

# The relations between different levels of government in Argentina

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**T**his article deals with the fiscal and financial relations between the national government and the provincial governments in Argentina during the last 15 years, identifying the factors which help to explain the high degree of conflictivity of those relations. In view of the institutional roots of the conflict, a historical review is made in order to place the recent problems and future discussion in a long-term context. First of all, the development of federalism in Argentina and the evolution of the various forms of autonomy of the provinces is examined, followed, in the central section of the document, by a review of the options that have dominated the changes in the functions and incomes of the different levels of government in recent decades. Those options have to do not only with the distribution of taxes but also with the process of decentralization and the changes in functions among levels of government.

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# I

## Introduction

It is well known that the benefits of a modern federal system of government are linked with the effective functioning of the democratic institutions. In Argentina, however, since those institutions came into effect again in 1983 the debate has centered almost exclusively on the possibility of approving a new system of distribution of taxes, and little progress has been made in the analysis of a more mature form of fiscal federalism which would provide a better quality of life all over the country. Still worse, it has not even been possible to achieve a stable system of distribution of taxes. Ten years ago, a Constituent Assembly agreed on the need for a new system, but it has never been possible to reach a consensus on this matter. Transitory pacts, bilateral agreements (often secret) and mutual mistrust have taken the place of the transparent and stable rules, confidence and complementarity needed in a modern federal system prizing consensus above conflict.

The recent crisis and the decisions taken to cope with it undoubtedly involve a change in the relations between levels of government which affects both the distribution of resources and income and the allocation of functions and indebtedness of each of those levels. It has therefore become necessary to rethink the problem, seeking the roots of the reasons for past

difficulties and the key to the construction of a more stable system under the new circumstances.

This article analyses the conflictive financial relationship between the national government and the provinces over the last 15 years in order to identify the factors that can explain the difficulty in generating a stable system of relations between the two levels: a system of which the Co-participation Law is only a part. In view of the institutional roots of this problem, a long-term historical review must be made in order to place the recent problems and the future discussion in a suitable context.

In line with this idea, the following section presents the historical roots of the conflict between the different levels of government, analysing the process of development of the federal State as a limitation on the autonomy of the provinces and the special history of tax distribution systems in Argentina. Subsequently, the central part of the document examines the relations between the different levels of government over the last 15 years, with regard to both functions and resources. That section goes into greater detail not only on the options for the distribution of taxes but also those regarding the process of decentralization and change of functions among the different levels of government.

# II

## The allocation of functions among levels of government

Argentina, like the United States, Switzerland and Australia, belongs to the group of countries whose Constitutions define the respective federal and

concurrent powers, leaving all the residual powers not elsewhere specified in the hands of the provincial governments. Thus the National Constitution of Argentina lays down that the provinces shall keep for themselves all those areas of competence not allocated to the federal government. As Bidart Campos (1993) notes, this indicates that for the provinces competence in any given matter is the rule, while for the federal government it is the exception. The federal government has exclusive responsibility for external relations,

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money issue, internal and external navigation, and defence. Competence is shared, however, in a number of areas such as the administration of justice, primary education and social security. Consequently, the constitutional framework is not very clear as regards the functions and responsibilities of each level of government, and this has made possible various processes of reallocation of functions in recent decades. These processes, which have not always been very orderly and transparent, have made the relations between the national government, the provinces and the municipalities even more complex.

The National Constitution delegates to each province the definition of its own municipal system. The Constitutions of the various provinces and the organic municipal laws establish different areas of competence for the municipalities, but in practice these differences have diminished. The main actions and policies of the local governments are connected fundamentally with basic urban services such as garbage collection services and public lighting.

### **1. Public expenditure and its allocation among the different levels of government**

The lack of a clear division of responsibilities for expenditure among the various levels of government is usually the main source of conflict among them, as well as leading to inefficient and unequal use of resources. Whereas some functions (such as defence) cause little discussion about the level of government that should provide them, others, such as education and health, have given rise to different ways of dealing with them in different countries over the last few years. Quite apart from the usual recommendation that overlapping of functions should be avoided, most often the various responsibilities of the public sector are shared among the different levels of government.

Unlike other countries, in Argentina the processes of devolving or decentralizing expenditure to the subnational levels of government cannot be viewed as an advance by those levels compared with the powers of the central government. Although on the one hand it may be noted that with each new legislative instance the coefficients of distribution in favour of the provincial governments have increased, on the other hand the processes of decentralization of expenditure, since they have not been accompanied by concomitant changes in the resources made available, have involved strong (military or civil) central governments and unequal negotiating power.

As also occurred towards the end of the 1970s, the process of fiscal decentralization which prevailed in the educational and health reforms of the early 1990s were exclusively motivated by the national government's decision to modify the financial relations with the provinces and municipalities in its own favour. Both the transfer of health and primary educational establishments in the first of the above-mentioned decades and that of hospitals and secondary schools in the early part of the latter decade were explicitly motivated by the desire to modify effective co-participation. Furthermore, no specific resources were envisaged to cover the financing of decentralized services, nor were any compensatory mechanisms designed before the transfers.

The decentralization policy has resulted in heavy costs in terms of "social cohesion". In the fields of both health and education, a wide range of local responses can be identified as regards the way the process has been adopted and its results in terms of equity and efficiency. The lack of coordination from the central level has permitted great heterogeneity of the forms of conduct at the provincial and municipal levels, depending largely on the prior configuration of each system and the sectoral policy adopted in each locality in response to the decentralization process. These responses are also strongly conditioned by the financial constraints, which affect each local area in very different ways. Thus, the possibilities of improving the decentralized social services are delimited by the degree of socioeconomic and productive development in each subnational area of jurisdiction and its financial capacity. Likewise, the development potential of each such jurisdiction is determined to a large extent by the state and level of its human and cultural capital, which is directly linked with its population's possibilities of gaining access to good levels of education and health.

There are no special fiscal and financial mechanisms associated with the distribution of fiscal revenue between the central government and the provinces which can be equated with national standards in terms of the provision and quality of education or health. Under the present policy design, this raises a difficult dilemma: if it is desired to apply nationwide programmes or policies and priorities, aimed at more equitable provision of education and health in the different provinces of the country, this will eventually call for additional funds from the national budget, but if this option is not viable from the fiscal point of view, this will adversely affect any actions to secure such improvement. As a result, the provision and quality of

education and health will tend to depend too much on the availability of economic and fiscal resources in the different jurisdictions in question.

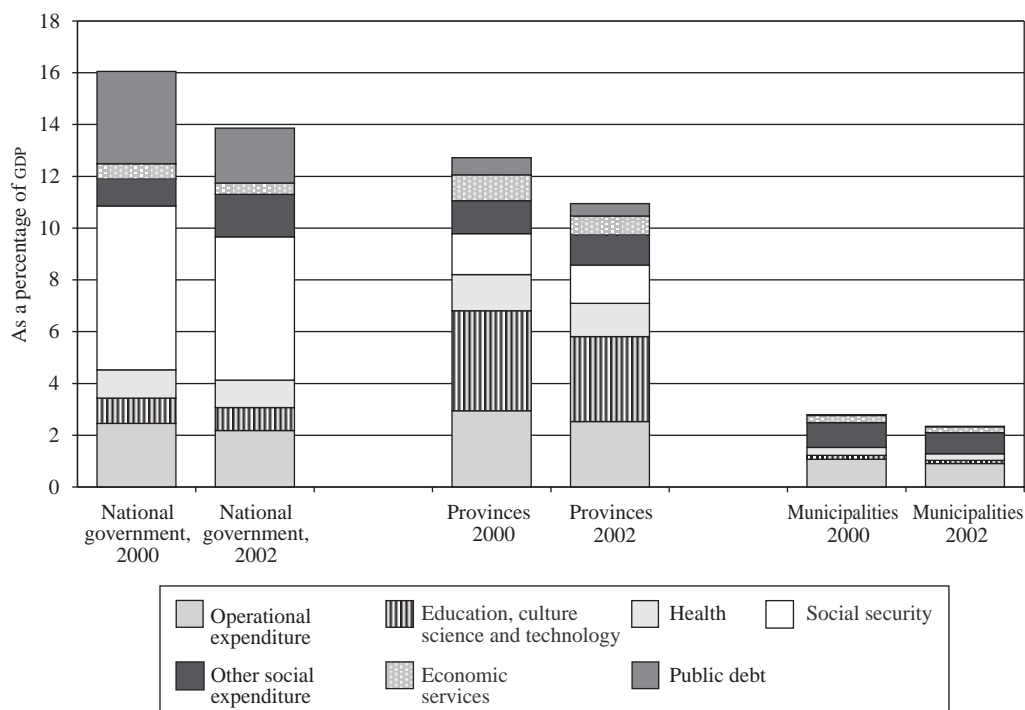
Moreover, the decentralization of social services has led to changes in the way these fiscal constraints are manifested. Since the structure of expenditure of the provinces has come to be increasingly dominated by social services, the efforts to put their finances on a sounder basis undertaken by the different provincial jurisdictions which have been faced with fiscal and financial problems necessarily had to consider the possibility of reducing their health and education outlays. Furthermore, since almost all of the expenditure in these fields is concentrated on the payment of salaries, in some provinces these efforts have given rise to episodes of serious social conflict. In order to deal with these problems, attempts have therefore been made to apply reforms in the health and education sectors aimed at improving the organization and management of social expenditure.

As a result of the processes of change in the country's fiscal structure, the national government has

increasingly centered its outlays on social security, health services for the elderly, and debt service. The provinces, for their part, have done so in the fields of education and health, while the municipalities have concentrated on different urban services. Simplifying the problem to the extreme, it could be said that the national government has concentrated its budget on dealing with problems of the past (usually established rights which it is difficult to alter), while the provinces have concentrated their efforts on the future. Indeed, the national government has used the financial needs of the pension system as an argument to put pressure on the provincial governments to agree to give up resources to ensure the financing of the social security system. As a result, both the provinces and the municipalities are now co-financing that system. In order to illustrate this point, figure 1 shows the level and composition of the expenditure of the different levels of government for the years 2000 and 2002 (i.e., before and after the end of the convertibility programme). This figure confirms the above-mentioned characteristics of the functional structure of expenditure by levels of government.

FIGURE 1

**Argentina: Composition of public expenditure by function and level of government, 2000 and 2002**



Source: Prepared by the authors on the basis of data from the Ministry of Economic Policy.

## 2. Allocation of taxation powers, and financial imbalance between the different levels of government

With regard to the financing of the different levels of government, the National Constitution (article 75, paragraph 2) delimits the taxation powers of the national government and the provinces, laying down that indirect taxes shall be concurrent between both levels, except in the case of import and export duties, which are an exclusive prerogative of the national government (article 4). In principle, direct taxes are exclusively provincial, but the national government has the right to use them for a limited time if defence, common security and the general good of the State so require.

In practice, most taxes are collected by the national government and the provinces share in them. The provinces, however, collect four important taxes themselves (on real estate, motor vehicles, stamps and gross income) which cover some 40% of their expenditure; the rest is financed through transfers from the central government and indebtedness.

In this sense, Argentina is no exception to international trends: the share of the subnational levels of government in total resources has not grown commensurately with their expenditure, thus leading to a growing gap between expenditure and resources at the subnational level.

For reasons of efficiency, the literature usually recommends that subnational levels of government should not use taxes whose bases are highly mobile and subject to major cyclical variations. This clearly limits the decentralization of income tax, whether on persons or companies. In the case of consumption taxes, tax administration considerations (economies of scale in collection and difficulties regarding trade between different areas of jurisdiction) likewise make their decentralization inadvisable. Wealth taxes are free from all these problems, but they usually generate amounts of revenue which are insufficient for financing the outlays of subnational levels of government in heavily decentralized countries.

The allocation of taxes between the different levels of government has to strike a balance between two sometimes opposing objectives. On the one hand, the theory of fiscal federalism holds that the subnational levels of government can better respond to the preferences of the inhabitants in those areas where local taxes can internalize the cost of the provision of a given amount of goods and services by the local government.

On the other hand, there are various reasons why it is difficult to give national governments sufficient powers of taxation to finance the growing provision of goods and services by those governments. Consequently, although it is agreed in theory that there should be a certain degree of symmetry between responsibilities for expenditure and taxation powers, in practice there are few taxes that can be decentralized without a serious loss of efficiency and equity.

This trade-off between two sometimes opposing objectives can be mitigated by suitable tax coordination between levels of government. Furthermore, a properly designed system of transfers which lays down explicit objectives and provides suitable incentives can offset the habitual difficulty of subnational tax systems in financing the responsibilities assigned to them. Nevertheless, as we shall see in following sections, this task can come up against many obstacles.

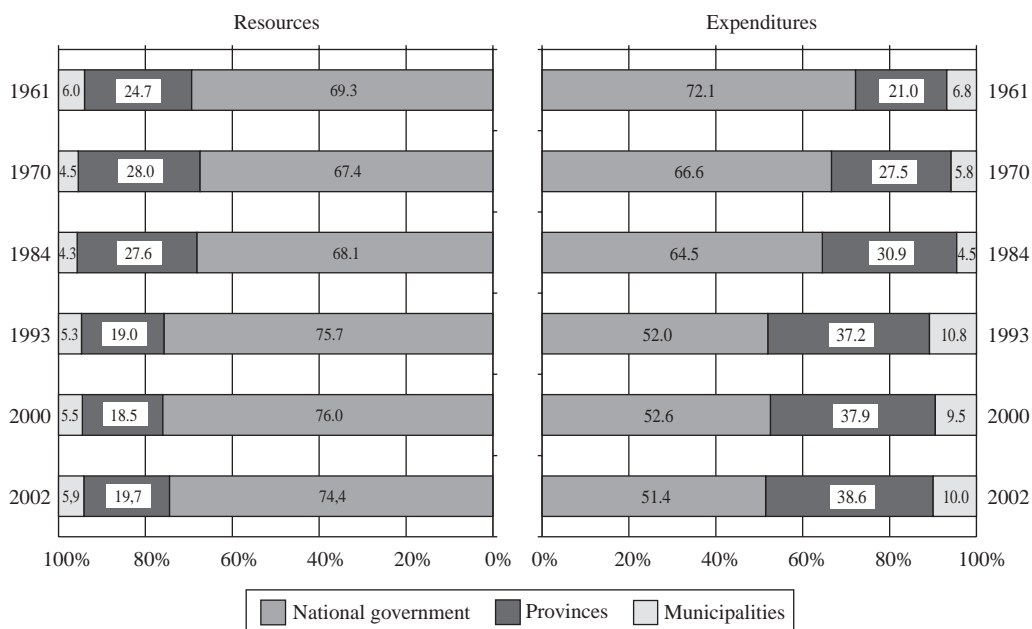
Taking a long-term view, it may also be noted that this inter-jurisdictional financial imbalance must also be considered as an element which has made the relations between the national government and the provinces even more conflictive. As may be seen from figure 2, the imbalances between the expenditure structures and tax and non-tax resources of the jurisdictional areas were only very slight up to the 1980s.<sup>1</sup> Since then, however, the increased concentration of resources administered by the national government and the decentralization of outlays have given rise to heavy pressure on the tax revenue distribution systems because the national government accounts for three-quarters of the resources but only about half the consolidated outlays. Before the decentralization of schools and hospitals in the late 1970s, the national government collected and spent fairly similar proportions of the total.

Finally, it is considered important, in order to complete the analysis of sources of financing, to take into account the degree of autonomy of the provinces and the availability of tax resources of their own, and

<sup>1</sup> Unfortunately, it is no easy task to reconstruct long-term fiscal statistics in Argentina. In preparing figure 2 we used several publications of the Ministry of Finance, which have presented the information according to various different methodologies over time. In this case, we tried to transform the data in accordance with one homogeneous method and we selected the years in the light not only of the changes in the levels of decentralization of resources and outlays but also of the availability of the information. The resources considered include not only tax resources but also non-tax revenue (rates and charges for services provided), in order to give a better idea of municipal financing.

FIGURE 2

**Argentina: Percentage structure of resources (tax and non-tax) and outlays, by level of government<sup>a</sup>**



Source: Prepared by the authors on the basis of data from the Ministry of Finance.

<sup>a</sup> The resources correspond to the tax and non-tax resources administered by each level of government. The outlays are classified according to the level of government which made them. In the case of public enterprises, interest payment and the primary deficit were also considered as outlays of the corresponding level.

to briefly consider their differences in productive capacity, the dynamics of their real economies, and some specific economic development problems of the different jurisdictional areas.

Recent studies suggest that the convergence of per capita income among the countries of the European Union has not been accompanied by a similar convergence within the subnational jurisdictions. On the contrary, the differences in per capita income between those areas has increased in Italy, Germany and France (Decressin, 1999). A similar finding is made in respect of Latin America by Silva (2003). However, it must be borne in mind that the size of such disparities varies considerably from one country to another. Thus, in Argentina the per capita income of the province of Santa Cruz (the richest in this respect)

is 8.6 times that of Formosa (the poorest); in Brazil, the per capita income of the Federal District is 7.2 times that of the state of Maranhão; in Mexico it is 6.2 times higher in the Federal District than in Chiapas, but in Canada the per capita income of the richest state is only 1.7 times that of the poorest. These big disparities in subnational terms not only affect the design of equalization schemes, but also place a limit on certain decentralization exercises. They are also reflected in different tax bases for financing a given supply of goods and services by the subnational public sectors, as well as in different capacities of the government apparatus. All this helps to emphasize the importance of the mechanisms for transfers to the subnational levels of government, which will be dealt with in the following section.

### III

## The federal fiscal structure in Argentina and co-participation in tax revenue: historical roots of the conflicts and areas of consensus between the different levels of government

#### 1. Historical roots of the conflicts between jurisdictions

For a long time after Independence, there was tension in Argentina between the two predominant tendencies in the efforts to constitute a State (a confederation of independent provinces and a federation with leadership at the national level), which was reflected in a series of pacts and agreements.<sup>2</sup> Only in the second half of the nineteenth century was it decided, with the 1853 Constitution, to adopt a federal form of government with leadership at the national level. The tension over the autonomy of the provinces continued, however (Botana, 1993). Since 1935, the relations between the national government and the provinces have mainly concerned the distribution of tax resources, with few efforts to coordinate expenditure and indebtedness. In this section we will deal specifically with the distribution of revenue and the systems of co-participation in taxes.

The disputes about co-participation in taxes are usually identified with conflicts about the financing of the activities of the different levels of government. The history of co-participation systems only reflects the third (and undoubtedly the best known) of the stages through which these disputes passed. Before, from the middle of the nineteenth century up to 1890, the tax sources of the different levels of government were clearly defined: the resources of the national government came basically from foreign trade, while the provinces relied on taxes on the production and consumption of specific goods. Later, between 1890 and 1935, with the creation of national consumption taxes which were superimposed on those levied by the provinces, there was a second stage, that of “de facto concurrency”.<sup>3</sup>

The system of co-participation in taxes began in 1935, with the adoption of laws designed to increase the amount of resources collected by the national government in order to cope with the financial difficulties caused by the fall in revenue from foreign trade during the 1930s crisis.

Subsequently, in the 1950s, the system of co-participation which remained in effect until 1973 was developed. This was characterized by the application of various laws which laid down the distribution of the different taxes and defined three different mechanisms for their distribution. It was only from 1973 onwards that the co-participation system was governed by a single law: Law No. 20.221. The system laid down in this law was novel in two ways: it involved a single system of distribution of the taxes subject to co-participation, and it laid down secondary distribution coefficients in which redistributive concerns were given some importance. These features made this system an obligatory point of reference every time new tax distribution arrangements are discussed.

Later, the macro-fiscal crisis of the early 1980s caused serious financial problems for the provincial governments. With new democratic governments at both the national and provincial levels, the conflict between the two levels reached such a point that, when the period of validity of Law No. 20.221 came to an end, it was not possible to agree on a new system of distribution for the next three years (between 1985 and 1987), and it was only in the last of these years, after the defeat of the national governing party at the polls, that it was possible to negotiate a temporary system (Law No. 23.548) which is still in force today, albeit with many amendments.

#### 2. Systems of distribution in the long term

Generally speaking, the long-term evolution of the systems of co-participation in the taxes collected by the national government was marked by three simultaneous

<sup>2</sup> The Federal Pact of 1831 was a clear expression of the desire for a confederation.

<sup>3</sup> For more details in this respect, see Porto (1990), Presman (1992) and Cetrángolo and Jiménez (1998).

trends: the increase in the number of sub-national jurisdictions included; the growing incorporation of national taxes in the total amount of resources to be shared, and the increase in the primary distribution coefficient.<sup>4</sup>

The first of these trends is shown in table 1, in which it can be seen that of the 24 provincial jurisdictions which now exist (including the city of Buenos Aires), only 14 had participated in the formation of the federal State. These were provinces which had formed part of one or another of the areas of government into which the Kingdom of Spain had organized the territory of what is now the Argentine Republic, so they were all prior to 1853 and, of course, to the adoption of the first tax distribution laws, towards the mid-1930s.

The remainder of the current provinces correspond to the so-called National Territories (previously under the jurisdiction of the Buenos Aires authorities), thus forming a unitary country entirely organized on the federal system but of enormous area (especially after the "Conquest of the Desert" in the 1880s), with nine sub-national governments coming under the central authorities.<sup>5</sup> Table 1 also shows the relative weight, in terms of population and the generation of wealth, achieved by these territories which were of little importance in these two respects 150 years ago. The provinces created during the 1950s, plus Tierra del Fuego, now account for rather more than 12% of the total population of the country and generate a similar proportion of the total GDP. The city of Buenos Aires, which was declared autonomous in 1994, belonged to the province of the same name in the mid-nineteenth century.

Table 1 also provides a striking picture of one of the outstanding features of the federal system and the economy in Argentina: the heavy concentration of wealth in a very few jurisdictions. The origins of the conflict between the "Port" and the interior of the country continue to be reflected, with a few variations, in an economy where 60% of the product is concentrated in only two jurisdictions (the City and Province of Buenos Aires), while 80% is concentrated in only five jurisdictions (the previous two plus Córdoba, Santa Fe and Mendoza). At the other extreme,

<sup>4</sup> An exception to this trend was the 1967 reform, in which the primary distribution coefficient was reduced.

<sup>5</sup> At that time, a portion of the provinces of Salta and Jujuy also formed part of a National Territory, the Territorio de Los Andes. See Botana (1993), p. 241.

TABLE 1

**Argentina: Year of creation and relative importance of the provinces of Argentina**

Jurisdiction	Year of creation	Population structure (% of population in 2001)	Economic structure (% of GDP in 2002)
<i>Created before 1853</i>			
Buenos Aires	1820	38.1	32.7
Catamarca	1821	0.9	1.1
Cordoba	1820	8.5	8.1
Corrientes	1821	2.6	1.2
Entre Rios	1821	3.2	2.1
Jujuy	1834	1.7	0.8
La Rioja	1820	0.8	0.5
Mendoza	1820	4.4	3.9
Salta	1821	3.0	1.6
San Juan	1820	1.7	0.8
San Luis	1820	1.0	1.0
Santa Fe	1815	8.3	8.1
Santiago del Estero	1820	2.2	0.9
Tucuman	1821	3.7	1.8
<i>Subtotal</i>		<i>80.0</i>	<i>64.6</i>
<i>Created in the 1950s</i>			
Chaco	1951	2.7	1.2
Chubut	1955	1.1	2.1
Formosa	1955	1.3	0.5
La Pampa	1951	0.8	1.0
Misiones	1953	2.7	1.2
Neuquen	1955	1.3	2.9
Rio Negro	1955	1.5	1.4
Santa Cruz	1955	0.5	1.8
<i>Subtotal</i>		<i>12.1</i>	<i>12.0</i>
<i>Created in the 1990s</i>			
City of Buenos Aires	1994	7.7	22.7
Tierra del Fuego	1990	0.3	0.7
<i>Subtotal</i>		<i>7.9</i>	<i>23.4</i>

*Source:* Prepared by the authors on the basis of information from the Federal Investment Council (1996), the National Institute of Statistics and Censuses (INDEC) and the ECLAC Office in Buenos Aires.

nine provinces with less developed production structures do not even account for 7% of GDP together.<sup>6</sup>

The second of these trends may be seen in table 2, which shows the transition from a primitive, fragmented system involving only three of the taxes collected by the national government to a unified set of systems

<sup>6</sup> According to estimates made by the ECLAC Office in Buenos Aires for the *Panorama Económico Provincial*, which is available on the web site of that office. For more information, see Gatto and Cetrángolo (2003).



seeking to put order in the distribution of almost all the taxes collected by the General Department of Taxes (DGI). Figure 3, for its part, shows the relative importance of the taxes incorporated into the total amount subject to co-participation.

With regard to the third of the above trends, table 3 shows the evolution of the distribution coefficients between 1935 and 1988. Up to 1972 the information shown corresponds to only one of the co-participation systems that were operating at the same time, because

TABLE 2

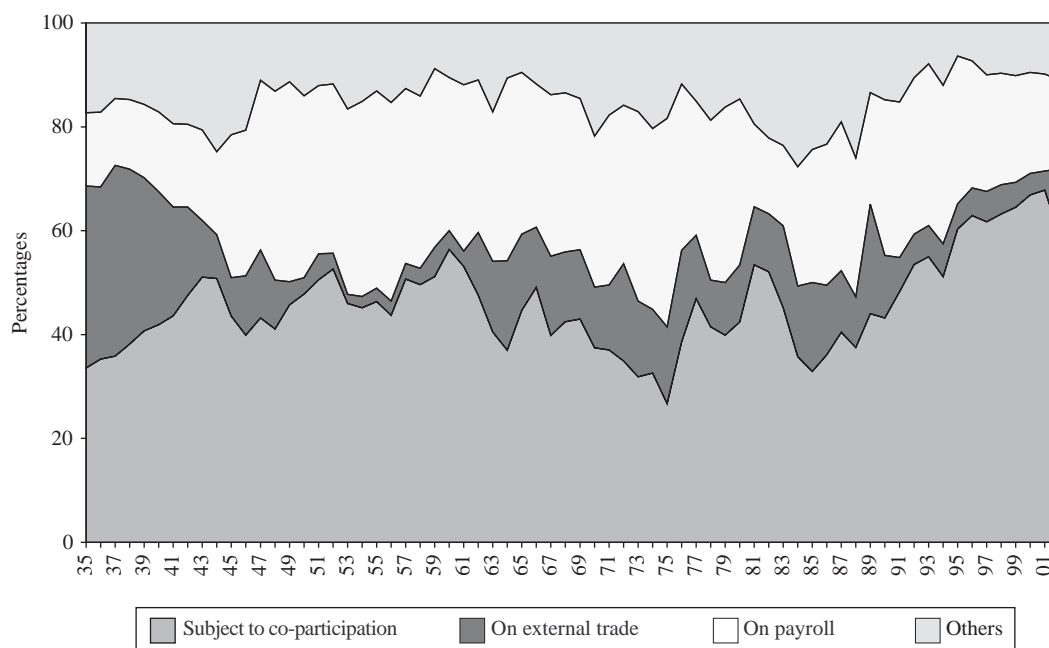
**Argentina: Incorporation of taxes into the co-participation system**

Year	Law	Taxes incorporated
1935	12 139 12 143 12 147	Internal taxes. Sales taxes. Income taxes.
1946	12 956	On windfall profits.
1951	14 060	Tax on the transfer of assets without payment.
1973	20 221	Taxes on land fit for agricultural use, regularization of net worth, foreign exchange, motor vehicles, real estate, lubricants, plus any taxes established as indirect taxes by the national government in the future. Will also include taxes levied for a specific purpose, once the objective of their application has been fulfilled.
1988	23 548	All existing or future national taxes, with the exception of: i) import and export duties; ii) taxes whose distribution is dealt with in other systems; iii) those established for a specific purpose and already in effect when this law was adopted. Once the purpose of their creation has been fulfilled, however, they will be incorporated into the system.

Source: Cetrángolo and Jiménez (1998).

FIGURE 3

**Argentina: Percentage distribution of national tax resources, 1935-2002**



Source: Prepared by the authors on the basis of data from the Ministry of Finance and Cetrángolo and Jiménez (1995).

TABLE 3

**Argentina: Evolution of primary distribution coefficients up to 1973<sup>a</sup> and Federal Co-participation System since then**  
(Percentages)

Laws	Period	National government	Provinces and Municipality of the City of Buenos Aires
12.143 y 12.147	1935-1946	82.5	17.5
12.956	1947-1958	79.0	21.0
14.788	1959	66.0	34.0
	1960	64.0	36.0
	1961	62.0	38.0
	1962	60.0	40.0
	1963	58.0	42.0
	1964-1966	54.0	46.0
	1967	59.2	40.8
	1968-1972	61.9	38.1
20.221	1973-1980	46.7	53.3 <sup>b</sup>
	1981-1984 <sup>c</sup>	48.5	51.5 <sup>d</sup>
23.548	1988	42.34	57.66 <sup>e</sup>

Source: Cetrángolo and Jiménez (1998), on the basis of the legislation.

<sup>a</sup> System according to Law No. 12.143 and Law No. 12.147 (and amendments).

<sup>b</sup> Includes 1.8% for the municipality of the City of Buenos Aires, financed by the national government and the Regional Development Fund.

<sup>c</sup> A deduction was made from the co-participation funds for the benefit of the social security system.

<sup>d</sup> Includes the Regional Development Fund.

<sup>e</sup> Includes contributions from the National Treasury.

the others did not operate with fixed coefficients. This table clearly shows the growth in the provinces' participation in the primary distribution of resources subject to co-participation over time, except in the period from 1967 to 1972, when the Parliament was not functioning.

An analysis of the share of resources for the provinces within the total tax revenue collected by the national government does not show an upward trend since 1935, however, as the above two long-term trends (the growing incorporation of taxes in the amount subject to co-participation and the increase in the primary distribution coefficients) would suggest. On the contrary, this evolution has been erratic.

The causes of this phenomenon are to be sought in the great changes that have taken place in the structure and level of taxation in Argentina over time. The development of the social security system has undoubtedly been one of these causes, together with the cyclical fluctuations in tax pressure on foreign trade

and the evolution of the other systems of allocation of taxes for specific purposes.

### 3. The federal tax co-participation system over the last 15 years

The 1980s began with the failure of the attempt to build a solid but dynamic system of co-participation in tax resources and ended with the approval of a new system which was described as provisional from its inception. Thus, towards the end of 1987 Law No. 23.548 was adopted, providing for a transitory system of distribution of tax resources between the national government and the provinces.

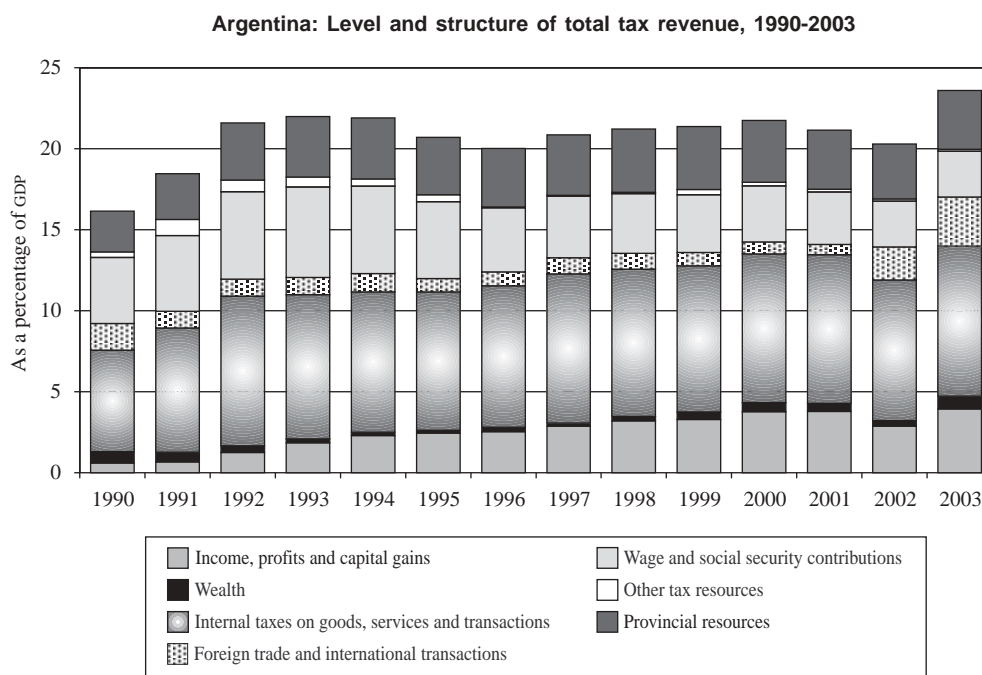
The new system involved substantial changes in the primary distribution of tax resources (between the national government and the provinces) and the secondary distribution (among the provinces). In the first case, the provinces obtained a bigger share in the distribution of funds, because the percentage distributed to the provinces was the highest since 1935 (when the first co-participation system was adopted) and the list of taxes included in the amount of resources subject to co-participation was expanded, extending even to taxes that might be established after the approval of the law in question.

With regard to the secondary distribution, the main difference from the previous system (Law No. 20.221, in force from 1973 to 1984) is the elimination of all explicit criteria for determining the distribution coefficients. In the previous system, the distribution was determined through a combination of clearly defined criteria (population, development gap, dispersal of population). In contrast, under Law No. 23.548 the coefficients are based on the distributions effectively carried out between 1985 and 1987, when there were no rules governing co-participation and—even more important—when distribution was effected according to the needs of each jurisdiction and the bargaining power of its government and legislators, although the distribution inherited from Law No. 20.221 was taken as a basis.<sup>7</sup>

Since Law No. 23.548 came into force, the evolution of tax revenue has been strongly influenced

<sup>7</sup> Over time, the different systems have increasingly been incorporating redistributive criteria at the level of the secondary distribution, to the detriment of criteria at the primary level. Consequently, the shares of the jurisdictions with the greatest tax collection capacity have been losing relative importance. This subject was dealt with in detail in Cetrángolo and Jiménez (1995).

FIGURE 4



Source: Prepared by the authors on the basis of data from the Ministry of Finance and the ECLAC Office in Buenos Aires.

by the way the global economic situation has evolved. In the first half of the 1990s there was considerable simplification of the structure of the resources subject to co-participation, but this situation was partially reversed from the middle of the decade on, when new emergency taxes had to be introduced in order to cope with successive episodes of macro-fiscal crisis.

Figure 4 shows the evolution of revenue in the 1990s. It may be seen that the tax burden was relatively constant between 1992 and 2002 (a period in which tax changes and the introduction of new taxes barely managed to keep up the level of the total burden), but there was a spectacular increase in 2003. This evolution also reflects changes in the tax structure due to an initial trend towards simplification of the system, with relative growth of revenue from the value added tax (IVA)<sup>8</sup> and, to a lesser extent, profits tax.<sup>9</sup> Subsequently, in the second half of the decade, there was a sharp fall in revenue from payroll taxes.

In contrast with this trend, the system of distribution of tax revenue has reached a level of complexity and fragility almost unparalleled in any other period of

Argentine history. As we will see, the concentration of revenue in taxes which are subject to co-participation by current law has led to a struggle for the allocation of these funds and a search for ways of getting round the law. Since 1996, the increase in the revenue subject to co-participation under Law No. 23.548 has not been reflected in an increase in transfers to the provinces but has been used to offset the loss of resources from payroll taxes that should have gone to the central government.

To sum up, the main features of transfers to the provinces in the 1990s were as follows: a sharp rise in the early years of the decade; a simultaneous increase in the proportion of specific allocations in the total transfers to the provinces, to the detriment of co-participation; stagnation of the total amount of transfers collected, and —partly related with this— the replacement of payroll taxes with taxes collected by the General Tax Directorate in the financing of the national government's needs.

The struggle for resources between the different areas of the national and provincial public sectors was so great that there are now almost no taxes which are not allocated, at least in part, for some specific purpose. In response to these pressures, the national authorities

<sup>8</sup> Included in internal taxes on goods, services and transactions.

<sup>9</sup> Included in the taxes on income, profits and capital gains.

negotiated specific allocations (especially for the social security system) to cover expenses that would otherwise have had to be paid by the National Treasury or transferred expenditures to other levels of government (schools and hospitals, for example). The result was a change in the “effective distribution” in order to arrive at a tax distribution system based on multiple “patches”. These “patches” have been growing in variety and size over the years since the current law on co-participation was approved.

Late in 1999 the Federal Commitment was signed, establishing a fixed sum for the year 2000 of 1,350 million pesos and a three-year average with a minimum level of 1,364 million pesos as from 2001. Later, in November 2000, another Federal Commitment was signed between the national government and the provinces under a new programme known as “guaranteed cover”. This agreement replaced the mobile averages with fixed sums for the following years, until a new co-participation law was approved.

The macroeconomic and fiscal situation sharply deteriorated from mid-2001 on. As from the third quarter of that year, the difficulties in obtaining financing obliged the national government to adopt a programme aimed at achieving month-to-month fiscal stability through a strict accounting rule called “zero deficit”. As part of the same programme, the national government negotiated with the provinces a “Second Addendum” to the November 2000 Federal Commitment, providing for a reduction in transfers of the order of 13%, and a voluntary debt swap scheme was put into effect. From then on, the different levels of government had serious difficulties in fulfilling their obligations, and in various jurisdictions serious delays in the payment of salaries reappeared. Furthermore, the practice of paying commitments with bonds spread rapidly, and a wide variety of means of payment began to be used. The failure of the “zero deficit” programme and an accumulation of political and social factors resulted in a profound political crisis which was reflected in the removal from office of various ministerial teams.

#### 4. Crisis and new circumstances

On 27 February 2002, after the end of convertibility, the national government carried out a new round of negotiations with the subnational levels of government aimed at agreeing on new rules for the transfer of resource to the provinces, the target deficit, and debt renegotiation. These involved some basic commitments, including the abandonment of fixed amounts of

transfers and their replacement with the coefficients laid down in the current legislation, plus 30% of the tax on credits and debits; the renegotiation of the provinces’ debts with the aim of converting them into debts in pesos; the establishment of a limit of 15% on the allocation of co-participation resources for payment of the service on the restructured debts; the reduction of the fiscal deficit of the jurisdictions, and limitations on provincial indebtedness.

Within the framework of this Federal Agreement, the national government signed bilateral agreements with some provinces. In 2002 agreements were signed with 17 provinces, and in 2003 with 15 jurisdictions. The Ministry of the Economy has signed what it calls Orderly Financing Programmes with each of the provinces, under which it provides them with finance each month to cover the agreed financial deficits and the debt service on the public debt for the current year.

The signing of the February 2002 agreement enabled the provinces to improve their relative fiscal position in two ways: first, through the return to the system of automatic resource distribution by coefficients which was in effect before the 1999 Federal Commitment, in a context of increases in price levels (in 2002) and the product (in 2003), and second, through the lower debt service payments due to the debt swaps and the 15% limit placed on the allocation of co-participation resources for debt service.

Consequently, with the aim of illustrating the overall changes in fiscal policy resulting from the crisis, it may be noted that there has been a considerable fiscal improvement, basically for three reasons: the smaller debt service payments, the lower level of remunerations and social security benefits (both in real terms and as a percentage of GDP), and the increase in revenue due largely to the incorporation of windfall resources only partially subject to co-participation (export duties and the tax on cheques). This has made possible a considerable improvement in the primary results of all the levels of government and, hence, somewhat greater leeway for increasing social assistance expenditures designed to relieve the serious social situation.

With regard to the level and structure of expenditure, figure 1 (in section II.1 above) shows the changes in the different levels of government after the end of the convertibility programme and the subsequent crisis. If we compare the data for 2000 and 2002, we see that —apart from the decline in expenditure of all three levels of government led by the reduction in public debt interest payments (which went down by 40.4% at

the national government level)—the only item which registers an increase is that corresponding to “other social expenditure” of the national government (57.4%). This item includes the Unemployed Heads of Household Programme. The remaining items of expenditure were influenced by the sharp fall in real public sector wages and in the real value of social security benefits.

As a reflection of a speculative nature, perhaps consideration could be given to the possibility of an incipient process of recentralization of functions based on three elements: i) the rescue of the provincial governments by the central government, through the renegotiation of the provinces’ debts with a ceiling on the allocation of provincial resources, implies a transfer of responsibilities to the national government; ii) the

introduction of assistance programmes for emergency situations (in view of the structural characteristics of the Argentine economy, the employment situation and the limitations of social security) can only be interpreted as a first step in a direction which will undoubtedly become more evident in the years to come; and iii) some programmes of the national government are dealing with shortcomings that the budgets of the provinces were not able to solve during the crisis. This latter element is particularly evident in the public health area, through the distribution of medicines (the “Re-mediar” programme) or the allocation of transfers, subject to the fulfillment of programme goals (along the lines of counterpart donations), in order to finance mother and child attention in the relatively less developed provinces.

## IV

### **Political conflict and institutional weaknesses in the financial relations between the national government and the provinces**

Inevitably, many references have been made in this article to the forms and magnitude of the underlying political conflict in the relations between levels of government in Argentina. In the opening sections we mentioned the origins and development of these tensions. We also referred to some aspects of these conflicts during the last 15 years, in which macroeconomic imbalances and the social security crisis have been the clearest causes of the difficulties in solving the problems pending in the financial relations between the different levels of jurisdiction.

Our view is that the period under analysis was one in which the national government exhausted all the sources of financing other than the tax resources subject to co-participation. The struggle among the different levels of government, which occurred at a time when there was a high level of political conflict and macroeconomic crisis, has also been accompanied by great institutional weaknesses in the field of federalism. This has been at once a cause and a consequence of the problems of the period in question.

As Bardhan (2001) notes, when institutional weakness is the result of serious distributive conflicts,

this makes it difficult for both the national and local levels of government to fulfill public policy objectives. Out of the many manifestations of these weaknesses in the federal organization of Argentina, we would like to briefly refer to those which have been most obvious during the last 15 years: the proliferation of emergency agreements instead of stable resource distribution systems, and the institutional weaknesses as regards regulation of the indebtedness of the subnational levels of government.

#### **1. The proliferation of emergency agreements instead of stable resource distribution systems**

A characteristic feature of the relations between the national government and the provinces while Law No. 23.548 was in force is the predominance of the relations between executive levels of authority over what is laid down in the legislation. This is reflected both in the emergency agreements between levels of government to modify what is laid down in the relevant legislation, and in the discretionary settlement of

specific situations affecting some jurisdictions by the national government. An extreme example of the institutional tension which has prevailed in the relations between jurisdictions, and which has run counter to the parliamentary solutions arrived at after negotiations between the executive authorities concerned, is the requirement by the 1994 Constituent Assembly that a new system of tax distribution should be negotiated and agreed upon. This has never been complied with by the executive authorities, however.

In the course of the period studied, various pacts or agreements have been negotiated and signed to deal with the many difficulties faced, ranging from the financing of the social security system to the renegotiation of the debt. All these involved agreements between executive authorities which modified the distribution of resources laid down in that co-participation law.

In the previous section we mentioned the multiplicity of makeshift solutions or patches which have modified the system until it has reached its present level of intricacy and irrationality. Many of these were implemented through legislative changes, but others—the most important—have given rise to legislative changes after agreements between executive authorities. Whenever this has happened it has left ample room for a form of negotiation in which political aspects have prevailed and elements have been incorporated which have not always been clearly expressed.

As a result of these agreements, plus the many changes made in the distribution of the different taxes subject to co-participation, the distribution of resources has become a chaotic set of varied ad hoc distribution mechanisms which have been multiplying over the years. The multiplicity of distribution mechanisms is not a response to a similar multiplicity of objectives, but is the result of a mass of conflicts and struggles. According to the legislation, it should be a formula based on a single distribution coefficient for all the taxes subject to co-participation (or at least it should allow very few exceptions, and even then only of a temporary nature), but in fact it has become a complex matrix linking those taxes with various different objectives through percentages and fixed sums which are a faithful reflection of the distributive struggle over the public accounts.

Three basic forms of pressure on the distribution system may be observed. First, there is the allocation of co-participative resources proper in order, mostly, to the need to provide more finance for the social security system. Second, there is the allocation of those

resources to finance the infrastructure, historically from taxes on hydrocarbons and energy. Finally, there are the struggles for the distribution of resources within the national budget. All this would appear to indicate that, apart from the struggle between the national government and the provinces, there are also sectoral struggles which it is sought to solve through the allocation of different taxes for specific purposes.

## **2. Institutional weaknesses as regards regulation of the indebtedness of the subnational levels of government**

During the second half of the 1990s, successive national policy decisions gave the provinces the possibility of gaining easier access to internal and external sources of finance. Since the credit market situation was favourable to this change, there was a considerable increase in the provinces' indebtedness, which reached a high point late in 2001.

During the 1990s the provinces' indebtedness was governed by a series of rules of different scope and institutional origin.<sup>10</sup> Most of the provinces had limits, laid down in their own constitutions, on the permissible level of indebtedness. These restrictions included mechanisms for the authorization of indebtedness, restrictions on the use of the funds thus obtained (for example, the prohibition of their use to finance current expenditure), or limitations on the level of debt service.<sup>11</sup>

At the same time, there was also a set of regulations on the indebtedness of the provinces in the national legislation. The reform of the Charter of the Central Bank of the Argentine Republic prohibited the granting of credits from financial entities to the public sector without the authorization of the Minister of the Economy. Resolution 1075/93 of that Ministry laid down that in the case of foreign-currency loans, the provincial governments needed special approval for operations with the financial system. This Resolution also established an automatic debt service payment mechanism through direct access to the co-participative

<sup>10</sup> Article 124 of the National Constitution gives the provinces the power to sign international agreements, subject to certain requisites, stating that the provinces "can also sign international agreements provided the latter are not incompatible with the foreign policy of the Nation, do not affect the faculties delegated to the Federal Government or the public credit of the Nation, and are signed with the knowledge of the National Congress."

<sup>11</sup> For a detailed analysis of this subject, see Cetrángolo, Jiménez and others (2002).

resources deposited by the national government in the accounts of provincial governments. This mechanism facilitated access to the financial markets by the provinces, by providing a reliable guarantee, but the fact that it was not applied with the aim of ensuring the financial solvency of the jurisdictions in question encouraged over-indebtedness in some cases. Only with the implementation of the Financial and Fiscal Assistance Programme early in 2000 and the Orderly Finance Programmes in 2002 was it possible for this mechanism to be used in a group of provinces as an effective means of limiting indebtedness in order to comply with the reduction of imbalances agreed upon between each provincial government and the national government.

The indebtedness mechanism used by the provinces since the early years of the 1990s, using the transfers of co-participative resources as a guarantee, has had two effects: on the one hand, it has encouraged growing indebtedness of the provinces by facilitating access to credit markets, while on the other, it has sharply restricted the provision of social goods and services by the provinces, by modifying the provincial budgetary process. The provinces have lost their capacity to establish budget priorities month by month, since payment of creditors is carried out automatically; consequently, they have to find additional finance to cover their operating expenses in each period.

Table 4 shows the percentages of co-participation resources allocated for debt payments in 2001, before the cessation of payments. It clearly shows the very limited budget leeway available to some provinces for covering their operating expenses after paying the debt

TABLE 4

**Argentina: Co-participation transfers allocated to debt payment, 2001**

*(As a percentage of the total transfers to each province)*

Jurisdiction	%
Buenos Aires	1.6
City of Buenos Aires	0.0
Catamarca	57.2
Cordoba	2.8
Corrientes	55.4
Chaco	39.0
Chubut	29.5
Entre Rios	22.8
Formosa	68.2
Jujuy	91.8
La Pampa	2.4
La Rioja	50.8
Mendoza	60.5
Misiones	48.6
Neuquén	9.2
Río Negro	97.3
Salta	73.5
San Juan	41.3
San Luis	27.5
Santa Cruz	4.7
Santa Fe	4.0
Santiago del Estero	36.6
Tucuman	85.3
Tierra del Fuego	37.9

Source: Prepared by the authors.

service. Subsequently, with the signing of the February 2002 agreement, a 15% limit was established for the amount allocated to service renegotiated loans, with the national government making itself responsible for commitments over and above that percentage.

## V

### Final remarks

In this article we have shown that the problems currently besetting the federal organization of Argentina are the result of the juxtaposition of structural problems, of the reforms made in the 1990s, and the crisis which followed the end of convertibility. We have emphasized the importance of taking into account the political and institutional aspects of the problem, which have been influenced by a combination of elements in which institutional weakness is the counterpart and reflection of a strong political struggle

about federal matters, whose origins may be traced back to the formation of the Argentine nation.

The dynamics of the political and institutional conflict have been further increased by the characteristics of the prolonged macroeconomic crisis which, with periods of greater or lesser tension, has dominated Argentine history in recent decades. With regard to the subject of this article, the dominant features of the conflict have been the course of the social security crisis and its growing needs for finance,

and a tax structure which is insufficient to finance properly the public policies that the different levels of government are trying to carry out.

We have seen that as long as the national public sector was able to obtain additional finance to cover the new demands of public policies, the expansion of government activities which accompanied the development of Argentina did not enter into conflict with the functioning of the federal system of the country. But when the macroeconomic crisis got worse, the sources of financing not subject to co-participation (customs revenue, the inflation tax, fuel taxes, payroll taxes, the social security surplus, indebtedness, privatization operations) were exhausted, a fiscal crisis broke out (impelled by indebtedness and the social security crisis) and the conflict over the distribution of the resources subject to co-participation became increasingly serious and complex.

The exhaustion of sources of financing not subject to co-participation for coping with the new functions that the national government has had to assume, the increase in the number of subnational jurisdictions participating in the distribution of resources, and the growing imbalance between outlays and resources among the jurisdictions were structural factors which, together with the typical characteristics of the last few decades (crises at the macroeconomic level and in the social security system and the ongoing political struggle), explain the high level of conflict which has dominated the financial relations between the national government and the provinces.

In the 1990s an important role was played by problems of another type, connected with the implementation of a macroeconomic programme with a fixed exchange rate, whose priority now needs to be reviewed. The urgent need to improve the international competitiveness of the tradeable goods sectors gave rise to a debate on the reform of provincial taxes on gross income, which were the main source of income of their own for the provinces. While not denying the importance of this matter, it is open to question whether the degree of urgency assumed by this question at that time continues today, now that the macroeconomic programme provides for a very different configuration of relative prices; nevertheless, work should be continued on this matter, albeit without the degree of urgency of that time.

Likewise, consensus was reached in the 1990s which must now be revised. Unfortunately, the possibility of introducing a system with new distribution criteria for increases in the amount of

revenue collected—an initiative which was widely supported in those years—now calls for agreements which are more difficult to reach: whether the levels to be respected are nominal or real, and, at all events, what price index to use.

It is worth noting that, in the light of the difficulty in finding a solution for the problems deriving from the absence of an explicit, stable and transparent resource distribution mechanism, the expectations raised by the constitutional commitment to agree on a new system have led to pressures to incorporate in that system—already difficult to agree on—new items that make this exercise even more complex. Thus, items have been added such as the new fiscal institutions, the need to redefine and harmonize the powers to levy taxes, the absence of fiscal rules, and the development of instruments to soften the effects of economic cycles.

There are, however, two structural problems which, as already noted, represent a serious weakness of the way the federal system functions in Argentina but unfortunately have not been sufficiently debated: the problems of financing compensatory social policies, and the imbalances in the product between the different provinces. In the first case, efforts should be made to correct the shortcomings observed in the past process of decentralization of social expenditure, especially in the fields of health and basic education. Under the pressure of urgent fiscal needs, the national government finally lost interest in compensatory policies and those aimed at coordinating social expenditure, with a consequent heavy adverse impact on equity. In order to solve these problems, it is necessary first of all to design suitable sectoral policies, as was done in the 1990s in the field of education as is now being discussed in the field of health. If these initiatives are to be successful, however, the future system of transfers must take these policies into account and include their financial needs in the debate.

In the second case, there are big disparities in the product of the different provinces. In view of the enormous development gap observed between the different provinces of Argentina, it cannot be imagined that fiscal correspondence (i.e., that the subnational governments should finance their expenditure from their own resources) is the solution to problems of incentives. It is unthinkable that the least developed provinces could ensure a supply of public goods similar to that of the more highly developed provinces without assistance from the national government (and not only financial assistance). This in turn leads us to



the problems of the promotion of production development and the role of local governments.

It is also necessary to identify the problems that will characterize the new economic situation. The end of convertibility was accompanied by a reformulation of the functions of the different levels of government. There are four features which must be taken into account in this respect:

- The changes in the tax structure, which have played a significant part in achieving a considerable primary surplus of tax resources not subject to co-participation (customs revenue) or those only subject to a low level of co-participation (bank credits and debits).
- The growing importance of social assistance expenditure in the national finances.
- The announcement of new changes in the social security system.
- The process of debt renegotiation and the transfer to the national government of much of the provincial debt burden.

It is hard to imagine a debate on a new system of distribution between the national government and the provinces which tries to arrive at a medium-term agreement without first of all making a pronouncement about the probability that these phenomena will persist and that—as everything seems to indicate—the large budget items earmarked, for example, for social assistance<sup>12</sup> and the new transfers to the provinces to support the provision of public health services (the “Remediar” and mother and child insurance programmes) will be maintained in the future. If this is so, then this will mean that we are witnessing a new redistribution of functions which will require a new examination of the questions of federalism and transfers between the different levels of government. The reformulation of the social security system, for its part, may be associated with the introduction of social assistance pensions for elderly persons who can not provide proof of 30 years of formal employment. These

expenditures will undoubtedly grow and will have to be paid by the national government.

Another element which we should not forget concerns the functioning of the macroeconomic level in coming years and its impact on the finances of the different levels of government. The particular fiscal situation prevailing today is supported by a set of relative prices in which the high exchange rate makes it possible to collect some windfall taxes not subject to co-participation, while the fall in public sector wages and social security benefits in real terms has made possible a considerable fiscal surplus (as well as financing new functions). The exceptional nature of this situation makes it necessary to be very careful about introducing new resource distribution rules which may be affected in the near future.

In recent months, however, the debate on a possible co-participation law has been resumed and the possibility of effectively achieving this has been discussed. Bearing in mind the analogy frequently drawn between the current distribution system and a labyrinth, in some cases the well-known phrase of Leopoldo Marechal seems to have been resorted to in order to try to find a new magic way out: “all labyrinths have a way out upward”.<sup>13</sup>

The new situation requires a flexible form of federalism which meets the different demands of each province and can be adapted to the changing circumstances of the Argentine economy. It is not necessary to seek an instrument which tries to solve all the problems at once. It would be advisable, instead, to discuss, agree upon and implement different solutions for specific problems which, in time, can clear the way for the solution of problems that are harder to tackle. The construction of a modern form of federalism is a task that must be continued every day, and the approval of some particular law cannot magically solve long-standing problems.

*(Original: Spanish)*

<sup>12</sup> Especially the Unemployed Heads of Household Programme.

<sup>13</sup> “Laberinto de amor”, a poem published by Sur in 1944.

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