (8)	41.2 (10)
Argentina	18.5	13.8
Bolivia	…	59.3
Brazil	28.3	30.3
Chile	47.4	45.9
Colombia	32.2	30.4
Ecuador	38.3	32.3
Mexico	46.8	49.5
Paraguay	41.9	45.9
Peru	…	66.9
Uruguay	38.4	37.9

* The data for 2000s is from 2000 to 2007
Source: ECLAC

While resources taxes account on average for about 80% of revenue in the region, the total fiscal resources are complemented by a multitude of additional non tax revenue resources. In several countries in the region, revenues from non-tax sources are very important, as in the case of Panama (34.6% of total revenues), Venezuela (38.4%), Ecuador (36.2), Mexico (38.4), Bolivia (31.2), Paraguay (28.3) and Chile (26.3).

In conclusion, the tax revenues concentration in the central government and the development disparities between regions within each country made it impossible for subnational governments to finance the provision of decentralized services with their own revenues. This created a central role to the intergovernmental transfers.

6. The role of central government and coordination mechanisms

As has been stressed, the structural characteristics of Latin American economies coupled with the reallocation of functions require a strong coordination role by the central government. This role was particularly evident in three key aspect: promoting macrofiscal sustainability, addressing regional disparities, and articulating decentralized sectorial policies. However, recent history in the region shows the inherent difficulties balancing these three objectives. The lack of intergovermental coordination led to instances in which one of the three aspects would dominate the others. The dominance of the macro fiscal goal over the others was very clear during certain crisis episodes in the region.

6.1. Macro fiscal coordination mechanisms macrofiscal

The recurrent macro crisis that the countries of the region have suffered tend to have their impact on intergovernmental relations. As described in Fanelli and Jimenez (2009), intergovernmental fiscal relations often deteriorate when the economy receives either a financial (sudden stop) or a commercial shock. When the shock is financial, the subnational governments, if they are allowed to borrow, have more difficulties obtaining credit, in a context of national transfers and subnational revenues decreasing. This increases their deficits or increase pressure for higher transfers. When the shock is commercial (i.e. a fall in the terms of trade), this tends to have an immediate impact on tax revenue and intergovernmenal transfers, which affects the fiscal balance.

These distributional conflicts, which were severely critical in some countries of the region in mid and late nineties (especially in Argentina and Brazil), led several countries to implement fiscal rules. In the case of those most decentralized countries in the region, like Argentina, Brazil and Colombia, the initial objective of this instrument was to coordinate, the fiscal policy (spending, deficit and debt) between levels of government.

Table 8: Latin America and the Caribbean: Fiscal rules currently in force

	Country	Implementation date	Coverage	Type	Additional rules	Legal status
Balance rule	Argentina	2004	Federal and subnational	Nominal growth of primary expenditure must not exceed nominal GDP growth		Law
	Brazil	2001	Federal and subnational	Current equilibrium (subnational); primary surplus (federal)	Limits on wage expenditure (percentage of total)	Law
	Chile	2006	Central	Overall structural surplus (1% of GDP)	Pension Reserve Fund (FRP) Economic and Social Stabilization Fund (FEES)	Law
	Colombia	2001	Subnational governments	Current equilibrium	National Coffee Fund (FNC) Petroleum Saving and Stabilization Fund (FAEP)	Law
	Ecuador	2005	Federal and subnational	Real growth of current expenditure must not exceed 3.5%	Oil Stabilization Fund (FEP) Saving and Contingency Fund (FAC)	Law
	Mexico	2006	Federal and subnational	Current equilibrium	Oil Revenues Stabilization Fund (FEIP)	Law
	Peru	2003	National	Deficit below 1% of GDP; real growth of primary expenditure no more than 3% per year	Fiscal Stabilization Fund	Law
	Venezuela (Bol. Rep. of)	2000	National	Current equilibrium	Macroeconomic Stabilization Fund (FEM)	Law

Debt rule	Argentina	2004	Subnational governments	Annual borrowing limits to ensure that debt servicing does not exceed 15% of current resources		Law
	Brazil	2001	Subnational governments	Annual borrowing limits		Law
	Colombia	1997	Subnational governments	Borrowing limits determined by solvency and liquidity indicators		Law
	Ecuador	2005	Federal and subnational	Timetable for reducing debt to 40% of GDP	Borrowing limits for subnational governments (outstanding debt, flow and guarantees)	Law

Source: Jiménez y Tromben (2007)

These macro fiscal rules (Table 8) have taken several forms and pursued different objectives, ranging from quantitative limits to fiscal balance, expenditure and debt to the design of stabilization funds. According to Kopits and Simansky (1998) the macrofiscal rules must have certain characteristics. They must be clear and transparent, appropriate to their purposes, flexible, and supported by key measures. However, as emphasized in Cetrángolo (2007), these theoretical characteristics can not always occur together. In fact, clarity and simplicity are not always compatible with flexibility, which is usually incompatible with demand. Moreover, the degree of enforcement depends heavily on the institutional conditions of each country, especially federals cases.

Fanelli and Jimenez (2009), contend only by chance would the fiscal balance levels compatible with the macrofiscal policy of the consolidated public sector, with those policies to offset regional disparities and those policies to articulate decentralized sectorial provision are the same and able to reflect in a rule. In these circumstances, the scarcity of funds and instruments necessitates choosing which objective (and therefore the amount of the fiscal balance) is privileged. The process of establishing priorities among objectives and allocating the use of scarce instruments among different policies requires a significant degree of coordination.

Moreover, to be successful, policy coordination requires that incentives for the agents responsible for implementing the policies be in line with the objectives. Such alignment is difficult to achieve when decentralized agents have very different amounts of political power, and are able to act for their own interests and objectives, or can make use of instruments that were reserved for other policies. When this occurs, some policies prevail over others, leading to failures in the coordination sought by the central government. Worse yet, when power is widely dispersed, lack of coordination can lead to a fiscal crisis that prevents the government from taking initiatives to stabilize the economy, thus exacerbating the effects of the shock.

Here it is emphasized that, despite the established norm, the use of resources and tools defined *ex ante* do not necessarily perform *ex post*. This depends on the ability of the central government to coordinate policies among themselves. As emphasized in Fanelli and Jimenez (2009), there are, based on this capability, three possible outcomes: coordination, dominance, and crisis. In principle, the coordinated result is optimal, but it is not difficult to imagine situations where dominance would be functional. Dominance, however, always creates a problem. Namely, it is often unclear if the goals that end up dominating are those reflecting the preferences of the central executive or those of society. The crisis case is the worst. In crisis, the situation is overdetermined , while the result of inconsistently implemented measures is undetermined.

Of course the larger the area of existing policy, the greater the capacity to coordinate policies. However, Fanelli and Jimenez (2009) have been pointed out that policy space is not constant and depends on the relation of the central government's resources, tools and goals to the three areas that must be coordinated: the macrofiscal policy of the public sector as a whole, the compensatory policies that address disparities, and sectorial policies

6.2. Coordination mechanisms: intergovernmental transfers

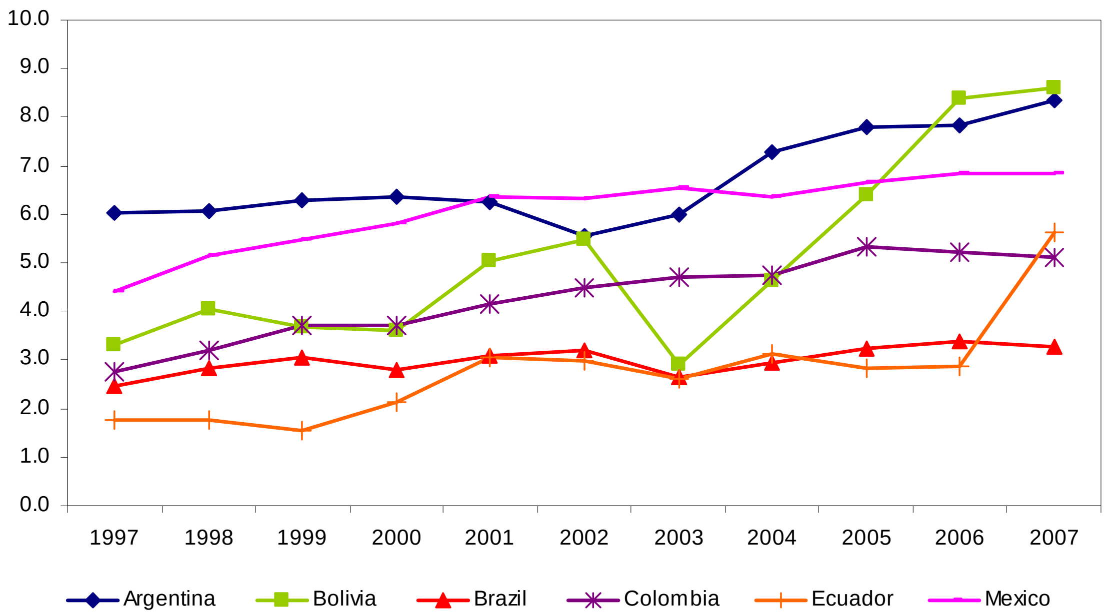
Furthermore, as highlighted in the opening chapters, the high regional inequality together with fiscal asymmetries requires a central role in coordinating the intergovernmental fiscal system to meet most effectively the basic aims of public sectors. In this regard, most of this coordination is focused on the central government. Amongst the different mechanisms utilized, intergovernmental transfers are a central aspect, whether addressing regional disparities or articulating sectoral policies

The combination of tax systems concentrated in the hands of central governments and the tendency of an increasing decentralization of public spending to subnational governments has determined varying degrees of imbalance between the spending levels and the resources of different levels of government. This phenomena highlights the growing importance of intergovernmental transfers systems being able to cover these imbalances and ensure the financing of subnational governments. Of course, the more advanced the processes of decentralization are, the greater the vertical imbalances and the need to establish mechanisms for coordination and compensation for sectorial policies.

According to Shah (2004), intergovernmental fiscal transfers financed almost 60% of subnational expenditures in developing countries and economies in transition. They financed approximately one third of expenditure in OECD countries. In addition to the expenditures that the transfers finance, they generate different incentives that the central government might be able to exploit to coordinate public policies.

As shown in the figure below, the transfers have grown in importance in recent decades as the amounts distributed have grown. Additionally, the objectives to be reached by these transfers have increased, which in many cases, have to be overdetermined.

Figure 14: Transfers to subnational governments in select Latin America and Caribbean countries (1990-2007) - Percentage of GDP



Source: ECLAC

Latin America presents a wide variety of types of transfers between levels of government. The following table summarizes this diversity, ordering seventy-seven of the systems used by countries of the region. These are based on four criteria: origin of the funds, transfer mechanism, type of allocation, and destination. This classification shows that the tax systems of central governments are the main providers of funds for these transfers and replicate procyclic character of tax systems in Latin America. However, there are few systems that transfer in accordance with the changes in the costs of services provided. It also draws attention to the large number of transfer systems with a specific allocation, marking the importance of central governments in the financing sector.

Table 9: Characteristics of the transfer systems in Latin America
(77 systems analyzed)

	Number of Systems
Origin of Funds	
Percentage of national taxes	40
Lump sum	3
Variable amount (by cost of service)	5
Budget allocation	15
Other	14
Transfer Mechanism	
Discretionary	29
Automatic	48
Type of allocation	
Free availability	38
Sector allocation	39
Destination	
Intermediate governments	37
Local governments	44

Source: Jiménez, J.P. (2006)

Taking into account the circumstances in which the process of decentralization developed, its outcome and central impact on social cohesion depends on the forms of financial transfers between government levels. Below, there is a ranking of the modalities that have been detected in the region, the different criteria used to allocate resources, and the use of conditionality to allocate funding policies.

1. Methods of transfer

The region presents a great diversity of patterns of transfers between levels of government, which makes identifying general features common to the region complex. Transfers correspond to different modalities depending on the objective.

In schematic form, it is possible to classify the systems of transfer as follows:

- Allocation among the nation and the interim government: federal countries: In the particular case of Argentina, the law provides that, except for taxes on foreign trade and payroll, 56.66% of the collection corresponds to the provinces. However, in reality, in 2005, as a result of a number of partial reforms and emergency measures, the provinces received under the partnership tax regime, only one third of the theoretically shared resources. There do not exist, however, systems of automatic transfers to municipal governments.

- Allocation among federal and different levels of the subnational government(s): In Brazil, these transfers, established by the Constitution, come from taxes on income and industrialized products, reaching both states and municipalities.

- Allocation among intermediate and local levels: This scheme is different from the aforementioned because, as in the case of Argentina, the municipal finance is covered by different legislation in each province. There exist 23 different systems of transfers between provinces and municipalities.

- Systems which include revenues derived from natural resources: In Mexico, during 1990, major changes were introduced in the basic system of transfers and in the General Fund of Investments. The fund distributed among subnational governments 20% of the tax amount with a few exceptions and included the rights to oil extraction and mining. In Peru, in addition to taxes, distribution resources included sources such as royalty income from mining, forestry and hydroelectric.

- Systems with exceptions: In Honduras, the Municipalities Law establishes the obligation of the central government to transfer 5% of budgeted revenue. In this case, one distinctive feature is that municipalities with port activity are excluded from this transfer. These receive 4% of the revenue from this activity and the customs that developed in each municipality.

- Horizontal division: In Chile the Common Municipal Fund redistributes resources among local governments also receive funds from central government.

- Distribution incorporating different destinations to subnational governments: As a result of disputes between state jurisdictions to elude budget constraints, certain institutions, in some cases, obtained specific allocations of a portion of the proceeds. In this regard, the Argentinean transfer system offers numerous examples of allocation of funds to finance, among others, infrastructure, the insurance system and the educational system. Bolivia, meanwhile, in addition to sharing income with municipalities and prefectures, also partially finances autonomous universities with these resources.

- Allocation of funds that do not come from tax revenue: These are very exceptional cases. For example, In Bolivia, due to their fiscal sustainability problems, social and economic development was benefiting from two debt reduction agreements with the IMF. While this is a debt forgiveness designed to help solve the fiscal and financial problems of the country, in some cases it was decided to transfer the relief funds that were intended to increase social spending into the hands of municipalities.

It must be emphasized that from the viewpoint of fiscal sustainability, the majority of these transfer systems have the problem of making endogenous transfers in order to augment collection revenues. They, therefore, contribute to a high cyclical component for sub-national spending. In contrast, there are very few cases where the design of the transfer limit the procyclicality of subnational finances or meet the specific characteristics of the sector policy being financed.

2. Criteria for distribution

In addition to the general characterization presented and taking into account the strong disparity between the regional incomes in each country, the possibility of improving regional cohesion depends largely on the dominant distribution criteria of each scheme for the transfer of resources between subnational jurisdictions (secondary distribution). It is understood that greater attention to the problem demands redistributive schemes that take into account explicit indicators of the needs of each region.

At one extreme, Argentina introduced a system of fixed coefficients without explicit criteria in its determination. However, in 1988 criteria for allocating the funds allocated to any specific purpose were introduced. Mexico, on the other hand, combines indicators related to the distribution of population and collection in different regions. Guatemala has a somewhat more complex scheme. It combines population distribution, in equal proportion, to the per capita income in each municipality, and the inverse to the number of villages and hamlets. In Peru, there is a Municipal Compensation Fund which distributes tax funds among various provincial and district municipalities. It uses an extensive set of indicators that distinguishes between the rural and urban municipalities. The case in Honduras is much simpler. There, the distribution comes from combining two criteria: equal parts and number of inhabitants.

There are also systems that must be considered in transition, following the pattern that defines the sharing indicators. This is the case of Colombia, which incorporates very specific elements that link the transfer system to sectoral policies. Indeed, as a unitary government that promotes decentralization, Colombia defines a transfer system that allocates resources by sector. Within each sector, the territorial distribution is made taking into account the specific distribution indicators. For example, the share of resources devoted to education is distributed mainly according to the cost of the target population, It is based on typologies established by the national government that consider the educational levels in urban and rural areas. In the event that there is a balance of resources after determining the target population, funds are distributed based on population criteria, considering issues of efficiency and equity.

In this way, this complex system finances the municipalities according to population served. However, it incorporates a "bargain" system that limits the financial loss before reducing enrollment. This feature can be seen, on one hand, as temporary, but on the other hand, as a way to incorporate a pragmatic solution to the rigidity of the indicators. In this way, certain political costs can be prevented and the fiscal pressure reduced. Additionally, it leaves a degree of discretion in the hands of the central government.

3. Transfers with conditions

According to literature, intergovernmental transfers can be of two types: conditional or non- conditional. The first are funds designated for specific purposes. In this case, the central power defines, in some way, the destination of the funds transferred. When it comes to non-conditional transfers, the funds are freely available and may be used in accordance with the priorities of local government. In turn, the conditional transfers have two modes: in one case the recipient is obligated to contribute financing, whereas in the other, there is no obligation to match funds.

The conditional transfers without counterpart are recommended for subsidizing activities that are high-priority for the central government but low priority for local government. This is frequently the case when the objective is ensuring a uniform level of provision for a service. The partnership conditional transfers, on the other hand, seek to resolve the problem of incentives that may be present in the previous alternative. These are recommended when the objective is to compel the local government to improve the provision of a certain service.

Governments receiving transfers obviously prefer non-conditional, as it allows complete flexibility in the use of funds according to their own priorities. However, these transfers can lower local government incentive to generate resource within their own jurisdictions. Consequently, this type of transfer is only justified when the objective is to compensate for fiscal gaps and to improve the welfare of local residents. Similarly, when, as a consequence of the economies of scale in the collection of one or more taxes, it is decided to centralize the tax administration and distribute the funds among different jurisdictions.

Consequently, to the extent that the resources transferred match the priorities defined by the central government in response to an incomplete decentralization of certain functions, conditional transfers are required.

As an example of conditionality in its most general definition, Bolivia states that a substancial part of resource sharing (85%) must be allocated for social or productive investment. Similarly, in Honduras, the transfers should be targeted primarily to capital expenditures. In El Salvador, for its part, the transfer system (comprised of the Fund for Economic and Social Development of the Municipalities and The Social Investment Fund for Local Development) is intended to finance projects of social and economic infrastructure. While in Uruguay, Article 298 of the Constitution establishes "for the development of the interior of country and the implementation of decentralization policies, a portion of national taxes collected outside the Department of Montevideo."

Another subset of conditional funds are those that specify transfers to a given sector. Brazil, for example, utilizes the transfers of The Fund for the Maintenance and Development of Fundamental Education and Evaluation of Teachers (FUNDEF), as well as those that finance the Unified Health System (SUS). In Argentina, there are a variety of automatic transfers but of conditional use. These include The Law on Education Financing, which allocates tax revenues for educational purposes. Finally, there are financing schemes for specific programs. For example, local governments oversee The Vaso de Leche program in Peru. When determining distribution, specific indicators related to the program (number of children, pregnant mothers, elderly, children affected by TB, poverty index) are considered.

As mentioned earlier, the Colombian case is very special in the region. Its general purpose system is regulated by Act 715 of 2001, as mandated by the Constitution. This Act divides the transfer into three main parts: a) education, which represents 58.5% of the resources, b) health, which represents 24.5%, of the resources and c) general purpose, which represents 17%. In each of these parts, the law establishes the criteria for distributing resources among departments and municipalities, as well as the conditions of use. The fund for the general purpose mandates 41% for safe water and basic sanitation, 7% for recreation and sport, 3% for culture and the rest for a list of sectors and purposes of expenditure such as public services, transportation, agricultural development, etc.. Consequently, it appears that if desired, a local municipality has no possibility of reallocating resources to general education or health. In this respect, local autonomy is very reduced, especially given the absence of decentralized tax power

Within the group of conditional transfers, there are some that require local government counterparts. This partnership usually exists in order to put pressure on sub-national governments to meet certain decentralization policy objectives that are defined in decentralized sector policy by the central government or in some federal consensus.

In these cases, to match policy objectives of the central government with sub-national government policy, the transfers from the central level are made only to the extent that each local government demonstrates its adherence to this policy by allocating a portion of its budget. This practice enhances the chance of greater equality while providing for the most efficient use of fiscal resources. One example is the Honduran Social Investment Fund (FHIS). This Fund is a decentralized institution of the Presidency of the Republic, who has recently made decentralization agreements with specific groups of municipalities. Further, these partnerships are defined in terms of the economic capacity of each municipality and subject to the submission of the Municipal Plan.

In Argentina, The Nacer Plan aims to reduce overall morbidity and mortality of mothers and children under 6 years through changes in the logic of the financing model. The central government transfers resources to the provinces for each registered person who does not have explicit social coverage (public or private insurance). Payments are then made in two parts: 40% in terms of objectives achieved and 60% in relation to the list of beneficiaries.

Another form of transfer that attempts to encourage the adoption of certain kinds of policy innovations is the introduction of competitive funds. In the Chilean case, they are national or regional in character and administered sectorally. Therefore, they are not reflected in municipal budgets. Rather, resource allocation criteria are defined centrally, encouraging municipalities to submit innovative project proposals for financing. Relevant examples of this type of funding are the Urban Improvement Program and Community Facilities District and the Chile Neighborhood programs. These are administered by the central level of government, which is part of the national policy for poverty eradication, with emphasis on urban areas. In Mexico, there is a similiar mechanism for competition through the allocation of national funds based on innovative proposals in the area of education

An additional issue that strongly impacts the effectiveness and efficiency of the system of transfers is the question of who should be responsible for the design and monitoring of the system. International experience shows three models to be considered:

- In the first, and most common, it is the central government alone that designs the system. This can have the disadvantage of biasing the system toward a centralized one, whereas what is sought, basically, is to facilitate decision making in a more decentralized way.
- A second model calls for the establishment of a virtually independent body, such as the grant commissions. The purpose of these commissions is to design and reform the system. In some countries, these commissions have proved ineffective, essentially because many of their recommendations, based on technical analyses, have been ignored and not implemented by the central government.
- A third possibility is the use of federal agencies made up of both central and subnational executive authorities. Policies are established by consensus, which encourages commitment by the different parties.. A variation of this model is the creation of a collegial body that includes representatives not only of the central government and the provinces but also of civil society.

7. Conclusions and final reflections

Over the past few years, various reforms to the organization of public policies have been discussed and implemented. They have affected the terms and scope of state intervention and, in particular, the actions of the public sector in each country. The processes of decentralization of functions in the provision of public goods and services from the central to subnational governments should be understood as part of this wave of reforms. These trends have been quite widespread, covering both developed and developing countries. In Latin America, they have been quite important and involved countries with both unitary and federal political structures

In many cases, decentralization processes have been accompanied by a deterioration of public finances and the provision of public goods and services. This has led some to believe that there is a necessary link between the two phenomena. Others hold that this deterioration is linked to the initial stages of the process and tends to disappear as the sub-national levels of government acquire the necessary capacity to manage their new functions. However, opinion is growing that these problems of deteriorating finances and provision of public services may have much less to do with the process of decentralization and more to do with underestimations of the necessary coordination mechanisms of the system of intergovernmental relations.

This paper has postulated that the structural characteristics of Latin American economies can be characterized by high institutional heterogeneity, and inequality in the distribution of both personal and regional income (with the consequent disparity in the distribution of the tax base).

Further, it contends that of tasks of reallocating functions neccesitates a strong coordinating role of central government in three key aspects of the process: promoting macrofiscal sustainability, compensating for the regional disparities, and articulation of decentralized sectoral policies. Moreover, there is a need to emphasize the complementary relationship between these three roles.

Recent history in decentralized countries in the region shows the difficulties of coordinating these three objectives. Lack of coordination led intergovernmental relations systems to instances in which one of the objectives dominated the others. The result was macrofiscal sustainability was hardly maintained, but only at the expense of addressing the other two concerns.

It is obvious that the larger the area of existing policy, the greater the capacity of central government to coordinate policies and objectives. However, the policy space is not invariably or necessarily associated with greater fiscal slack in the public sector. This depends on existing resources, the instruments available, and a functioning relationship between stated objectives.

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