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**Decentralisation, Inter-Governmental Fiscal
Relations and Macroeconomic Governance.
The Case of Argentina**

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SUMMARY

I. INTRODUCTION.....	1
II. THE DISTRIBUTION OF COMPETENCE.....	2
II.1. DISTRIBUTION OF TAX-RAISING POWERS.....	3
II.2. REGULATORY POWERS.....	4
III. FISCAL FEDERALISM AND ARGENTINA'S EXPERIENCE	8
III.1. THE CO-PARTICIPATION LAW OF 1988	11
III.2. CONDITIONAL TRANSFERS	12
III.3. IMPLICIT TRANSFERS	13
III.4. REFORMS SINCE 1991	13
IV. PUBLIC SPENDING, REVENUES AND TRANSFERS. A QUANTITATIVE DESCRIPTION FROM THE 80'S.....	16
IV.1. PUBLIC SPENDING.....	16
IV.2. TAX RESOURCES.....	18
IV.3. TRANSFERS	19
V. MACROECONOMIC POLICY AND FISCAL DECENTRALIZATION.....	23
V.1. COUNTERCYCLICAL POLICIES AND DEBT	23
V.2. THE CHARACTERISTICS OF DISTRIBUTION.....	25
VI. SOME CONCLUSIONS.....	28
BIBLIOGRAPHY.....	30

I. INTRODUCTION

Argentina is, as its constitution dictates, a federal state whose government is organized in three levels: national or central, provincial and municipal -though only the first two are directly regulated by the National Constitution (NC)-.

The country's history points to a progressive centralization of power in the hands of the national government in terms of public spending as well as tax raising powers and regulations. The lower levels of government have been dependent -and continue to be dependent- upon the national government's decisions and funding. This has given rise to relationships in which "vindication politics" between provincial governments and toward the national government, have become increasingly pertinent.

The result has been a weak level of autonomy for the lower levels of government, a lack of equity between provinces and an explosion of demands made by the different jurisdictions, together with a lack of autocorrecting mechanisms (which have been dependent on central government action, due to the marked vertical imbalance).

The first part of this work will elucidate upon the division of jurisdiction over spending, tax raising and regulatory powers. This will be followed by a quantitative description of the situations of the different levels of government through the country's history and to more recent changes along with a quantitative description of the last 15 years. The report will continue by showing the macroeconomic, redistributive and efficiency implications of this framework. Lastly, a set of conclusions that arise from the analysis will be exposed.

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II. THE DISTRIBUTION OF COMPETENCE

Argentina's federal system of government is laid out in Article 1 of its National Constitution. Power is distributed geographically, through regional organisms who rule over their part of the national territory. The criteria by which the constitution allocates powers to the national and provincial governments, are explicit in the case of the national government and implicit in the case of provincial governments. The provinces have exclusive powers (those which are not explicitly delegated to the federal government), concurrent powers (those which can be exercised simultaneously with the national government), and superseding powers (which must cede to federal regulations). The general rule is that the provinces have jurisdiction over what powers are not delegated to the national government. The powers delegated to the national government are those dealing with international and inter-provincial relations and regulations.

Regarding municipal powers, the national constitution limits itself to assigning the responsibility of organizing and guaranteeing municipal systems to the provinces. The first ruling of the Supreme Court considered the municipalities as autarchic entities, organized along territorial lines, which should administer the norms established by the higher levels of government¹. However, in recent years, some provincial constitutions have been modified to allow for the recognition of municipal autonomy (that is, giving them the power to determine their own governing norms, especially those relating to management²).

Municipal autonomy is supported, according to recent Supreme Court rulings³, by the following concepts: (a) the constitutional origin of the municipal regime in contrast to the merely judicial basis of autarchic entities and the consequent impossibility of its suppression or disappearance; (b) municipal ordinances are by nature local legislation; (c) its nature as public legal entities whose existence is guaranteed by the constitution; (d) the scope of its decisions, which includes all the inhabitants of the municipal territory, and (e) the possibility they have to create autarchic entities, which does not apply to these same entities.

Consequently, the present situation regarding municipal powers, is somewhat confused. This constitutes a serious obstacle to the setting of municipal regulatory powers -since, if they are considered as autonomous units, their powers to regulate matters which have up to now not been within their jurisdiction, must be recognized.

¹ In a 1911 ruling, the Supreme Court determined that the municipalities were "mere delegations of the same provincial powers, enclosed to administrative aims and limits"...

² Full fiscal autonomy is recognized by Catamarca, Córdoba, Chubut, Jujuy, La Rioja, Misiones, Neuquén, Río Negro, Salta, San Juan, San Luis, Santiago del Estero and Tucumán. Limited autonomy is recognized by Chaco, Formosa, La Pampa and Santa Cruz.

³ "Rivademar vs. municipality of Rosario", 1989.

II.1. Distribution of tax-raising powers

The national constitution allocates tax raising powers both to the nation and to the provinces (depending on the type of tax). That is to say, in principal, the law supports a separation of tax raising powers, but in reality these powers have been concentrated in the hands of the national government which legislates and collects the Lyon's share of taxes (VAT, income taxes, specific consumption taxes, fuel taxes, etc.)

As stated in the constitution, the federal government has exclusive powers over import and export duties and direct taxes "for a limited time". The nation and provinces have concurrent powers over indirect taxes. The provinces "maintain all powers which are not delegated" to the federal government and could thus impose permanent direct taxes -a power which, in reality, has been restricted by the fact that the direct taxes imposed by the nation have taken on a permanent character since they are constantly being renewed by law.

In accordance with the constitutional reforms of 1994, the revenue-sharing regime will for the first time be given constitutional weight- thus acquiring a higher level in the hierarchy than it currently enjoys- establishing a general framework for that tax regime. This guarantees that, for example, funds will be automatically sent out to the provinces and that primary and secondary distribution of these funds... "will be directly correlated with the jurisdiction, services and functions of each of province and will reflect objective criteria of sharing". In addition, the criteria will show "equity, solidarity and will give priority to achieving an equivalent level of development, quality of life and equality of opportunities in the whole of the national territory"...

Other constitutional reforms relevant to the federal tax-sharing system are as follow:

- the inclusion of the City of Buenos Aires as an independent jurisdiction in the system⁴;
- Revenue-sharing law will originate in the Senate. In this way, the smaller jurisdictions will enjoy relatively greater influence in negotiations because all provinces are equally represented within it;
- transfers of services and responsibilities between nation and provinces will be restricted, unless they are accompanied by the corresponding funds and are consented to by the legal representatives of both levels of government;
- it is expected that a federal fiscal entity will be created. Its function will be to control the fiscal relationships between the nation and the provinces and will be made up of representatives of each province and the City of Buenos Aires- though the presence of a representative of the nation is not mentioned;
- the nation's powers to modify taxes which are subject to revenue-sharing through specific allocations (pre-coparticipation) are increased, though these pre-coparticipation measures will require an absolute majority in both houses.

⁴ In 1981, Law 22451 eliminated the Municipality of Buenos Aires from the federal tax coparticipation regime.

Regarding the municipalities issue, the debate between autonomy or autarchy will directly influence the existence (or not) of tax raising powers at this level of government. As autarchic entities, they were given the power to charge fees for services but not to collect taxes⁵. In view of current judiciary tendencies, there is nothing in the national constitution which disallows tax-raising powers at the municipal level- these will depend on provincial legislation^{6, 7}.

Argentine federalism then, is characterized by a strong vertical imbalance, since control over the most important taxes is concentrated in the federal government. The federal government shares these tax revenues with the provincial governments through a system of tax coparticipation (revenue-sharing) which is set in law, but which has been subject to a profound judicial instability⁸. The compliance with the precepts of the constitutional reforms may give this system a greater level of certainty.

II.2. Regulatory powers

The regulation of the exercise of constitutional rights is a concurrent power of the nation and the provinces. Nevertheless, Supreme Court rulings validated the advance of the federal government over its provincial counterparts by consistently ruling in favor of the central government when local norms attempted to interfere in the exercising of its concurrent powers.

Powers are assigned in the following ways:

- **Justice:** The majority of legislation is rooted in the nation (the Congress dictates the civil, commercial, penal, mining and work and social security codes, as well as legislating on naturalization, citizenship, bankruptcies etc.) The provinces dictate the procedures by which common law is applied, the actions of respective courts, electoral laws, laws on provincial government lands, taxes, education and public administration.

The judicial administration is made up of two systems: the Federal Judicial Authority, which, in turn, is made up of the National Supreme Court and the nation's lower courts, and the supreme courts of each province and their respective lower courts.⁹. The federal courts pass judgment on all cases involving issues included in the constitution and on national laws when the objects or persons involved fall under this jurisdiction, international treaties, cases involving foreign diplomats, sea

⁵ At the moment, the municipalities collect taxes disguised as fees for services.

⁶ It should be noted that the present Federal Coparticipation Law obliges the provinces to set limits on the revenue-raising powers of municipalities. They may not impose "local taxes analogous to those distributed by the national government".

⁷ The situation of the Municipality of Buenos Aires has peculiar characteristics. The nation imposed certain taxes on it (i.e. stamps) while recognizing the municipality's powers of collecting real estate taxes and the gross revenues tax.

⁸ The 1994 reform, for example, set the last day of 1996 as the deadline for the passing of a new norm for federal coparticipation. However, this norm has yet to be put into effect, let alone debated.

⁹ The Federal Capital has both a provincial or "local" judicial system (though its members are elected by the National Congress, which in this case acts as the local legislative) and the federal system (also elected by the National Congress). All judges practicing in the Federal Capital are "federal", and the division between local and federal is only set by competence on the issue at hand.

and river navigation, aerial transport or cases involving the nation as a whole. The federal courts also intervene in inter-provincial cases or those involving neighbors from different provinces or foreign governments as well as ruling over jurisdictions given it by the federal government (e.g. possession, distribution and consumption of narcotics). The provincial judicial authorities rule on cases falling under common law, when these are under their respective jurisdictions.^{10, 11}

- **Education:** According to the national constitution, the provinces must "ensure... primary education", implying that the other levels of education are a concurrent responsibility with the federal government. However, the federal government's educational policy (law 4874/05) has, over time, come to monopolize every level of education- including primary.

During 1976-83, this trend was reversed, when all national primary schools were transferred to the provinces and to the city of Buenos Aires. From then on, various provinces created new constitutions which extended the provincial governments mandates to include higher levels of education.

Law 24049/92 transferred the educational services which were still under national control (mostly secondary schools) to the provinces and to the municipality of Buenos Aires (MCBA). In this way, primary and secondary education are now controlled exclusively by the provinces. In the context of this new law, each province can now dictate its own laws regarding the organizational norms of its respective educational system.

The regulatory aspects of private education are dealt with by the government (national or provincial) which provide funding to the respective establishment. Establishments which do not receive subsidies are regulated according to the (provincial or national) territorial jurisdictions in which they are located.

The "Federal Education Law" (24195/93) gives the national ministry competence over the coordination of the national education system, ensuring the coherence and quality of the educational plans and programs, the realization of compensatory actions in order to correct inequalities in the quality of educational services and technical and financial assistance to the different jurisdictions who render educational services.

The National Ministry of Education has competence over the determination of the validity of studies and diplomas. The regulation of the professions is up to the provinces -especially the granting of professional qualifications and the regulation of professional practices. The nation has sole competence over the exercise of professions on a national scope¹².

¹⁰ There are "Default Courts" at the municipal level, which are not dependent on the judicial power and that pass judgments on infractions (of the urban building code, transit laws, sanitary codes, etc.). Their decisions can be appealed through the judiciary.

¹¹ For example, the author of a crime is punished according to the penal code, which is the same throughout the country, in the province where the crime took place and according to its procedures.

¹² This distribution of competence always ensure that the provinces do not interfere in the practice of professions or block the national governments practice of authorizing qualifications which are valid nationally. The regulation of professions can not limit its practice.

- Work: The National Congress dictates the Labor Code (which deals with work contracts), while the provinces dictate the norms referring to working conditions, with the following limitations: the national authority pronounces in places which fall under provincial jurisdiction when the activities are linked to inter-provincial trade or when companies operating concessions contracted out by the national government are involved. Nevertheless, this same law allows the provincial and national governments to reach agreements "by which the province can take charge of the indicated functions".
- Police: The Federal Police carries out the functions of a security and judicial police force throughout the national territory. It prevents and investigates crimes against federal laws, provides security for the federal government's employees and assets, cooperates in the guarding of frontiers, grants passports and other identification documents, etc., as well as acting as the "local authority" in the City of Buenos Aires. The provincial police forces enforce the laws dictated by the respective provincial legislature- carrying out the functions of a security and judicial police force.
- Pension system: The nation has most regulatory powers in this area (Art.14 bis. NC). The provinces enjoy limited faculties respective pension funds for their employees and public officials, complementary funds to increase the benefits of determined activities (e.g. teachers, etc.), and pension funds for professional sectors¹³.
- Health: Since the national constitution makes no reference to the jurisdiction of responsibilities in this area, the general principles of federalism must be applied. In this way this area is shared by the provinces and the nation according to jurisdiction.
- Environment: Both levels of government have competence over this. The provincial governments are responsible for their jurisdiction, though the national government may intervene if pollution crosses over to different jurisdictions.
- Transportation, ports and airports: The general principles apply to this area. If the activity is inter-jurisdictional, international or takes place within the boundaries of the Federal Capital, its regulation will be competence of the national authority, if not, the provincial authority will have competence. The municipal authorities¹⁴ act within the urban framework, as representatives of the provinces (e.g. municipal ports are controlled by the municipalities, albeit through powers delegated to them by the provinces). As for transport issues within the city of Buenos Aires, there is a complex system of competence between the City and the National Transport Secretariat, though almost all regulatory powers over this service belong to the latter¹⁵.

¹³ Pension systems, which have for the most part been (and continue to be) transferred to the nation through the Fiscal Pact for Employment, Production and Development (August 1993). See *infra*.

¹⁴ There are no norms considering the existence of municipal airports.

¹⁵ National decrees deregulating transport (817/92, 1492/92, etc.) have been included in the Fiscal Pact (August 1992). When this pact is ratified by the provinces, a regulatory regime for the whole nation could be implemented.

- Energy, telecommunications and potable water: If these services are interconnected (which is usually the case), they are considered federal. If not, their regulation falls under provincial authority. The municipalities have no regulatory powers over these areas.
- Insurance: Regulation of this service corresponds to the nation since it falls under the "basic norms" stated above. Enforcement of regulations also falls under national control since the activity is a part of inter-provincial trade.
- Other Services: Public lighting, cleaning and hygiene, approval of projects, conservation of streets, nutrition, conservation of parks and squares are provided and regulated by municipal bodies. Provincial laws allow the municipalities to collect fees in order to cover the costs of these services.
- Other Regulations: Automobile registrations are at this moment controlled by the federal government¹⁶. Real Estate registries (coupled with the registration of mortgages) are compiled by the provinces and the City of Buenos Aires. As for commercial licenses, the Commercial Code and the Law of Commercial Enterprises stipulate the inscription at the "commercial court where it is located". In view of the national character of the fundamental legislation and the existence of local judicial systems in each province, each jurisdiction has established these registries according to different criteria and systems¹⁷.

¹⁶ According to the Civil Code, the transfer of moveable goods operate traditionally (that is, with the physical or symbolic delivery of the good). Nevertheless, the provinces and municipalities established automobile registration (first for fiscal purposes and later to police property) and made the registration of the change of ownership of vehicles obligatory. Decree/Law 6581/58 established a national registry, with federal range.

¹⁷ In some cases, the Public Commercial Registry is dependent on the provincial executive power and In others on the judicial power.

III. FISCAL FEDERALISM AND ARGENTINA'S EXPERIENCE

During the first period of institutional organization (1853-90), the criteria by which tax-raising powers were to be separated, was the predominant issue: the nation retained the proceeds from foreign trade and the indirect taxes which it collected in the Federal Capital and national territories. Two factors favored this system: i) a light tax burden to finance the low level of public spending.; ii) .high tax receipts from foreign trade due to a high level of openness in the economy. The financing of the provinces depended on their capacity to collect from their own tax bases. Because of the difficulty of funding unexpected deviations, discipline in public spending, as well as a high level of autonomy, characterized the provincial governments of this era.

Between 1890 and 1935, an increase in the functions of the public sector - in areas such as education, the justice system, health and defense- created a necessity for new resources. This led to the imposition of consumption taxes in the early 1890's which were referred to as "internal taxes". Customs taxes became less significant relative total receipts, while provincial tax receipts became relatively more important. The lack of financial coordination between the different level of government caused a powerful distortion which was marked by a wide scattering of the supply of public services, which tended to be corrected later.

The crisis of the 1930's, which had a severe effect on the Argentine economy due to its openness, forced the adoption of a set of emergency measures. These included; laws creating income taxes (12147), sales taxes (12143) and the unification of "internal taxes" (12139), taxes which were to be shared between the national government and the provinces, thus introducing an incipient regime of federal tax co-participation.

This system of revenue-sharing, was consolidated as time passed, acquiring greater weight in the financing of provincial spending as well as making up a greater share of total tax receipts. The co-participation regime corrected, until 1960, some of the asymmetries in spending capacities which had been caused by differences in tax bases.

In March of 1967, the co-participation shares for sales taxes, income taxes and other taxes included in the regime were reduced. An additional modification was introduced with the Budget Law of 1968, reducing the participation of the City of Buenos Aires which was absorbed into the National Government. This was an attempt at correcting the public deficit through structural changes which would ensure that additional receipts would not be used to increase spending but to reduce pressure on the capital markets and the printing of money by the Central Bank.. These efforts began to deteriorate after 1970, when a process of fiscal laxity began, becoming even more lax in the following years. An example of this was the national funding of provincial spending which grew by eight percent (from 47% to 55%) between 1967 and 1972. Meanwhile, total per capita provincial spending grew from \$ 179.5 to \$ 398 (1995 pesos) between 1959 and 1972, with a noticeable dispersion among provinces. In 1970, total provincial spending made up 72% of the federal administration's spending, following a strong upward trend associated with the process of

decentralization, an increase in the federal participation in public services as well as the possibilities of spending offered by the federal government's willing supply of funds. Provincial public employment rose to 28.4% of total public employment and to 71.1% of the national administration's total employees.

The Federal Co-participation Law 20221 was passed in 1973. Its aims were to reduce the financial dependence of provincial governments, to specify distribution criteria among provinces so as to give added weight to redistribution (since the predominant criteria had been devolution), and to surmount the complex and fragmented character of the system (the previous system was governed by 3 laws). However, the criteria established by this law deepened the separation of spending and financing decision making (financial responsibility), gave added spending incentives to the provinces and created a very rigid system in the case of increased receipts- whether through higher rates, less tax evasion or greater co-participation receipts..

This new regime garnered all national taxes (except import/export duties) under one system, and established that all taxes would be included in the regime -except those whose revenues were specifically allocated- and obliged the provinces not to duplicate federal taxes. 48.5% of the co-participation receipts were to be automatically distributed to the provinces and to the nation respectively (which in turn distributed 1.8% to the City of Buenos Aires and 0.2% to Tierra del Fuego). 3% of the receipts went to a regional development fund whose objective was to finance infrastructure projects¹⁸.

The secondary distribution among provinces took place 65% according to population, 25% according to an under-development index¹⁹ and 10% according to demographic dispersion²⁰. These last two indices were supposed to reflect upon, in the case of the first, the weak taxable base, by trying to offer the same level of public services to individuals with different levels of per capita incomes. The second one, was aimed at achieving greater spending per capita in extensive and scarcely populated jurisdictions.

The quantitative results of this reform were the following: with respect to primary distribution, the funds transferred to the provinces increased by 25% (from 38.6% to 48.5%), the nation loses 22% and the City of Buenos Aires receives the same share as before; in the case of secondary distribution, the share of developed provinces increased by 11% (from 22.2% to 24.6%), the share of middle income provinces increased 38% (from 6% to 8.3%), the share of less developed provinces increased 54% (from 7.3% to 11.2%), and the share of the provinces with low population densities increased by 47% (from 3.0 to 4.4%).

¹⁸ The regional development fund was distributed according to the provincial governments' proposed investment projects.

¹⁹ The arithmetic average of three indices -housing quality, level of education of human resources and automobiles per capita- was the measure used to compute the development gap.

²⁰ Demographic density was calculated by measuring the difference between the less than average densely populated provinces and the average population density. Thus, the funds were distributed according to the gap between the average density and that of each province.

During the effective period of this law, the process of decentralization continued apace with the transfer of responsibilities for social spending (pre-primary and primary education, health, etc.) to the provincial level. As a result, the provinces' public spending increased enormously (for example, between 1972 and 1975 it grew by 125% in constant pesos). With this, public employment at this level of government experienced accelerating growth. This in turn led (on various occasions) to National treasury bailouts of provinces through additional transfers of funds (i.e. beyond those transferred as part of the revenue sharing regime).

In 1980 the provinces' per capita spending reached 832 pesos (1995 pesos)²¹, in terms of GDP it doubled the level it had reached in 1960. The Argentine economic conditions of the time coincided with the implementation of a rigid pre-announced exchange rate ("tablita"), together with a significant necessity of reducing the rate of external debt accumulation.

Toward the end of that year, an increase and generalization of the VAT and an increase in cigarettes and fuel taxes were decided, in conjunction with the goal of reducing payroll costs through the reduction of taxes on labor. At the same time, a series of taxes whose revenues are specifically allocated were eliminated while a considerable tariff reform was put into effect.

A "pre-coparticipation" mechanism, which was calculated on a basis of personal pension contributions^{22,23} (Law 22293), was put into effect in order to transfer the funds collected from the increased VAT base to the pension system and to the "Fondo Nacional de la Vivienda" (National Housing Fund) (FONAVI²⁴). The implicit aim of these changes was to limit excessive spending due to the increased availability of funds. Surely, a more reasonable solution would have been to transfer some of the co-participation funds to the pension system and to replace the specifically assigned federal tax revenues.

The provinces' primary share of the co-participation funds fell abruptly, reaching 29% of total co-participation revenues, and continued to fall in the following years.

Between 1977 and 1980, some permanent expenditures (primary and adult education, hospitals and health centers, local water works, and local distribution networks) were transferred to the provinces. These amounted to around 20% of the funds sent to the provinces. The transfer of these expenditures were not accompanied by the funds necessary to pay for them.

Towards 1983, National Treasury contributions needed to cover provincial deficits -caused partly by the increase of spending on public services which had been transferred to the provinces and by the decrease in funds from the pre-coparticipation to the pension system and the FONAVI- exceeded

²¹ These expenditures reached \$ 975 and \$ 927, in 1994 and 1995, respectively.

²² It should be noted that the reduction of taxes on wages precipitated the legalization of workers which favored the diversion of funds towards the pension system.

²³ Furthermore, Budget Law 22451 eliminated Federal Coparticipation to the Municipality of Buenos Aires, which had enjoyed a privileged situation (the federal government financed spending on police, justice, prisons, infrastructures, primary and pre-primary education, secondary and universities, transport subsidies, etc.).

²⁴ The FONAVI's funds (which were financed with national returnable contributions aimed at the construction of housing in the provinces) previously came from taxes on work.

the provinces' own resources as well as the co-participated federal resources (they reached 175% of the federal co-participation intended for the provinces). This mechanism, not only substantially altered the secondary resource distribution established in Law 20221, but also encouraged provincial fiscal irresponsibility. This validated higher spending, independent of the criteria of efficiency, equity or necessity²⁵.

The revenue sharing regime expired at the end of 1984, and was only replaced on the first of January 1988. This created a legislative vacuum between 1985 and 1987, which led to the substitution of co-participation for Treasury contributions.

As a consequence, spending grew to incredible levels during 1986. This was due, especially to provincial employment policies which can only be described as out of control. Between 1983 and 1986/1987 the number of provincial government employees grew by 200,000, while their average salaries grew by 15%. In 1986, provincial public employment reached 60% of total public employment. The provinces' spending responsibilities represented 85% of total spending on pre-primary education, 91% of spending on primary education, 36.7% of spending on secondary education, 65% of spending on law and order and 70% of spending on justice.

The resources available for co-participation recovered, reaching almost 51% of total resources (compared to 25% in 1983), though this figure is far from the 60% seen during the late 70's. The financing of provincial spending with national funds reached 55% towards 1986, thus returning to more comprehensible levels than those seen in 1983 (72%), though they did not reach the levels seen in 1980 which were below 50%.

III.1. The co-participation law of 1988

A new Law of Federal Co-participation (Law 23548) came into effect in 1988. This was accompanied by a series of special laws, creating national taxes whose revenues would be distributed differentially (totally or partially) to the provinces.

The Law of Federal Co-participation (which includes VAT, income taxes, assets taxes²⁶, internal taxes, fuel taxes, etc.) was passed in January of that year. It gave the main system of transfers between nation and provinces added transparency and predictability. It also ended the legal vacuum which had existed since 1985 eliminating the discretionality in the determination of the amount and distribution of collected tax money. This was done by establishing that 42.34% of these funds would go to the Nation while the remaining 57.66% would be distributed to the provinces (56.66% automatically, and 1% as National Treasury Transfers)²⁷.

²⁵ *As an example of provincial fiscal descontrol, the number of provincial government employees reached 750,000 in 1983- clearly outdoing the National Central Administration.*

²⁶ *Repealed in 1996.*

²⁷ *In time, what became the Province of Tierra del Fuego was included. This added 0.388% to the provinces' share at the expense of the nation.*

This law conceded the greatest share of primary distribution to the provinces in the history of Argentina. Moreover, these funds were calculated on a wider tax base^{28, 29}. Attempts to justify this greater share of resources pointed to the greater public spending responsibilities which had been placed on the provinces during the late 70's without being accompanied by corresponding greater tax raising powers³⁰.

As for secondary co-participation, Law 23548 implied a greater redistribution of funds between the provinces. The coefficients assigned to each jurisdiction only represented the continuation of the ad hoc participation which occurred between 1985-1987. This had been caused by a lack of definition of objective criteria and by the powerful incentive to spend when the political cost of taxation is born by another level of government.

The regional redistribution scheme contained in this law, deepened existing disparities in the per capita spending of each jurisdiction. This allowed the provinces with low population densities to spend 3.58 times more than the developed provinces, and the under-developed ones, almost twice.

III.2. Conditional Transfers

These types of transfers, are fixed amounts tied to the funding of certain provincial programs. This category includes transfers to: the National Housing Fund (FONAVI), the Road Co-participation System (Sistema de Coparticipación Vial) which finances the building and repair of roads- the Fund for the Development of Electrical Energy in the Interior (FEDEI), and other minor social programs (Health Programs, School Meals, Rural Education, National Plan for Potable Water, etc.)

The FONAVI is the most important recipient of these transfers. Its purpose is the financing of housing and it is one of the few programs explicitly dedicated to the reduction of disparities in the distribution of personal income. One recently introduced improvement to this mechanism (Law 24464/95) established that the FONAVI's funds should be distributed according to their correct use, the level of re-payments (throughout its history, the FONAVI's highest rate of repayment has been 6% per year), investments in housing projects and changes in the housing deficit of each province. All these are revised every two years by law.

Some difficulties are implicit in the existence of these funds. Mainly that, beyond adding to the transfers to provinces, it is difficult to control their proper use. In practice, these funds have become just another part of federal co-participation.

²⁸ In addition, it was established that the amount to be distributed to the provinces would not be less than 34% of the central administration's tax revenues- whether they are part of the coparticipation system or not.

²⁹ It should be noted that the funds are transferred automatically and that their use is not subject to conditions or determined objectives.

³⁰ The transfers of spending obligations to the provinces are restricted to education and public health. Distribution of drinking water and electricity should not require additional transfers since these services can be financed by fees.

III.3. Implicit transfers

In addition to budgeted transfers, there are also a series of implicit mechanisms. These include: (i) Central Bank rediscounts to the provincial banks, which were generally used to finance the provincial governments' budget deficits and (ii) tax credits allowed in the different industrial promotion regimes.

The impact of rediscounts is minor for the average province, though they have substantially benefited the less developed ones. Industrial promotion has had greater impact by noticeably increasing the share of middle income provinces in the total. An example of this can be seen in the particular situation of the province of San Luis.

It should be noted that these mechanisms are now becoming less common. This is partly due to the fact that many provincial banks have been, or are about to be, privatized. It is also due to the elimination of the majority of promotion regimes, so as to make room for new projects.

III.4. Reforms since 1991

- Since August 1991, the FONAVI has been financing with part of the proceeds from fuel taxes. This measure has reduced the transfer payments from the federal tax sharing system. In this way, funds which had reached the provinces through the revenue sharing system now arrive through the FONAVI, thus altering secondary distribution.
- in October of that year, a new transfer of spending obligations from nation to province occurred. The aim of this new reform was to make spending more efficient (by bringing it closer to where decisions are made and consequently by bringing these decisions closer to the wishes of the people regarding social spending in health, education and child care), as well as reducing the transfer of co-participation funds to the provinces. The transfer of these services came into effect in January of 1992 and resulted in an estimated increase in the provinces' spending obligations of 1.2B\$ annually (890M\$ for secondary education and 323M\$ in health and child care). This reform did not change the primary distribution of funds. However, it did have an effect on secondary distribution since part of the co-participation funds of each province is retained (this amount is calculated according to the province's distribution coefficient established in the federal co-participation law). Resources are then assigned to each province in order to fund the obligations which had previously been funded directly by the nation (this especially benefited Buenos Aires which receives 30% of these 1.2B\$ but only contributes 22% of the co-participation funds).
- In April 1992 Law 24073 established that 16% of income tax would be used to resolve the problems of the large urban conglomerations. 10 of these 16 points go to the province of Buenos Aires (Fondo del Conurbano Bonaerense)³¹ while the rest is distributed to the other jurisdictions

³¹ Since 1.1.96 the exceeding amount over \$ 650 million -on an annual basis- goes to the rest of the provinces.

(2 percentage points are distributed discretionary since they go to the National Treasury Fund, while the rest must be used to finance basic social infrastructure). In June of that year, a new pre-coparticipation of this tax was put into effect, this time to finance the national Social Security System. In this way, only 64% of the funds collected through this tax are used in accordance to what was established in the Federal Co-participation Law 23548³². From October 1996 (Law 24699), \$580M are taken out of income tax receipts before the above percentages are applied. Of these \$580M, \$ 120 million go to the Pension System ; \$ 20 millions to the National Treasury Fund and the remaining \$ 440 million are divided among the provinces according to the stipulations of Law 23548 (including Tierra del Fuego). These changes altered both the primary and secondary distribution of revenue sharing. In the case of the primary distribution, the participation of the provinces decreased. Secondary distribution became more discretionary in the sense that the executive branch of the national government now has greater decision making powers regarding the coefficients which grew out of the political dispute of 1985-87.

- Law 23966, which has been in effect since September 1991, established a time frame for the distribution of liquid fuel and natural gas taxes. The national government was to cede part of its share of revenues from these taxes to the provinces, so that both would receive an equal 29% from January 1996. It should be noted that the national government received 47% of these revenues in 1991, while the provinces only received 13%. Of the funds corresponding to the provinces, 60% were designated for transport related spending, 30% for infrastructure projects involving electrical energy and/or public works- according to the percentages established in Law 23548-, and the remaining 10% for the FEDEI. Law 24699/96 established that some of these funds would also go to the national social security system.
- Law 23966 dealt with the distribution of VAT receipts. It established that, from 1.1.91, 11% of VAT revenues would go to the pension system (90% to the national system and 10% to the provinces according to their respective numbers of beneficiaries).
- This same law established the “tax on personal assets which are not incorporated in the economic process”, a direct tax which the national government would collect for 9 fiscal periods. 90% of proceeds from this tax would go to the national pension system, while 10% would go to the provinces and the City of Buenos Aires according to their respective numbers of beneficiaries. Law 24699 establishes that, between October 1996 and the end of 1998, 90% of the revenues collected by this tax will be distributed between the nation and the provinces according to the criteria established by law 23548.
- In August 1992 and 1993, the nation and the provinces signed two fiscal agreements. The first established that the provinces would cede 15% of the whole of its co-participation revenues (those left over after all pre-coparticipation revenues have been subtracted). These funds were appropriated for the national pension system and “other operative spending”. A monthly \$43.8M

³² Of the total funds corresponding to the nation, \$6 million per month are deducted and distributed to the provinces (not including the City of Buenos Aires.). These funds are distributed according to the ratios set by Law 23548. In 1997, this sum is doubled and an additional \$6 million a month is taken out of the National Treasury Contributions Fund, also to be distributed to the provinces.

was also subtracted so as to be distributed within a sub-group of provinces, according to different criteria than those stipulated in Law 23548. This had a negative effect on both primary and secondary distribution. In exchange, the National Treasury guaranteed a minimum monthly transfer of \$ 725 millions to the whole of the jurisdictions³³. A year later, the "Federal Pact for Employment, Production and Growth" established the following changes to the previous agreement; the fixed sum which was subtracted from co-participation funds was increased to \$45.2M per month and the National Treasury's guaranteed transfers were increased to \$740M per month.³⁴ Furthermore, a series of measures were agreed upon to increase the efficiency of the tax system. The nation agreed to eliminate its tax on assets and to reduce its withholding of VAT receipts and employer contributions. The provinces, in turn, were to eliminate: (i) stamp duties on financial operations and insurance (up to now only the province of Santa Cruz has eliminated this tax), (ii) specific provincial taxes on fuels, gas, electrical energy and sewerage services (eliminated), (iii) taxes on banks' interest and debt (eliminated) and (iv) payroll taxes (Chaco, Chubut and Entre Ríos have yet to eliminate these). The gross revenues tax (a turnover tax) would be replaced by a tax on consumption (in process), and real estate tax rates were also to be unified between different jurisdictions. The provinces also pledged to transfer their pension systems to the nation.

In synthesis, it is clear that, in all but one of the reforms mentioned above, the changes made to the primary distribution of resources were to the detriment of the provinces. The exception is Law 23966 which assigned fuel tax revenues.

The greatest beneficiary of these reforms was, in all cases, the pension system. Though it went through considerable reform in 1994, transforming it from a state funded system to a mix of private capitalization and state funding, it suffered (and continues to suffer) from strong imbalances between active and inactive workers as well as from a large quantity of payment obligations to retired workers³⁵.

The secondary distribution was altered by two different criteria. In the case of transfers of services, the purely discretionary criteria (set by Law 23548) were replaced by the objective criterion of the cost of transferred services (this will probably be different for each government offering similar services). In the other cases, discretionary criteria were simply exchanged for other criteria which were also discretionary. These were the results of political struggles in which power and the distribution of representatives of respective governments were significantly different to those of 1985/87.

³³ To this guarantee must be added those funds corresponding to transfers for health and education spending.

³⁴ Because of successive extensions, this pact is still in effect today.

³⁵ For many years, the system accumulated a large explicit debt as a consequence of the national governments failures to fulfill the payment obligations imposed on it by law coupled with the large implicit debt originated in its long term disequilibrium.

IV. PUBLIC SPENDING, REVENUES AND TRANSFERS. A QUANTITATIVE DESCRIPTION FROM THE 80'S.

IV.1. Public spending³⁶

From the early 1980's the level of spending in Argentina's public sector has been erratic, both in terms of dollars and constant currency. During the 1990's, a strong upward trend is clear. This same trend is visible relative to primary expenses, though a small decrease in interest payments on public debt is noticeable in recent years (after the debt restructuring and expirations caused by entrance to the Brady Plan). This trend is even more notable when the national companies are excluded from primary spending (national companies were an important part of total spending before the rapid process of privatization began in the early 1990's). In this way, real growth between 1990 and 1995 reached an accumulated annual 3.6% for total expenditure, in the case of primary expenses, this figure increases to 5.3%, reaching 6.8% when public companies are excluded.

In this context, the lower levels of governments' (provinces and municipalities) shares of total public spending has also been erratic in the 16 years being analyzed. It is clear that in a comparison between the 1990's (1990-1995) and the 1980's (1980-1989) this share of total spending grew considerably. While municipal and provincial expenditures averaged 31.5% of total expenditure during the 1980's, this figure had already reached 36% in 1990 (equivalent to the highest share of the previous decade, seen in 1986³⁷). This figure reached its highest level in 1993- 47.4%.

This increase in local government expenditure as a share of the total, is caused by a combination of factors. First, it is due to a tendency of decentralization of public expenditure originating in the transfers of public services (health, education, child care) from nation to provinces. Second, growth in the nation's resources (as a consequence of economic growth, improved tax controls and improvements in the tax system) and transferred to the provinces through the federal co-participation regime probably also contributed to this. Third, the privatization of public companies, which were in essence national, has allowed for reductions in the level of spending at this level of government. Finally, restructuring of the maturity of national debt has had a similar impact.

A more accurate evaluation of the effects of decentralization can be arrived at by only considering primary expenses or, even more clearly, if the public company sector is subtracted from it. This reveals that, during the 1980's, provincial and municipal spending together accounted for 41.4% of

³⁶ The whole of public spending analyzed here includes health insurance and subsidies to private education. That is, expenditures financed by compulsory payments made by workers (health insurance) and the public sector's financing aimed at education (even if carried out by private entities) are included.

³⁷ Bear in mind that, in that year, transfers to the provinces were mostly funded by National Treasury Contributions since the Law of Federal Coparticipation had expired, thus, the size of these transfers corresponded to the pressure exerted on the national government by the provinces.

total public spending. The provinces' share of expenditure increased progressively from 1989, reaching 49.9% in 1993 and then stabilizing at around 49%. The average figure for the 1990's was almost 48%.

Within the lower levels of government, it is improbable that any decentralization took place. This becomes apparent when one considers that, while provincial and municipal expenditure increased as a share of consolidated total expenditure, the corresponding share of the municipalities within the combined municipal/province share decreased somewhat in recent years.

Regarding the carrying out and financing of public expenditure, it should be noted -as pointed out by Artana and others (1995)- that the expenditure carried out directly by the Federal Government has decreased between 1983 and 1992 both in relative and absolute terms. The nation's share of the primary expenses excluding public sector enterprises carried out by the public sector (that is, without health insurance and private education- whose funds are derived wholly or in part from different levels of the public administration but whose final execution is carried out by the private sector) was 52.3% in 1983. This figure dropped to 42.8% in 1992. In 1983, the nation financed 68.1% of primary expenses excluding public companies, while this figure dropped to 57.8% in 1992.

Expenditures carried out by the provinces grew from 30.1% in 1983 to 36.6% in 1992. The financing of these expenditures, whether through their own resources, non-conditional transfers or debt³⁸, also increased- from 26.5% in 1983 to 34% in 1992.

The level of expenditures carried out by municipalities were practically unchanged in relative terms between 1983 and 1992- though the provisions of financing for this level of government have decreased. The share of public expenditure carried out by the private sector has also been stable between 1983 and 1992.

An analysis of each level of government's share of spending for the different functions shows that the provinces' social spending related to total spending of the whole Argentine public sector has increased considerably from an average of 16.5% during the 80's to 24.3% in the first years of the 90's, reaching 26.3% in 1995. This figure has not been below 25% since 1992 when the transfers of responsibilities over secondary education, health and child care occurred.

Spending on education should be divided in three periods: in the first part of the 80.'s (1980/83 inclusive), the nation carried out around 47% of spending on culture and education; between 1984 and 1991 (inclusive) its share dropped to 38%; while during 1992/1995 it dropped by another 16%. The reduction of the nation's share of total spending is reflected in the increase of the provinces' share- since the municipalities show only minor variations through this period which are only perceivable from 1994. As might have been expected, the expenditures driving this growth are those relating to education (basic, superior and universities)- since culture's share of spending decreased.

³⁸ *Financing with conditional transfers are not considered. these are funds whose destination is pre-established by a higher level of government, such as the FONAVI.*

Expenditures related to medical services also increased due to the transfer of social services. The above figures relating to the incidence of each level of government within the different aims and functions of expenditures clearly demonstrate the process of decentralization of public spending which has occurred in recent years.

Another sector acquiring an increasing share within provincial and municipal governments in recent years has been payments made on public debt. This is related on the one hand to the smaller payments made by the nation and on the other to the greater level of borrowing by the sub-national governments.

As for general administration expenditures, they are shared by the three levels of government- while almost all urban services are offered by the municipalities. This confirms the above mentioned division of spending obligations between the different levels of government.

IV.2. Tax resources

In the above sections, the tax-raising powers of the different levels of governments were described while emphasizing the loss of tax powers that the provinces had suffered in practice. It was mentioned that the provinces had direct and indirect tax raising powers, in this case, concurrently with the nation.

The provinces legislate, manage and collect³⁹ four main taxes and other minor ones. This first group is made up of a turnover tax (sales tax), stamps⁴⁰, automobile registrations and real estate taxes.

The latest fiscal agreement (between the nation and the provinces) established that the turnover tax would be replaced by one levied on final consumption. If this were put into effect (that is, if the turnover tax were exchanged for a retail sales tax or a VAT based on point of sale⁴¹), the structure of provincial taxation would come into line with economic theory. This is because two of the more important taxes (automobile registrations and real estate) have a relatively fixed taxable base -what impedes the exportation of taxes and greatly restricts the possibility of "tax wars" and of "voting with ones feet". The fixed nature of these taxes means that the revenues they bring in do not fluctuate significantly with the economic cycle. Furthermore, the provinces are allowed to set their own rates on their taxes.

It is quite clear that the provinces have not put their tax systems to good use. An indication of this is the fact that they only collected around 17% of the amount collected by the central government and

³⁹ Some provinces have delegated the power of collecting some taxes. In Chubut, Santa Cruz, Chaco and Corrientes urban and suburban real estate and automobile taxes are collected by the municipalities.

⁴⁰ Since the different provincial jurisdictions approved the second fiscal pact, stamp duties on financial activities had to be eliminated- most provinces did so.

⁴¹ In this case, some doubts emerge relative the possible effects of mechanisms imposing taxes on the importation of goods and not on exports (border adjustments).

provincial jurisdictions put together (this figure averaged 16% during the 80's and increased slightly to 16.6% during the first six years of this decade)⁴². The funds collected from provincial taxes only amounted to around 29% of provincial expenditures (the corresponding figure was 30.9% in 1995).

The turnover tax, which distorts economic activity and is highly procyclic, has generated the most revenues for the provinces throughout history (56% of total tax collections in recent years). Automobile and real estate taxes have only represented 10 and 20%, respectively, in this level of government's tax revenues.

Clearly, the provinces did not have any incentives to collect taxes therefore diminishing their fiscal responsibility and accountability. This is largely due to the structure of the revenue-sharing scheme, their possibilities to acquire debt (in the past with its own banks, suppliers and rediscounts from the nation), coupled with the near certainty of national bailouts when they are confronted by possible default. The harmful consequence of this has been a very low level of correlation between expenditure and tax collection- which decreases even more as expenditure is being decentralized.

Another, closely linked and continuing problem is the loss of the provinces' tax-raising powers to the nation. This constraint would be lifted if, for example, the central government ceded the tax base of fuels or of other consumer goods with inelastic demands (i.e. alcohol or cigarettes). Another possibility would be for the national government to stop imposing some direct taxes which could then be collected by the provinces (i.e. some personal income taxes- though in this case, the levy should not be progressive). This would lead to an increase in fiscal accountability, better correlation between taxes and spending and of course, a more efficient allocation of resources which in turn would diminish the importance of the federal tax co-participation regime.

At the municipal level, the result of the debate between the autarchic or autonomous frameworks has been that the municipalities charge fees for services. These fees are in practice more akin to transaction taxes, since they actually exceed the cost of the services rendered. Some limits placed on the municipalities' ability to acquire debt, have allowed for a higher level of correlation between collected funds and expenditure than that seen at the provincial level. It should be noted that an important part of the municipalities' funding originate in provincial co-participation. This system functions along the same lines as the federal co-participation system- though the primary distribution from province to municipality is much smaller both in relative and absolute terms than that established by federal co-participation.

IV.3. Transfers

As has been explained throughout this work, the federal revenue sharing regime is the most important mechanism for transfers to the provinces. So far this decade, it has accounted for

⁴² If only tax revenues are counted (not including revenues from taxes on salaries) the figures are: 19.8 and 22.1%, respectively.

almost 71% of total explicit transfers (automatic and non-automatic, conditional and non-conditional).

Although the system's criteria were initially based on devolution (funds were transferred according to their origin), other criteria entered into the system as time passed. An example is the criteria of population which aimed at correlating transfers to the number of people living in each province. For the time being, redistribution towards regions (and not families) is the preferred criteria.

Transfers to provinces (including National Treasury Contributions) accounted for 52% of national expenditure in 1995. This is a large share, especially considering the existence of pre-co-participation mechanisms mentioned above. It should be noted that there is a considerable spread in provinces' shares of expenditure funded by transfers. Developed provinces such as Buenos Aires, Córdoba and Santa Fe are less dependent on national transfer to finance their expenditure (so far this decade, Buenos Aires financed 43.8% of its expenditures with transfers, Córdoba 47.9% and Santa Fe 53%). Less developed provinces such as Catamarca, Santiago del Estero and La Rioja funded more than 80% of their expenditures with transfers. San Luis, one of the "middle income" provinces, was the most dependent on federal transfers, which funded 83% of its expenditure.

In Argentina, transfers from the nation to the municipalities are practically non-existent. It is the provinces which, to a certain degree, copy the mechanism of federal co-participation relative to transfers to their respective municipalities. Municipal co-participation is basically funded by parts of the federal co-participation funds. This generally includes shares of taxes collected within their jurisdiction such as turnover taxes, automobile registrations (often almost all that is collected from them) and real estate taxes. Primary distribution, in contrast to the federal system, allows much smaller shares to the municipalities.

Finally, transfers from municipalities to provinces, that is, transfers from an inferior level to a superior level of government -which in some countries may be important- are minimal. This is the case of the province of Buenos Aires.

The mechanism of federal revenue-sharing does not include incentives for the efficient provision of services nor for increasing their coverage. If this is to be reversed, they must be accompanied by a fixed level of expenditure as well as objectives for the growth of coverage. Even if these measures were taken, their fulfillment will not be certain and their control, costly.

This situation may lead to moral hazards among local officials. For example, if one of them decides to hire personnel in order to lower the unemployment rate rather than for reasons of economic efficiency, he/she (agent) would be maximizing political benefits at the cost of future generations. Since bureaucrats do not bear the full brunt of their actions -as a consequence of hidden information- the motive which led to an increase in public employment does not risk immediate detection.

A similar problem occurs when funds transferred for specific programs (e.g. conditional transfers such as FONAVI or other health or education programs) are diverted to a general fund to then be spent in other, politically profitable, ways (e.g. temporary jobs for potential supporters or, simply, the reduction of the deficit). The central government can not immediately detect if this has an effect on the local government's housing, health or education budget, nor can it legally prevent it unless it is legally or constitutionally authorized⁴³.

Improving fiscal accountability requires a systematic knowledge of the government's activities as well as an institutional framework that allows the community to participate in it. The best way to foment community participation is for programs financed by the central government to be co-financed by local governments. Linking performance to tax payments creates a powerful incentive for community involvement.

A complementary solution would be to sanction laws which impose a strict code of conduct on local administrators making them personally responsible and legally liable when they do not serve the best interest of the community. These laws could serve as a powerful dis-incentive against corruption if civil institutions are allowed to bring class action suits against local politicians.

Regarding secondary co-participation, the Argentine system's design can also be thought of in terms of a game. In this case, it is a non-cooperative game in which the players are the provinces and the City of Buenos Aires.

In a first game (following the precepts of Porto, A.)⁴⁴ let us suppose: (i) that the whole of collected taxes to be distributed between the provinces through federal revenue sharing is equal to the sum of funds coming from each jurisdiction⁴⁵ and, (ii) the distribution will be decided in only one debating chamber⁴⁶. In this case, the conclusion will be reached that the devolution criteria is the only alternative if an equilibrium is to be achieved- since any solution reached, that is better for one province, will be worse for another- this will be made clear in the debating chamber.

In a second, more complex, game, in which the criteria are those commonly used for secondary distribution (i.e. funds originating in each jurisdiction, population and a development index) and in which the deputies agree, no new equilibrium solution emerges. In this case, there are only two criteria to be determined, since the third is derived from the other two. In all votes, one supposes, all deputies will vote for a combination which favors their province with the most funds. The

⁴³ The same problem could arise if an administrator who is a representative of the central government, pursues his personal political interests with government funds. This activity implies even higher costs, as well as risks, since local voters will have no incentives to replace him because they can not choose his successor. This in turn increases the central government's costs of detecting him.

⁴⁴ Porto, A., *Federalismo Fiscal en la Argentina. Evolución y perspectivas*. Buenos Aires, March 1995.

⁴⁵ The provinces will always prefer this strictly devolving arrangement than collecting by themselves. In spite of the loss of autonomy, this way they avoid the political costs of tax collection and they benefit from the expenses that can be financed with these funds.

⁴⁶ This is a simplification, since in Argentina the National Congress has two chambers. Nevertheless, the inclusion of the second chamber does not change the final result.

simulations performed prove that there is no combination of the parameters, which is preferable to the present law (23548) and that would not be blocked by another preferred configuration-independent of the majority required to pass a new law.

V. MACROECONOMIC POLICY AND FISCAL DECENTRALIZATION

V.1. Countercyclical policies and debt

This is probably the most controversial issue in literature on fiscal decentralization. It is clear that, when it comes to allocating resources, a decentralized government will always be more efficient in that it will correlate its expenditure decisions -and its financial alternatives- to the citizenry than a centralized one. At the same time, its functioning will tend to place limits on the expansion of the public sector. (Leviathan problem).

Nevertheless, while it seems reasonable that a nation should have one macroeconomic policy, by consequence deriving from the central government, certain precepts must be fulfilled before this can happen. For example, the design of the tax system must be such that the predominant taxes at the national level should be those which fluctuate with the cycle and which afford an important source of funds (i.e. VAT, corporate profits), while local governments must be authorized to collect taxes with a more stable and fixed base.

The design of fund transfer regimes is another important element of a viable macroeconomic policy. When the grade of fiscal correlation (revenue to expenditure) in the lower levels of government is low, in which case the cost of financing an elevated public deficit is born by another level of government, the citizen only sees the benefits of a greater supply of public goods without immediately perceiving how these are financed. Furthermore, even if this imbalance were not significant, the attainment of horizontal equity creates a necessity to put transfer mechanisms into effect between the different levels of government. The first requirement that a transfer regime must fulfill is not to be directly connected to the economic cycle. The basic fact is that local government public expenditure plans should be made on the basis of the long term, not in function of present economic circumstances, but according to the availability or lack of financing.

The debt policy of local governments is a third factor- perhaps the most important one- which could hinder the processes of macro-economic policies. The sustainability of the debt/GDP ratio must be taken into account, while the debt/net internal investment ratio must be controlled⁴⁷. A fundamental element is that the central government must not bail-out local governments faced with default, although this restriction will often be bypassed for reasons of public order or when health services or education are affected. If the politicians and bureaucrats (together with banks, lenders or other lending institutions) believe that the central government will not allow lower levels of government to default, a problem of moral hazard could arise which would contribute to the creation of structural deficits. The jurisdictions' expectations that the central government will come to their rescue will allow them, in practice, to act as if they had only minor budget restrictions, which does

⁴⁷ *When measuring debt, contingent liabilities should be noted (e.g. implicit debt in the state pension system).*

not necessarily force them to seek economies in their expenditure (or consolidate their revenues)⁴⁸ in order to keep their budgets in equilibrium, neither within a given period and even less on a continuous basis. Similarly, the money-lender will have an added incentive to lend if he is aware of this possible rescue.

If a provincial or local government is too important or too big to be allowed to fall, central government intervention will be necessary, perhaps in the form of restrictions on the level of allowed indebtedness or other regulations. However, another possibility would be to reduce the size of local governments. The separation of the big urban economic centers from the main governmental centers (functional decentralization) or the fragmentation of large sub-national governments into multiple jurisdictions (spatial decentralization) could help to strengthen the budget controls of the lower levels of government.

The motives mentioned above, indicate that the debt of sub-national governments should not be left to their free refereeing. There are various ways in which local governments' acquisitions of debt can be limited: i) apply the discipline of the market; ii) cooperation between the different levels of government in the designing and implementation of debt controls; iii) controls based on norms, iv) administrative controls (Ter Minassian, 1996).

In the first case, financial intermediaries must not be subject to the rules that privilege the government in its acquisition of loans; lenders must have adequate information on the borrowers' pending debt obligations and on his ability to pay; and, fundamentally, the possibility of a bailout should be very limited, so as to effectively prohibit the use of federal transfers as collateral. In this case, the role of the risk rating agency is essential. Giving free reign to market forces and assimilating local governments into the private sector, is probably not a viable alternative; nevertheless, one possibility would be to only permit debt through the floating of medium term bonds, again prohibiting the use of federal transfers as collateral and obliging debts to be qualified.

In the second route, local government debt limits are established through a process of negotiations with the central government, thus defining the global debt targets and the estimates relating to the growth of the principal categories of revenues and expenditures.

The third possibility consists of fixing limits to the absolute level of debt of sub-national jurisdictions, and/or on the purposes for which they may be used (e.g. investment). A restriction could also be applied, which would be linked to the ability to service the debt (e.g. debt servicing/total debt, debt servicing/past revenues or tax base), or some types of financing could be prohibited (e.g. those granted by the central banks). This type of method, implies the existence of clear and uniform accounting norms for government entities, that strictly limit or eliminate the possibility of extra-budgetary operations, clear definitions of debt must be given (contingent

⁴⁸ *This same opportunistic modus operandi would occur if transfers were strongly procyclic and if they finance an important part of local expenses -which is the case in Argentina-.*

assets from sub-national government pension systems, for example, must not be forgotten), as well as a modern system informing on the government's financial management.

The fourth possibility implies the establishment of annual limits (or more frequent) on sub-national governments' global debts (or of some of its components, such as, for example, foreign debt); the approval of debt acquiring operations; or the centralization of all government loans, combined with their re-issue to sub-national governments subject to conditional use.

The problem with debt is not only its level, but also the increase in risk caused by its uncontrollable growth along with the difficulties this implies for the private sector.

In the case of Argentina, as was mentioned above, the regime organizing fiscal relationships is strongly procyclic (even when the effects of precoparticipation on the most important taxes is considered) and the provincial and municipal governments are very dependent on these funds for their financing⁴⁹.

Regarding indebtedness, both the provinces and the municipalities have the capacities to acquire debt. However, only the provinces can borrow abroad and require the approval of Congress to do so, especially if they use transfers from the nation as collateral.

As far as the municipalities are concerned, while in most cases the authorization to acquire debt requires a qualified majority in the Deliberating Council (Concejo Deliberante), other cases must be authorized by the provincial legislature. In general, limitations are imposed on debt, mainly by not allowing debt servicing payments to exceed a certain percentage of the municipality's resources (frequently 25%)⁵⁰.

V.2. The characteristics of distribution

The central government's re-distributive policy should be aimed at eliminating the problem of horizontal inequity, tending to equalize the initial opportunities of individuals with different incomes through a minimum supply of public goods- that is, compensating for the weakness of the tax base.

The high level of personal and capital mobility limits the ability of sub-national governments to implement redistribution programs financed by their own resources. Because of this, one of the basic objectives of an intergovernmental transfer regime should be a policy of income redistribution. The problem with personal or family income redistribution programs is that it must be defined at the national level (though its carrying out can be decentralized).

⁴⁹ It is because of this that successive stabilization programs have opted for the reduction of the coparticipation percentages, the transfer of services or changing the destination of resources.

⁵⁰ In some cases, the provinces are also subject to this type of restrictions.

Musgrave and Musgrave⁵¹ have proposed that federal subsidies be used to redress the differences in the tax bases of different jurisdictions, trying to finance a standard level of spending according to the characteristics of the population⁵². Supposing a uniform system of taxation is applied to all jurisdictions with a similar level of compliance, the transfer will allow the financing of a jurisdiction's weak tax base or a greater level of demanded expenditures caused by the specific combination within the population (e.g. a greater demand for old-age subsidies caused by a relatively high presence of senior citizens compared with other jurisdictions).

There is no reason why the region rather than the individual, should be the determinant of the distributive scheme. One reason for this, among others, is that this could imply that the poor of one richer jurisdiction were subsidizing the rich of a poor jurisdiction.

The Argentine revenue sharing regime has had a strong redistributive content, in which the larger proportion of transfers are organized along regional, and not personal, lines. Those that can be considered as being aimed at individuals or families include the FONAVI and school meals on the national level, and in the case of the provinces some health services (especially in the province of Buenos Aires).

The fact that transfers are organized on a regional basis, does not necessarily mean that they are incapable of improving personal income distribution. However, it appears that this is the case in Argentina. For example, the practice of correlating each province's federal coparticipation system per capita transfers to the proportion of households whose basic needs are not satisfied in the total population⁵³, does not have an effect on the variables. On the other hand, an analysis of social expenditures relating to households with un-satisfied basic needs per province reveals that the objective of leveling per capita social expenditure has not been contemplated. Finally, the transfers mentioned above do not tend to correlate with the objective of compensating the weakness of provincial tax bases (for example, provinces with equal relative weaknesses in taxable bases, such as La Rioja, Corrientes and Misiones or San Juan and Santa Cruz, received very different federal coparticipation transfers).

The Argentine experience illustrates that the increase in transfers is not commensurate with the consolidation of an "equivalent expenditure" level. Rather, it leads in a skyrocketing level of spending in the jurisdictions receiving the greater part of these transfers.

In 1934, the federal tax coparticipation regime did not exist and the provinces practically auto-financed themselves. This allowed the relatively more developed jurisdictions to carry out a per capita expenditure that almost tripled that carried out by the least developed provinces. The introduction of the federal coparticipation regime, in 1935, allowed the balancing of per capita

⁵¹ Musgrave, R. and Musgrave, P., 1980.

⁵² It should be noted that the criteria of compensating the differences in taxable bases does not necessarily lead to an equalization of per capita public spending, because the redistribution criteria compensate the existing differences in order to provide a minimal public expenditure and not the whole of expenditure.

⁵³ See Artana, D., Libonatti, O., Moskovits, C. y Salinardi, M., *La descentralización fiscal en América Latina : problemas y perspectivas. El caso de Argentina. BID, July 1994. Work Series N°184.*

public expenditure in each group of jurisdictions. In 1959, per capita expenditure was similar in developed, middle income and less developed provinces, while the provinces with low population densities (Patagonia area) spent 15% more per capita than the country's average expenditure. A substantial imbalance surfaced in 1992, in which the low population density provinces had a per capita expenditure which tripled that of the more developed provinces, while the least developed almost doubled it. There were also significant differences between provinces within the same group.

The policy based on the criteria of regional redistribution of national funds presumably attempted to achieve a greater settlement of the country's interior, though actually this was not based on rational assumptions- though it is clear that the general rule is that the richer jurisdictions subsidize the poorer ones.

The significant territorial redistribution provoked a profound inequality in the per capita distribution between different provinces: residents of the more developed provinces receive 64% less through coparticipation than the less developed provinces, 60% less than the provinces with low population densities and 55% less than the middle income provinces. Notably, the residents of Buenos Aires receive a per capita coparticipation that is 48% less than the national average. In addition, if households with unsatisfied basic needs are used as a proxy of personal distribution of income, it is clear that the more developed provinces receive a coparticipation for each of these households which is 17% less than the less developed provinces and 51% less than the provinces with low population densities. A disadvantaged household in the province of Santa Cruz receives six times as much as a similar household in the province of Buenos Aires, while one located in La Rioja receives four times as much as one located in Buenos Aires.

From a historic point of view, regional redistributive policies -on top of having shown poor results relative their objectives- have probably led to net losses for society. The loss of fiscal correlation in the provincial jurisdictions' management of public funds has contributed to the skyrocketing public expenditure and a weakening in their tax collecting efforts. The provinces receiving smaller per capita transfers (i.e. the more advanced ones) have smaller per capita expenditures and exploit relatively more their theoretical bases. Exactly the opposite is true of the less advanced provinces.

VI. SOME CONCLUSIONS

Numerous difficulties can be deduced from what has been explained above, relative the organization of Argentina's tax system.

In the first place, the system's initially good design should be noted. These positive aspects though, began to deteriorate as the activities of the public sector became more relevant. In view of this: (i) the nation gained powers which had previously belonged to the provinces, particularly in tax raising matters, but also in what pertained to social spending (this has been the case with primary education during the first steps of national organization), (ii) the lack of clearness regarding municipal powers permitted that, while the nation was taking over provincial powers, these, in turn, were taking over municipal powers⁵⁴.

In this way, a state with a federal government structure (in which the provinces existed before the nation), tended to become more centralized. With this came the reduction of benefits inherent to a decentralized regime relative to resource allocation. Essentially, as a consequence of the fact that the demand for public and meritorious goods do not express the real wants and needs of citizens, because the provision of these public goods are financed, fundamentally, through taxes imposed and collected by the nation, whose obligations are not clearly perceived. It follows that this system suffers from a very low level of correlation of revenues to expenditures and accountability.

The transfers of expenditure obligations from nation to province which has occurred (with some interruptions) through a large part of the nation's history, and which was very important in the early years of the present decade- deepened the already considerable imbalance- since *pari passu* with the decentralization of functions, the nation did not cede any of its tax raising powers. In more recent times (as in previous stabilization plans), the mechanism of federal revenue sharing was affected by the assignation of part of the regime's funds to other destinations. The objective of these measures were to reduce the provincial imbalances but also to cover the lack of financing of the pension system. The result was the restriction of funds distributed in primary coparticipation.

The system of fund transfers (determined by federal tax coparticipation, which is based on direct rather than conditional transfers which fluctuate with the economic cycle) favors a set of perverse behaviors. For example, neither sub-national nor the national government have an incentive to collect taxes. In the first case because these transfers can be used to pay for expenditure or if not, to use debt mechanisms during periods of imbalance. In the second, this is due to the fact that a large part of the effort made to collect taxes is only directed to the financing of provincial and municipal expenditure. The result then, is the increasing necessity to finance the whole of the public sector

⁵⁴ For example, in 1948, the provinces had delegated the power of collecting the gross revenues tax to their municipalities. However, the amplification of national government tax raising powers led the provinces to reassume this function. To compensate for this, the provinces allowed the municipalities to charge an "Inspection Fee for Commercial Security and Hygiene".

together. In this context, the nation's efforts to reduce its expenditure, does not produce an exemplary effect on the lower levels of government since there are no mechanisms forcing them to adopt similar strategies.

The Argentine tax sharing system generates, as far as macroeconomic policy is concerned, the loss of central government controls over stabilizing policies. The acquiring of debt by the lower levels of government is favored by the regime's design. Argentine provinces are not restricted when acquiring debt, since they can use future funds transferred to them through this regime as guarantees (collateral). It is probable that the nation would provide funds to prevent provinces from falling into bankruptcy, even if these funds are not part of the coparticipation regime.

The basic objective of a transfer mechanism, which is to serve the income distribution policies implemented by the central government, is not covered, either under the present system. It has been demonstrated that the regime is not aimed at improving the personal distribution of income, be it through financing a minimum level of per capita public expenditure or trying to equalize the tax bases. Rather, this distribution only serves to benefit determined provinces at the expense of others, since rich citizens in poor provinces are being subsidized by poor ones in rich provinces.

It is very important to note, as has already been mentioned, that the coefficients of the secondary distribution established by the present co-participation law, only responds to political arguments from 1985/87 in which no explicit federal co-participation regime existed. Later on, the established pre-coparticipations modified these shares by only showing the existing political framework.

The passing of a new federal coparticipation law -expected in the constitutional reforms of 1994- will probably permit an improvement in the regime's redistribution criteria. Nevertheless, it is probable that the essence of the system will not change (dependence on procyclic taxes, based on automatic and non conditional transfers). Under these hypothesis, the difficulties created for macroeconomic stabilizing policies, scarce fiscal accountability and a low level of fiscal correlation will continue.

It is clear that these indicators could be improved if within the criteria established for assignment of funds through secondary distribution, elements such as good fiscal performance at the provincial level are included. One enormously important element necessary for this to occur is the provision of frequent and high quality information as well as auditing mechanisms and controls in addition to the periodic review of results relevant to the chosen criteria.

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Argencard S.A.
Aseg. de Cauciones S.A. Cía. Seg.
Aseg. de Créditos y Garantías
Asoc. Argentina de Seguros
Asoc. de Bancos Argentinos
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