

Decentralization, territorial transfers and local development

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Concerted action by political, social and private actors at the local level can be very useful for promoting economic competitiveness, but in order for it to become a reality it would be essential for the local communities to have greater autonomy and resources, as well as equal opportunities. This article begins by investigating the conditions required in order to ensure that the deeper political decentralization needed for local development will promote efficiency and equity, as well as the ways in which transfer systems can become decisive means for increasing equity and generating greater efficiency. Within this theoretical framework, an analysis is then made of the basic transfer systems used in the older and/or more advanced decentralization processes of the region, and some guidelines are proposed not only for making local development viable in the conditions in question but also for progressing in building fuller citizenship.

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I

Introduction

Political decentralization in Latin America forms part of the democratization processes begun in the 1980s, which took as their starting point the historical territorial organization of each country. The main aim of decentralization—with differing types of emphasis in each country—was to generate new spaces for citizen participation, tackle problems of fiscal imbalance, and organize the State apparatus at the local or territorial level in order to implement social policies that would make it possible to address the problem of the social debt. In the countries where this territorial reform was started earliest, this was of decisive importance for broadening or focusing those policies, although it was only possible to channel citizen participation in a constructive manner in the cases where suitable social capital already existed. Decentralization has often failed to give positive results, however, in terms of aiding fiscal balance, and this has undoubtedly hindered the progress of these processes.

Political decentralization is taking on renewed importance today, not only for promoting fuller citizenship and social inclusion, but also in terms of economic development. Thus, it is now generally agreed that competitiveness depends not only on the firms themselves, the macroeconomic balances and active national policies, but also on the capacity of each locality to tackle its own development through processes of concerted public-social-private decisions and action. In order for this to take place, it is essential that local areas should have greater autonomy.

An essential aspect of decentralization is that of the transfers needed to make up for the different income-generating capabilities of the different political and administrative divisions. In Latin America, such transfers are the main source of income for most of the

subnational levels of government—especially the municipalities—and in some countries they account for a substantial proportion of public expenditure.

In terms of equity, the transfer systems which have accompanied the decentralization processes in Latin America have involved, in all cases, substantial initial progressive territorial redistribution, although this has often subsequently proved to be insufficient to offset the inequalities generated by the decentralization process itself.

It would have been desirable for the transfer systems to have been designed in such a way as to make the objective of equity compatible with stability, but in most cases, as the territorial transfers involve fixed shares of national taxes, they prove to be procyclical (Ocampo, 2001), and when, in addition, they encourage expenditure that does not depend on the corresponding tax efforts, they help to generate pressures that give rise to imbalances (Finot, 1996 and 2001).

In order to counteract these pressures, there is a tendency to adopt controls on spending and limits on subnational indebtedness. Examples of this are the Fiscal Responsibility Act in Brazil (Federal Republic of Brazil, 2000) and, in the case of Colombia, the Indebtedness Control Act (Colombia, 1997), the Territorial Expenditure Rationalization Act (Colombia, 2000a) and the Fiscal Responsibility Act (Colombia, 2003). While these measures aid fiscal balance, they may restrict the autonomy of local bodies. Yet, as already noted, making local economic development viable calls for more, not less, local autonomy. Furthermore, it is necessary to continue progressing in terms of social equity and citizenship-building, while maintaining efficiency and stability. How can the objective of strengthening local autonomy be reconciled with those of equity, efficiency and stability?

In order to answer this question, section II of this article analyses the conditions needed to attain deeper political decentralization while at the same time promoting efficiency and equity; with this aim, a summary updated version of the conceptual framework that has been developed since earlier studies is presented. In section III, an analysis is made of the main autonomy-related financial aspects of the older and/or more advanced decentralization processes in the

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region: those of Argentina, Brazil and Mexico, among the federal countries, and those of Bolivia, Chile and Colombia in the case of the unitary countries.¹ Finally,

section IV presents some conclusions and guidelines that may be useful for the countries of the region in pursuing the objectives in question.

II

Conditions for efficiency and equity

The economic aspects of decentralization are undoubtedly essential in these processes, but it would appear that in the Latin American region we have not yet taken sufficient account of that branch of the economy whose field is the provision of public goods at the different territorial levels, nor are we developing it sufficiently to allow us to progress in line with our needs.

This may have occurred partly because the founder of that branch, Wallace Oates, called it “fiscal federalism” (Oates, 1972), which may have given the impression that it referred only to federal countries.² The theory based on that branch is perfectly suitable, however, for analysing the economic aspects of decentralization, especially when this is aimed at the levels closest to citizens themselves, since reducing the ambit of demands could facilitate the processes of determining collective preferences.

This section thus begins by analysing the conditions whereby political decentralization aids efficiency and then going on to deduce the requisites for ensuring that transfer systems aid both efficiency and equity.

1. Decentralization

Decentralization refers to the provision of public goods, in which two types of decisions may be distinguished: i) what part of income is to be used to provide those goods, who should provide them, and what amount

should be provided, and ii) how are the publicly provided goods going to be produced. Generally speaking, in Latin America both types of decisions have been decentralized to the subnational levels of government, but some decisions of the second type have also been decentralized to the market.³ The necessary conditions for efficiency can be analysed for both forms of decentralization, but in view of the objectives of the present article, these conditions will be analysed here only for the case of the decentralization to subnational levels of government of the responsibility for providing public goods.

Generally speaking, the concept of decentralization to lower levels of government has been associated with the idea of greater political autonomy (see Palma and Rufián, 1989, for example). All the processes, however, involve the assignment of functions to subnational governments not only in their capacity as the heads of autonomous units but also as agents of the national government: they execute different combinations of decisions adopted at the local level and other decisions taken at the central level. In the first case, this is political decentralization, and in the second it is operational decentralization,⁴ each of which has different requisites for efficiency, so that it is important to be able to distinguish which tasks each level of government carries out as the head of an autonomous unit, and which it carries out as an agent of the central government.

We will now analyse what those requisites are, with the main emphasis on political decentralization, which is more closely linked with autonomy.

¹ In order to have comparable data, the quantitative analysis is based on figures from the International Monetary Fund.

² Oates himself (1999) admits, on looking back, that it was probably unfortunate to call the theory he founded “fiscal federalism”, because this would tend to restrict it to the narrow fiscal field, whereas the subject of that theory was rather the entire vertical structure of the public sector. Moreover, according to Afonso (2003), since “fiscal federalism” is based on a methodology of individualism, it would not be suitable for studying federalism proper, which by definition is an agreement among communities, not individuals.

³ In the sense assigned by Bennett (1990): a process which we have called “economic decentralization” (Finot, 1996).

⁴ I prefer to use the term “operational decentralization” rather than “delegation” (as some authors call this situation) because, as Palma and Rufián (1989) explain so well, delegation can be suspended by the principal at any moment. The concept of decentralization, in contrast, implies a definitive transfer of authority and freedom to take decisions (in this case, administrative decisions).

a) *Political decentralization*

Political decentralization may be understood as the transfer of democratic decision-making processes on expenditure and financing for the provision of given public goods from one political/administrative level to another lower level.

There are three main conditions for ensuring that this transfer contributes to greater efficiency: i) that the ambits of the local decision-making processes correspond to geographical differences in demand; ii) that citizen preferences are effectively revealed; and iii) that the gains generated by the foregoing conditions are greater than the possible losses in terms of economies of scale.

i) *Adaptation to differences in demand.* Oates (1972) noted that the main problem in decentralization is to decide to what level each type of provision best corresponds.⁵ The fundamental problem would be that, generally speaking, political/administrative maps do not coincide with geographically differentiated demands. Indeed, there is no reason why they should: the former have been configured as a function of political/administrative control of the territory, while the latter are the result of such factors as the location of natural resources, access facilities, and investments in infrastructure. Trying to modify the former could give rise to conflicts between local areas, whereas the latter undergo constant modification without any limits other than the respective local regulations (including those on international relations).

What can we do about the lack of adaptation between decision-making processes encompassed by the political/administrative maps and those subject to the corresponding geographical/economic maps? In principle, the solution could be to deepen decentralization down to the levels closest to the citizens and promote association among local governments in respect of shared differentiated demands through transfers.⁶

ii) *Effective revelation of preferences.* In the provision of local public goods, each community should be able to reveal its preferences, in full knowledge of the cost of the alternatives, and should be able to opt for a mix of goods in the light of what it will cost them.⁷

In order to stimulate the economic mechanisms of efficiency, then, the communities to which authority is decentralized should have the power not only to define expenditure but also to determine the level of the taxes whereby they will help to finance that expenditure. In order to avoid the multiplication of taxes, the tax bases should be established nationally but the subnational communities at which political decentralization is aimed should have the faculty to modify the respective tax rates (within a certain range). The most desirable situation would be for these decisions to refer to direct taxes (in principle, on immovable property), since modifying indirect tax rates would directly affect the system of prices (as well as requiring the keeping of accounts on inter-territorial imports and exports).⁸ This would also be desirable in the case of taxes with shared bases, where the subnational levels of government should have the power to fix their own rates.

On the other hand, for reasons of equity it would not be a good idea for the royalties received for the exploitation of non-renewable natural resources to be shared with the subnational levels (Musgrave and Musgrave, 1989), or at any rate not in substantial percentages. Moreover, strictly speaking these sources of income cannot be considered as taxes.

An assumption which is not explicitly stated in Oates's work is that the local mechanisms for the revelation of preferences must be at least as efficient as those at the central level. If decentralization tended to strengthen undemocratic—or still worse, corrupt—assignment processes, it could turn out to be less efficient than assignment through centralized processes.

⁵ Ostrom, Tiebout and Warren (1961) had already noted that, for a metropolis, a "polycentric" system in which the provision of public goods whose demand is geographically differentiated corresponds to locally elected governments, while only the provision of goods with uniform demand is left in the hands of the central metropolitan government, would be a more efficient solution than a system in which the provision of all services is centralized. This finding was subsequently formalized by Oates (1972) in his "decentralization theorem".

⁶ Furthermore, to the extent that this adaptation of territorial organization to differentiated demands was achieved, this would reduce externalities, which are another typical aspect involved in decentralization.

⁷ This process can be clearly seen, for example, in the decisions taken by innumerable social organizations of the region, which very often make an important contribution to the provision of public goods and externalities. As we have been proposing since 1990 (Finot, 1990), these contributions should be considered as "quasi taxes".

⁸ It is generally agreed that the best local taxes would be those based on property and also, increasingly, that the way to increase subnational income might be to share in income taxes, as Bird (2001) notes. As the same author warns, however—quoting Shome (2000)—few Latin American countries have really solid income tax systems.

The electoral system based on proportional representation—which prevails in the region at the municipal level⁹—would not be the most suitable for expressing citizen preferences at the local level, since it means that representatives are answerable to the politicians who included them in their lists, rather than to the population represented, and in the final analysis it is those representatives who, when approving the relevant budget, decide what goods are to be provided publicly, in what amount, and with what local contributions.

Even if the electoral system is changed from proportional representation to a system based on territorial representation,¹⁰ however, it is obvious that both politicians and administrative officials have their own interests, so that it is important to offset these through other forms of citizen participation. Direct political participation (referenda, citizen consultations, revocation of authority) and social participation, through social organizations, are forms which should be facilitated in this respect in order to generate and clarify easily understood information—both basic information and information on management performance.¹¹

It is not enough, then, for democratic decision-making processes on allocation merely to correspond as accurately as possible to differences in demand: in order for political decentralization to promote more efficient allocation it is essential that decisions on local expenditure should be linked with local contributions and that there should be suitable systems of citizen representation and participation so that the citizens' preferences may be effectively revealed.

iii) *Economies of scale*. The weighting given to this factor may have gone down more recently: the

flexibility of present-day production processes may help decentralized solutions to be more efficient, but for this to be so there must be access to new technologies, and above all, availability of suitably skilled staff. At all events, the ambit to which the provision of each decentralizable public good should be transferred should always correspond to a level where the benefits of decentralization outweigh its costs, including among the latter the costs deriving from an increase in the number of administrations involved.

b) *Operational decentralization*.

Operational decentralization occurs in cases of the provision of public goods where decentralization does not include the decision-making power over what goods are to be provided, in what amount, and with what contributions from citizens, but only matters connected with the implementation of decisions adopted in that respect by a central government. According to Heymann (1988), the benefits of this form of decentralization mainly derive from the better information possessed by the local levels of government, while the costs stem from the risk that the agents may take advantage of the situation to the detriment of the interests of the principal.

In this case too it would be desirable to assess whether the benefits of having the local governments as agents are higher than the costs of enlisting them for this purpose. Just as, in the case of political decentralization, the basic criterion of efficiency would be to achieve the greatest possible correspondence between effectively expressed geographically differentiated demands and the existing political and administrative divisions, so in the case of operational decentralization the criterion would be to achieve the best possible combination between the benefits of taking advantage of the capabilities of the local governments (either individually or in association) and the costs generated by losses of economies of scale and the installation of control mechanisms.

Within each sectoral policy, an evaluation should be made of what should be decentralized politically and what should only be decentralized operationally. In school education, for example, it would be appropriate to politically decentralize the definition of part of the compulsory minimum curricula, but income redistribution policies designed to give equal opportunities to all the inhabitants of the country, whatever their place of residence, should only be decentralized operationally.

⁹ An exception is Panama, where the Municipal Councils are made up of representatives of the "corregimientos" or districts which make up each municipality.

¹⁰ Using a system providing for the election of single representatives or, what would be preferable (as I have been proposing since 1990, on the basis of Duverger, 1970), a system providing for one representative per district defined in line with the existing historical and geographical situation, plus an additional number of representatives depending on the population of each district.

¹¹ Porto Alegre's experience with regard to participative budgets shows the advantages of social participation for revealing preferences better and increasing citizen input. Harnecker (2003), who followed up the process from the beginning, notes the "consternation" initially caused among those taking part in "participative budgeting" when they realized that, in order to achieve what they were proposing, they would have to pay taxes. It can now be seen that participative budgeting has not only led to more efficient resource allocation but also to an ongoing increase in revenue collection (Prefeitura Municipal de Porto Alegre, 2003).

c) *Responsibility (accountability)*

Just as, in political decentralization, information systems on the actions of the authorities should be aimed primarily at the local communities, in the case of operational decentralization the local levels of government should be primarily accountable to their principal: the respective central government (Silverman, 1992). Apart from the difficulties inherent in the agent-principal relationship, however, the practical problem in this case is that the accounts of the local administrations do not usually make any clear differentiation between tasks carried out on the basis of local decisions and those carried out in line with central government decisions, or regarding the origin of the resources with which those tasks are executed, so that it is not possible to distinguish clearly to what authority the local governments are primarily accountable in each case.

In short, in both situations it would be essential to have suitable management information systems: in the case of political decentralization, in order to render accounts primarily to the community, and in the case of operational decentralization, in order to render accounts to the central government. It would be highly desirable for citizens to be properly informed in both these cases, but in order for there to be effective responsibilities, this difference between principals should be clearly laid down in the accounts themselves.

2. Transfers: how to reconcile efficiency with equity

Generally speaking, the specialized literature distinguishes two basic types of territorial transfers: unconditional and conditional transfers. If it is accepted that one of the requisites for efficiency is that decisions on expenditure should be linked to those regarding the respective contributions to be made by the citizens, however, the first question to be asked about territorial transfers is whether or not they are designed to support local expenditure decisions linked with local contributions of resources.¹² Completely unconditional transfers would not help to ensure fulfillment of this condition for efficiency and would give rise instead simply to a political decentralization only of the expenditure. Furthermore, expenditures which do not involve citizen contributions would disincentivate citizen participation (which is already made more

difficult by the prevailing electoral systems) and would facilitate the use of resources for private purposes.

The situation would be different in the case of transfers which, while not conditional upon local contributions, are conditioned in respect of the use to be made of them, since if such conditions were imposed, this would make it possible to introduce controls like those of operational decentralization. Finally, if transfers were conditional upon both the use to be made of them and the provision of local contributions (for example, co-financing funds), the operational decentralization elements would exceed those of political decentralization.

Table 1 gives a summary of this analysis. Only transfers which are freely disposable but are proportional to local contributions (those of type 1) would help to generate conditions of efficiency in political decentralization.

If transfers are to depend on local contributions, however, how will it be possible to attain the primary objective of those transfers, which is to make up for differences between local areas? The theoretical solution—already proposed some years ago (Finot, 1996; ECLAC/ILPES, 1998)—would be for territorial transfers to be proportional to the respective local contributions, measured not in absolute terms, however, but as a proportion of the levels of income of the inhabitants of each community.¹³ The principle

TABLE 1
Conditions for transfers and types of decentralization

Conditions		Conditional on local contribution?	
		No	Yes
Conditional on use to be made of resources?	No	2 Political decentralization of expenditure	1 Political decentralization
	Yes	3 Political decentralization ≥ operational decentralization	4 Operational decentralization > political decentralization

Source: Prepared by the author.

¹² In line with the pioneering proposal by Wiesner (1992 and 2002).

¹³ A more equitable alternative to the present situation would undoubtedly be for the municipal expenditure per inhabitant to be brought up to a standard level through transfers, as proposed for Brazil by Prado, Cuadros and Cavalcanti (2003): this involves an important difference from the proposal made in this article, because in that case the transfers would not be linked to local efforts.

of taxing individuals *in proportion to their respective capacities, that is to say, in proportion to the incomes they enjoy*, which was proposed by Adam Smith (and cited by Musgrave, 1959), should also be applied to local communities.

This transfer system should coincide with the expansion of the taxation powers of the subnational levels, in order for the various local communities to be able to determine, by democratic processes, the level of the taxes whereby they will help to finance the expenditure they decide upon.¹⁴ This would reconcile the objectives of equity with those of efficiency and stimulation of citizen participation.

3. Territorial redistribution and social redistribution

A system in which territorial transfers were freely disposable but proportional to the relative local contributions would make it possible to deepen political decentralization under conditions of both efficiency (including fiscal efficiency) and territorial equity, but it would not ensure social equity. Achieving this latter objective is the primary *raison d'être* of conditioned transfers. This has led countries such as Mexico to make a clear differentiation between freely disposable transfers and transfers designed exclusively for such purposes as health and education services.

Generally speaking, the decentralization processes in Latin America are marked by the expansion of powers for the local provision of basic infrastructure services and—in particular— by the transfer of authority in respect of education and health services; initially (except in the case of Mexico, as already mentioned), both types of goods were treated similarly.

The characteristics of social services are very different, however, from those of basic infrastructure services: whereas in the case of the latter demand is clearly differentiated geographically (especially by physical factors), in the case of post-Welfare State social services the demand is differentiated geographically in its qualitative aspects, but in quantitative terms all citizens have an equal right for the State to give them similar access, regardless of their place of residence.

This differentiation, already postulated as early as 1996 (Finot, 1996; eclac/ilpes, 1998), should provide a clear distinction between two systems of redistribution: one based on purely territorial transfers, with free availability of resources but only in proportion to the corresponding relative local efforts,¹⁵ whose aim is to subsidize local initiatives and efforts to provide infrastructure services, and the other, based on social transfers and operated by the local government authorities, designed to ensure that all the inhabitants of a country have access to a minimum basket of “social” goods and services.¹⁶

III

Fiscal decentralization in Latin America

Initially, Latin American decentralization processes could be classified according to whether they take place in federal or unitary countries. In federal countries, decentralization was initially focused on the states or provinces making up such countries. This was also the case in Brazil in 1941, but since the entry into force of the 1988 Constitution, the Brazilian process has been focused not only on the states but also on the

municipalities, and there has even actually been greater emphasis on the municipal level. The municipalities are considered to have the same autonomous status as the federated states, and it is laid down that the relations between the two levels should only be relations of coordination (Federal Republic of Brazil, 1988).

In the unitary countries, in contrast, decentralization focused on the municipal level prevails, although there are also cases of different extents of decentralization to the intermediate level: in Bolivia and Chile, for

¹⁴ This would make it possible to equalize, for all the communities, the marginal benefit of the expenditure with its respective cost in terms of taxes, in a similar manner to the (theoretical) case in which the whole of local expenditure is financed with local taxes, which is a condition for efficiency emphasized by Tanzi (1995) and Oates (1999).

¹⁵ Relative fiscal efforts: basically measured as a function of the level of income (or poverty) of each local community.

¹⁶ Whose financing should, however, be aided by contributions by the local areas with higher incomes, as José A. Ocampo points out.

example, designated authorities share powers with representatives elected by the municipal councils,¹⁷ while in Colombia both the Governors and the members of the Departmental Assemblies are directly elected.

In the following sections, the framework thus defined will be applied both to the countries studied

and to their systems of basic transfers from the national level.

1. Tax bases, by levels

Table 2 gives a summary of the tax bases for each level of government in six Latin American countries,

TABLE 2

Latin America (six countries): Main sources of tax income of each level of government^a

Taxes	Argentina	Brazil	Mexico	Colombia	Bolivia	Chile
Income tax (corporate and personal)	Profits tax: N ₁ Personal income tax: N ₁	Income tax: N ₁ Additional income tax: I	Corporate income tax: N ₁ Personal income tax: N ₁ Personal income: I	Corporate income tax: N ₁ Personal income tax: N ₁	Profits tax: N ₁ Personal income tax: N ₁	Corporate income tax: N Personal income tax: N
Wealth and assets tax	Wealth and assets tax: N ₁	Large fortunes: N ^b Death duties and donations: I	Corporate assets: N		Asset transfers: N ₁	Net wealth: N
On foreign trade	Trade and transactions: N	Imports and exports: N	Imports and exports: N ₁	Foreign trade: N ₁	Imports: N	Imports: N
Sales taxes	VAT: ^c N ₁ Gross income of enterprises: I	GSST: ^d I ₁	VAT: N ₁	VAT: N ₁	VAT: N ₁	VAT: N
Other indirect taxes	Electric power: N Fuels: N	TIP: ^e N ₁	Production and services: N ₁ Agriculture, industry and commerce: I	Gasoline: N Liquor and cigarettes: I Gasoline: I	Transactions: N ₁ Specific consumption: N ₁ Special tax on hydrocarbons: N ₁	Transactions: N Specific consumption: N
On exploitation of natural resources	Royalties: I ₁	Royalties: N ₁			Royalties: N ₁ Complementary tax on hydrocarbons: N ₁ Royalties: I	Royalties: I
On vehicles	Ownership: I ₁	Ownership: I	Ownership and use: N ₁	Registration: I	Ownership: M	Use: M ₂
On real estate	Property: I ₁	Rural property: N ₁ Urban property: M Transfers: M	Transfers: I Property: M	Registration: I Property: M	Property: M	Urban property: M ₂
On operation of businesses		Services: M	Industry and commerce: M	Licences to operate businesses: M	Licences to operate businesses: M	Licences to operate businesses: M ₂

Source: Finot (2001), updated.

^a N = national or federal; I = intermediate level; M = municipal; ₁ = contributes to the system for compensating units of government at a lower level or levels; ₂ = contributes to the system for compensating units of government at the same level.

^b Envisaged in the 1988 Constitution, but not yet instituted.

^c VAT = Value Added Tax.

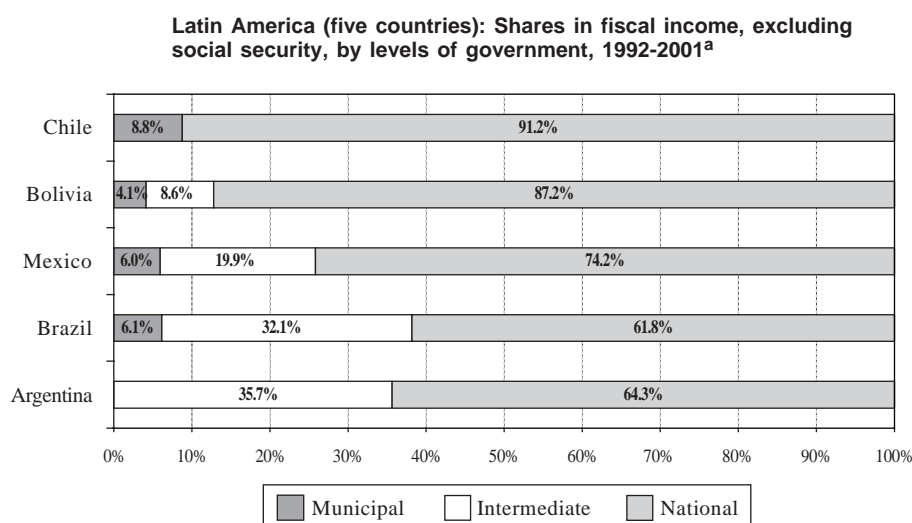
^d GSST = Goods and Services Sales Tax.

^e TIP = Tax on Industrial Products.

¹⁷ In both these countries there is now strong pressure for these representatives to be directly elected, which would be in keeping

with the view that each subnational level should be independent of the others, as in Brazil.

FIGURE 1



Source: Prepared by the author on the basis of data from the International Monetary Fund (IMF, 2001 and 2002).

^a For Brazil, the period studied was 1991-1998, and for Mexico, 1991-2000.

^b In the percentage shown for the intermediate level in Argentina, five percentage points are estimated to be generated at the municipal level.

indicating also which taxes are shared (i.e., help to finance basic transfers) and with which level of government.

In Argentina and Brazil, the main sources of tax income at the intermediate level are sales taxes; in Mexico, the main source is personal income tax and corporate income tax (not levied in some states), while there are no important sources of such income in Venezuela. In Bolivia, the main tax income of this level comes from departmental royalties on hydrocarbons (11% of the wellhead value); in Chile there is no important source of such income, while in Colombia the tax income of the departments comes only from taxes on property registration and on liquor and cigarettes.

At the municipal level, the main tax bases are the authorization of economic activities (licences to operate), corporate income tax, real estate and, to a lesser extent, ownership and/or circulation of vehicles (in Brazil, these latter taxes belong to the states). The fact that Argentina is practically the only country where the municipal level has no direct tax income shows that in that country decentralization is focused primarily on the provincial level.¹⁸

¹⁸ In Chile, urban real estate taxes are not officially municipal either, but almost the whole of the revenue from those taxes goes to that level.

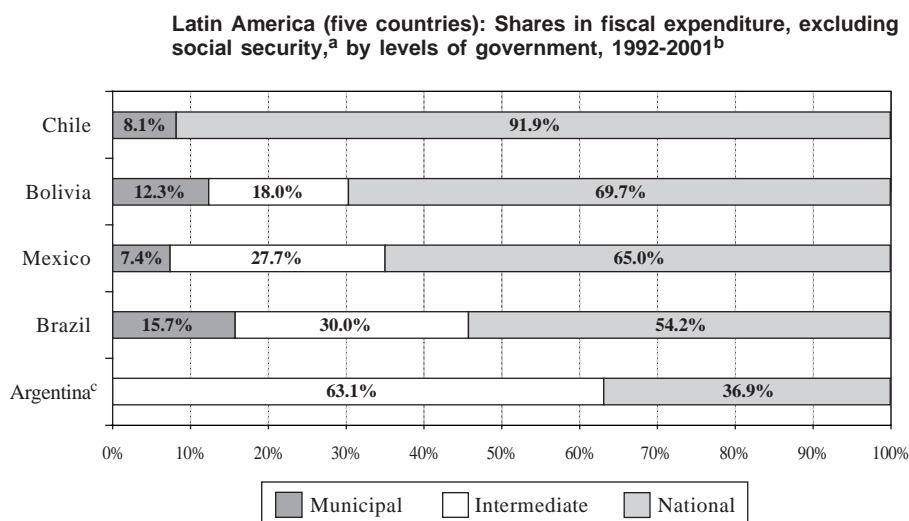
Figure 1 shows the importance of the contributions of each level to public income in the countries for which comparable information is available.¹⁹ Table 2 and figure 1 show the preponderance of the national level—and to a lesser extent of some intermediate levels—in resource generation, in contrast with the low weight of the municipal level. It should also be taken into account that the municipal share corresponds largely to a minority of municipalities which have the most valuable economic activities and real estate.

2. The financing of basic transfers

Figure 2 shows the share of the autonomous decisions of subnational levels of government in total fiscal expenditure. Obviously, in this case the share of the subnational levels is higher because it includes

¹⁹ The following tables have been prepared using the database of the International Monetary Fund (IMF). In this database, corresponding data are not available for Colombia, in the case of Argentina the amounts corresponding to municipalities are not separated from those for the provinces, and the accounts for Brazil and Argentina were prepared on the basis of classification criteria which do not coincide with those used for the countries in question. In the fiscal accounts for Brazil, for example, for legal reasons “social contributions” include income which would actually be earmarked taxes according to other criteria. For making comparative analyses, however, the IMF data are the only ones available which are calculated on the basis of common criteria.

FIGURE 2



Source: Prepared by the author on the basis of data from the International Monetary Fund (IMF, 2001 and 2002).

^a According to Afonso (2004), the distribution of expenditure for the same years, but including social security, would be: municipalities: 16.1%; states: 27.3%, and national level: 56.7%.

^b For Brazil, the period studied was 1991-1998, and for Mexico, 1991-2000.

^c In the percentage shown for the intermediate level in Argentina, ten percentage points are estimated to be generated at the municipal level.

transfers.²⁰ Noteworthy is the importance of the intermediate levels in the decentralized federal countries and, once again, the markedly lesser importance of the municipal level. This shows the ample space that still exists for deepening decentralization in Latin America.

In the following paragraphs, the analysis will concentrate on basic transfers: that is to say, those designed to support autonomous subnational decisions. These transfers typically come from shared taxes. Table 3 gives an updated summary of the sources of financing of basic transfer systems in each of the countries studied.

It can be seen from that table that, whereas in most cases basic territorial transfers come from national taxes almost as a whole, in Brazil they come mainly from only two federal taxes (income tax and the tax on industrial products), while in Chile they come exclusively from municipal taxes. The advantage of the Brazilian system is that, since the transfers come from only a few taxes, the federal government has ample leeway to apply its fiscal policy, while the advantage

of the Chilean system is that it involves sharing out sources of income that are usually very unequally distributed, whereas its obvious disadvantage lies in the small amount of resources generated by that source.

3. Distribution criteria

In both Argentina and Brazil, basic transfers are determined in line with fixed coefficients which were originally determined on the basis of criteria taking account of population and, to a lesser extent, poverty.²¹ In Brazil, however, the Interstate Participation Fund is focused primarily (85%) on the relatively less developed states, while the Municipal Participation Fund is distributed in the light of the number of inhabitants of each municipality. In Bolivia, population is the main criterion, whereas in Colombia and Chile there is a tendency to try to make up for social inequalities (table 4).

Colombia has recently decided on a major transformation of its transfer system (Colombia, 2003): under Act No. 715, all the previous systems (municipal participation, fiscal subsidies and development funds)

²⁰ Comparing figures 1 and 2 does not give any idea of the vertical imbalance at each level, because they are not based on absolute values.

²¹ For more details on the transfer systems of Brazil and Argentina, see respectively Afonso (2004) and Cetrángolo and Jiménez (2004).

TABLE 3

Latin America (six countries): Financing of basic territorial transfers^a

Country	Administrative level	System	Percentage of taxes	Taxes
Argentina	Provinces	Co-participation System	Approx. 30% Approx. 30% Approx. 47%	Value Added Tax (VAT) Profits Tax Consumption and other taxes
	States	State Participation Fund	21.5%	Income Tax Tax on Industrial Products
Brazil ^b	Municipalities	Municipal Participation Fund	22.5%	Income Tax Tax on Industrial Products
Mexico	States	Participation System	20%	Income Tax Tax on Production and Services External Trade Tax Tax on Vehicles
	Municipalities	Participation in Taxes	20%	All national taxes except Special Tax on Hydrocarbons
Bolivia		National Dialogue	–	External Debt Relief (transfers from rest of world)
Colombia	Departments and municipalities	General Participation System	Fixed amount, depending on GDP growth	On total current income
Chile	Municipalities	Common Municipal Fund	Approx. 50%	Taxes on real estate, vehicles and licences to operate businesses

Source: Prepared by the author on the basis of official information of each country.

^a This table does not include basic transfers from the intermediate to the municipal level, which in the case of Brazil amount to 25% of the Goods and Services Sales Tax, each state being obliged to distribute 75% of this amount as a function of the gross domestic product of each municipality.

^b Other territorial participation systems in Brazil are the Compensation Fund on Exports of Industrial Products (FPEX) —10% of the revenue from the Tax on Industrial Products— and the Rural Territorial Tax.

were unified in a single General Participation System and a clear differentiation was made between a “multi-purpose” transfer system (17%) —which would now consist of basic transfers to be used primarily for the provision of basic infrastructure services— and two other systems, the amounts of which are calculated in the light of needs and costs. The latter two systems are designed to provide family income subsidies so that all inhabitants can have the same access to a certain minimum level of education and health services, thus representing a social redistribution system to be operated by the subnational levels of government (83% of all transfers).²²

In Mexico, a clear differentiation was made from the beginning between freely disposable transfers to the states (“shares”, of which 20% would be for the municipalities) and transfers aimed exclusively at financing specific social programmes, especially infrastructure and education and health services (“contributions” to the states and municipalities). The Mexican Participation System is the only one in the region in which the subnational fiscal effort predominates (45.17%), followed in this respect by Colombia, where 10% of the general-purpose resources depend on local fiscal efforts. In Chile, using a strictly redistributive criterion, the amount of transfers is

²² On the basis of the Colombian experience, Shah (2002) proposes the more general use in Latin America of “conditioned” transfers, in order that all citizens may have equal access to a certain minimum level of services. In this case, however, these would not be

conditioned territorial transfers but social transfers operated by the subnational levels of government. This author does not explain how local autonomy would be promoted under this system.

TABLE 4

Latin America: Distribution criteria for basic territorial transfers

Countries/ criteria used	Brazil (states)	Brazil (municipalities)	Mexico (states)	Bolivia (municipalities)	Colombia (general purpose)	Chile (municipalities)
Territory	85% for the northern, northeastern and centre-west regions	10% to municipal capitals				9%, equally shared
Number of inhabitants		86.4% to municipalities with more than 156,000 inhabitants; 13.6% to those with less than 156,000	45.17%	100% of shared resources	40%	13.5%
Poverty				100% of resources from External Debt Relief	40% according to level of unsatisfied basic needs	27% according to number of properties exempt from real estate taxes
Own efforts (directly or inversely)			45.17% according to increase in own income 9.66% in inverse relation to the shared resources received per inhabitant		10% according to increase in own income	31.5% according to lower per capita fiscal income
Administrative efficiency					10%	5%
Provision for emergencies						5%

Source: Prepared by the author on the basis of each country's legislation.

calculated as an inverse function of per capita municipal income.

4. Conditioning of expenditure

Table 5 gives a summary of the conditions imposed on the use of basic transfers in each of the countries studied. Neither Argentina nor Mexico apply conditions on the use of these transfers.

In Brazil, the Fiscal Responsibility Act adopted in the year 2000 (Federal Republic of Brazil, 2000) lays down that states and municipalities can only spend a maximum of 50% on personnel costs, or 60% in the case of the federal government. Furthermore, according to the 1988 Constitution, at least 25% of the expenditure of states and municipalities must be devoted to education.

Brazil has an ongoing policy of seeking to reduce territorial differences in the levels of provision of social services. With this aim, since 1988 health services receive additional compensatory financing through the Unified Health System, and in 2000, through a constitutional amendment, it was decided to gradually increase transfers and the conditions imposed on expenditure for the benefit of this sector. In addition, in order to reduce territorial differences in school education services, the Fund for the Maintenance and Development of Basic Education and the Upgrading of Teaching Staff (FUNDEF) was established, mainly financed through a 15% share in the State Participation Fund, the Municipal Participation Fund, the Goods and Services Sales Tax and the Export Promotion Agency (APEX), for the purpose of ensuring a certain minimum level of public expenditure per pupil.

TABLE 5

Latin America (seven countries): Conditions on the use of basic territorial transfers

Argentina	Brazil	Mexico	Venezuela	Bolivia	Colombia	Chile
None	a) Maximum of 50% for staff costs b) 25% for education c) 12% (states) and 15% (municipalities) for health ^a	20% for municipalities	50% for investment 20% for municipalities	Shared resources: i) Maximum of 25% for operational expenses ii) 7.5% for health iii) Participative preparation of municipal plans Resources from External Debt Relief: i) 10% for health, 20% for education ii) Subject to meeting targets	41%: sanitation 7%: sport 3%: culture	None

Source: Prepared by the author on the basis of each country's legislation.

^a Limitation on expenditure, not only on the transfers.

Generally speaking, the unitary countries apply more conditions to basic transfers in line with the size of the latter. In Colombia, 51% of the “general purpose” transfers must be spent in sectors defined by the central government (41% on drinking water supply and sanitation). In Bolivia, although there are fewer conditions on basic transfers, in most of the municipalities these are used as local contributions for gaining access to resources from the Regional Development Fund (loans) and the Investment Fund for Production and Social Activities (transfers), which are assigned at the central level.²³

Finally, in Chile basic transfers (coming from the municipal level itself) are freely disposable but, since they are only small, in most cases they are used almost entirely for operational expenditure (including that arising from the operation of the system of social transfers) and for the provision of some services such as refuse collection and disposal; for investment, the

municipalities depend on various other sources, the most important of which is the Regional Development Fund, where local contributions are usually required and transfers are decided on a project by project basis at the intermediate level.²⁴

5. An overview of the transfer systems

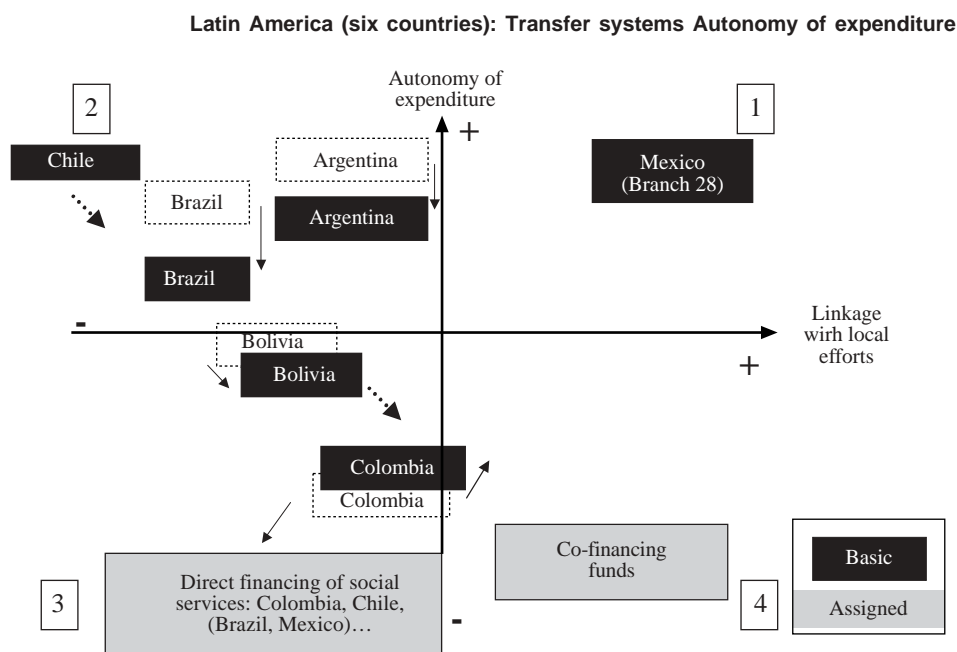
Using the analytical framework designed in the first part of this section (see table 1), figure 3 classifies the different transfer systems analysed and schematically outlines their characteristics and evolution. This figure shows that—except in the Participation System of Mexico and, to an incipient extent, that of Colombia—²⁵ the basic transfer systems adopted in Latin America do not help to encourage expenditure

²³ Although it is not among the countries studied, it is important to mention the case of Guatemala, where it was recently decided that resources from the Integral Municipal Development Programme will be distributed to municipalities and associations of municipalities “in direct proportion to their respective local contributions with regard to their respective levels of poverty and their population density, taking into account both the amount of local taxes collected and the value assigned to their citizens' contributions in terms of labour, kind or money for the provision of public goods” (Guatemala, 2002).

²⁴ In the case of primary health attention and school education in Chile and health attention and school education in Bolivia, there is decentralization—in principle, political decentralization—to the municipalities of responsibility for the provision of infrastructure, equipment and supporting personnel, but there is only operational decentralization of responsibility for specialized personnel (both the terms of employment and the financing of such personnel are decided at the national level). The particular feature of Chile is that the financing of specialized personnel is effected, in the case of education, through subsidies to municipalized and private schools according to the number of students who attend classes in them, and in the case of health services, through demand subsidies assigned through a system of evaluation of beneficiaries by the municipalities. Colombia has adopted the main lines of this system, but has applied it to the total cost of the services in question.

²⁵ And the Integral Municipal Development Programme in Guatemala.

FIGURE 3



Source: Prepared by the author.

to depend on local contributions. Consequently, in the absence of this automatic control mechanism, there is a tendency to increase administrative control mechanisms, which is standard practice in the programmes financed with assigned transfers. At all events there is a clear tendency to move out of the quadrant corresponding to political decentralization of expenditure, including the cases of Chile and Bolivia mentioned in the previous paragraph (this situation is represented in figure 3 by the bold arrows).

Although the Mexican system promotes fiscal efficiency, it does not appear to give corresponding results in terms of equity: the fact that transfers are proportional to increases in revenue collection may act as a multiplier of disparities, as local governments with fewer resources would find it more difficult even to make investments in the improvement of their revenue collection procedures.²⁶ Furthermore, the Mexican

system is focused on the states, and reaches the municipalities only through them. Finally, the amounts of these freely disposable transfers are still markedly below those of the assigned transfers, so that there is a good deal of room for improving this system and even establishing a similar one aimed at the municipalities while maintaining the basic mechanism for ensuring efficiency.

The fundamental explanation for this situation would be that—as already noted on other occasions—in the political context in which these processes were initiated, the necessary distinction was not made between territorial distribution, on the one hand, and social distribution, designed to guarantee certain levels of access to the whole population, on the other. The present tendency all over the region, however, is precisely to make such a distinction, although this is more difficult in the case of the federal countries. This may be seen in the case of Brazil, and more clearly in that of Chile, but it is in Colombia that the distinction has been most clearly marked, as already noted.

So far, decentralization processes have been aimed mainly at the implementation of social policies. This tendency is evident even in the conditions imposed on the use of multi-purpose transfers under the new system introduced in Colombia. What is to be

²⁶ In the European Union, territorial transfers are also subject to decisions which take account of the respective local (by the intermediate and/or municipal levels) and national contributions. Unlike the Mexican case, however, these transfers are exclusively for regions and localities whose per capita GDP is below the European average, and in principle they are proportional to that difference. At present, 41% of such transfers is for infrastructure and 34% for production development.

done, however, when increasing local autonomy is of decisive importance for enhancing economic competitiveness and incorporating small and medium-

sized producers into this effort, so that they can increase their income? And what can be done to give all localities equal opportunities?

IV

Some guidelines

The transfer systems adopted in most of the countries of the region involve various combinations of political decentralization and purely operational decentralization of decisions taken by the central government. Both types of decentralization are of value, depending on the characteristics of the different types of public goods whose provision is decentralized, but generally speaking the transfer systems are causing the dividing line between the two types of decentralization to depend not so much on the demand characteristics of the goods in question as on the capacity of each local district to generate its own resources. This means that the right of citizens to provide themselves with local public goods depends on the level of wealth of the district in which they live: the poorer the district, the lower its level of autonomy in this respect.

Except in Brazil, the great majority of Latin Americans have very little autonomy for deciding, initiating and controlling the execution of local development strategies, and moreover this autonomy is tending to grow still smaller. Not only is the share of municipal expenditure in total public expenditure still quite small, and generally depends to a large extent on territorial transfers, but those transfers are tending to be increasingly subject to conditions on their use. In each case, local autonomy depends more and more on the capacity of the local area to generate income of its own—specifically, to receive tax revenue—and in Latin America this capacity is extremely unequally distributed, since the generation of value added is concentrated in a relatively small number of localities. All this gives rise to a situation of growing inequality as regards a citizen's right to receive local public goods.

The transfer systems prevailing in the region are inadequate not only in terms of equity but also efficiency. Even within the limited amounts of autonomy they allow, they tend to separate decisions on expenditure from those on the generation of local income (and this occurs even in Brazil, the only exception in the region being the Participation System applied in Mexico). They thus impede the process of

revealing geographically differentiated preferences, which is essential if decentralization is to contribute to efficiency.

There is undoubtedly a need for transfer systems which are not linked with local fiscal efforts, especially in the case of social services. In Latin America, however, the main design problem is that, in the attempt to “devolve” to local levels of government the functions which they previously exercised, the financing of services such as education and health—in which the State must ensure that all persons have a similar level of access, regardless of their place of residence—has been treated in the same way as the financing of basic infrastructure services, the demand for which is clearly differentiated by physical factors. In the first case, the autonomy of local governments should be limited to the definition of qualitative aspects, and as far as financing is concerned, those governments should act primarily as agents of a national social redistribution system. In the second case—basic infrastructure services—however, it would be extremely desirable to transfer the whole process of their provision, including the decisions on their financing, to the subnational level whose territorial area of authority best corresponds to the common characteristics of the demand for each such public good.

A clear distinction should be made, as in Colombia, between social transfers designed to give all individuals equal opportunities and territorial transfers proper, which are designed to give equal opportunities to subnational communities in terms of the goods consumed by all, the major part of which, from the financial point of view, would correspond to basic infrastructure services.²⁷ In order to reconcile equity with efficiency, in this second case the transfers should

²⁷ A given level of drinking water consumption should form part of the “basket” of social goods. As we proposed elsewhere, subsidies for such consumption would be added to the income flow that local communities should receive in order to provide their inhabitants with drinking water and sanitation (Finot, 1999).

be freely disposable but proportional to the relative fiscal efforts of each local community.

These changes in the system of territorial transfers could be accompanied by changes in local decision-making processes designed to promote the effective identification of preferences: that is to say, to promote effective citizen participation in decisions not only on “what” and “how much” to provide, but also on how much of their income they should contribute for that provision. The systems of decision-making, representation and participation should be adapted to this purpose.

The present system for electing citizens’ representatives at the municipal level —proportional representation— would not appear to be the most suitable for securing better expression of local citizens’ preferences: the “preferences” represented under this system could easily correspond to those of the political leaders who put candidates on their lists rather than to those of the citizens they are supposed to represent. The opposite could be expected if a system of territorial representation were adopted in which representatives were obliged to collect information from the people they represent, and inform the respective electoral districts accordingly, on pain of losing their seats. This change should be accompanied by the installation of easily understood systems of basic and management information and social participation and representation policies designed to equalize citizens’ capacity to exert their influence. Furthermore, in order to clearly establish who is responsible for controlling expenditure, a clear distinction should be made, both in budgets and in the accounts, between items corresponding to autonomous decisions of the local communities and those corresponding to actions executed by the local governments as agents of the central government.

In order for the citizens thus represented to be able to decide what part of their income should be used for the provision of local public goods, as a function of the benefits offered by different options for such provision, it would be essential —as I have been proposing since 1996— to increase citizens’ powers to levy taxes on themselves, and specifically, to decide the rates of local taxes directly affecting their property and income,²⁸ incorporating in the calculation of the

local contributions for the generation of public goods the amounts that citizens contribute through their organizations in the form of labour, kind or money.²⁹

Territorial transfers, then, should be subject to these local decisions. In the interests of stability, however, the national authorities should periodically define the factors by which the subnational fiscal efforts are multiplied for determining the amount of such transfers.

Within this institutional framework, one crucial aspect remains to be settled: to what level should the provision of each local public good be decentralized? Obviously, the closer the correspondence between the area of demand for each local public good and the ambit of the respective political decisions on resource assignment, the more efficient the latter decisions will be. On the one hand, decisions on the provision (and financing) of local goods should be decentralized to the levels closest to the citizens (the sub-municipal levels), while on the other hand territorial association in line with the different ambits of demand should be promoted through the new transfer system (Finot, 2003).

In the case of habitat-related public goods, many decisions could be taken at sub-municipal levels. With regard to production development, however, the municipal area is often insufficient. In order to stimulate local economic development under conditions of efficiency and equity, then, both in unitary and federal countries it should promote —through territorial transfer systems like that proposed above (freely disposable but proportional to the respective relative contributions)— the formation of municipal consortia configured as a function of physical, biological, cultural and/or economic factors common to the members of the consortium (but different from other areas of the country).

This form of territorial organization could be expected to correspond better to geographical differences in demand for public goods, such as the planning of land use, the organization of the supply of services, and the provision of basic infrastructure services, and it would have the additional advantage of generating economies of scale, not only for creating favourable conditions for local and/or regional development but also for managing the provision of social services and subsidies better. In order to facilitate these functions, such consortia should be of a public

²⁸ This does not mean decentralizing the tax collection process. In many cases it is preferable to have a single tax collection system serving all levels of government. It would also be appropriate, in order to reduce moral hazard, to externalize the valuation of real estate used as a basis for calculating property taxes.

²⁹ As currently provided for in the Regulations of the General Decentralization Act in Guatemala.

nature but should only be temporary, so that the districts represented can keep on adapting to the way the geographical configuration of demand evolves over time.³⁰

Through a system of territorial transfers like that proposed above, the formulation of local/regional development strategies involving commitments for local contributions could be promoted through processes of concerted decision-making and action between public, social and private actors and the various levels of the State. These strategies would serve as the basis for land use definition and a multi-year budget programme for the provision of infrastructure services and advanced services. The levels above the purely local ones would be responsible for complementing these decisions with the provision of such services in their own respective ambits and with

policies in the areas of the environment, production development and support for small and medium-sized enterprises.

These broad guidelines are aimed primarily at providing some basic elements for progressing efficiently towards equality of opportunities for local communities and creating suitable conditions for local and/or regional development as a function of real current economic development needs. Obviously, however, in so far as citizens are better represented and can participate effectively in decisions on their contributions, the fact of achieving deeper decentralization like that required for local development will also help to reduce corruption, to develop citizenship, and to broaden social inclusion.

(Original: Spanish)

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³⁰ Coinciding with our proposal, the Brazilian Congress has just adopted an Act giving the status of public organizations to all inter-territorial consortia, for as long as the members of the consortia deem appropriate.

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