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Financing decentralization

Dolores María Ruíz Lizana

The financing of a State’s sub-national levels of government, in federal and other systems alike, is an instrument of decentralization; first, each State has to decide what area of responsibility to assign to each governmental level and then it must design a suitable financing mechanism. If these sub-national governments’ degrees of fiscal and administrative autonomy are not kept in alignment, then eventually the initiative may fall as the bodies at these levels gradually lose decision-making power within their sphere of responsibility. It is unlikely that sub-national levels of government will be able to cover all their financial requirements with their own funds. Instead, they receive differing amounts of funding from a whole series of financial sources, including their own tax receipts, a share of the central government’s tax revenues and subsidies granted by the central government. Nevertheless, they achieve a high level of fiscal maturity when they are not heavily dependent upon the central government for financing. Independence is only possible when sub-national levels of government are financially self-sustaining or are financed by predictable resource transfers that have no specific conditions attached. What engenders the greatest degree of dependency, on the other hand, is financing based on tied resource transfers. The article cites a number of examples to illustrate how these funding sources operate in selected Latin American countries.
I

Introduction

Decentralization is the process of transferring areas of responsibility or authority from the central government to sub-national levels of government (state and municipal institutions in countries with federal systems, regional and community bodies in non-federal systems). Thus, we say that a State is decentralized when the local government agencies responsible for different zones within the nation's territory have been endowed with a significant degree of authority.

But in order for these sub-national levels of government to actually exercise the authorities transferred to them, they must have the necessary resources. The financing of federated states, regions and municipalities is therefore a fundamental topic in the study of decentralization, which, in most of the State reforms undertaken in Latin America during the past decade, has been seen not only as a bulwark of the State's democratization but also as a means of helping to make the allocation of authority and resources within the country more efficient.

Decentralization programmes whose design does not provide for an adequate flow of funding to the relevant sub-national government bodies are doomed to failure. The question is by no means a trivial one because, although decentralization has been justified as a means of reducing central government expenditure or achieving a more efficient allocation of public-sector resources, "in practice, however, the most immediate result of decentralization programmes in Latin America (e.g., Brazil, Colombia, Ecuador, Guatemala and Venezuela) has been to increase the central government's expenses as a consequence of a combination of factors: the legal requirements pertaining to formulas for intergovernmental resource transfers; the unexpected ramifications of income-distribution policies, which have worked as a disincentive for any increase in revenues on the part of sub-national units; the conditions imposed by central-government authorities with respect to the use of funding for specific purposes; and, most importantly, the limitations placed on sub-national governments' efforts to expand their revenue base" (Morgan, 1991, p. 10). It is clear, then, that unless more attention is paid to financial questions, the centralized nature of the tax system may lead to a "re-centralization" of administrative functions.

In short, the financing of the decentralization process needs to be based on an efficient allocation of powers and duties so that the various sub-national levels of government will have sufficient resources to assume the corresponding responsibilities within a context of autonomous decision-making and of equity among the various territorial zones making up the nation. ¹

The subject is a complex one not only because of the tensions inherent in the organization of a State having various levels of government and the consequent difficulty of allocating tasks and functions among its components, but also because the question of financing per se entails additional tensions owing to the diverse objectives being pursued, the wide range of instruments available, and the complicated relationships and juxtapositions among them (Giménez, 1979).

The efficient allocation of authority is in itself an enormously complex objective, since central government bodies are usually more efficient in performing some functions and decentralized bodies are more efficient in others; for example, the management of revenues is usually carried out more efficiently at the central level, whereas the mobilization of resources is often performed more satisfactorily at the local level.

As regards the objective of balancing the budget, when new functions are transferred to sub-national levels of government, then those levels' expenses will increase, and sufficient funds to cover them therefore need to be forthcoming. This generates a great deal of tension since, in situations where funding constraints (such as those currently affecting Latin America) are already making it difficult to balance the State's budget, a move towards decentralization can easily throw it out of kilter altogether; the reason for this is that usually, especially in the beginning, the central government will have to continue to take charge, at least partially, of the functions that have been transferred to other levels, and this inevitably entails some degree of inefficiency.

¹ In regard to the current relevance of these concepts, see Castells (1991).
The funding for the activities that have been transferred to sub-national governmental units can be drawn from those institutions' own tax revenues or from State transfers. The use by such bodies of their own tax revenues is a hallmark of financial autonomy, whereas the use of State transfers—especially if the central government attaches conditions to that funding—is an indication of the extent of their dependency. The push and pull between autonomy and dependence is usually heightened if sub-national levels of government are fiscally irresponsible, since this will give rise to major conflicts between the State's macroeconomic objectives and the financial objectives of the country's regions and municipalities. If this situation is compounded by problems in connection with the various sub-national bodies' policies regarding borrowing and deficits, then the tension between them and the central government will be exacerbated.

Finally, with respect to the objective of equity, it should be noted that sharp differences in the incomes of sub-national governments of equal rank may be reflected in disparities in the services provided to different areas within the same country; this makes some sort of income-leveling or equalization mechanism necessary, and the establishment of such a mechanism invariably generates inter-zonal tensions. Consideration also has to be given to the means of financing the measures taken to re-establish an inter-zonal balance through the alignment of the various territorial divisions' levels of development, since a different policy will be required in order to accomplish this.

II
Financing decentralization: a question of implementation

In the final analysis, the financing of sub-national levels of government is a secondary issue—or at least a question of implementation—for decision-makers concerned with the decentralization process. Each country must first decide how centralized or decentralized its services should be, and only then will it go on to determine what financing mechanism is the most appropriate. The decision as to the process of decentralization itself, on the other hand, is a policy decision; it must be based on constitutional grounds and must then be translated into a distribution of functions and authorities among the various levels of government. The State must first determine each governmental level's quantum of functions and authorities, and only then will it analyse how the corresponding activities are to be financed.

The fact needs to be borne in mind, however, that the correspondence between the administrative decentralization of government functions and fiscal autonomy is not exact, at least during the early stages of the process. A high degree of administrative decentralization means that decentralized regional or municipal bodies are able to take independent decisions regarding the responsibilities transferred to them, while a high degree of fiscal autonomy means that they are able to decide independently what taxes will be assessed within their territorial jurisdiction. The two types of autonomy do not correspond, however, because decentralized services are generally funded—especially in non-federal systems—primarily by transfers from the central government, while only a very small percentage is covered by the decentralized governments' own tax revenues. These institutions' inability to generate any considerable amount of tax revenues on their own is not, in theory, an obstacle to the transfer of more responsibilities. However, if the lack of synchronization, which is understandable at the start of the process, persists over time, then the viability of the process itself may be jeopardized (Castells, 1991).

The decentralization of government functions can be measured by looking at the responsibilities actually transferred to sub-national governments; this transfer will be reflected in the share of the central government's public expenditure represented by that of the sub-national governments. The size of this share will not, however, tell us anything about the source of the revenues spent by sub-national governments. The concept of fiscal decentralization is what provides this information by means of various sorts
of measurements, which may denote different sorts of autonomy.

One way of looking at revenue sources is to determine which body has established the corresponding tax. Thus, we say that a financial model is centralized when taxes are primarily levied by the central government’s Treasury, and the majority of the sub-national treasuries’ incomes are provided by transfers from the national Treasury. In contrast, a financial model is said to be decentralized when each treasury department establishes its own taxes and derives the majority of its income from them, although it may still receive redistributive transfers from the central government (Sevilla Segura, 1991).

This criterion is not always used; sometimes fiscal decentralization is said to be determined by how autonomous a sub-national government is in terms of its expenditures, and it may have this type of autonomy regardless of whether it establishes its own taxes or receives automatic, predictable transfers from the State, such as those provided for under revenue-sharing schemes. This is why, for example, countries such as Argentina are included in the category of nations with a high degree of fiscal decentralization despite the fact that Argentina’s federal system of finance is based on arrangements for sharing the revenues from the central government’s taxes (World Bank, 1990).

Despite its implementational character, the issue of financing tends to introduce an additional contradiction into the administrative decentralization process because in practice, especially during the early stages of the process, it entails a higher level of expenditure by government bodies as a group even though the quantity or quality of services may not increase.

A recent World Bank study of nine Latin American countries (Campbell, 1991) indicates that most decentralization strategies have resulted in significant additional net expenses (particularly in Colombia, Brazil, Guatemala and Venezuela). Although part of the reason for this may be that during the reorganization of governmental responsibilities, necessary improvements are made in the quality of services, the fact remains that in most cases there has been no significant real reduction in the central government’s expenses. And although some expenses may be temporary, experience shows that any reduction in central-government expenditure takes a long time to materialize and is never complete. Only in Chile, Ecuador and Argentina has intergovernmental financial reform been used as a tool of national budgetary restraint.

As a result of this situation, the decentralization process may fall into disrepute and the State may be re-centralized, with all previously-distributed functions being transferred back to the central government, simply because the authorities failed to find the right solution for these financial problems. In such cases, financing ceases to be simply an implementational aspect of decentralization.

III

The allocation of functions and resources among the various levels of the bureaucracy and government

The allocation of powers and duties among the various levels of government is a complex subject which has been exhaustively studied from the perspective of economic analysis. Here we will refer only briefly to this topic as we seek to explore the issue of financing. For the purposes of this discussion we will therefore assume the validity of the traditional approach developed by Musgrave, which differentiates among three public-sector functions—allocation, redistribution and stabilization—and postulates that allocation, consisting primarily of the provision of public goods, is the only function which should be performed by all.

2 Something along these lines took place in Brazil, for example, when the health services that had been in the hands of the federal government were transferred to the states and municipalities, since these services were in a shambles and large investments had to be made in order to continue offering them. In this regard, see Brakarz (1991).
levels of government. This has given rise to what has been called the “decentralization theorem”, which holds that decentralization in the provision of public goods permits the diversification of supply according to the preferences of a country’s citizens, taking into consideration the existence of differentiated demands.

This theorem has a strong economic foundation in the proposition that the optimum provision of services can only be achieved on a decentralized basis; but it also has an important political component which distinguishes between decentralization and deconcentration, with the advantage of decentralization being that it introduces the element of elections as a mechanism for determining citizens’ preferences.

An economic analysis of government functions also serves as the basis for the other crucial statement we can make about financing: that, as a rule, it is not the job of sub-national bodies to establish taxes of a redistributive or income-leveling nature.

The allocation of responsibilities to the various levels of government is not, however, a theoretical process by which each function is assigned to the level that can perform it most efficiently. On the contrary, it is a highly complex procedure. The first necessary element is a political decision to embark upon the process of decentralization or, in the case of a State that is already functioning on a fairly decentralized basis, to carry it forward. Another consideration is the fact that not all sub-national government bodies of the same rank are capable of performing the same functions. Finally, the vertical allocation of functions is virtually impossible; the administration of most of the services provided by a State requires the involvement of various levels of government.

Decentralization is an issue that is now being debated in almost all Latin American countries, but their actual decentralization processes are very different from one another.

In countries with a federal system of government, the subject is one of the topics of the day, despite the fact that these countries are, theoretically, already decentralized. In these cases, the idea is basically to transfer more functions to the states than they already have and to make those duties their exclusive responsibility; to establish systems of concurrent jurisdictions or spheres of responsibility; and to set up mechanisms for coordination with the central government and among the various states themselves. Although the processes themselves and the political formulas differ a great deal from country to country, as a rule the Latin American countries that have a federal system are more closely associated with the continental centralist tradition than with the North American federalist model. Some countries, such as Venezuela and Brazil, are currently analysing and implementing plans to carry the decentralization process further because their polity and civil society have decided that the state and municipal governments should take over the administration of more services from the central government (Shah, 1990; CLAD, 1991). Mexico’s society, on the other hand, is more inclined to have the central government be the one that provides services (ECLAC, 1985).

If the extent of decentralization is measured by the sub-national governments’ levels of expenditure, then the foregoing becomes obvious, since in Mexico their expenditure amounts to less than 20%, whereas in countries such as Argentina and Brazil, the figure approaches 30% of total expenditure (World Bank, 1988, using 1974-1986 averages).

In some countries that do not have federal systems, attempts have first been made to create regions that will function as decentralized units to which responsibilities can subsequently be transferred (Peru and Guatemala).

Finally, in another group of countries, the aim of decentralization is to reinforce local government at the municipal level (which is already a decentralized body) and transfer new functions to it (Colombia and Chile).

The financial issues are different in each of these cases. If decentralized bodies—-even if they have few responsibilities and small budgets—-are already in existence at the start of this process, then this means that decentralized treasury departments have already been organized, and such departments can serve as the basis for a new finance system. A relatively advanced position within the administrative decentralization process, as we would expect to see in countries having federal systems, ought, in its turn, to lead to an opening up of the fiscal decentralization process whereby financing based on central-government resource transfers to sub-national bodies would gradually

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3 While Musgrave’s economic analysis (1991) is still relevant, it can now be questioned from some standpoints.
give way to the use of revenues from taxes assessed by the latter, which would manage their own incomes and be answerable for that management to the electorate. This was apparently one of the objectives of Brazil’s reform of its fiscal system, where the debate surrounding the subject of financing not only referred to the financial self-reliance of the Brazilian states in covering their expenses, but also to their autonomy in attaining a position of self-reliance.

There is, none the less, another difficulty associated with decentralization, and this is that sub-national governments’ finances are often shaky even before the bodies at these levels assume their new responsibilities, which may make state, regional and local governments reticent about the entire process. Therefore, rather than seeking to encourage the transfer of functions based on technical criteria, central governments often attempt to transfer funds over to sub-national bodies without any prior agreement as to the transfer of functions and without requiring their assumption, which may lead to financial difficulties.

Instead, when new, decentralized bodies are created, they need to be given treasuries of their own as well. Moreover, the financial problems faced by federated states or regions are obviously different from those that arise in municipalities.

The allocation of functions is complicated by the fact that states, regions and municipalities usually lack the necessary management capacity to assume their new responsibilities all at the same time.

In theory, there are three types of transfer systems:

(i) A system of transfers en masse, in which the functions to be decentralized are transferred to all the various territorial levels of government in one fell swoop. Theoretically, this would forestall the financial disorganization of the central government since the resources to administer a given service would be transferred at the same time as the responsibility for the service itself; however, this approach may generate a large number of management problems for the newly decentralized government agencies.

(ii) A system of piecemeal transfers, in which the decentralized bodies are the ones that must request that a given responsibility be transferred to them from the central government once they feel that they have sufficient management capacity to administer the new service; this system offers some advantages to sub-national government agencies, but it gives rise to all sorts of imbalances in the central government; even more importantly, expenditures increase.

(iii) A combination of the two above systems, whereby the preferred course of action is for sub-national governments to take the initiative; thus, when these governments request that they be given a specified responsibility, it is immediately transferred to them; however, if a certain amount of time has passed without the corresponding responsibilities or functions having been requested, the central government may decide on its own to transfer them en masse. This system initially has a destabilizing effect and generates diseconomies of scale, but it ensures that the system will operate more smoothly in the future. Most of the countries have used some variation of this approach.

At this point reference should be made to shared or concurrent functions. When there are various levels of government, it is impossible to separate the different jurisdictions entirely because all functions are performed within the same territory; thus, in this case conflict and decentralization are consubstantial. Although it may seem paradoxical, studies on decentralization indicate that it is more feasible to minimize this conflict when the distribution of responsibilities is not rigid and the various levels are assigned concurrent functions, which makes negotiation and consensus-building an essential element in the provision of the service in question. Even if jurisdictions are not rigid, however, it is important for the law to define exactly where the boundary between different government responsibilities lies. In such a situation, administrative and fiscal maturity is called for in order to resolve the conflicts that arise.

In view of the foregoing, it is clear that, for any given configuration of jurisdictions in terms of their assignment to different levels of government, a financing scheme should be devised that will provide decentralized agencies with sufficient resources to render the services for which they have been given responsibility. There is, however, no general financing model that is shared by most federal or other forms of government.
IV

The resources available to decentralized government bodies

The resources used to finance sub-national levels of government may come from a variety of sources. Essentially, these sources fall into three general categories: (i) taxes levied by that level of government; (ii) a share in the central government’s tax receipts; and (iii) central-government subsidies.

To differing extents, decentralized bodies use all three types of sources. The amount of funding that such bodies derive from their own taxes is almost always very small, however, so transfers of central-government revenues or subsidies provide the bulk of the financing. This is what is known as financial dependence: sub-national government bodies depend upon the central government to fund the services they provide. Their degree of financial dependence is a function of the financing instrument chosen, which may or may not restrict their autonomy in respect of expenditures; such dependence is greatest in the case of conditional, or tied, subsidies.

Some studies simply exclude tied or non-automatic transfers from the range of sources for sub-national government income that they consider. Actually, however, the degree of dependence is not associated with particular types of systems for financing decentralized bodies. Moreover, there is no reason why sub-national levels of government should be opposed to dependence upon the central government; they may in fact prefer such a system, even at the risk of losing autonomy, either for economic reasons (considerations of efficiency together with the ready mobility of goods and persons that a differential fiscal treatment may afford) or for political reasons (considerations relating to the political cost of taking unpopular fiscal decisions). Viewed from another vantage point, a position of dependence may signal sub-national governments’ inability to be financially self-sustaining (Suárez Pandello, 1988, pp. 79 and 80).

Sub-national bodies’ dependence upon the central government to fund decentralized services has two major implications (Sevilla Segura, 1991):

(i) Sub-national governments may easily lapse into fiscal irresponsibility, since they obtain the funding they need without having to bear the political cost of levying taxes on their own constituency. Since this political cost falls only upon the central government, sub-national governments tend to pressure the central government for more resources.

(ii) The central government, for its part, will then try to ensure a high degree of dependency and will tie the provision of resources to sub-central levels of government to the fulfilment of certain conditions. Tied subsidization is thus a major source of income for decentralized bodies which restricts the autonomy of the corresponding sub-national level of government.

Let us now take a closer look at these types of funding sources and at some examples of their use in Latin America.

V

Fiscal autonomy through self-generated income

Although, as noted earlier, administrative decentralization and fiscal decentralization do not—at least during the initial stages of a decentralization process—necessarily go together, it is also true that the very dynamics of the process demand that as time goes on, decentralization will increasingly be financed by taxes assessed and collected in the sub-national territorial jurisdictions themselves, since this
is the only lasting solution for the financing problems which affect both decentralized bodies and the central government. This is because the needs of sub-national government bodies grow so fast that they will inevitably jeopardize the central government’s ability to balance its budget and to continue providing the services assigned to it, as well as performing its stabilization and redistributive functions. What is more, the autonomy of a decentralized body will be severely undermined if its funding institution attaches strings to the financing it provides. Nevertheless, setting up a system of taxation is no easy task because it requires a level of fiscal maturity throughout the entire territory which is unlikely to be found in Latin America and because, for all intents and purposes, certain kinds of taxes are beyond the reach of sub-national government bodies for economic reasons.

Although self-generated income may be classified in various ways, for the purposes of this analysis we will define it as income from taxes or charges received by the corresponding governments in accordance with stringent criteria of territoriality; in other words, the tax receipts of a government having jurisdiction over the location in which they were collected. These include taxes to which only the decentralized body is entitled; taxes to which the decentralized body shares its entitlement with another institution by virtue of surcharges or other sources that permit double taxation; and territorially-based tax sharing. In contrast, entitlement to a share of State taxes based on some criterion other than territoriality, as in the case of subsidies or general transfers, is defined as a revenue-sharing arrangement. It is important to bear in mind, however, that the terminology used in this connection varies from country to country and from author to author, and sometimes arrangements for sharing in tax receipts of any sort whatsoever may be regarded as a transfer or subsidy. On the other side of the coin, in reference to the autonomy or dependence of a sub-national government, some authors classify tax sharing as a form of self-generated income. The subject is of particular relevance in Latin America, where the sub-national bodies in countries having federal systems derive the bulk of their funding from such arrangements.

A word should also be said here about taxes to which the central government is entitled but which are collected by other levels of government. For our purposes here, these taxes will be regarded as corresponding to the central government if it holds legal title to those receipts; it is true, however, that participation by sub-national governments in the administration of such taxes can play an important role in enhancing their own fiscal accountability and perhaps even attaining higher collection rates.

Economic analysis suggests a number of technical guidelines for attributing the different sources of tax revenue to the various levels of government.

Musgrave (1991) offers the following guidelines: (i) mid- and lower levels of government should use the least inter-jurisdictionally mobile tax bases; (ii) graduated personal taxes should be used by the jurisdictions in which a comprehensive base can be most efficiently applied; (iii) graduated taxes levied for distributive purposes should be a tool of the central government; (iv) taxes used for purposes of stabilization should be levied by the central government, while those used by lower levels should be cyclically stable; (v) tax bases whose distribution among sub-jurisdictions is highly unequal should be used by the central government; (vi) taxes based on the benefit principle and user taxes are appropriate for all levels. This scheme therefore assigns consolidated income taxes, taxes on expenditure, taxes on natural resources and public service charges to the central level; income taxes for residents and non-residents, destination-point sales taxes, taxes on natural resources and public service charges to mid-level government; and property taxes, payroll taxes and public service charges to local government. Matthews later added the observation that tax-sharing formulas needed to be devised to offset fiscal imbalances between different levels of government (see Castells, 1988).

There are two ways in which decentralized bodies can establish their own taxes; these two approaches are by no means mutually exclusive:

(i) Dividing up the various revenue sources. Under this “complementary treasury” system, some sources are reserved for the central government and some for decentralized bodies; this poses a problem,

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4 Strong evidence to back up this statement is provided by the present crisis of the system used to finance Spain’s decentralized State. Although this system has been very successful in transferring functions over to what are known as the Autonomous Communities, the financing problems that have arisen can only be resolved by increasing the share of funding provided by the Communities’ own tax revenues. For a discussion of the current controversy, see Castells (1991) and Sevilla Segura (1991).
however, since good sources of tax revenues (primarily income and sales taxes) are limited, and if the best sources are reserved for the central government, as the above economic analysis would seem to suggest, then the autonomy of decentralized bodies cannot be guaranteed. A good example of how these revenue sources may be distributed is provided by Brazil’s Constitution of 5 October 1988, which seeks to ensure an ample degree of fiscal autonomy for decentralized agencies (articles 153-156): the Federal Union is vouchsafed the taxes on imports, exports, income, manufactures, credit operations, exchange and insurance transactions, and the transfer of bearer bonds and securities, as well as rural land taxes and taxes on large estates; the federated states and the Federal District are entitled to inheritance and gift taxes, taxes on motor vehicle ownership, turnover taxes and service taxes; and the municipalities are assigned the taxes levied on urban real estate and property, the transfer of real estate and rights there-to, retail fuel sales and some services. This allocation of sources of revenue reserves a very high-yielding tax (income tax) for the Federal Union, but it also grants another, very elastic, tax (the turnover tax on goods and services) to the federated States and the Federal District, which at least theoretically should ensure some degree of fiscal autonomy for the latter. The municipalities are granted the traditional sorts of local taxes, which have low yields, and special charges and rates based on the benefit approach.

(ii) Allowing each autonomous body to establish its own taxes using a system of parallel treasuries. This system may lead to double taxation (e.g., an income tax levied by the State and another established by the corresponding sub-national government). Although double taxation is not objectionable per se, it may cause problems if its aggregate effects on the public sector as a whole and on the private sector are not taken into account. In addition, it may create complications for the general public by giving rise to a profusion of similar types of tax provisions; consequently, the countries in which double taxation exists have tended to reduce the number of instances where it arises. (The frequency of double taxation in the United States, for example, has been reduced considerably.) A system of parallel treasuries can, however, be easily implemented if the system is structured around the central government treasury and autonomous bodies are then allowed to add surcharges on to the central government’s taxes. This second system of taxation is not incompatible with the first. A system of financing could be devised whereby some sources of tax revenues are reserved for a given entity while other bases can be taxed by a number of different bodies. For example, Brazil’s Constitution provides that, in addition to the taxes they may assess on their own tax bases, the federated states and the Federal District may also place a surcharge on the income tax levied by the Federal Union. A similar system is now being proposed in Venezuela which would involve surcharges on national income taxes or on excise, sales or value-added taxes. In this last case, the system would allow governors to add a few extra percentage points to the tax assessed by the national government (De la Cruz, 1989).

The two systems of decentralized taxation described above provide autonomous bodies with a high degree of political autonomy and fiscal responsibility, since they will then decide how much to tax their constituencies. The principle of autonomy demands that the level of taxation should be decided by each decentralized body individually, although this is sometimes done at the national level. For example, Brazil’s value added tax (vat) is administered by a council on which all the states are represented, and any change in the tax must be approved by that council.

Non-federal countries in which the regions have taken on the status of autonomous entities can also provide for the assessment of regional taxes. The Basic Regionalization Act of Peru (Act No. 24650 of 19 March 1987) provides, as one of the resources available to regional governments, for “any taxes they may create pursuant to legislative authorities delegated to them”. Similarly, Bolivia’s Departmental Governments Organization bill provides for the generation by each region of resources of its own.

In countries that have no plans to convert national regions into decentralized entities (whether they have federal systems or not), some provision is none the less made for the municipalities to generate some resources of their own, although the amount of these receipts is not great, since they are primarily obtained from public service charges and property taxes. When a country wishes to speed up the decentralization process, however, steps are usually taken to increase this type of municipal income. As part of Colombia’s municipal decentralization programme,
for example, Decree-Law 1333 (04/1986) updates the Municipal Code, which contains legal provisions (Act No. 14 of 1983) that authorize the municipalities to augment the taxes on, *inter alia*, land, industry, commerce, advertisements and billboards, circulation and transit, parks and landscaping, entertainment and casinos. More recently, Act No. 44 (12/1990) and principles set forth in the country’s new Constitution (of 1991) regarding sub-national territorial jurisdictions are having the effect of promoting autonomy in relation to taxation and of strengthening the regional and local economic base.

A third category of self-generated income is tax sharing, i.e., the receipt of a share of central-government tax revenues in accordance with territorial criteria, i.e., based on the amount of tax revenue collected in each autonomous entity. Tax collection and tax management in general can be performed directly by the central government or by the sub-national governments themselves. Strictly speaking, these are transfers from the central government to sub-national levels of government. The central government is legally entitled to the tax and it determines the base to which the tax will be applied, as well as the type of levy to be used (unlike the above cases), but all or part of the receipts from the tax will subsequently be distributed according to the proportion of those receipts collected in the corresponding territorial divisions; the amount to be distributed will not, however, be influenced by considerations of population size, economic factors, equity among the various territorial divisions of the country, etc.

This type of financing also has certain advantages as regards the autonomy of decentralized bodies because each zone’s receipts will be directly related to its fiscal capacity. This makes the decentralized body accountable to the electorate and hence gives it a measure of independence from the central government, especially if the sub-national body is involved in administering the tax. However, not all taxes can be parcelled out on the basis of territorial jurisdictions; what is more, this type of financing will not eliminate vertical or horizontal disequilibria within the State and, in fact, creates many problems when it is the only criterion used for transferring income to sub-national units.

The importance of this issue was clearly demonstrated in Mexico, which had traditionally based its fiscal decentralization on the sharing out of State taxes to the country’s various territorial divisions.

As long as Mexico’s tax receipts came primarily from taxes on production and consumption, and the contribution from PEMEX was quite small, the system’s method of distribution was territorially based, with the principle being that each component of the federation should receive what it had helped to create. Then, however, the introduction of a value added tax (VAT) —a tax that would be difficult to regionalize—and the rise in oil prices, which benefited some states much more than others, triggered a major change in the system which gave expression to concepts relating to the interdependence of the Mexican states and equity. Some elements of the system’s former territorial basis are still left, however, and article 2 of the Fiscal Coordination Act of 1980 stipulates that those states belonging to the Fiscal Coordination System which coordinate their taxes on real estate sales are to receive an additional percentage in the General Apportionment Fund (which is tantamount to the sharing of tax revenues) and an 80% share of the receipts from taxes on motor vehicle ownership and use in their territory provided that they collaborate in the collection of those taxes.

Brazil’s Constitution also provides for a very important territorially-based mechanism for the sharing of revenue which has an especially significant impact on the country’s municipalities (article 158); the Constitution draws a very clear distinction between this mechanism and the transfers provided for in article 159, which will be discussed at a later point. Under these provisions, the municipalities are entitled, *inter alia*, to: 50% of the Union’s receipts from the rural land tax that are collected within their boundaries; 50% of the Union’s receipts from the tax on the ownership of motor vehicles whose licenses were obtained in their district; and 25% of the State’s receipts from the turnover tax, from taxes on inter-state and inter-municipal transportation and communications services.

Peru plans to use this same type of tax-sharing system to distribute the receipts from the national tax on profits obtained from the development of natural resources to the regions in which those resources are located.

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VI

Vertical and horizontal disequilibria

All fairly decentralized countries experience what has come to be called vertical disequilibria, which are the discrepancies that can arise between autonomous agencies’ incomes and their expenses. This fiscal shortfall is covered by transfers from the central government to sub-national levels of government and is reflected in the latter’s dependence upon the former.

Experience has demonstrated that the amount of income taken in directly by sub-national levels of government is insufficient to cover their expenses. Subsidies or transfers represent an attempt to offset this disequilibrium through a redistribution of the fiscal resources available to public-sector bodies as a group; such resources are therefore channeled down from the higher levels to the lower levels since, on the whole, the lower levels suffer from a shortage of funding (Castells, 1988, pp. 69-70).

There are two reasons for this disequilibrium: the slow growth of the sub-national governments’ self-generated income, and the increasing amount of expenses being concentrated at those levels of government. Thus, the extent to which vertical fiscal disequilibria become a problem will depend primarily on what degree of fiscal autonomy each decentralized entity has attained by generating income of its own and how functions and responsibilities have been allocated. Obviously, the disequilibrium will be more severe in countries such as Mexico, where the federal government’s revenues are based on more elastic taxes (e.g., income and sales taxes) and the federated states’ own revenues come primarily from land taxes, and less severe in federations such as that of Brazil, in which the sales tax has been assigned to the federated states.

The second cause of this disequilibrium, i.e., increasing expenses, is a factor in all countries, but the extent of its impact will depend on how the various government functions have been allocated. In Mexico, for example, the decentralized entities’ scant measure of autonomy in respect of taxation has been dealt with by reducing the states’ and municipalities’ duties; in this case, then, the authorities have resolved the problems associated with fiscal decentralization by reducing the country’s administrative decentralization.

In addition to the problem of vertical disequilibrium, a horizontal disequilibrium may exist among units of the same level of government (federated states, regions or municipalities) as a result of a lack of correspondence between their tax capacity and their expenses. Not all such units will have the same amount of income, or the same tax capacity, and some means of re-establishing a balance will therefore be needed. Equalization subsidies or transfers are often the means chosen to ensure that the poorer units will have access to services comparable to those available to the wealthier ones. In some cases, the same type of transfer may be designed to correct both vertical and horizontal disequilibria.

VII

Transfers: modalities and purposes

We have just said that transfers or subsidies are the tools used to deal with both horizontal and vertical disequilibria. There are many types of such mechanisms, and they may be classified on the basis of various criteria. The main problem with these classifications is that a given transfer may be included in different categories depending on the criteria selected.

One type of classification is based on the criteria used to determine the total amount involved. One possibility is for the amount of a subsidy to be expressed as a fixed percentage of the central government’s income when such income is to be shared out

5 Regarding the case of Mexico, see ECLAC (1985).
among the various levels of government. This type of system is known as “revenue sharing”, which is so named because the subsidy is a percentage of the state’s revenues. In Peru, for example, Act No. 25.193 (30 January 1991) stipulated that in 1991 all receipts at the national level from income and wealth taxes should be transferred to the regional governments. Subsequently, the 1991 Annual Budgetary Act for the Public Sector and the State Entrepreneurial System (Act No. 25.294 of 15 January 1991) qualified the provisions of the above-mentioned law, stating that the transfer of income-tax receipts to the regional governments would amount to 50% in 1991 and that the executive branch would programme the remaining 50% in the 1992 budget. This is an example of a transfer made under a revenue-sharing system.

Leaving aside the question of territorial distribution (in which case we would no longer be dealing with a subsidy but rather with a form of self-generated income referred to in the literature as “tax sharing”, as has been discussed earlier in this article), subsidies may be classified according to whether the transfers are allocated in accordance with a pre-established formula, on a discretionary basis or as a reimbursement for specified expenses. A formula-based form of distribution is, theoretically, preferable because it is based on objective, measurable criteria; this procedure is frequently used for such mechanisms as Brazil’s and Chile’s common municipal funds. Discretionary transfers are used, in particular, for infrastructure works by many countries, and may be based on objective, technical evaluations of proposed projects or on purely political considerations. Nevertheless, in some countries discretionary transfers have been used because basic problems relating to the distribution of government revenues have not been resolved. This was the case of National Treasury contributions in Argentina, which were in use between 1983 (when the law relating to revenue sharing expired) and 1987 (when the new law on this subject was enacted). The best course of action, whenever possible, is to design transparent, stringently-defined mechanisms for the provision of such subsidies.

Finally, we have placed subsidies intended to reimburse a decentralized body for specific expenses into a separate category (e.g., the expenses incurred by a municipality when it takes on new functions such as the provision of health or educational services) regardless of whether the size of the subsidy is based on an established formula or is discretionary in nature.

Another relevant classification refers to whether the subsidy has conditions attached to it or not. The usual procedure is to divide them into general, or untied, and tied subsidies. The latter, in turn, can be classified in many different ways according to their degree of conditionality. Untied subsidies impose no conditions whatsoever on the sub-national governments regarding the use of the funds. Tied subsidies, on the other hand, restrict the use of the corresponding funds to certain sectors or specific projects and may, in addition, establish other requirements of a more or less restrictive nature even within the specified sector or project. For example, a subsidy given to the health sector may carry the condition that the funds be spent on hospital beds and may also require that, in order to be eligible for the subsidy, the sub-national government must demonstrate it is capable of providing a certain level of primary health care services. Conditions relating to tax collection are of particular interest. Argentina provides a good example of this type of transfer; in order for the provincial governments to be eligible for a share of revenues, they must draw up and implement a financial action plan for avoiding fiscal deficits. Along the same lines, the fiscal reforms currently under discussion in Venezuela would provide for the co-administration of national taxes, particularly the VAT; under this arrangement, it would be the states’ job to supervise the collection of these taxes, and the amount of funds transferred to them (based on their yields) by the central government would therefore depend on how well they do that job.

Subsidies may also be classified as fixed-sum or proportional subsidies, according to whether the subsidy is a set amount or a percentage of the sub-national government’s expenditures; this latter arrangement introduces an additional element—cost-sharing by sub-national governments—that may foster greater financial restraint on the part of sub-national governments when designing projects and may encourage them to increase their tax capacity for generating income of their own. Another possibility is whether to place a cap on the subsidy or not.

A final category that should be mentioned here draws a distinction between equalization subsidies and subsidies that do not have that aim. These
income-leveling subsidies are intended to correct horizontal fiscal imbalances among decentralized agencies of the same type.

All these classifications provide a wide array of options for the allocation of resources based on a combination of one or more features, each of which has its own theoretical justification, advantages and disadvantages. In the following section we will discuss some of these modalities and see how they have been used by a number of countries in Latin America.

VIII

Revenue-sharing

This heading refers solely to the origin of a subsidy, not to how it is subsequently spent. Revenue-sharing is considered to be equivalent to a general subsidy, and one of the major issues it raises therefore concerns the lack of a link between the share of revenue and the revenue actually generated by the corresponding jurisdiction. In Latin America revenue-sharing plays a very important role in providing central-government tax receipts to finance the states' operations in countries with federal systems of government and in financing the municipalities.

The problem which these transfers are intended to resolve is the inadequate finances of sub-national governments, although they also sometimes incorpo-rate considerations of inter-jurisdictional equity.

Of course, in a sense all transfers involve sharing in the income of another governmental agency or level, but the distinguishing trait of those included in this discussion is that the amount of the transfer is fixed as a given percentage of the receipts from one or more taxes which are then distributed among the various sub-national jurisdictions without reference to the tax effort made by each, although some type of incentive may be provided in this regard.

This system has its origin in a fund that was set up in 1966 in the United States when the federal government set aside 2% of actual receipts from the personal income tax (levied on a net basis rather than on the amount of receipts) in order to form a fund that would then be distributed among the states according to the size of their populations. From a theoretical perspective, this raises an interesting problem as to whether this type of income should be classified as one that contributes to a sub-national government's autonomy or to its dependence. In Latin America, this has taken various forms, some of which will be discussed below.

In Brazil, article 159 of the new Constitution establishes a State Apportionment Fund which is financed by the federal government. The federal government must deposit 21.5% of its receipts from income taxes and from the tax on manufactures in this fund, which is then distributed by the Council of States to each state in the federation. It should be noted that the above percentage is calculated on the basis of actual tax receipts (the result of applying the tax rate to the net base) rather than the tax base itself. In determining the size of each state's share, 85% of the fund is reserved for distribution among the northern, north-eastern and mid-western states while the remaining 15% goes to the states in the south and south-east of the country. This initial distribution of the fund seeks to uphold the objectives of regional equity. A subsequent redistribution is based on a formula that takes into account the size of the states' populations and an indicator of tax capacity which is inversely proportional to those population groups' per capita incomes.

In addition to this fund, the Constitution establishes two other federal revenue-sharing mechanisms: 3% of the receipts from the above-mentioned taxes is set aside for the implementation of financing programmes for the production sector in the northern, north-eastern and mid-western regions of the country through their regional financial institutions, as provided for in the regions' development plans; and 10% of the receipts from the tax on manufactures is transferred to the states and the Federal District, with their shares being proportional to the value of their respective exports of manufactures.

The Brazilian Constitution also establishes a Municipal Apportionment Fund. This fund is very similar to the fund set up for the states; its resources come from a 22.5% share in the receipts from income taxes and from the tax on manufactures and are distributed to the municipalities based on the size of their populations and their per capita incomes.
Colombia's and Venezuela's constitutionally-mandated transfer payments and Mexico's General Apportionment Fund are quite similar, although in these cases the shares are percentages of total revenues rather than of specific tax receipts.

Colombia's revenue-sharing mechanism, which is established by its Constitution and has recently been modified, sets a minimum percentage of current income that must be transferred to the governments of the country's departments, for education and health services. The new criteria to be taken into account in its distribution are the affected population, these services' objectives and basic needs, and the entities' administrative effectiveness and tax efforts. These criteria have also been incorporated into the new Constitution, and regulatory proposals also would provide for the possibility of decentralizing health and educational services as far down as the municipal level.

In Venezuela, a special, constitutionally-mandated item is included in the budget for distribution to the states, Federal District and federal territories "in the following manner: 30% of this percentage [is to be distributed] in equal parts and the remaining 70% in proportion to the population of each of the aforementioned entities. This item will amount to no less than 12.5% of the relevant budget's total current income estimate ... The corresponding Basic Act shall determine the municipal entities' share of the budget item" (article 229 of the Constitution).

The reforms recently implemented in Venezuela with a view to increasing the country's political, administrative and fiscal decentralization have entailed major changes in this field. The Basic Act for the Decentralization, Delimitation and Transference of Governmental Responsibilities of December 1989 repeated the pre-existing Special Budget Item Coordination Act and set forth more equitable distribution procedures by means of the following provisions: (i) the special budget item was set at 16% of the budget's total current income estimate, with this percentage increasing by 1% per year until reaching an annual figure of 20%; (ii) the states' budget acts would include an item earmarked for the municipalities, which for 1990 was to amount to 10% of total current income. This percentage, too, was to be increased annually until reaching a level of 20% and was to be distributed in accordance with the Basic Act on Municipalities.

Mexico had traditionally used a tax-sharing system based on how much was collected by each entity, but this was modified by the Fiscal Coordination Act of 1980. The explanatory statement for this legislation described the amendments as follows: "shares shall not be granted on the basis of the collections obtained in each entity but shall instead be placed in a General Apportionment Fund, to be charged against all federal taxes, which shall be distributed to the entities under the terms of a new Fiscal Coordination Act and of agreements concluded with the Federation by any states wishing to do so. Said agreements shall also set forth the powers for administering the tax to be exercised by the federated entities".

The new system is chiefly based on two agreements between the states and the federation: the Fiscal Coordination System Membership Agreement and the Administrative Collaboration Agreement. Three funds were set up for the system's operations: the General Apportionment Fund, the Supplementary Financial Fund and the Municipal Development Fund (ECLAC, 1985).

The General Apportionment Fund is made up of 13% of the federation's total annual income from taxes and other duties on hydrocarbons, natural gas and mining. For purposes of distribution, only actual collections are considered. Each state is guaranteed an amount equal to what it received the year before plus an increase calculated on the basis of a formula that takes into account each state's tax effort in respect of the collection of federal taxes within its territory. This particular formula, which incorporates a rating of the State's tax effort in determining the size of the transfer payment, helps to narrow the gap between income and expenditure associated with the tax-sharing arrangement and is not only of economic importance, but of political significance as well, in that it increases the sub-national governments' fiscal accountability.

A Supplementary Financial Fund has also been created using 0.50% of the federation's total annual income from taxes and other duties on hydrocarbons, 3% of the General Apportionment Fund and a like amount charged to the federation itself. This Fund's resources are distributed in inverse proportion to the per capita shares received by each entity from the General Apportionment Fund.

Finally, the Municipal Development Fund has been drawn from various types of income and is initially distributed to the states in accordance with
rules similar to those applying to the General Apportionment Fund; the states then distribute the funds among their municipalities pursuant to the rules laid down by their local legislatures.

Argentina’s new Federal Co-Apportionment Act, which has been in force since 1988, provides that, initially, 42.34% of the relevant funds will go to the central government and 57.66% to the provincial governments. The funds to be apportioned in this manner are the receipts from the VAT and from the profits, capital, fuel and other lesser taxes. The subsequent distribution of these funds among the provinces is influenced more strongly by territorial than by demographic criteria, but does provide for larger transfer payments to areas in which a larger number of poor households are concentrated.

IX

Transfers as reimbursements for specific expenditures

Another very important type of transfer in Latin America is a payment intended to reimburse a decentralized entity for particular expenditures. This mechanism is a very useful one, especially during the early stages of a decentralization process, because it enables the central government to transfer a function to a sub-national level while at the same time transferring the resources needed to perform it; in principle, this allows both the national budget (which is relieved of an area of responsibility at the same time that the corresponding resources are transferred) and the decentralized entity’s budget to be balanced.

This is, for example, the procedure set forth in Venezuela’s Decentralization Act of 1989, which provides for the transfer of each sphere of responsibility together with the budget allocation used by the central government to provide the service in question. A similar procedure has been used fairly successfully in Chile for the transfer of certain types of health and educational services to the municipalities (Castañeda, 1990).

Chile embarked upon a series of sweeping educational reforms in 1980 which involved, among other changes, the transfer of the pre-primary, elementary and secondary schools to the municipalities. To this end, the school infrastructure was transferred to the municipalities under the terms of a special agreement, while the money to pay teachers’ salaries was transferred from the Ministry of Education to the municipalities. In addition, this same Ministry is providing the municipalities with a subsidy to defray educational expenses, which are calculated using a formula based on enrollment. In the health sector, in 1981 the government also began to transfer medical centres and clinics to the municipalities. Under the financing arrangements for this transfer, the municipalities are paid for the health care they provide using an invoicing system that is referred to by its acronym, FAPEM. FAPEM is an advance-payment and reimbursement system having 15 categories of primary care services, for each of which an amount is provided that covers outlays for goods and services, personnel and maintenance.

A similar arrangement was established in Brazil for the health system, but at the state level; it differs from Chile’s system, however, in that the size of the subsidy is set by agreement rather than on the basis of a formula. Brazil recently created what is known as the Consolidated Health System (SUS) by transferring basic units and regional hospitals, as well as doctors and system administrators (although the latter continue to be paid by the federal government), to the states and municipalities. The distribution of SUS resources is carried out by means of an integrated planning system; under this system, an estimate is made of the health care needs to be covered and the investments to be made in each health district. The estimates are prepared on the basis of an epidemiological profile for each district, the number of hospital admissions or office visits made the year before, the installed physical network (public and private) and other variables. Health district plans are consolidated for each state, which prepares its own plan of action, and are then sent to
sus national headquarters. The sums to be allocated to each state are determined at meetings attended by the state secretaries and the Minister of Health (Brakarz, 1991).

This type of transfer is characterized by a marked level of dependency upon the central government and a high degree of conditionality, since the funds received must be used for a pre-established purpose.

X

Equalization or distributive transfers

Although some revenue-sharing transfers usually incorporate considerations of equity, most of the financing systems for decentralized entities include some type of special transfer payment whose purpose is to shift resources from the richest to the poorest entities with a view to ensuring a basic minimum of public services and solidarity among the nation's different territorial divisions. Thus, while some of these objectives may be incorporated into such mechanisms as revenue-sharing arrangements, the possibility of making additional transfers for this purpose is not ruled out. Venezuela's fiscal reforms, for example, include not only modifications in the country's constitutionally-mandated subsidies but also the creation of an Interregional Solidarity Fund.

The guidelines used for this type of transfer payment vary a great deal, but the basic purpose is to take resources from the richest zones and give them to the poorest.

Chile's Common Municipal Fund fits this definition, since it provides for a large transfer of resources from the richest districts, or communes, and from the State budget to the poorest communes. In fact, this is the latter's chief source of funding.

This Fund is composed of the following resources (DL 3063, Municipal Income Act):

(i) 60% of each commune's land tax receipts (the other 40% remains within the relevant commune as part of its own resources);
(ii) The fiscal contribution stipulated by the public-sector's budget act;
(iii) 50% of motor vehicle registration fees;
(iv) 45% of commercial license fees in the commune of Santiago; and
(v) 65% of commercial license fees in the communes of Providencia and Las Condes.

The Fund's resources are distributed among the communes of the country in accordance with the following provisions:

(i) 10% in direct proportion to the number of communes;
(ii) 20% in direct proportion to the population of each commune;
(iii) 30% in direct proportion to the number of properties exempted from the land tax in each commune; and
(iv) 40% in direct proportion to the lower level of permanent per capita income in each commune as compared to the national average.

The law also states that the municipalities should, whenever possible, use the resources from this Fund for the creation, maintenance and provision of services to the local community.

XI

Conclusions

The topic of fiscal decentralization, or of the financing of sub-national levels of government, is of instrumental relevance to the process of decentralization. A decentralization initiative calls for political and administrative decisions about how the State and the government service of each country are to be organized; once this process has begun or, at the least, once a model of governmental organization has been designed, then the financing of the decentralization process takes on great importance, since
the question of how decentralized bodies are to finance the functions transferred to them will have to be resolved. Political and administrative decentralization initiatives may end in failure unless they are coupled with a parallel process of fiscal decentralization. In addition, decentralization is sometimes justified on financial grounds (e.g., the efficiency of public resource allocation within the State), and the subject should therefore be studied and analysed when the relevant political and administrative issues are being explored.

There is no exact correspondence between the administrative decentralization of government functions and fiscal autonomy in the sense that transferred services must be financed by the relevant sub-national governments. The relationship between the two will, of course, depend upon the nature of the decentralization process itself. Nevertheless, if there is no synchronization of the two forms of autonomy whatsoever, then the viability of the decentralization process as a whole may be jeopardized, since a lack of fiscal autonomy entails, to some extent, a more limited degree of political and administrative autonomy. In order for a decentralized system of administrative functions to reach an advanced stage of development, decentralized units must have a high degree of fiscal autonomy.

The autonomy of a decentralized entity does not hinge solely on its ability to finance its activities with its own resources; its capacity for deciding how to spend the income it receives from the State is also a factor. Sub-national entities receive various types of income from the central government. Generally speaking, such an entity will only be autonomous in terms of its expenditures if it is financed with its own resources or when the funds it receives take the form of revenue-sharing or of automatic, predictable, untied transfer payments.

The financing obtained by decentralized entities from their own taxes is invariably quite limited in Latin America, where such entities are marked by a high degree of financial dependence, since most of their resources come from the central government. The extent of their dependency will vary according to the type of source from which their financing is drawn. In general, when sub-national governments do not finance the services they provide with their own resources, they may easily lapse into fiscal irresponsibility (since they do not have to bear the political cost of levying taxes), while the central government may tend to ensure a high degree of dependence upon it and try to control sub-national governments by providing them with transfers and specifying how they must be spent.

Be that as it may, transfers from the central government will always be necessary because financing based on self-generated resources, in whole or in part, generates disequilibria. These imbalances may arise either because of a differential between autonomous governments’ sources of income and their expenses (vertical disequilibria) or because the incomes and expenditures of different governmental units at the same level do not correspond (horizontal disequilibria).

There are many different types of financing instruments available, ranging from various sorts of self-generated income (i.e., revenues collected by a sub-national body within its own territorial jurisdiction which are parallel or complementary to the national system of taxation) to tied transfers (i.e., those made in cases where the central government takes major decisions about how the transfers are to be spent). The choice of instruments has important implications for sub-national governments, and all of them are used in Latin America for different purposes; thus, the system applied in each country is a mixture of a number of different financing modalities. These instruments include, for example, the revenues from State taxes that are obtained by a sub-national entity on the basis of territorial criteria (and, hence, based on its fiscal capacity), which bolsters the entity’s fiscal autonomy; tax sharing on a basis other than territoriality, which deals with the problem of disequilibria in an efficient manner but also breaks the connection between the origin of income and the consequent expenditure; and various sorts of transfers, tied and untied, which are also used to eliminate disequilibria but in so doing provide the central government with a greater measure of control.

(Original: Spanish)
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