

DECENTRALIZATION IN MERCOSUR COUNTRIES: THE DEVIL IS IN THE DETAILS

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FOREWORD

CONTENT

I - Introduction

During the past two or three decades, decentralization has been much advocated, and practiced, in developing countries in general, and in Latin America in particular. The theoretical foundation of this policy prescription is largely North American. In a brilliant book entitled “Fiscal Federalism”, Wallace Oates (1972) explained how the joint decentralization of taxes and expenditures could improve welfare. Assuming different tastes in different sub-national jurisdictions, that political tax and expenditures decisions reflect the views of the median voter (two assumptions that are present to a large extent in the USA and Canada), and that there are no economies of scale in the provision of sub-national public goods and services; Oates showed that a decentralized system is superior to a centralized system in terms of allocative efficiency¹.

Both the mix of public and private goods and the mix of various public goods generated by decentralization will maximize welfare. An idea that promises to deliver more at no additional economic cost is always very appealing.

Decentralization was also supported by more political and perhaps stronger considerations. It can be argued that a decentralized system is a more democratic system. Political power is more widespread. This makes it more difficult for a single man, party, or group to confiscate power. Tocqueville, contrasting Europe and America -- more precisely the USA-- in the early 19th century, first established these equations: strong central government equals autocracy; strong local governments equal democracy. Such a rule has its exceptions, and the marked federal character of Argentina and Brazil did not prevent these countries from becoming dictatorships. However, it is true that more elections, and more elected politicians, provide a good antidote against the poison of totalitarianism. In the many developing countries, particularly in Latin America, that had experienced extreme forms of autocracy in the 1950-80, an idea that promised to deliver more democracy was also very appealing.

¹ *Riccardo Rietti says that you should mention in here more recent theoretical developments such as Club theory to explain behavior of municipalities.*

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At the beginning of the 1980s, most Latin American countries were rather centralized. Sub-national governments were politically weak; in many cases mayors and governors were not even elected, but appointed. They were also fiscally weak; their taxing and borrowing powers were limited and controlled by the top. They were also administratively weak, with few qualified professionals. Power was largely concentrated at the center.

This statement could and should be qualified. Several of the largest Latin American countries (Mexico, Brazil, Argentina, and Venezuela) were even then federal countries, with States and provinces enjoying a certain degree of political, legal and administrative discretion. The historical heritage is mixed. On the one hand, as colonies, these countries were centralized, with major decisions taken not even in the national capitals but in Lisbon and Madrid. On the other hand, because these countries were large, undeveloped, agricultural, and poorly integrated, their regions (provinces or states) had a *de facto* and often *de jure* fair degree of autonomy, as in the case of Argentina.

It is true, however, that municipalities had traditionally been weak in Latin America, in part for demographic reasons (most of the people lived in low density rural settlements) and in part for political reasons (the central and occasionally regional governments concentrated power). It is also true that military dictatorship, as in Brazil, or *de facto* single party States, as in Mexico, had led to a curtailment of regional autonomy. In Brazil in 1980, for instance, urban transport policies—a typically local issue—were entirely handled at the center; EBTU (Empresa Brasileira de Transporte Urbano), a national entity based in Rio, but controlled by Brasilia, owned mass transit systems in the various cities, and managed them, deciding on fares or investments or wages.

As Tim Campbell (2003) puts it, “a wave of decentralization occurred in Latin America during the latter half of the 1980s” (p. 75). Two major developments justify this statement. First, the number of countries with *elected* local and regional councils, mayors, and governors increased very significantly; presently all municipal councilors and mayors in the region are elected, and most regional councilors and governors are. More than 100,000 people are thus popularly elected at sub-national governments in the region. Second, sub-national governments expenditures increased substantially, both absolutely and relatively to total public expenditures.

This “wave of decentralization”, however, took many very different forms. In Chile, the Pinochet regime (not exactly a herald of democracy) created and strengthened regional governments, and improved the administration of municipalities—without regional or local elections. In Brazil, the 1985 Constitution gave States and Municipalities additional responsibilities and resources. The concept of “decentralization” must be flexible to encompass such diverse, not to say contradictory, changes. The word by itself does not say much, and it is necessary to go beyond it and to look at what happened exactly in the various countries.

This study is limited to six countries: Brazil, Argentina, Uruguay, Paraguay, Bolivia, and Chile. This choice is justified by geography, politics and economics. These six countries are the six most southern countries of the continent; they are often referred to as the Southern Cone. The first four countries have formed the Mercosur, and the other two are associated to Mercosur. These countries have between themselves economic relationships somewhat more intense than the relationships they have with other Latin

American countries. The choice is also justified by chance, by the fact that we were first asked to look at decentralization issues in Bolivia and Uruguay (and previously Brazil), then asked to generalize our conclusions by studying the cases of Argentina and Chile. In all these countries, we selected municipalities and regions (about ten per country), interviewed their local officials, and studied their accounts –in addition to Municipal Councils the central government agencies, ministries, funds, etc. dealing with sub-national governments. Our work is therefore primarily based on first-hand fieldwork.

This paper is an attempt to synthesize our findings. It first presents our six countries, which are very different in terms of size, wealth, administrative set-up, economic structure, and decentralization experience, although they do have some common features. It then examines quantitatively the importance of sub-national governments, in terms of expenditures, and of resources (taxes, transfers, and borrowing) in some details. It continues with an analysis of the outcome of decentralization in the various countries. Our dominant themes or study are: first, that there is too much decentralization at the regional level, and not enough at the municipal level; and second that there is nearly nothing at the metropolitan level. The paper concludes by trying to derive some policy implications of these analyses..

II - Decentralization in Mercosur Countries: An Overview

Our six countries have as many differences as they have similarities. Table 1 indicates the most important characteristics. Seven features of relevance to the study of decentralization can be identified.

Table 1 – Major Characteristics of Southern Cone Countries

	Brazil	Argentina	Chile	Bolivia	Paraguay	Uruguay
Population 2003 (Millions)	176.6	38.4	15.8	9.0	5.2	3.4
Area (Millions. km2)	8.5	2.8	0.8	1.1	0.4	0.2
Pop. Growth 90-03	1.4	1.3	1.4	2.4	2.4	0.7
GNI per capita 1980 (US\$)	2,710	3,650	4,390	890	1,100	3,790
GNI per capita 2003 (US\$)	7,480	10,920	9,810	2,450	4,700	7,980
GDP growth 80-90	2.7	-0.7	4.2	-0.2	2.5	0.5
GDP growth 90-03	2.6	2.3	5.6	3.5	1.7	1.5
<i>Extreme Poverty</i>						
<i>Population with < US\$2 pd</i>	<i>22.4%</i>	<i>14.3%</i>	<i>9.6%</i>	<i>34.3%</i>	<i>33.2%</i>	<i>3.9%</i>
<i>(Year of survey)</i>	<i>(2001)</i>	<i>(2001)</i>	<i>(2000)</i>	<i>(1999)</i>	<i>(2002)</i>	<i>(2000)</i>
<i>Corruption index</i>	<i>3.9</i>	<i>2.5</i>	<i>7.4</i>	<i>2.2</i>	<i>1.9</i>	<i>6.2</i>

Sources and notes: World Bank Development Reports, except for the corruption index which comes from Transparency International; « growth » numbers are in % per year; *extreme poverty* is defined as the share of the population living with less than 2 US\$ per day; the Transparency International corruption index ranges from 10 (no corruption) to 0 (absolute corruption).

The six countries are demographically mature or maturing. The population growth rates are relatively low: about 1.4% per year for the three largest countries, more for Bolivia and Paraguay, much less for Uruguay. They are also low-density countries: about

20 persons per square km for Brazil, Chile, and Uruguay, about 10 for the other three countries. In Europe, in Asia, and even in the USA, much higher densities are common.

They are highly urbanized countries. According to published statistics, which may exaggerate the true extent of urbanization, the share of total population living in urban areas is between 80 and 90% in Brazil, Argentina, Chile and Uruguay, although lower in Bolivia (62%) and *Paraguay* (57%). These are numbers commonly found in the developed countries of Europe, North America and Japan, but much higher than those found in Asia, Africa or the Middle East.

Except for Chile and Uruguay, these countries have a bad reputation in terms of governance. The Transparency International index of corruption stands at about 2 for Argentina, Bolivia, and Paraguay, which are ranked number 108, 122 and 140 out of about 145 countries. Brazil with 3.9 (ranked 59) does better, but only Chile with 7.4 (ranked 20) and Uruguay with 6.2 (ranked 28) do reasonably well.

With the exception of Chile, the Southern Cone countries have not done well economically in the past two decades. In the 1980ies, ignoring Chile, GDP growth rates ranged from -0.2% in Bolivia to 2.7% in Brazil, which implies very low or negative per capita income growth. The 1990ies were better, but only slightly better, in all countries except for Brazil and Uruguay. The variance of income or output levels per capita is large. In Brazil, Chile, Argentina and Uruguay, these levels are not low, relative to what can be found in most Asian or African or Middle Eastern countries. Bolivia and Paraguay, with output levels three or four times lower, are definitely low-income countries, although not very poor by Asian and African standards.

Most of these countries exhibit high levels of inequality. The Gini index for Brazil, Argentina, Chile and Paraguay has very high values (from 52 in Argentina to 59 for Brazil). In part, this reflects large geographical disparities. In part, it reflects socio-political structures. This inequality combined with average or low-income levels per capita produces significant pockets of absolute poverty in all countries (except for Uruguay, which offers a relatively high income and a relatively low inequality).

In most Southern cone countries, regional (i.e. sub-national) identities are strong. Geography, history, and institutions explain this. The three most populated countries (Brazil, Argentina, and Chile) are very large, with North-South dimensions of more than 5,000 km, which account for marked differences between regions. Bolivia is more compact, but geographical disparities between regions are equally very strong. Over the course of time, because of the high time and money costs of communications, the intensity of interrelationships between the various regions of a given country has not been high. These regions have historically therefore enjoyed a fair degree of economic autonomy. In Argentina and Brazil, this has been reflected and intensified by the federal nature of the countries. This feeling of regional identity is exemplified by what happens in the Bolivian parliament: members of parliament are regrouped (and vote) by political persuasion, but also by regional origin.

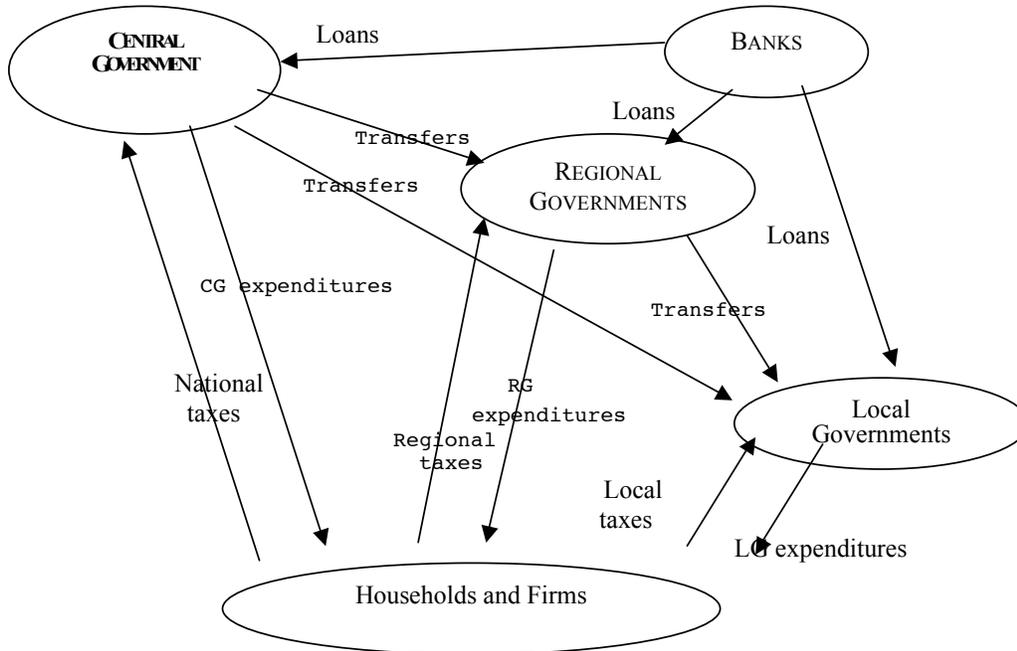
This mix of differences and similarities does not make it easy to describe and analyze the decentralization experience of these six countries. The problem is compounded by the existence of at least two levels of “sub national” governments: municipalities and regions. For nearly any generalization —transfers constitute the main source of sub-

national government income, for instance— it is possible to find a case (a country and a level of government) that will confirm the statement. But it would also be possible to find a case that contradicts the statement. The mere size of Brazil makes inter-country comparisons difficult. Brazil is 50 times the size of Uruguay in population terms (and 40 times in area terms). Clearly, decentralization issues in Brazil are markedly different from what they are in Uruguay. The concept of “intermediate level governments”, which means States in Brazil and Departamentos in Uruguay, is a misleading concept. Brazilian States (7 million people on average) and Uruguayan Departamentos (170,000 people on average) are completely different realities. Calling them with the same name and comparing their resources or their responsibilities is a futile exercise that cannot be very useful, and can even be dangerous. We believe that, for an analysis of decentralization, it makes more sense to compare Brazilian States to other South cone countries rather than to regional governments in these countries. The average population size of Brazilian States is 6.5 million inhabitants. This is about the median of the five other countries. Since we could not study in depth all Brazilian States, we selected one of them, Parana. With 9.6 million people, Parana is about the population size of Bolivia, larger than Paraguay and Uruguay, and smaller than Argentina and Chile.

Conceptual framework

Decentralization, as mentioned above, is about the devolution of power and money to sub-national governments. Because power and money are no simple concepts, decentralization is a multi-dimensional notion. To analyze decentralization in the six countries of our sample, we use a simplifying model that is represented in Figure 1. In this diagram, arrows represent money flows.

Figure 1 - A Simplified Model for the Analysis of Decentralization



Let us assume a country with three levels of government: central, regional and local. Households and enterprises pay taxes to each of the three levels. In addition, each level of government receives loans from the banking sector. Central government expenditures are of three types: transfers to regional and/or local governments, payments (interest and capital) to the banking sector, and expenditures on the production of goods and services benefiting households and enterprises (including direct transfers to households and enterprises). Regional and local governments expenditures are similar: they may include transfers to local governments, payments to the banking sector, and expenditures benefiting households and enterprises. In a given country, some of these money flows may not exist. The banking sector may be prohibited from lending to local governments, for instance. Or there may be no transfers “upwards”, from local to regional and central government, or from regional to central government. This case is so frequent that it is the one represented in Figure 1. There might also exist additional money flows. In some countries, for instance, foreign grants may constitute an additional source of revenues for any of the three levels of government.

Money flows are essential. However, what could be called “power flows” are equally important and in some cases even more important. Power flows refer to how the various governments are constituted (by election or by appointment) and to the various mandates or constraints imposed by a government upon another, usually by upper governments upon lower governments. They define the degree and the nature of autonomy of each level of government. For the sake of clarity, power flows are not represented in Figure 1. Understanding decentralization in a given country means understanding each of

the money and power flows just mentioned, and how they interact. This is what we tried to do for each of the six countries studied.

Agents of Decentralization

Table 2 shows the main agents of the decentralization game and their relative importance in population terms.

Table 2 – Sub-national Governments, Mercosur Countries

	Intermediate-level governments			Lower level (local) governments		
	Name	Number	Size ^(a) Million inhabitant	Name	Number	Size ^(a) Inhabitants
Brazil	Estado	27 ^(b)	6.5	Municipio	5,507	30,000
- Parana			7.0		392	24,000
Argentina	Provincia	24 ^(c)	1.6	Municipio	2,157	17,800
- W/o GBA		23	1.1		2,131	13,100
Chile	Región	15	1.1	Municipio	341	44,600
- W/o RMS					309	31,300
Bolivia ^(d)	Departamento	9	1.1	Municipio	311	28,900
Paraguay ^(e)	Departamento	17	0.3	Municipio	200	22,800
Uruguay	Intendencia	19	0.2			
W/o Montevideo		18	0.1			
Total Mercosur w/o Uruguay	Regional governments	101 92	1.2 1.1	Local governments	8,508	29,000 ^(f)

Notes:

^(a) The size numbers are averages, and give only a gross idea of the size of the various subnationals.

^(b) Twenty-six states (estados, singular - estado) and one federal district (distrito federal). The Federal District is an anomalous unit of the federation, as it is not organized the same manner as a municipality, does not possess the same autonomy as a state and is closely related to the central power. It is considered a single municipality, divided into the seat (Brasilia itself) and some urban districts called Satellite Cities. Satellites cities are created and governed directly by the governor of the federal district and possess no autonomy.

^(c) Twenty-three provinces (provincias), and one autonomous city (distrito federal).

^(d) In Bolivia, the area is called departamento and the government is called prefectura.

^(e) In Paraguay the area is called departamento and the elected authority gobernador.

^(f) Un-weighted averages.

The size numbers are averages, and give only a gross idea of the size of the various governments concerned. This is because, for any one category, the variance is very large. This is true in every country: the size of California is about 50 times that of Delaware. But it might, if possible, be truer in the Southern cone countries. For instance, in Argentina, Chile, or Uruguay, for intermediate-level governments, there is a very large unit, accounting for a good third of the country population (Buenos-Aires province in Argentina, Santiago region in Chile, and Montevideo prefecture in Uruguay), with many

much smaller units. The average size of intermediate level governments excluding the major one is therefore much smaller—nearly half as small— than suggested by Table 2. The same is true for lower-level governments, i.e. municipalities, except that the distribution of municipalities by size is smoother. They include a few large municipalities (the main cities), medium sized municipalities, and many small or very small rural municipalities.

The average size of regional and local governments does not vary much from country to country. Regional governments rule on average a little more than 1 million people—about 500,000 people if one excludes the major region. Some are smaller than that, particularly in Argentina and Chile. This justifies our treatment of Brazil: The average size of Brazilian States is 6.5 million people, six times larger than regional governments in the other Southern cone countries. Brazilian States and regional governments elsewhere do not play in the same league. The average size of local, or municipal, governments varies from 18,000 people in Argentina to 45,000 people in Chile, a relatively small difference. Municipalities throughout the Southern cone can therefore be compared in terms of functions, resources, responsibilities and organization. Brazilian municipalities are no exception: their average size is 32,000 people, slightly larger than the average size for Parana reported in Table 2 (24,000 people).

Uruguay, because of its small population size, is a special case. There is only one level of sub-national government: prefectures, which are hard to allocate in Table 2. With 200,000 people on average, (about 100,000 excluding Montevideo), they are too small to be classified as intermediate-level governments; but they are too large to be classified as local governments. Not without hesitation, we placed them in the intermediate-level governments' column.

To sum up, decentralization in the Southern cone countries means shifting power and money from the central governments to 27 States of (on average) 7 million people in Brazil, to 74 regions of (on average) almost 1 million people in other countries, and to 8,500 municipalities of (on average) 30,000 people. Each of these 8,600 governments comprises a council (a legislative body), a boss (an executive mayor or governor), and an administration. How they are designated is a first and basic indicator of the nature and degree of decentralization in a given country. Table 3 provides some information on this issue.

Table 3: Designation of Governing and Administrative Bodies in Subnational Governments

	Council	Boss	Administration (Politicization)
Brazil			
State	E (1986) 4/2	E(1986) 4/2	3
Municipalities	E (1986) 4/2	E (1986) 4/2	3
Argentina			
Province	E (1986) 4/∞	E (1986) 4/2	4
Municipalities	E (1989) 4/∞ ²	E (1989) 4/∞	4
Chile			
Regions	E (1992) 4	A (1975)	1
Municipalities	E (1993) 4/∞ ³	E (1993) 4/∞	2
Bolivia			
<i>Prefectures</i>	<i>E(1995)5/∞</i>	<i>E&A⁴(2005)5/?</i>	3
<i>Municipalities</i>	<i>E(1994)5/∞</i>	<i>E (1994)5/2</i>	5
Paraguay			
<i>Departamentos</i>	<i>E (1993) 5/∞</i>	<i>E (1993) 5/1</i>	4
<i>Municipalities</i>	<i>E (1991) 4/∞⁵</i>	<i>E (1991) 4/2</i>	4
Uruguay			
Departamentos	E(1986) 5/∞	E(1986) 5/1	3

Notes: E stands for elected and A for appointed. In the case of election, the year between parentheses is the year when the first election (in the recent past) took place; the first of the following numbers is the length (in years) of electoral mandates, and the second number is the maximum number of consecutive mandates authorized (thus 4/2 means that the mayor is elected for 4 years, and can be re-elected only once). The degree of politicization is the author's estimate on a scale of 1-5 of the number of political appointment in the administration (with 1 = very low and 5 = very high)

Three points stand out. First, most government officials in the legislative and in the executive (councilmen, mayors, governors) are elected. This is a major achievement of the 1970s and 1980s. In all countries, they are elected as members of national political parties. There is one exception to this rule: in Chile at the regional level, the governor is appointed by the central government. Since, the regional council is elected (albeit indirectly), there is the possibility of conflict. In practice, conflicts are avoided by giving regional council only an advisory role. It could therefore be argued that in Chile regional governments are not really autonomous governments, but merely administrative geographical subdivisions of the central government, or to put it otherwise that this is best described as deconcentration rather than decentralization. The Bolivian case was similar until 2006; since then, however, regional (departamental as they are called) executives are elected.

² *The largest thousand municipalities elect a council and a mayor (intendente). Smaller rural municipalities (communes) have no executive branch. Mayors are elected for four years and can be reelected several times. Councilpersons are also elected for four years, but every two years, half of the council seats are up for election. In Santa Fe province, mayors can only be re-elected once, i.e. can serve only two terms; the same is true for the mayor of Buenos Aires.*

³ *Called regidores in Chile*

⁴ *From 1995 on, prefects (prefectos) were appointed, in accordance to the Constitution and the Deconcentration Law (Ley de Descentralización Administrativa), by the President of the Republic. Since 2005 prefects are first elected and then appointed by the President of the Republic. The new Constitution should clarify this ambiguity.*

⁵ *From 1992 (first municipal election) until 1996, tenure for majors was five year. Since 2001, the electoral code was changed reducing the tenure to four years.*

Second, in all countries, mandates *fluctuate from four to five* years, and usually are not renewable more than once. This is in contrast with what can be found in many developed countries: in France, for example, municipal councils and mayors are elected for 6 years for an undefined number of mandates, and it is common to see a mayor remaining in office for 12 or even 18 years, as long as voters are satisfied with his/her action. The Latin American system has two drawbacks. The brevity of the mandate is an inducement to short-termism. Moreover, the impossibility of being re-elected eliminates a strong incentive to efficiency. This can be seen as an inducement to corruption. Being elected is seen by some (and by the general public) as having a few years to make money. On the other hand, the system makes it possible for a larger number of politicians to be in office.

Third, in all countries, except in Chile at the regional level, elected politicians appoint many administrators. A generalized spoils system is the rule. When a new team is voted in, all director of services, and many more people, are kicked out, and new officials—politically close to the winners—are appointed. This tends to discourage high quality professionals from joining sub-national administration. Long-term projects, requiring continuity and stability, are made more difficult to develop. Administrators do not benefit from experience. They are more politicians than technicians.

This has an impact upon political life at sub-national government level. Political battles can be very hot even when there are no serious personal financial issues at stake (as is the case in many developed countries where being elected might even be a luxury that only the well-off can afford). When election is also a matter of livelihood, political battles are likely to be fought even more violently.

Indicators of decentralization

Politically autonomous—that is elected— governments may be financially dependent or constrained. The transfers they receive may come with strings attached. Their borrowing capacity may be restricted. All these “details” matter very much in assessing decentralization in a given country, and will be subsequently discussed. Nevertheless, two ratios, or set of ratios, are indicative of the degree of decentralization in a given country: the relative importance of sub national expenditures, the relative importance of sub national taxes. All the other “details” constant, the greater these ratios, the more decentralized the country. These numbers are provided in Table 4. Because the importance of total taxes and expenditures relative to GDP varies from country to country, Table 4 also gives the ratios of sub national taxes and expenditures relative to GDP, to provide another (slightly) different perspective on the importance of decentralization.

The numbers given in Table 4 come from our own calculations. These numbers may be different from the numbers found in international publications (such as the IMF *Financial Yearbook*) or in national publications. Defining sub national expenditures and taxes is not as obvious and simple as it might seem. Consider wages of schoolteachers decided nationally but paid locally with a specific central government transfer: is this expenditure to be considered national or local? Or consider nationally decided taxes the proceeds of which are partly handed out to local governments: is such a local government resource a local tax or a transfer? The answers given to such questions vary from country to country, and are often more dictated by legal considerations than by economic reasoning. International compilations usually reflect national official choices. Their

comparability is therefore not guaranteed. Our numbers are not “better” than others. But they have two characteristics: they are based on “economic” definitions, and they are consistent. We consider as sub-national only those expenditures that imply a reasonable degree of decision and discretion of sub-national governments. Similarly, we define as sub-national only those taxes that imply some political commitment of sub-national governments. Shared taxes (co-participations) in particular are treated as transfers.

Table 4 – Main Indicators of Decentralization, Mercosur Countries, Recent Years

	SNG exp/ Total exp. (%)	SNG Taxes/ Total taxes (%)	SNG exp./ GDP (%)	SNG Taxes/ GDP (%)
Brazil: (2001)⁶				
State	38.5	34.1	15.6	13.0
Municipalities	19.8	6.3	7.8	2.4
Total	58.3	40.4	23.4	15.4
Argentina (2002)				
Provinces	40.0	22.7	11.6	5.6
Municipalities	7.3	5.3	2.3	1.3
Total	47.3	28.0	13.9	6.9
Chile (2002)				
Regions	1.2	-	0.3	-
Municipalities	16.1	8.2	3.9	2.0
Total	17.3	8.2	4.2	2.0
Bolivia (1999)				
Regions	7.2	1.2	2.4	0.3
Municipalities	10.8	2.8	3.7	0.7
Total	18.0	4.0	6.1	1.0
Paraguay (2004)⁷				
Departments	2.4	0	0.5	0
Municipalities	6.0	7.9	1.2	0.9
Total	8.4	7.9	1.7	0.9
Uruguay (1999)				
Regions	15.4	13.2	4.0	3.1
Total	15.4	13.2	4.0	3.1

Source: Authors' calculations (see following chapters). *Notes:* SNG = Sub National Governments. Regions in Chile and in Uruguay are only partly autonomous and could also be considered as deconcentrated branches of the central government. In Chile, expenditures of municipalities include, for about half the amount, expenditures on health and education that are executed by municipalities on behalf of the central government and could equally be considered as central government expenditures.

The most decentralized country is clearly *Brazil followed by Argentina*. If instead of considering Brazil we consider Brazilian States (on the premise that they are comparable in size and power to the other countries rather than to the regions of other countries), Brazil becomes one of the least decentralized counties of our sample.

⁶ *Source:* Ministerio da Fazenda . Does not include Central Bank operations or public enterprises. <http://www.tesouro.fazenda.gov.br/hp/downloads/ResGovGeral.xls>

⁷ From Jorge Vega Castro, “Descentralización y Desarrollo Local en Paraguay”, Preliminary report for IADB/REI/SOI, May 2004.

Expenditures of sub-national governments represent about 15-20% of total public expenditures (and 4-6% of GDP) in all countries, except Argentina where they are twice as large. Such an estimate is generous for Chile, because it treats the expenditures of regions and the expenditures of municipalities on health and education, as sub-national government expenditures, when they could arguably be treated as central government expenditures. It is also generous for Bolivia and Uruguay because it treats the expenditures of regions as sub-national rather than national.

Sub national government taxes are low everywhere (as a share of total taxes or of GDP). These taxes represent 4-6% of total taxes in Chile, Bolivia and Uruguay, twice that percentage in Argentina. The case of Brazil is more complex.: If the State (of Parana) is considered as a sub national government, sub national government taxes represent 33% of taxes paid in Brazil, at least in the State of Parana; if the State is not considered as a sub-national government, sub national government taxes are municipal taxes and they represent 5% of total taxes paid by households and enterprises. In any case, sub-national taxes are much lower than sub-national government expenditures. SNG raise on average less than one-third of the money they spend. The balance consists mostly of transfers from central governments.

It might be more meaningful to focus on decentralization at the lower, i.e. municipal, level. Most of the theoretical arguments for (or against) decentralization are developed with municipal governments in mind, even when they refer to the more general expression of “sub national governments”. Then —unlike intermediate level governments— municipalities in the six countries are comparable in size (30,000 people on average) and in autonomy (elected councils and mayors). Municipalities control about 10% of public expenditures representing about 3% of GDP; and they raise about 4% of total taxes or a little more than 1% of GDP. These numbers vary from country to country. They are higher in Chile (at least when health and education expenditures are counted as municipal expenditures) and in Brazil, lower in Bolivia and Argentina. If Uruguayan *departamentos* were treated as municipalities (this is not our preferred option, but it is arguable), Uruguay would also appear as one of the Mercosur country most decentralized at the municipal level.

III - Local Public Finance in Mercosur Countries: A Summary

The combined expenditures of sub-national governments in the six Southern cone countries are huge. Table 5 provides an estimate of such expenditures. To understand what decentralization is in reality, it is important to get an idea of what such expenditures are, and of how they are financed.

Table 5 – Expenditures of Sub National Governments in Mercosur Countries, 2003

	Regional Gov. (G US\$)	Local Gov. (G US\$)	SNG (G US\$)
Brazil	74.70	37.6	112.1
Argentina	16.20	3.2	19.4
Chile	0.20	2.7	2.9
Bolivia	0.20	0.3	0.5
<i>Paraguay</i>	<i>0.03</i>	<i>0.1</i>	<i>0.1</i>
Uruguay	0.50	-	0.5
Total	92.13	44.9	135.5
Total excl. Brazilian States	17.13	6.3	23.4

Sources & notes: Percentages presented in Table 4 have been applied to the GDP of each country in 2003 given in the 2005 *World Development Report*. G (giga) stands for billion (10⁹)

Expenditures

The standard question: “what are the functions allocated to the various levels of government?” has no simple answer. For a given level of government, it varies from country to country. Then, in many cases, it is only loosely defined. In most countries, accounting categories are such that it is not possible to know how much is spent on each of the various functions (health, water, welfare, etc.): the only expenditure breakdown available is by nature (wages, other current expenditures, investments, etc.). This vagueness is probably indicative of the limited interest given to the public services actually offered by sub-national governments. Table 6 is an effort to indicate which functions are allocated to which level of government in Mercosur countries.

Table 6:
Assignment of Functions by Level of Government, Mercosur Countries

	Cleanliness	Water	Transport	Welfare	Education	Health
Brazil:						
Federation	-	-	X	X	X	X
States	-	X	X	X	X	X
Municipalities	-	X	X	x	X	X
Argentina:						
Federation	-	X	X	X	X	X
Provinces	-	X	X	x	X	X
Municipalities	X	-	-	x	x	x
Chile:						
Central gov.	-	X	X	X	X	X
Regions	-	X	X	-	-	-
Municipalities	X	-	-	-	X	X
Bolivia:						
Central gov.	-	X	X	X	X	X
Prefecturas	-	X	X	X	x	x
Municipalities	X	x	x	x	x	x
Paraguay						
Central gov.	-	X	X	X	X	X
Departamentos	-	x	x	-	x	x
Municipalities	X	x	x	x	x	x
Uruguay:						
Central gov.	-	X	X	X	X	X
Departamentos	X	-	x	-	x	x

Source: Authors fieldwork

Note: X means major involvement; x stands for minor involvement; and – denotes no involvement.

Table 6 shows that for most functions, (except for “cleanliness” —refuse collection and disposal, street lighting, street cleaning— which is the responsibility of municipalities only) several levels of governments are involved. This happens for three reasons. First, our functional categories are rather broad: transportation may be a shared responsibility because different kinds of roads are built and/or managed by different levels of governments. Second, in many cases, the same service is provided jointly by several governments. In Bolivia, for instance, school buildings are provided and maintained by municipalities (often with international financing) whereas wages are paid by the central government, through the regional semi-governments. In Chile, health and education are entirely financed by the central government, which gives the money to municipalities that actually disburses it. Amounts disbursed by the various levels of governments do not give a meaningful picture of the relative importance of each level. Third, in yet other cases, a given level (usually the central or regional level) is formally responsible for a given service, but other levels (usually municipalities), unsatisfied with the quality provided, find it appropriate to “complement” the service. In Uruguay, for instance, although health is basically provided by the central government, some municipalities do not hesitate to

finance additional nurses and doctors. Regulations and bylaws are generally vague enough to make this legal.

Sub-national government taxes

As mentioned above, sub-national government taxes are a relatively small share of GDP and of total taxes in Mercosur countries. They are a more variable share of sub-national government resources, as shown in Table 7. They range from a low 0% for regional governments in Chile (which are not genuine governments) or 6% for regional governments in Bolivia (which are only beginning to be genuine governments) to a high 74% for Brazilian States and even 84% for Uruguayan Departments.

Table 7 - Taxes as a Share of Resources, Sub-national Governments, Mercosur Countries, Recent Years

Government:	Regional	Municipal	Sub-national
Brazil (2002)	74%	15%	49%
Argentina (2002)	48%	48%	48%
Chile (2002)	0%	51% (0%)	47% (0%)
Bolivia (1999)	6% (0%)	20% (0%)	12% (0%)
<i>Paraguay (2004)</i>	<i>0%</i>	<i>71%</i>	<i>51% (0%)</i>
Uruguay (1999)	84% (42%)	-	84% (42%)

Source and notes: Author's calculations. The numbers between parentheses and in italics are obtained by considering that taxes the rate of which is not decided by receiving SNG are not SNG taxes.

These estimates are generous; because of the way they treat taxes the rate of which is decided by the central government. They define them as regional or local taxes. One could certainly define such taxes as national, and the money they provide as mere transfers. With such taxes, sub-national governments have no fiscal autonomy. They remain passive. The political link between taxes and expenditures does not exist. This concerns all municipal taxes in Chile and Bolivia and about half departments taxes in Uruguay. The true share of taxes to resources could therefore be reduced, to the levels that appear between parentheses in Table 7. This view would imply that there are no sub-national government taxes in Chile and Bolivia.

Such a view might be somewhat excessive. These taxes are assessed and collected by sub-national governments. Even though these governments have no freedom in rate setting, they do have some autonomy in tax assessment and collection. They can in practice increase or decrease the taxes paid by households and enterprises, by pursuing taxpayers with a varying degree of effectiveness.

In a country like France, tax assessment and collection is delegated by municipalities and other sub-national governments to the central government ministry of Finance; that performs it (for a fee) in a uniform and fair fashion. It does not diminish the fiscal autonomy of sub-national governments. Autonomy in assessment and collection is certainly a poor substitute of autonomy in rate setting. It invites corruption and favoritism. The degree of effectiveness may vary according to taxpayer and not merely to jurisdiction. Some might even be tempted to think that this is one of the reasons why so much

importance is attached to assessment and collection at sub-national levels in some Mercosur countries.

The share of taxes in the resources of sub-national governments therefore has, so to say, a quantitative dimension. It may not be as high as indicated by the plain numbers in Table 7, but is not as low as suggested by the numbers in italics and in parentheses in the same Table.

Local and regional taxes in Mercosur countries are mostly of four types: property taxes, vehicle taxes, business taxes and sales taxes. Table 8 offers estimates of the relative importance of these types of taxes.

Table 8 Sub-national Government Taxes by Type, Mercosur Countries Recent Years

Taxes on:	(In percentage of total SNG taxes)				
	Property	Vehicles	Sales	Business	Other
Brazil (Parana) 2002					
State	-	6	89	-	5
Municipalities	34	-	-	41	25
Argentina, 2002:					
Provinces					
Municipalities					
Chile, 2002:					
Regions	-	-	-	-	-
Municipalities	30	-	27	42	-
Bolivia, 1999:					
Regions	-	-	-	-	-
Municipalities	51	13	-	7	29
<i>Paraguay (2004)</i>					
<i>...Regions</i>	<i>15</i>		<i>15</i>	<i>-</i>	<i>10⁸</i>
<i>...Municipalities</i>	<i>85</i>	<i>75</i>	<i>-</i>	<i>75</i>	<i>40</i>
Uruguay 1999:					
Departamentos	46	51	-	-	3

Source: Author's compilation

At the municipal level, the property tax is everywhere a pillar of local taxation. This is a desirable feature. The property tax is one of the best possible local taxes, although it is also one of the most difficult to assess and collect. Automobile taxes (a form of property tax) are very important in Uruguay, and significant in Bolivian municipalities and Brazilian States. Taxes on the sales of goods and services are the main tax resource of Brazilian States, and (in a different form) important for Bolivian municipalities. Taxes on business activities are important at the municipal level in Brazil and Bolivia.

Transfers

Transfers from upper levels of government are in most cases the most important financial resource of sub-national governments in Mercosur countries. This, by the way, is

⁸ According to law 40% of royalties and other income paid by the hydroelectric mega projects (Itaipú and Yacyretá) should go to municipalities and 10% goes to the Regions by 2010.

also the case in most European countries (although not in the US, which is the exception rather than the rule). Thus, decentralization in practice is not the joint decentralization of taxes and responsibilities to lower levels of governments described and discussed in decentralization textbooks. It is instead the devolution of responsibilities to lower levels of government accompanied by transfers from higher levels. Central governments are expected to raise the money, and SNG to spend it. Understanding the rules that govern transfers (their magnitude, their allocation, the strings that come or do not come with them, etc.) is key to understanding the realities of decentralization in a given country. Table 8 provides a rough picture of the main transfer flows in Mercosur countries.

Table 9 – Intergovernmental Transfers in Mercosur Countries, An Overview, Recent Years

criteria	% GDP	Name	Allocation
Brazil (Parana) 2002:			
CG to State	2.35	FPE; % salario educacao	?
CG to municip.	2.45	FPM	City size
State to municip.	2.14	Shared taxes	Source, other
Argentina 2002:			
CG to provinces	4.75		
CG to municip.	0.16		
Provinces to municip.	0.85	Coparticipación	P, A, B, needs
Chile 2002:			
CG to regions	0.40	Investment subsidies	Needs
CG to municip.	1.80	Health & educ. subsidies	Needs
Regions to municip.		Ad hoc invt subsidies	Needs
(municip to municip) (povert)	0.70	Fondo Comun municipal	P, B, needs
Bolivia 1999:			
CG to regions	1.2	Coparticipación; regalías	P, source
CG to municip.	2.6	Coparticipación	P only
Funds to regions	1.2	Cofinanciamiento	« Needs »
Funds to municip.	0.7	Cofinanciamiento	« Needs »
<i>Paraguay (2004)</i>			
<i>CG to Departamentos</i> source	<i>0.5</i>	<i>Royalties Electricity</i>	<i>P & others,</i>
<i>CG to Municipalities</i>	<i>-</i>		
<i>Municipalities to Dptos</i>	<i>0.02</i>	<i>Shared property tax</i>	<i>Source</i>
Uruguay 1999:			
CG to departamentos	0.6	Taxes compartidos	P. Size

Sources and notes: Author's compilation. CG = Central Government. FPE = Fundo de Participacao do Estado. FPM = Fundo de Participacao Municipal; P = Population; A = Area; B = Tax base

Tables 8 show that transfers to sub-national governments represent between 2% and 7% of GDP in Mercosur countries (except in Uruguay). This is much more than sub-national governments taxes. Each country —indeed each transfer— has its own characteristics.

The specificity of Bolivia, for instance, is —or rather was, because things are changing rapidly in this country) the importance of the “Funds”, largely financed by foreign aid, that allocate money to investment projects of regions and municipalities, provided these governments also pay part of the bill, i.e. co-finance the projects. An interesting and sophisticated method had been developed in order to simultaneously take into account the legitimate wishes and preferences of sub-national governments (in terms of sectors) and the equally legitimate wishes of the Funds and of the donor countries. The

co-financing rate reflects the preferences of the Funds; the Funds might co-finance education at 70% (if education is their top priority) and health at 50% (if they give less importance to health). Municipalities are then faced with a set of “prices” that they take into account when asking for co-financing. Actually, the system is more complicated than suggested by this description. The set of prices offered varies not only by types of projects, but also by types of municipalities. If the 70% and 50% just mentioned apply to “poor” municipalities, rich municipalities might be offered 40% for education and 30% for health.

Chile has two specificities. One is its *Fondo Común Municipal* (Common Municipal Fund) or FCM. This is an intermunicipal redistributive mechanism. All municipalities contribute to the FCM a share of their property and vehicles taxes, and four richer municipalities a share of their business tax. Then all municipalities receive a transfer based on a complicated formula that includes the level of per capita tax resources, two indicators of poverty (one is the relative number of properties exempted from property tax), population, and an equal amount per municipality. In the end, 51 municipalities are net providers to the FCM and 290 are net receivers. The FCM does contribute to horizontal equalization, although this equalization is far from perfect.

The other Chilean specificity is that transfers are not automatically determined and allocated. Investment subsidies to regions are decided each year by the central government ministries according to their perception of the needs of the various regions (although there is a clear policy to favor “extreme zones” of the North and South of the country). Transfers to municipalities are earmarked for health and education, and decided by the central government as part of its health and education policy. Indeed, municipalities are mere “agents” of the central government in the use of these subsidies.

Transfer systems, therefore, vary substantially. Three important features, however, are to be found in many cases.

The first one is that, for a given transfer, the total amount is usually defined as a share of the tax resources of the giving government. This is called “*co-participación*” (and *Taxs compartidos* in Uruguay). The “tax resources” which are the basis for *co-participación* can include all tax resources, several taxes, or just one tax. The percentage that is applied to determine the total amount of the transfer is a key number, that cannot be changed annually, and is even enshrined in the Constitution in Brazil.

The second is that in most cases the allocation of this total amount of transfer to the various municipalities or regions is done by formula, not in a discretionary fashion. The criteria used in the formulas are often very crude and unsophisticated. They often include population (implying an equal amount of transfer per capita, which is not unfair), area, needs, source (that is the amount of national tax resources collected in the region or municipality, a much more unfair criteria), and (the inverse of) per capita tax resources of each receiving municipality.

The third is that most of the transfers studied are in the form of block grants. They come without strings attached, and sub-national governments can do what they please with the money received. There are exceptions to that rule: most of the Chilean transfers, transfers from the Bolivian Funds, investment subsidies in Uruguay, are specific transfers, with very limited expenditure autonomy left to the receiving sub-national governments.

What do transfers achieve in Mercosur countries? Transfers have in theory two justifications, or purposes: to reduce the so-called vertical and horizontal gaps between sub-national governments. The “vertical gap” refers to the simple idea that it is more desirable to decentralize expenditures than taxes. Most (not all) expenditures can fruitfully be decentralized. Not many taxes can. Hence a gap. Transfers in Mercosur countries certainly go a long way to fill or reduce that gap. A substantial share of central government taxes—some 15 to 20%—is handed over to sub-national governments.

The “horizontal gap” refers to the disparities that exist everywhere between the various municipalities or regions of a given country. Whatever local tax bases (be they on property, on income, on activity, on consumption, etc.) they are unequally distributed. There will always be tax-base rich and tax-base poor municipalities. The expenditures “needs” of the various municipalities or regions can also differ. If municipalities and regions were to compete with only their own tax resources, this would be a very unfair—and inefficient—competition. Tax-base rich municipalities could offer lower tax rates or/and better public services, thus attracting more people and activity, therefore enlarging their tax bases. This cumulative process would aggravate further the horizontal gap between municipalities or regions. A major role of transfers is to counter-balance this unacceptable potential consequence of decentralization. It is to give more to jurisdictions that have low tax bases, and also high needs. How do Mercosur transfer systems fare in this respect?

Not too well. They do reduce tax base disparities. Practically all transfer systems do. Consider a country with two regions of similar population: region Poor with a tax capacity (tax base multiplied by an average tax rate) of 100, and region Rich with a tax capacity of 300. The ratio of tax capacity is 3 to 1. Assume a simplistic transfer of 100 to each. The resources of Poor become 200, the resources of Rich become 400. The ratio of resources is now 2 to 1. This simplistic transfer has substantially reduced the horizontal gap. We tried to find out whether the complex yet crude formulas utilized to allocate transfer money achieved more. In many cases, they do not.

In Uruguay, transfers per capita appear uncorrelated to tax bases per capita. In Bolivia, the allocation of royalties (*regalias*) to regions is source-based. The royalties decided and collected by the central government on mining, oil and gas, are to a large extent, particularly for the increases decided in 2005, returned to the region where these natural resources are located. The main winner at this lottery is the Santa Cruz region, which happens to be the richest of Bolivian region. The allocation is so random and unfair that a Compensation Fund (financed by the central government budget) has been created to correct—but not eliminate—this unfairness. In Parana, a regression analysis of transfers received by municipalities suggests that per capita transfers increase with GDP per capita (a proxy for tax base), decrease with city size, and decrease with tax effort. To maximize transfers, a municipality must be small, rich, and do not raise much in local taxes. In Argentina, transfers from provinces to municipalities (accounting for the bulk of transfers received by municipalities) are largely determined by transfers received by provinces per capita; differences in these transfers, which are enormous, are therefore translated into differences in transfers received by municipalities. Even if provincial allocation formulae were redistributive between the municipalities of each region (a big “if”), this would produce an unfair allocation between municipalities at the national level. Consider two municipalities will identical tax bases. The first is located in a province that receives massive per capita transfers from the center. The second is located in a province that does

not receive such massive transfers. The first municipality will receive much more in provincial transfers than the second. This differential treatment of equals is a definition of unfairness.

Borrowing

Borrowing by subnational governments in Mercosur countries is difficult to summarize because its scope, conditions, importance, mechanisms, etc. varies greatly from country to country —more so than in the case of transfers or taxation. There is no single pattern, and for every statement, there are important exceptions. Four points can nevertheless be made.

Poorly known — The first is that subnational borrowing is often poorly known. The exception would be Brazil, or rather Parana, where Paranacidade, a State entity monitors very effectively the loans it makes to municipalities. In general, important loans, particularly international loans, are properly recorded. But small loans made by commercial banks are not. It is not easy to distinguish between long-term loans and constantly renewed short-term loans. It is even more difficult to identify arrears in payment to suppliers or to social security institutions which are often a major form of indebtedness. Even in Parana, these forms of *de facto* local borrowing are poorly known. In Bolivia, the central government had to ask private consulting firms to make surveys of local governments indebtedness.

Generally minor — Inasmuch as we can tell without hard numbers, subnational borrowing in Mercosur does not seem to be very large —with the exception of Argentina. Loans do not seem to be a major share of total resources, even in gross terms. Total indebtedness relative to public resources does not appear to be an unmanageable ratio, and is generally much lower than the similar ratio for the central government. Consequently, debt service does not seem to be a major share of current expenditures.

Dominated by commercial banks — In Mercosur countries, subnational governments borrow mostly from commercial banks, not on the bond market, and not much from specialized banks or funds. There is practically no bond markets for municipalities or regions. This much talked about instrument, supposed to introduce responsibility in subnational government borrowing (with ineffective governments getting low ratings by independent rating agencies, thereby facing higher borrowing rates, and reducing their borrowing) simply does not operate in Mercosur countries. In Parana, as mentioned, and also in Bolivia, there are specialized public Agencies or Funds that make loans to municipalities or regions, with national or international capital, but not in other countries.

Imperfect control mechanisms — None of the three standard mechanisms used to control subnational government borrowing seems to function in Mercosur countries. One is the bond market discipline mentioned above, which is absent in these countries. A second consists of strict, a priori, authorizations given by a central government office, usually the ministry of Finance, which is also absent, with the possible exception of Brazil. A third mechanism would be to let subnational governments go bankrupt when they are no longer performing on their loans. This has not happened. On the contrary, bailing them out has been the rule rather than the exception.

IV - Decentralization in Mercosur Countries: A Tentative Assessment

As we have seen, decentralization has taken many different forms and characteristics in the various Mercosur countries. This makes generalizations difficult and dangerous. Nevertheless, several points can tentatively be made.

A politically motivated movement

The first point is that the changes in favor of decentralization that have taken place in Mercosur countries have been politically motivated. They have not been introduced to improve the efficiency of the public sector and the welfare of citizens, contrary to what economic textbooks suggest. They may, or they may not, contribute to these economic goals (as discussed above), but this is not their primary motivation and achievement.

Decentralization has essentially been a way to create or develop a new class of politicians. Whether this has been the main goal is debatable. However, it has certainly been the outcome. In highly centralized countries, like Bolivia in the 1970ies, or even Brazil at the time of dictatorship, political power—and the socio-economic benefits that come with it— was concentrated in the hands of a limited number of people, whether elected or (in the case of dictatorships) appointed. How numerous were the people who derived directly and predominantly their income from political activities (members of parliament, ministers and their aides, heads of ministerial departments, appointed governors and mayors, appointed heads of public enterprises, etc. —people who would lose their job in case of a major political change)? We have no solid numbers to offer, but our guess is that in each country there were no more than 2-4,000 such people, and that the number was relatively independent of the size of the country. This would mean some 20,000 politicians for the six Mercosur countries.

Decentralization has created an entire class of people whose income depends upon the outcome of decentralized elections. Assuming an average of 15 elected people per council, and an average of 40 political appointees per government, this accounts for 150,000 people in Mercosur countries.

This carries great political benefits. It reduces the distance between citizens and politicians. It promotes political discussion and debate. Where there are strong regional or local feelings of specificity, it makes it possible for the people to feel better represented and integrated in the life of their country. It encourages political pluralism. A politician who is ousted at one level of government may well come back at another level. The pool from which national politicians are selected is enlarged. It functions like an imperfect, yet valuable, insurance policy against the return of totalitarian systems.

All this comes at a cost. The wages of elected politicians are generally voted by themselves. In Mercosur countries, it is considered that central government intervention in this matter would run counter to the spirit of decentralization or in certain countries (Argentina) be unconstitutional. Such a view is not universal: in France, for instance, the salaries of elected sub-national government councils members and of mayors are set by a central government decree, as a function of the size of the local government; and they are rather low: council members, for instance, are not supposed to be working full-time and are paid accordingly. In our six countries, some of the councils cannot resist the temptation of voting for themselves high salaries. The case of the members of the high chamber of a

small and particularly poor Argentinean province who paid themselves 200,000 pesos per year (at the time when 1 peso was worth 1 US\$) may be an extreme case, but it illustrates the dangers of the system. Assuming an average income of US\$ 30,000 per year per politician and political appointee, this would put the bill at US\$ 15 billion per year for the six countries.

Questionable Efficiency of Decentralized Governments

The economic justification of decentralization in Mercosur countries, defined as the strengthening of some 8,400 municipalities and regions, is that local public services are now delivered more efficiently, relative to how efficiently they were delivered in the previously more centralized system. Is it the case? Are households and enterprises getting better, or cheaper, or more adequate services? Is welfare and economic development increased as a result of decentralization? There are some reasons to doubt it, although the lack of good indicators of “efficiency” makes it difficult to answer rigorously the question.

A first point is that there is no positive relationship between degree of decentralization and socio-economic performance in Mercosur countries. Admittedly, our sample is small, and our measures of the variables are fragile, and “other things” are difficult to control. Nevertheless, it is noteworthy that the least decentralized country, Chile, is also the fastest developing country, whereas the most decentralized, Argentina, is (or has been for many years) also the least developing one.

A second point is that incentives to efficiency (in the decentralized governments of Mercosur countries) are often weak or blunted. Certainly, the standard incentives of decentralization theory are largely absent. Sub national governments, it is argued, will compare the political benefit of an additional peso of expenditures with the political cost of an additional peso of taxes, and select the level and mix of taxes and of services that best suits their voters (thereby improving allocative efficiency). It is hard to see anything of this taking place in Mercosur countries. In most cases, decentralized governments have little or no control over the level of taxation: they just cannot increase it or decrease it to any optimal level (assuming there is anything like that). Then, the theory assumes implicitly that expenditures are financed out of local taxes: in most cases, they are primarily financed out of transfers. In yet other cases, expenditures are mandated or constrained by upper levels of government; the clearest example is health and education expenditures in Chile, which are done by municipalities with earmarked transfers and specific directives from the central government. In short, efficiency implies autonomy; and autonomy (that is economic and financial autonomy) is usually limited.

The theoretical model also implies an effective election feedback mechanism, which is not always present. The citizens-taxpayers, it is claimed, will vote in the team that will give them what they want, and vote it out if it does not perform. Having election is a necessary condition (which is met in Mercosur countries), but it is not a sufficient condition. For a local election to influence local service outcomes, the elected must be held accountable. The main determinants of accountability are probably information and re-election. Both are weak in Mercosur countries. Information on how and to what purpose public money has been spent at the sub-national level is scarce and poor. When available, it is usually more legalistic than economic. Having tried to find such information in dozens of cases, the authors can testify that it is not easy. It is not reasonable to expect that the electorate is fully informed, even if it is true that citizens can see the results —or the lack

of results. Then, in many cases, re-election is not a possibility. The fear of not being re-elected, one of the most powerful incentives to efficiency, is often absent. All this is reflected in the often low-opinion in which local—as well as national—politicians are held by the citizenry. They are all too often considered corrupt and inefficient.

A third point is that the administrative capacity of decentralized governments is often weak. Even if (or when) elected politicians genuinely want to pursue a program that meets the wishes of their electorate, it is not sure that their administration will be able to deliver. Local administrations are often under-staffed, under-paid, under-skilled, under-equipped, under-trained. The systematic politicization of the management (and below in some cases) weakens it further. It sends the message that one cannot make a career based on competence and dedication in sub-national administrations. This is not the best way to attract talented professionals, even though there are, obviously, exceptions.

Admittedly, these points are not evidences of inefficiency, and even less of relative inefficiency (relative to central government efficiency). The record of central government delivery was in many cases not particularly bright. Decentralized government, particularly municipal government, has at least two definite advantages: it is closer to the people, and better informed of their needs and problems; it is closer to the solutions and can more easily tailor them to local potentialities. Whether these advantages outweigh the disadvantages mentioned above is a matter of debate. However, the discussion of these disadvantages is useful. It suggests that the common view that more decentralization systematically equals more welfare and more economic development is at best naïve and questionable.

Decentralization at the Wrong Level?

Decentralization can take place at the municipal or/and at the regional level. Our view is that municipal decentralization is much more desirable and necessary than regional decentralization, because there is often over-decentralization at the regional level and under-decentralization at the municipal level. The present picture in this respect is varied. Argentina is highly decentralized at the regional (provincial) level, but highly centralized at the municipal level. In both Chile and Bolivia, there is decentralization at the municipal level (more so in Bolivia than in Chile) and little decentralization at the regional level; but there is a very strong, and politically difficult to resist, pressure to decentralize further at that level in both countries, particularly in Bolivia. In Uruguay, a rather small country, there is decentralization at just one level, which is more regional than municipal. In Brazil, if one considers that Brazilian States are more comparable to the other Mercosur countries than to their regions (as we argued should be done), there is only decentralization at the municipal level, since there is nothing between a State government and municipal governments. The Brazilian model seems more efficient.

The reason for this contention is that Mercosur countries are by now highly urbanized. As mentioned above, the share of people living in urban areas is between 80% and 90% in Brazil, Argentina, Chile and Uruguay, although lower in Bolivia and Paraguay. What counts for people's welfare and economic development is what happens in these cities, much more than what happens in inter-cities areas.

This has not always been the case. In earlier times, when Mercosur countries were predominantly agricultural and rural, the economic reality was the region or the province.

There were cities, as administrative and commercial centers, but it was the region that made the city. Then, public services had to be designed and provided primarily for the benefit of the region. In addition, communication with the capital city of the country was slow and costly. There was a strong justification for the existence of regional governments.

No longer. Now, it is not the region that makes the city, it is the city that makes the region. This is obvious in economic terms, with most of the regional GDP originating in cities. This is even true in population terms. In many regions in Chile, Argentina, and Uruguay, the population of the main city (or main 2 or 3 cities) accounts for more than 80% of the region's population.

In such cases, having a regional government taking care of the local needs of 100 people next to one or two municipal governments taking care of the local needs of 80 of these people is an obvious duplication, involving unnecessary costs and conflicts. In addition, the more important of the two types of government is the city one—which can, as a first approximation, be taken to be the municipal level. In many cases, less decentralization at the regional level, and more decentralization at the municipal level, would probably be an improvement. The shift that has taken place in economic geography terms should be reflected in decentralization terms.

The Lack of Metropolitan Institutions

One can and should go one step further. What is missing from the present decentralization picture is the metropolitan dimension. Cities have become essential to economic production and development. The output of a country is now largely the sum of the output of its cities; it is, and will be, more and more so. Table 9 provides estimates of the economic importance of the largest cities in Mercosur countries.

**Table 9 – Relative Importance of the Largest Mercosur Agglomerations,
Recent Years**

	Pop. (in M)	GDP/Country GDP (in %)
Sao Paulo (Sao Paulo)	16.7	30%
Rio (Rio)	10.5	
Belo Horizonte (Minas)	3.8	
Curitiba (Parana)	2.3	
Buenos Aires (Argentina)	11.5	45%
Santiago (Chile)	6.1	59%
<i>La Paz-El Alto (Bolivia)</i>	<i>1.7</i>	
<i>Asuncion (Paraguay)</i>	<i>1.5</i>	<i>(Population) 30%</i>
Montevideo (Uruguay)	1.8	66%

Cities, particularly large cities, must be managed efficiently. Productivity (output per worker, but also per unit of capital) is higher in cities than in rural areas, and it tends to increase with city size. Large cities are the engines of economic growth. However, they are only potentially so. To reap the benefits of size, they have to be reasonably well managed, with an effective labor market, good urban planning, an efficient transport system, a well functioning housing market, cost-effective urban public services, etc. A simple econometric model links the productivity of an agglomeration to the “effective size” of its labor market (defined as the average number of jobs that can be reached by workers in less than n minutes, for instance in less than 60 minutes). It further relates this “effective size” to three factors: the potential size of the labor market (the total number of jobs in the area), the prevailing sprawl (the average distance of all jobs to all homes), and the average speed at which people move from their home to their jobs. This suggests that effective land use policies and transport policies are key to the productivity of a city.

Such policies cannot be provided by market forces only (which does not mean that market mechanisms cannot and should not play a key role) but require the intervention of some government. In addition, these policies only make sense for the agglomeration as a whole. Unfortunately, most of the large agglomerations in Mercosur countries comprise several or many municipalities, as illustrated in Table 10.

Table 10.

Municipal Fragmentation in Mercosur Countries, Selected Agglomerations

	Number of municipalities
Sao Paulo	38
Rio de Janeiro	18
Belo Horizonte	23
Curitiba	23
Buenos Aires	26
Cordoba	2
Rosario	
Santiago	32
Valparaiso	3
Concepción	
La Paz-El Alto	2
Asunción	7
Montevideo	2

In an article on Sao Paulo, *The Economist* (January 29, 2005) explains many of the problems of the agglomeration by this fragmentation, and laments that “Brazil’s federal system does not provide for metropolitan government”. Yet, the case of Sao Paulo is far from being the worst. The city of Sao Paulo, with 10.7 M. inhabitants represents a large (64%) share of the agglomeration population. And the State of Sao Paulo has been active in making plans for the physical development or the transport system of the agglomeration, or metropolitan region as it is called.

The case of Buenos-Aires, for instance, is much worst. The agglomeration consists of a city of 2.7 million people, which has the rank of a province, surrounded by 25 municipalities (home of 9.1 million people) that are part of another province, the Buenos Aires province. There is no institution in charge of or able to operate and develop the agglomeration. It cannot be done by the city of Buenos Aires (too small, and not allowed to interfere in another province’s business), nor by the 25 other municipalities (too poor, and hardly allowed to get together), nor by the province of Buenos Aires (more interested in the more rural parts of the province), nor by the Federal government (not empowered to do so, and hard-pressed by other tasks). In the end, there is nobody in the Buenos Aires plane. This absence of metropolitan leadership and of metropolitan policies leads to inefficiencies. Greater Buenos Aires is far from being as efficient an urban area as it should and could be. A number of basic urban public services (in land use control, transport, water and sanitation) seem to be inadequately provided in the area for lack of metropolitan planning and policies.

Mutatis mutandis, similar problems can be found in many, if not most, agglomerations in the Mercosur zone. This is the case for other Argentinean agglomerations, particularly those that include municipalities belonging to two provinces, such as Corrientes-Resistencia or Santa Fe-Parana. This is the case of all Brazilian “metropolitan regions”. This is the case of Santiago agglomeration, where the municipality of Santiago (400,000 inhabitants) is only one, and not even the largest, of 32 municipalities⁹. Note that a small number of municipalities in an agglomeration, as in

⁹ Greater Santiago is a conurbation extending throughout 37 municipalities. The majority of Santiago lies within the same named province, with some peripheral areas contained in the provinces of Talagante, Maipo and Cordillera. The province of Santiago is divided into 32 municipalities (*comunas* in Spanish). Some of the important municipalities are: Santiago Centro, Las Condes, Providencia, Maipú, La Florida and Ñuñoa.

Valparaiso or Montevideo, do not guarantee joint action. Non-cooperative behavior is as frequent, or more frequent, with 2 or 3 players than with 25 players.

In short, decentralization in Mercosur countries has completely ignored a major socio-economic change: the development of multi-communal agglomerations. None of the two levels of government that have benefited from decentralization is equipped to provide urban public services at the agglomeration level.

V - Decentralization in Mercosur Countries: Policy Implications

Decentralization in Mercosur countries has not been the panacea expected or even described by some. But decentralization is there to stay. The political benefits it produces, as well as the interest of the “decentralization class” it has created, makes this certain. The problem therefore is not to expand or to restrain decentralization, but rather to improve it. It is not to have more or less decentralization, but to have a better one. The foregoing analysis and evaluation suggest some policy recommendations in this spirit. They are offered with caution. The variations in conditions and in decentralization in the Mercosur countries, as well as differences in political constraints, are such that the very idea of a single blueprint for action would be futile. We have about a dozen of such recommendations.

Strengthen local rather than regional governments

In many cases, particularly in the smaller countries, efficient local governments coupled with an efficient central government would be sufficient for an efficient administration of the entire country. This is what we find in Brazil, if we consider Brazilian States as central governments—which is what they are in relation to most other Mercosur central governments. In Parana, there is nothing between the State and the 400 municipalities, and nobody feels that there is a missing level of government.

This statement is justified by the economic and demographic geography of the countries concerned, which has changed drastically over the past century. Nowadays, most of the people live in cities, and urban activities are the core economic activities of the country. Urban areas, not regions, need to be managed. Then, introducing an intermediate level of government means paying for the administrative costs of any government, and finding out an appropriate set of taxes to allocate to that government.

In Chile, *Paraguay* and Bolivia, the transformation of regional administrative units of the central government into full-fledged regional government, is hard to justify—even though there are very strong, probably irresistible, political pressures to do so. In Argentina, the power of provinces is so great that it would be ridiculous to advocate their elimination. Yet, the idea that future changes should favor the weak municipalities, possibly at the expense of the rich provinces, makes sense.

Modify election rules

For decentralization to work, elected officials must be able to, and have incentives to, efficient and responsible behavior. Their terms must be sufficiently long to enable them to conduct policies that will take some time to bear fruits: 3 years is not enough, 4 years is better but a bit short, 5 years is appropriate, but 6 years may not be too much. Councils and

mayors must be re-electable for several terms. If they are not good, the voters should get rid of them; but if they are good, why not keep them?

The rules should also make impossible (or very rare and difficult) conflicts between councils and mayors. When councils and mayors are elected independently, there is the risk that the mayor will not belong to the same party as the majority of the council. This breeds conflicts, paralysis, frequent changes of mayors, irresponsibility, and lack of clarity for the electorate. This might be good for politicians and political life, but it is bad for economic development and urban management. When they vote, voters should know for what mayor they vote, and their choice should be respected during the entire term. This might raise some political and even constitutional questions. But there are often technical answers to these questions. In France, for instance, to elect councilmen, people vote for political lists; the number 1 on each list will be the mayor if his/her list wins; and the list that gets the largest number of votes obtains automatically at least 50% of council members. Thus people know for whom they vote, and the mayor is sure to be supported by at least 50% of the council.

Allocate more tax bases to sub-national governments

The share of sub-national taxes in decentralized governments resources must be as high as possible. Only a substantial share of own taxes will induce decentralized governments, under the pressure of their electorate, to behave responsibly. Decentralization cannot be: “you, central government, raise the money —and get the political blame that comes with it— whereas we, local governments, spend it —and reap the political benefit that comes with it”. The famous 18th century motto, “no taxation without representation” can be held to mean: “no representation without taxation”.

Unfortunately, there are severe limits to the amount of sub-national taxes that can reasonably be raised by decentralized governments, both because most taxes cannot easily be decentralized (vertical gap), and because there are great differences in tax capacity between the various decentralized governments (horizontal gap). This is no reason not to exploit fully existing possibilities. Property taxes exist everywhere in Mercosur countries. Automobile taxes (a form of property taxation) could be introduced where they do not exist yet. Business or sales taxes are not perfect as local taxes, but they are better than nothing. Income tax could also be introduced, as an addition to national income taxes for example.

Give more freedom to decentralized governments in rate setting

In many, indeed most, cases, decentralized governments are not allowed to change the rate of their own taxes. There is no good justification for that. Rate setting is one of the basic prerogatives of a government. It makes it possible for this government to develop a fiscal policy: to increase taxes and expenditures, or on the contrary to decrease both, and to present it to the choice of voters. Without the freedom to set rates, local taxes are hardly taxes at all: local governments just pocket what the central government has decided they should have. This is very much the definition of a transfer. Local tax assessment or collection, by contrast, is much less important. It is usually allocated to decentralized governments that often use it as a (bad) proxy for rate setting. But assessment and collection are in a sense technical tasks. They could be undertaken by higher levels of governments (on behalf of local governments) or even be contracted out.

It is occasionally argued that sub-national governments cannot be trusted for rate setting, because some at least might end up deciding extremely high or extremely low rates that would inflict serious damages upon their or other jurisdictions. If this is the case (which is doubtful), then a compromise solution is to let decentralized governments decide tax rates within prescribed upper and lower limits.

Establish national rules for mayors and councilmen compensations

In many Mercosur countries, elected councils decide themselves the salaries of mayors and councilmen. This is done in the name of respectable principles. But in practice, it leads to excesses that undermine the credibility of decentralized governments. The central government could introduce norms governing such salaries. These norms could be (as is the case in France for instance) a function of the size of the decentralized government. The central government already decides on the number of council members, which is often a function of city size. These norms are well accepted, and not seen as violation of the basic rights of sub-national governments.

Professionalize local administrations

A major weakness of decentralized governments in Mercosur countries is the relatively low level of competence of administrators. This is in part due to the generalized spoils system that prevails. At every change in the political persuasion of the mayor or governor, a very large number of administrators, and certainly the heads of services, are fired, and replaced by people politically close to the mayor. Some may be technically competent; others may not. Politicians, not technicians, administer decentralized governments. This is not desirable. It discourages talented people from careers in local administration, and therefore lowers the average quality of the staff. It is wasteful: the new team spends the first year trying to understand what the problems are, the second year to start policies, and the third year to prepare the incoming election—since their fate depends much more upon the results of this election than upon the effectiveness of their policies. Admittedly, a new boss wants his new policies to be implemented, not betrayed, by his/her administration. However, the same problem arises in a private enterprise. And yet a newly appointed CEO usually changes very few people at the higher echelons of his/her enterprise, and none at the lower echelons. He brings with him, at best, a few advisors, and expects his staff to implement the new policy directions he decides.

Develop reporting, auditing and evaluation

The way the accounts of decentralized governments are presented leaves much to be desired. At best, it is done along purely legalistic lines. This makes it difficult, not to say impossible, to know what purposes are served by expenditures, much less to find out whether stated objectives are being reached. Local citizens or analysts cannot properly appreciate the effectiveness of municipal management. A remarkable effort has been made in several countries, such as Brazil or Argentina, to put available municipal finance data on the web (one finds on line more information on Brazilian municipalities than on French or British municipalities). But what can be found is not always very meaningful.

More should be undertaken to improve, that is to simplify and to modify, reporting frameworks. These frameworks have often been in use for decades or even centuries. The concepts or words used do not throw light on to-day's realities. An extreme case is offered

by Argentina. Public finance reports distinguish between “tax resources” (*recursos tributarios*) and “non tax resources” (*recursos no tributarios*). This sounds clear and simple enough. A closer look, however, shows that “non-tax resources” refer mostly to older “fees” (*tasas*) originally collected for public services or inspections, which have become compulsory, are based on property or business activities, are not related directly to services provided, and are not even ear-marked for specific purposes. They are in reality taxes, and should be called as such. The opposite happens with the resources described as “tax resources”. They consist mostly of a *co-participación*, of a share of taxes decided and collected by an upper level of government. For the recipient government, these resources do not have the characteristics that define a tax. They are in reality transfers, and should be called as such. The vocabulary used therefore is completely misleading: “non-tax resources” are actually taxes, and “tax-resources” are actually transfers!

It would also be desirable to develop auditing by specialized bodies, and to promote evaluation by independent institutions or individuals. In many cases, there are courts of accounts at the national or regional level to oversee and certify decentralized governments accounts. Their function, when fulfilled, is usually purely legalistic. They refrain from analysis of trends, comparisons with other jurisdictions, or projections. The lawyers that staff them would, in most cases, be ill prepared to undertake such tasks. Yet, the need for independent and trustworthy evaluations is great. This gap is in part filled by rating agencies. But rating agencies only rate a very limited number of decentralized governments; and they do so from the limited angle of ability to repay loans.

Improve transfer systems, particularly allocation formulae

Transfers, as mentioned, are the main pillar of fiscal decentralization, and deserve more attention than they usually obtain. The total amount of transfer is usually determined as a fixed share of the resources of the upper level of government. There is nothing wrong with that. Only two points should be added. One is that it might be desirable to introduce some flexibility in the share to be transferred: not just 16%, but 14%-18%. This would imply a cost in uncertainty to the recipient governments, but it would imply a gain in flexibility to the giving government. The other point is that the larger the pool of tax and non-tax resources to which the percentage is applied, the better. It is better for decentralized governments to have 10% of all central government resources than to have 50% of a few selected taxes of the central government. The reason is that different taxes may have a different cyclical behavior, and therefore that the total amount of taxes is likely to be more stable than just a few taxes.

What leave most to be desired are the allocation formulae, the way the total amount of transfer is distributed between the various decentralized governments. In practically all cases, the allocation is not discretionary, but made by means of a pre-determined formula. This is very desirable. But the formulas, which have usually evolved as a result of complex political negotiations over the course of time, are generally very crude. Transfers should aim at reducing vertical and horizontal imbalances. The mere existence of a transfer contributes to the reduction of the vertical imbalance. But transfer formulae should be such that horizontal imbalances are also corrected.

The most important one is differences in tax capacity, or tax bases per capita. Those decentralized governments that have lower tax bases should receive higher transfers, all other things equal. Tax base (or rather the inverse of tax base, or the

difference with the average tax base) should therefore be a criteria appearing in the allocation formula.

A second imbalance to be corrected refers to differences in “needs”. This is a delicate concept, not much liked by economists. Yet, common sense suggests that some decentralized governments have greater needs (per capita) than others: because they are poorer, because they lack natural resources, because they have larger (and more costly) cities, etc. Trying to integrate these differences in allocation formulae is desirable, although difficult.

Organize and control sub-national borrowing

There are two very different types of municipal borrowing: (i) loans used to finance revenue-producing investment projects, such as a toll bridge, or a parking garage, and (ii) loans to finance the supply of public or merit goods, such as schools or health clinics.

The first type of borrowing does not raise great difficulties. If the discounted value of the revenue stream to be produced by the project is larger than its costs -- or more precisely if the financial rate of return of the project is greater than the interest rate -- then it is desirable and healthy that borrowing finance investment. In such a case, a municipality is like a commercial enterprise, and borrowing is not dangerous. Subject to liquidity constraints, and to a margin of protection from the uncertainties and risks of financial rates of return analysis, one can even say that borrowing for such projects is highly desirable. The more a municipal government borrows for such projects (with a high financial rate of return), the better. They will provide the money to repay interest and principal. The only question that should be asked is: should not such projects be undertaken by private companies rather than by municipal governments? The a priori hypothesis is that private companies will be more efficient than municipal governments at managing such projects, and that the projects should rather be privatized —with public control and supervision when and where appropriate. There may be cases, however, when control or supervision are considered too difficult or/and too costly, and when public ownership is an option.

The second type of borrowing, for non-revenues producing activities, is more contentious. In this case, excessive hopes are often placed by local politicians in local borrowing, as if it could magically become a permanent resource, and become a low-cost alternative to taxation, transfers or charges. At best, borrowing buys time, but it has to be repaid out of future permanent resources. It is particularly appropriate in municipalities or regions which are growing fast, in terms of population and output. But this is generally not the case of Mercosur sub-national governments, at least in terms of population. The population of most municipalities is no longer increasing fast in highly urbanized and demographically mature countries. This being said, there is scope for a better organized borrowing system. Three ideas might be considered.

First, specialized municipal banks or funds are an option. The example of Paracidade in Parana sounds quite convincing. It has been able to identify local borrowing needs and to provide advice and tutoring in addition to finance. Lending to municipalities is a specialized job that most ordinary or commercial banks are not well equipped to undertake. The example of Crédit Local de France, later Dexia, in France is

quite interesting in this respect. CLF started as a public institution that had a sort of legal monopoly on local lending in France. Over the course of time, this monopoly was eliminated, and all banks could engage in local lending. It was expected that commercial banks would take a large share of the market. Many tried to do so. Few succeeded. CLF, now Dexia, remained the dominant lender to French sub-national governments.

Second, subsidized borrowing is also an option. Should loans to municipal governments benefit from concessionary rates? There are pros and cons. On the "yes" side, one can note that only a handful of municipal governments will, in today's Mercosur, be in a position to borrow at market rates. Subsidized loans could substantially increase that number. One can also note that society at large benefits from many municipal investments. As mentioned above, these benefits are in the nature of externalities, with municipal governments recuperating only a (small) share of the additional welfare created by their investments. As in all cases of positive externalities, a subsidy is justified. In fact, subsidized loans to municipalities have been utilized in many now developed countries, particularly when they were urbanizing. This has been the case in France until the 1970ies. One could even say that this has been for long the case in the USA: interests on municipal bonds were exempt from the federal income tax, which made it possible for municipalities to borrow at below market rates.

On the "no" side, it can be said that subsidized loans tend to evict out non subsidized loans: why would a municipal government take a loan with an interest rate of 8% if it can have access to a loan with an interest rate of 4%? Discriminating within municipal governments (identifying those that will benefit from subsidized loans and those that will not) is technically difficult, and inefficient in the sense that it does not induce beneficiary municipal governments to improve their situation and to "graduate". Subsidized loans can also be unfair. The lower interest rate is a subsidy that will be distributed pro rata the amount of borrowing. The more a municipal government borrows, the more it receives in subsidies. But those that borrow most are usually the richest. Subsidized loans amounts to a subsidy to the rich. Subsidized loans are also criticized because they can distort resource allocation. If and when utilized by municipal governments to finance revenues-producing investments, subsidized loans will increase the financial rate of return of the project. This may promote projects that should not be undertaken because they have neither a sufficiently high rate of return nor positive externalities -at the expense of other, more socially desirable, projects. Finally, there is the question of financing the subsidy. Even if this is done with foreign resources, it will be done with resources that have an opportunity cost, and could have been utilized to other — equally or more useful— purpose.

Third, some central government controls and constraints on sub-national government borrowing are generally required. This is not much in line with the idea and the ideals of decentralization. But there are good justifications for such constraints. The central government has the responsibility of managing the macro-economic situation of the country, which can be affected by excessive of inefficient sub-national borrowing. Then, in practice, central governments are often obliged to bail out (at least in part) defaulting sub-national governments. They cannot let a municipality go bankrupt and stop providing some basic services: the members of this municipality are also citizens of the nation. The more generous bailing out is, the more widespread it becomes. If lending to municipalities is a risk-free activity, then lenders are encouraged to make bad loans. This justifies the imposition of some central government controls over sub-national borrowing. Some

balance has to be struck between the dangers of bailing out and the dangers of imposing controls.

Improve vertical co-ordination

As we have seen, the functions of the various levels of governments are often not clearly defined. Hence the temptation to clarify who should be responsible for what. Efforts to clarify responsibilities cannot do harm, but not too much should be expected from it. Many functions will require some inputs from various levels of government. Take education, for instance. Municipal governments, who are closer to the people, should certainly play a role, particularly for primary education. However, central governments, which are responsible for the overall level of education and skill in the country, cannot ignore the content of the education provided to citizens by lower level governments. Regional governments may be in a good position to make some purchases or construction (to benefit from economies of scale), or to prevent and correct spatial disparities in the quality of education provided. In Chile or Uruguay, when some services like education or health or welfare are provided by the central government, it is common for municipal governments (when they can afford to) to complement and improve the level of service (by providing an additional nurse here or an additional class room there), because they know that this is what their constituents want.

Rather than trying to prevent the need for co-operation by defining strict roles for each level of government, it is therefore more important to organize the unavoidable joint provision of public services by the various levels of governments. This vertical co-ordination, as it is called, is no simple task. It may be achieved by means of specific earmarked transfers, of expenditures floors or ceilings imposed by upper levels of government, by the sharing of information and experiences, by regular formal and informal Councils.

Ensure horizontal cooperation, particularly for metropolitan areas

Even more important than vertical co-ordination is horizontal co-operation, the joint provision of services by the various municipalities that comprise a functional urban area. As we have seen, one the striking features of decentralization in Mercosur countries, is the near total absence of institutions and mechanisms at the urban or metropolitan level—in countries where urban areas play a key economic role and where urban areas are usually fragmented in many municipalities. This fragmentation makes it difficult to ensure the adequate provision of certain urban public services like transportation, water, waste disposal, health, education, that have an obvious metropolitan dimension.

One solution—most probably not the best— would be to press for metropolitan governments. They would either replace existing municipalities, or constitute an additional level of government. In both cases, this would create serious political and economic difficulties. In particular, the elected mayor of an agglomeration that comprise one-third of the total population and produces one-half of the total output, would have such a political weight that he/she would be a rival to the elected president of the country.

A more appropriate, and modest, solution is to create, for the major functions, groupings or consortia or syndicates of municipalities. There could be such a grouping for transport, for instance, that would be empowered (by the municipalities themselves, with

the help of upper levels of government) to define a unified transport policy, to make transport investments, or to negotiate contracts with transport private enterprises. Such a system functions in France (where fragmentation is even more important than in Mercosur countries) in a satisfactory fashion. There could be similar groupings for planning, for water supply, for waste collection and disposal, or for health services; and the perimeters of these various groupings need not even be the same. Such institutions are not a panacea, but they can go a long way to provide services at the appropriate scale, and therefore to improve the efficiency of cities —and of the economy in countries that consist mostly of cities.

VI — Conclusions

Mercosur countries have been and continue to be a very rich laboratory for the study of decentralization. And the topic continues to be high on the reform agenda of many of these countries. The question often asked: has decentralization been a good thing for these countries, and should we have more, or less, of it in the future? is not a good question, for two main reasons. First, the decentralization record, like so many things on earth, is obviously mixed. It has probably been positive in political terms, in fostering the creation of an entire class of politicians, bringing in a dose of stability and democracy. It has done so at an economic cost, and it is not clear that the delivery of public services has really been much improved as a result of decentralization. Second, and most important, there is no such thing as “decentralization” and asking for more, or less, does not mean much. What matters is the content of decentralization, the many details that define it, and that determine its meaning and its efficiency. Mercosur countries do not need “more” decentralization, but they might need better formulae for the allocation of transfers, or a better allocation of taxes between levels of government, or different election rules, or better institutions and coordination mechanisms at the level of agglomerations. For each of these “details” there is no magic solution. But improvements are possible, therefore necessary.

Three points stand out. First, most government officials in the legislative and in the executive (councilmen, mayors, governors) are elected. This is a major achievement of the

1970s and 1980s. In all countries, they are elected as members of national political parties. There is one exception to this rule: in Chile at the regional level, the governor is appointed by the central government. Since, the regional council is elected (albeit indirectly), there is the possibility of conflict. In practice, conflicts are avoided by giving regional council only an advisory role. It could therefore be argued that in Chile regional governments are not really autonomous governments, but merely administrative geographical subdivisions of the central government, or to put it otherwise that this is best described as deconcentration rather than decentralization. The Bolivian case was similar until 2006; since then, however, regional (departamental as they are called) executives are elected.

Second, in all countries, mandates fluctuate from four to five years, and usually are not renewable more than once. This is in contrast with what can be found in many developed countries: in France, for example, municipal councils and mayors are elected for 6 years for an undefined number of mandates, and it is common to see a mayor remaining in office for 12 or even 18 years, as long as voters are satisfied with his/her action. The Latin American system has two drawbacks. The brevity of the mandate is an inducement to short-termism. Moreover, the impossibility of being re-elected eliminates a strong incentive to efficiency. This can be seen as an inducement to corruption. Being

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During the past two or three decades, decentralization has been much advocated, and practiced, in developing countries in general, and in Latin America in particular. The theoretical foundation of this policy prescription is largely North American. In a brilliant book entitled “Fiscal Federalism”, Wallace Oates (1972) explained how the joint decentralization of taxes and expenditures could improve welfare. Assuming different tastes in different sub-national jurisdictions, that political tax and expenditures decisions reflect the views of the median voter (two assumptions that are present to a large extent in the USA and Canada), and that there are no economies of scale in the provision of sub-national public goods and services; Oates showed that a decentralized system is superior to a centralized system in terms of allocative efficiency. . 1 .

Both the mix of public and private goods and the mix of various public goods generated by decentralization will maximize welfare. An idea that promises to deliver more at no additional economic cost is always very appealing. . 1 .

Decentralization was also supported by more political and perhaps stronger considerations. It can be argued that (... [1]

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Supprimé: Except for Chile and Uruguay, these countries have a bad reputation in terms of governance. The Transparency International index of corruption stands at about 2 for Argentina, Bolivia, and Paraguay, which are ranked number 108, 122 and 140 out of about 145 countries. Brazil with 3.9 (ranked 59) does better, but only Chile with 7.4 (ranked 20) and Uruguay with 6.2 (ranked 28) do reasonably well. . 4 .

With the exception of Chile, the Southern Cone countries have not done well economically in the past two decades. In the 1980ies, ignoring Chile, GDP growth rates ranged from -0.2% in Bolivia to 2.7% in Brazil, which implies very low or negative per capita income growth. The 1990ies were better, but only slightly better, in all countries except for Brazil and Uruguay.

The variance of income or output levels per capita is large. In Brazil, Chile, Argentina and Uruguay, these levels are not low, relative to what can be found in most Asian or African or Middle Eastern countries. Bolivia and Paraguay, with output levels three or four times lower, are definitely low-income countries, although not very poor by Asian and African standards. . 4 .

Most of these countries exhibit high levels of inequality. The Gini index for Brazil (... [2]

elected is seen by some (and by the general public) as having a few years to make money. On the other hand, the system makes it possible for a larger number of politicians to be in office. 10

Third, in all countries, except in Chile at the regional level, elected politicians appoint many administrators. A generalized spoils system is the rule. When a new team is voted in, all directors of services, and many more people, are kicked out, and new officials—politically close to the winners—are appointed. This tends to discourage high quality professionals from joining sub-national administration. Long-term projects, requiring continuity and stability, are made more difficult to develop. Administrators do not benefit from experience. They are more politicians than technicians.

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This has an impact upon political life at sub-national government level. Political battles can be very hot even when there are no serious personal financial issues at stake (as is the case in many developed countries where being elected might even be a luxury that only the well-off can afford). When election is also a matter of livelihood, political battles are likely to be fought even more violently. 10

Politically autonomous—that is elected—governments may be financially dependent or constrained. The transfers they receive may come with strings attached. Their borrowing capacity may be restricted. All these “details” matter very much in assessing decentralization in a given country, and will be subsequently discussed. Nevertheless, two ratios, or set of ratios, are indicative of the degree of decentralization in a given country: the relative importance of sub national expenditures, the relative importance of sub national taxes. All the other “details” constant, the greater these ratios, the more decentralized the country. These numbers are provided in Table 4. Because the importance of total taxes and expenditures relative to GDP varies from country to country, Table 4 also gives the ratios of sub national taxes and expenditures relative to GDP, to provide another (slightly) different perspective on the importance of decentralization. 10

The numbers given in Table 4 come from our own calculations. These numbers may be different from the numbers found in international publications (such as the IMF *Financial Yearbook*) or in national publications. Defining sub national expenditures and taxes is not as obvious and simple as it might seem. Consider wages of schoolteachers decided nationally but paid locally with a specific central government transfer: is this expenditure to be considered national or local? Or consider nationally decided taxes the proceeds of which are partly handed out to local governments: is such a local government resource a local tax or a transfer? The answers given to such questions vary from country to country, and are often more dictated by legal considerations than by economic reasoning. International compilations usually reflect national official choices. Their comparability is therefore not guaranteed. Our numbers are not “better” than others. But they have two characteristics: they are based on “economic” definitions, and they are consistent. We consider as sub-national only those expenditures that imply a reasonable degree of decision and discretion of sub-national governments. Similarly, we define as sub-national only those taxes that imply some political commitment of sub-national governments. Shared taxes (co-participations) in particular are treated as transfers. 10

The most decentralized country is clearly *Brazil followed by Argentina*. If instead of considering Brazil we consider Brazilian States (on the premise that they are comparable in size and power to the other countries rather than to the regions of other countries), Brazil becomes one of the least decentralized countries of our sample. Expenditures of sub-national governments represent about 15-20% of total public expenditures (and 4-6% of GDP) in all countries, except Argentina where they are twice as large. Such an estimate is generous for Chile, because it treats the expenditures of regions and the expenditures of municipalities on health and education, as sub-national government expenditures, when they could arguably be treated as central government expenditures. It is also generous for Bolivia and Uruguay because it treats the expenditures of regions as sub-national rather than national.

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Sub national government taxes are low everywhere (as a share of total taxes or of GDP). These taxes represent 4-6% of total taxes in Chile, Bolivia and Uruguay, twice that percentage in Argentina. The case of Brazil is more complex: If the State (of Parana) is considered as a sub national government, sub national government taxes represent 33% of taxes paid in Brazil, at least in the State of Parana; if the State is not considered as a sub-national government, sub national government taxes are municipal taxes and they represent 5% of total taxes paid by households and enterprises. In any case, sub-

national taxes are much lower than sub-national government expenditures. SNG raise on average less than one-third of the money they spend. The balance consists mostly of transfers from central governments. 12

It might be more meaningful to focus on decentralization at the lower, i.e. municipal, level. Most of the theoretical arguments for (or against) decentralization are developed with municipal governments in mind, even when they refer to the more general expression of “sub national governments”. Then — unlike intermediate level governments— municipalities in the six countries are comparable in size (30,000 people on average) and in autonomy (elected councils and mayors). Municipalities control about 10% of public expenditures representing about 3% of GDP; and they raise about 4% of total taxes or a little more than 1% of GDP. These numbers vary from country to country. They are higher in Chile (at least when health and education expenditures are counted as municipal expenditures) and in Brazil, lower in Bolivia and Argentina. If Uruguayan *departamentos* were treated as municipalities (this is not our preferred option, but it is arguable), Uruguay would also appear as one of the Mercosur country most decentralized at the municipal level. 12

III - Local Public Finance in Mercosur Countries: A Summary 12

The combined expenditures of sub-national governments in the six Southern cone countries are huge. Table 5 provides an estimate of such expenditures. To understand what decentralization is in reality, it is important to get an idea of what such expenditures are, and of how they are financed. 12

The standard question: “what are the functions allocated to the various levels of government?” has no simple answer. For a given level of government, it varies from country to country. Then, in many cases, it is only loosely defined. In most countries, accounting categories are such that it is not possible to know how much is spent on each of the various functions (health, water, welfare, etc.): the only expenditure breakdown available is by nature (wages, other current expenditures, investments, etc.). This vagueness is probably indicative of the limited interest given to the public services actually offered by sub-national governments. Table 6 is an effort to indicate which functions are allocated to which level of government in Mercosur countries. 13

Table 6: 14

Assignment of Functions by Level of Government, Mercosur Countries 14

Table 6 shows that for most functions, (except for “cleanliness” —refuse collection and disposal, street lighting, street cleaning— which is the responsibility of municipalities only) several levels of governments are involved. This happens for three reasons. First, our functional categories are rather broad: transportation may be a shared responsibility because different kinds of roads are built and/or managed by different levels of governments. Second, in many cases, the same service is provided jointly by several governments. In Bolivia, for instance, school buildings are provided and maintained by municipalities (often with international financing) whereas wages are paid by the central government, through the regional semi-governments. In Chile, health and education are entirely financed by the central government, which gives the money to municipalities that actually disburses it. Amounts disbursed by the various levels of governments do not give a meaningful picture of the relative importance of each level. Third, in yet other cases, a given level (usually the central or regional level) is formally responsible for a given service, but other levels (usually municipalities), unsatisfied with the quality provided, find it appropriate to “complement” the service. In Uruguay, for instance, although health is basically provided by the central government, some municipalities do not hesitate to

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finance additional nurses and doctors. Regulations and bylaws are generally vague enough to make this legal. 15

As mentioned above, sub-national government taxes are a relatively small share of GDP and of total taxes in Mercosur countries. They are a more variable share of sub-national government resources, as shown in Table 7 They range from a low 0% for regional governments in Chile (which are not genuine governments) or 6% for regional governments in Bolivia (which are only beginning to be genuine governments) to a high 74% for Brazilian States and even 84% for Uruguayan Departments.15

These estimates are generous; because of the way they treat taxes the rate of which is decided by the central government. They define them as regional or local taxes. One could certainly define such taxes as national, and the money they provide as mere transfers. With such taxes, sub-national governments have no fiscal autonomy. They remain passive. The political link between taxes and expenditures does not exist. This concerns all municipal taxes in Chile and Bolivia and about half departments taxes in Uruguay. The true share of taxes to resources could therefore be reduced, to the levels that appear between parentheses in Table 7. This view would imply that there are no sub-national government taxes in Chile and Bolivia. 15

Such a view might be somewhat excessive. These taxes are assessed and collected by sub-national governments. Even though these governments have no freedom in rate setting, they do have some autonomy in tax assessment and collection. They can in practice increase or decrease the taxes paid by households and enterprises, by pursuing taxpayers with a varying degree of effectiveness. 15

In a country like France, tax assessment and collection is delegated by municipalities and other sub-national governments to the central government ministry of Finance; that performs it (for a fee) in a uniform and fair fashion. It does not diminish the fiscal autonomy of sub-national governments. Autonomy in assessment and collection is certainly a poor substitute of autonomy in rate setting. It invites corruption and favoritism. The degree of effectiveness may vary according to taxpayer and not merely to jurisdiction. Some might even be tempted to think that this is one of the reasons why so much 15

importance is attached to assessment and collection at sub-national levels in some Mercosur countries. 16

The share of taxes in the resources of sub-national governments therefore has, so to say, a quantitative dimension. It may not be as high as indicated by the plain numbers in Table 7, but is not as low as suggested by the numbers in italics and in parentheses in the same Table. 16

Local and regional taxes in Mercosur countries are mostly of four types: property taxes, vehicle taxes, business taxes and sales taxes. Table 8 offers estimates of the relative importance of these types of taxes. 16

At the municipal level, the property tax is everywhere a pillar of local taxation. This is a desirable feature. The property tax is one of the best possible local taxes, although it is also one of the most difficult to assess and collect. Automobile taxes (a form of property tax) are very important in Uruguay, and significant in Bolivian municipalities and Brazilian States. Taxes on the sales of goods and services are the main tax resource of Brazilian States, and (in a different form) important for Bolivian municipalities. Taxes on business activities are important at the municipal level in Brazil and Bolivia. 16

Transfers from upper levels of government are in most cases the most important financial resource of sub-national governments in Mercosur countries. This, by the way, is 16

also the case in most European countries (although not in the US, which is the exception rather than the rule). Thus, decentralization in practice is not the joint decentralization of taxes and responsibilities to lower levels of governments described and discussed in decentralization textbooks. It is instead the devolution of responsibilities to lower levels of government accompanied by transfers from higher levels. Central governments are expected to raise the money, and SNG to spend it. Understanding the rules that govern transfers (their magnitude, their allocation, the strings that come or do not come with them, etc.) is key to understanding the realities of decentralization in a given country. Table 8 provides a rough picture of the main transfer flows in Mercosur countries. 17

Tables 8 show that transfers to sub-national governments represent between 2% and 7% of GDP in Mercosur countries (except in Uruguay). This is much more than sub-national governments taxes. Each country —indeed each transfer— has its own characteristics. 18

The specificity of Bolivia, for instance, is —or rather was, because things are changing rapidly in this country) the importance of the “Funds”, largely financed by foreign aid, that allocate money to

investment projects of regions and municipalities, provided these governments also pay part of the bill, i.e. co-finance the projects. An interesting and sophisticated method had been developed in order to simultaneously take into account the legitimate wishes and preferences of sub-national governments (in terms of sectors) and the equally legitimate wishes of the Funds and of the donor countries. The

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co-financing rate reflects the preferences of the Funds; the Funds might co-finance education at 70% (if education is their top priority) and health at 50% (if they give less importance to health). Municipalities are then faced with a set of “prices” that they take into account when asking for co-financing. Actually, the system is more complicated than suggested by this description. The set of prices offered varies not only by types of projects, but also by types of municipalities. If the 70% and 50% just mentioned apply to “poor” municipalities, rich municipalities might be offered 40% for education and 30% for health. 19

Chile has two specificities. One is its *Fondo Común Municipal* (Common Municipal Fund) or FCM. This is an intermunicipal redistributive mechanism. All municipalities contribute to the FCM a share of their property and vehicles taxes, and four richer municipalities a share of their business tax. Then all municipalities receive a transfer based on a complicated formula that includes the level of per capita tax resources, two indicators of poverty (one is the relative number of properties exempted from property tax), population, and an equal amount per municipality. In the end, 51 municipalities are net providers to the FCM and 290 are net receivers. The FCM does contribute to horizontal equalization, although this equalization is far from perfect. 19

The other Chilean specificity is that transfers are not automatically determined and allocated. Investment subsidies to regions are decided each year by the central government ministries according to their perception of the needs of the various regions (although there is a clear policy to favor “extreme zones” of the North and South of the country). Transfers to municipalities are earmarked for health and education, and decided by the central government as part of its health and education policy. Indeed, municipalities are mere “agents” of the central government in the use of these subsidies. 19

Transfer systems, therefore, vary substantially. Three important features, however, are to be found in many cases. 19

The first one is that, for a given transfer, the total amount is usually defined as a share of the tax resources of the giving government. This is called “*co-participación*” (and *Taxs compartidos* in Uruguay). The “tax resources” which are the basis for *co-participación* can include all tax resources, several taxes, or just one tax. The percentage that is applied to determine the total amount of the transfer is a key number, that cannot be changed annually, and is even enshrined in the Constitution in Brazil. 19

The second is that in most cases the allocation of this total amount of transfer to the various municipalities or regions is done by formula, not in a discretionary fashion. The criteria used in the formulas are often very crude and unsophisticated. They often include population (implying an equal amount of transfer per capita, which is not unfair), area, needs, source (that is the amount of national tax resources collected in the region or municipality, a much more unfair criteria), and (the inverse of) per capita tax resources of each receiving municipality. 19

The third is that most of the transfers studied are in the form of block grants. They come without strings attached, and sub-national governments can do what they please with the money received. There are exceptions to that rule: most of the Chilean transfers, transfers from the Bolivian Funds, investment subsidies in Uruguay, are specific transfers, with very limited expenditure autonomy left to the receiving sub-national governments. 19

What do transfers achieve in Mercosur countries? Transfers have in theory two justifications, or purposes: to reduce the so-called vertical and horizontal gaps between sub-national governments. The “vertical gap” refers to the simple idea that it is more desirable to decentralize expenditures than taxes. Most (not all) expenditures can fruitfully be decentralized. Not many taxes can. Hence a gap. Transfers in Mercosur countries certainly go a long way to fill or reduce that gap. A substantial share

of central government taxes —some 15 to 20%— is handed over to sub-national governments.

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The “horizontal gap” refers to the disparities that exist everywhere between the various municipalities or regions of a given country. Whatever local tax bases (be they on property, on income, on activity, on consumption, etc.) they are unequally distributed. There will always be tax-base rich and tax-base poor municipalities. The expenditures “needs” of the various municipalities or regions can also differ. If municipalities and regions were to compete with only their own tax resources, this would be a very unfair —and inefficient— competition. Tax-base rich municipalities could offer lower tax rates or/and better public services, thus attracting more people and activity, therefore enlarging their tax bases. This cumulative process would aggravate further the horizontal gap between municipalities or regions. A major role of transfers is to counter-balance this unacceptable potential consequence of decentralization. It is to give more to jurisdictions that have low tax bases, and also high needs. How do Mercosur transfer systems fare in this respect? 20

Not too well. They do reduce tax base disparities. Practically all transfer systems do. Consider a country with two regions of similar population: region Poor with a tax capacity (tax base multiplied by an average tax rate) of 100, and region Rich with a tax capacity of 300. The ratio of tax capacity is 3 to 1. Assume a simplistic transfer of 100 to each. The resources of Poor become 200, the resources of Rich become 400. The ratio of resources is now 2 to 1. This simplistic transfer has substantially reduced the horizontal gap. We tried to find out whether the complex yet crude formulas utilized to allocate transfer money achieved more. In many cases, they do not. 20

In Uruguay, transfers per capita appear uncorrelated to tax bases per capita. In Bolivia, the allocation of royalties (*regalias*) to regions is source-based. The royalties decided and collected by the central government on mining, oil and gas, are to a large extent, particularly for the increases decided in 2005, returned to the region where these natural resources are located. The main winner at this lottery is the Santa Cruz region, which happens to be the richest of Bolivian region. The allocation is so random and unfair that a Compensation Fund (financed by the central government budget) has been created to correct —but not eliminate— this unfairness. In Parana, a regression analysis of transfers received by municipalities suggests that per capita transfers increase with GDP per capita (a proxy for tax base), decrease with city size, and decrease with tax effort. To maximize transfers, a municipality must be small, rich, and do not raise much in local taxes. In Argentina, transfers from provinces to municipalities (accounting for the bulk of transfers received by municipalities) are largely determined by transfers received by provinces per capita; differences in these transfers, which are enormous, are therefore translated into differences in transfers received by municipalities. Even if provincial allocation formulae were redistributive between the municipalities of each region (a big “if”), this would produce an unfair allocation between municipalities at the national level. Consider two municipalities will identical tax bases. The first is located in a province that receives massive per capita transfers from the center. The second is located in a province that does 20

not receive such massive transfers. The first municipality will receive much more in provincial transfers than the second. This differential treatment of equals is a definition of unfairness. 21

Borrowing by subnational governments in Mercosur countries is difficult to summarize because its scope, conditions, importance, mechanisms, etc. varies greatly from country to country —more so than in the case of transfers or taxation. There is no single pattern, and for every statement, there are important exceptions. Four points can nevertheless be made. 21

Poorly known — The first is that subnational borrowing is often poorly known. The exception would be Brazil, or rather Parana, where Paranacidade, a State entity monitors very effectively the loans it makes to municipalities. In general, important loans, particularly international loans, are properly recorded. But small loans made by commercial banks are not. It is not easy to distinguish between long-term loans and constantly renewed short-term loans. It is even more difficult to identify arrears in payment to suppliers or to social security institutions which are often a major form of indebtedness. Even in Parana, these forms of *de facto* local borrowing are poorly known. In Bolivia, the central government had to ask private consulting firms to make surveys of local governments indebtedness.

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Generally minor — Inasmuch as we can tell without hard numbers, subnational borrowing in Mercosur does not seem to be very large—with the exception of Argentina. Loans do not seem to be a major share of total resources, even in gross terms. Total indebtedness relative to public resources does not appear to be an unmanageable ratio, and is generally much lower than the similar ratio for the central government. Consequently, debt service does not seem to be a major share of current expenditures. 21

Dominated by commercial banks — In Mercosur countries, subnational governments borrow mostly from commercial banks, not on the bond market, and not much from specialized banks or funds. There is practically no bond markets for municipalities or regions. This much talked about instrument, supposed to introduce responsibility in subnational government borrowing (with ineffective governments getting low ratings by independent rating agencies, thereby facing higher borrowing rates, and reducing their borrowing) simply does not operate in Mercosur countries. In Parana, as mentioned, and also in Bolivia, there are specialized public Agencies or Funds that make loans to municipalities or regions, with national or international capital, but not in other countries. 21

Imperfect control mechanisms — None of the three standard mechanisms used to control subnational government borrowing seems to function in Mercosur countries. One is the bond market discipline mentioned above, which is absent in these countries. A second consists of strict, a priori, authorizations given by a central government office, usually the ministry of Finance, which is also absent, with the possible exception of Brazil. A third mechanism would be to let subnational governments go bankrupt when they are no longer performing on their loans. This has not happened. On the contrary, bailing them out has been the rule rather than the exception. 21

IV - Decentralization in Mercosur Countries: A Tentative Assessment 22

As we have seen, decentralization has taken many different forms and characteristics in the various Mercosur countries. This makes generalizations difficult and dangerous. Nevertheless, several points can tentatively be made. 22

The first point is that the changes in favor of decentralization that have taken place in Mercosur countries have been politically motivated. They have not been introduced to improve the efficiency of the public sector and the welfare of citizens, contrary to what economic textbooks suggest. They may, or they may not, contribute to these economic goals (as discussed above), but this is not their primary motivation and achievement. 22

Decentralization has essentially been a way to create or develop a new class of politicians. Whether this has been the main goal is debatable. However, it has certainly been the outcome. In highly centralized countries, like Bolivia in the 1970ies, or even Brazil at the time of dictatorship, political power—and the socio-economic benefits that come with it—was concentrated in the hands of a limited number of people, whether elected or (in the case of dictatorships) appointed. How numerous were the people who derived directly and predominantly their income from political activities (members of parliament, ministers and their aides, heads of ministerial departments, appointed governors and mayors, appointed heads of public enterprises, etc.—people who would lose their job in case of a major political change)? We have no solid numbers to offer, but our guess is that in each country there were no more than 2-4,000 such people, and that the number was relatively independent of the size of the country. This would mean some 20,000 politicians for the six Mercosur countries. 22

Decentralization has created an entire class of people whose income depends upon the outcome of decentralized elections. Assuming an average of 15 elected people per council, and an average of 40 political appointees per government, this accounts for 150,000 people in Mercosur countries. 22

This carries great political benefits. It reduces the distance between citizens and politicians. It promotes political discussion and debate. Where there are strong regional or local feelings of specificity, it makes it possible for the people to feel better represented and integrated in the life of their country. It encourages political pluralism. A politician who is ousted at one level of government may well come back at another level. The pool from which national politicians are selected is enlarged.

It functions like an imperfect, yet valuable, insurance policy against the return of totalitarian systems.

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All this comes at a cost. The wages of elected politicians are generally voted by themselves. In Mercosur countries, it is considered that central government intervention in this matter would run counter to the spirit of decentralization or in certain countries (Argentina) be unconstitutional. Such a view is not universal: in France, for instance, the salaries of elected sub-national government council members and of mayors are set by a central government decree, as a function of the size of the local government; and they are rather low: council members, for instance, are not supposed to be working full-time and are paid accordingly. In our six countries, some of the councils cannot resist the temptation of voting for themselves high salaries. The case of the members of the high chamber of a

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small and particularly poor Argentinean province who paid themselves 200,000 pesos per year (at the time when 1 peso was worth 1 US\$) may be an extreme case, but it illustrates the dangers of the system. Assuming an average income of US\$ 30,000 per year per politician and political appointee, this would put the bill at US\$ 15 billion per year for the six countries. 23

The economic justification of decentralization in Mercosur countries, defined as the strengthening of some 8,400 municipalities and regions, is that local public services are now delivered more efficiently, relative to how efficiently they were delivered in the previously more centralized system. Is it the case? Are households and enterprises getting better, or cheaper, or more adequate services? Is welfare and economic development increased as a result of decentralization? There are some reasons to doubt it, although the lack of good indicators of “efficiency” makes it difficult to answer rigorously the question. 23

A first point is that there is no positive relationship between degree of decentralization and socio-economic performance in Mercosur countries. Admittedly, our sample is small, and our measures of the variables are fragile, and “other things” are difficult to control. Nevertheless, it is noteworthy that the least decentralized country, Chile, is also the fastest developing country, whereas the most decentralized, Argentina, is (or has been for many years) also the least developing one. 23

A second point is that incentives to efficiency (in the decentralized governments of Mercosur countries) are often weak or blunted. Certainly, the standard incentives of decentralization theory are largely absent. Sub national governments, it is argued, will compare the political benefit of an additional peso of expenditures with the political cost of an additional peso of taxes, and select the level and mix of taxes and of services that best suits their voters (thereby improving allocative efficiency). It is hard to see anything of this taking place in Mercosur countries. In most cases, decentralized governments have little or no control over the level of taxation: they just cannot increase it or decrease it to any optimal level (assuming there is anything like that). Then, the theory assumes implicitly that expenditures are financed out of local taxes: in most cases, they are primarily financed out of transfers. In yet other cases, expenditures are mandated or constrained by upper levels of government; the clearest example is health and education expenditures in Chile, which are done by municipalities with earmarked transfers and specific directives from the central government. In short, efficiency implies autonomy; and autonomy (that is economic and financial autonomy) is usually limited. 23

The theoretical model also implies an effective election feedback mechanism, which is not always present. The citizens-taxpayers, it is claimed, will vote in the team that will give them what they want, and vote it out if it does not perform. Having election is a necessary condition (which is met in Mercosur countries), but it is not a sufficient condition. For a local election to influence local service outcomes, the elected must be held accountable. The main determinants of accountability are probably information and re-election. Both are weak in Mercosur countries. Information on how and to what purpose public money has been spent at the sub-national level is scarce and poor. When available, it is usually more legalistic than economic. Having tried to find such information in dozens of cases, the authors can testify that it is not easy. It is not reasonable to expect that the electorate is fully informed, even if it is true that citizens can see the results —or the lack 23

of results. Then, in many cases, re-election is not a possibility. The fear of not being re-elected, one of the most powerful incentives to efficiency, is often absent. All this is reflected in the often low-opinion in which local—as well as national—politicians are held by the citizenry. They are all too often considered corrupt and inefficient. 24

A third point is that the administrative capacity of decentralized governments is often weak. Even if (or when) elected politicians genuinely want to pursue a program that meets the wishes of their electorate, it is not sure that their administration will be able to deliver. Local administrations are often under-staffed, under-paid, under-skilled, under-equipped, under-trained. The systematic politicization of the management (and below in some cases) weakens it further. It sends the message that one cannot make a career based on competence and dedication in sub-national administrations. This is not the best way to attract talented professionals, even though there are, obviously, exceptions. 24

Admittedly, these points are not evidences of inefficiency, and even less of relative inefficiency (relative to central government efficiency). The record of central government delivery was in many cases not particularly bright. Decentralized government, particularly municipal government, has at least two definite advantages: it is closer to the people, and better informed of their needs and problems; it is closer to the solutions and can more easily tailor them to local potentialities. Whether these advantages outweigh the disadvantages mentioned above is a matter of debate. However, the discussion of these disadvantages is useful. It suggests that the common view that more decentralization systematically equals more welfare and more economic development is at best naïve and questionable. 24

Decentralization can take place at the municipal or/and at the regional level. Our view is that municipal decentralization is much more desirable and necessary than regional decentralization, because there is often over-decentralization at the regional level and under-decentralization at the municipal level. The present picture in this respect is varied. Argentina is highly decentralized at the regional (provincial) level, but highly centralized at the municipal level. In both Chile and Bolivia, there is decentralization at the municipal level (more so in Bolivia than in Chile) and little decentralization at the regional level; but there is a very strong, and politically difficult to resist, pressure to decentralize further at that level in both countries, particularly in Bolivia. In Uruguay, a rather small country, there is decentralization at just one level, which is more regional than municipal. In Brazil, if one considers that Brazilian States are more comparable to the other Mercosur countries than to their regions (as we argued should be done), there is only decentralization at the municipal level, since there is nothing between a State government and municipal governments. The Brazilian model seems more efficient. 24

The reason for this contention is that Mercosur countries are by now highly urbanized. As mentioned above, the share of people living in urban areas is between 80% and 90% in Brazil, Argentina, Chile and Uruguay, although lower in Bolivia and Paraguay. What counts for people's welfare and economic development is what happens in these cities, much more than what happens in inter-cities areas. 24

This has not always been the case. In earlier times, when Mercosur countries were predominantly agricultural and rural, the economic reality was the region or the province. 24

There were cities, as administrative and commercial centers, but it was the region that made the city. Then, public services had to be designed and provided primarily for the benefit of the region. In addition, communication with the capital city of the country was slow and costly. There was a strong justification for the existence of regional governments. 25

No longer. Now, it is not the region that makes the city, it is the city that makes the region. This is obvious in economic terms, with most of the regional GDP originating in cities. This is even true in population terms. In many regions in Chile, Argentina, and Uruguay, the population of the main city (or main 2 or 3 cities) accounts for more than 80% of the region's population. 25

In such cases, having a regional government taking care of the local needs of 100 people next to one or two municipal governments taking care of the local needs of 80 of these people is an obvious duplication, involving unnecessary costs and conflicts. In addition, the more important of the two

types of government is the city one—which can, as a first approximation, be taken to be the municipal level. In many cases, less decentralization at the regional level, and more decentralization at the municipal level, would probably be an improvement. The shift that has taken place in economic geography terms should be reflected in decentralization terms. 25

One can and should go one step further. What is missing from the present decentralization picture is the metropolitan dimension. Cities have become essential to economic production and development. The output of a country is now largely the sum of the output of its cities; it is, and will be, more and more so. Table 9 provides estimates of the economic importance of the largest cities in Mercosur countries. 25

Cities, particularly large cities, must be managed efficiently. Productivity (output per worker, but also per unit of capital) is higher in cities than in rural areas, and it tends to increase with city size. Large cities are the engines of economic growth. However, they are only potentially so. To reap the benefits of size, they have to be reasonably well managed, with an effective labor market, good urban planning, an efficient transport system, a well functioning housing market, cost-effective urban public services, etc. A simple econometric model links the productivity of an agglomeration to the “effective size” of its labor market (defined as the average number of jobs that can be reached by workers in less than n minutes, for instance in less than 60 minutes). It further relates this “effective size” to three factors: the potential size of the labor market (the total number of jobs in the area), the prevailing sprawl (the average distance of all jobs to all homes), and the average speed at which people move from their home to their jobs. This suggests that effective land use policies and transport policies are key to the productivity of a city. 26

Such policies cannot be provided by market forces only (which does not mean that market mechanisms cannot and should not play a key role) but require the intervention of some government. In addition, these policies only make sense for the agglomeration as a whole. Unfortunately, most of the large agglomerations in Mercosur countries comprise several or many municipalities, as illustrated in Table 10. 26

In an article on Sao Paulo, *The Economist* (January 29, 2005) explains many of the problems of the agglomeration by this fragmentation, and laments that “Brazil’s federal system does not provide for metropolitan government”. Yet, the case of Sao Paulo is far from being the worst. The city of Sao Paulo, with 10.7 M. inhabitants represents a large (64%) share of the agglomeration population. And the State of Sao Paulo has been active in making plans for the physical development or the transport system of the agglomeration, or metropolitan region as it is called. 27

The case of Buenos-Aires, for instance, is much worst. The agglomeration consists of a city of 2.7 million people, which has the rank of a province, surrounded by 25 municipalities (home of 9.1 million people) that are part of another province, the Buenos Aires province. There is no institution in charge of or able to operate and develop the agglomeration. It cannot be done by the city of Buenos Aires (too small, and not allowed to interfere in another province’s business), nor by the 25 other municipalities (too poor, and hardly allowed to get together), nor by the province of Buenos Aires (more interested in the more rural parts of the province), nor by the Federal government (not empowered to do so, and hard-pressed by other tasks). In the end, there is nobody in the Buenos Aires plane. This absence of metropolitan leadership and of metropolitan policies leads to inefficiencies. Greater Buenos Aires is far from being as efficient an urban area as it should and could be. A number of basic urban public services (in land use control, transport, water and sanitation) seem to be inadequately provided in the area for lack of metropolitan planning and policies. 27

Mutatis mutandis, similar problems can be found in many, if not most, agglomerations in the Mercosur zone. This is the case for other Argentinean agglomerations, particularly those that include municipalities belonging to two provinces, such as Corrientes-Resistencia or Santa Fe-Parana. This is the case of all Brazilian “metropolitan regions”. This is the case of Santiago agglomeration, where the municipality of Santiago (400,000 inhabitants) is only one, and not even the largest, of 32 municipalities. Note that a small number of municipalities in an agglomeration, as in 27

Valparaiso or Montevideo, do not guarantee joint action. Non-cooperative behavior is as frequent, or more frequent, with 2 or 3 players than with 25 players. 28

In short, decentralization in Mercosur countries has completely ignored a major socio-economic change: the development of multi-communal agglomerations. None of the two levels of government that have benefited from decentralization is equipped to provide urban public services at the agglomeration level. 28

V - Decentralization in Mercosur Countries: Policy Implications 28

Decentralization in Mercosur countries has not been the panacea expected or even described by some. But decentralization is there to stay. The political benefits it produces, as well as the interest of the “decentralization class” it has created, makes this certain. The problem therefore is not to expand or to restrain decentralization, but rather to improve it. It is not to have more or less decentralization, but to have a better one. The foregoing analysis and evaluation suggest some policy recommendations in this spirit. They are offered with caution. The variations in conditions and in decentralization in the Mercosur countries, as well as differences in political constraints, are such that the very idea of a single blueprint for action would be futile. We have about a dozen of such recommendations. 28

In many cases, particularly in the smaller countries, efficient local governments coupled with an efficient central government would be sufficient for an efficient administration of the entire country. This is what we find in Brazil, if we consider Brazilian States as central governments—which is what they are in relation to most other Mercosur central governments. In Parana, there is nothing between the State and the 400 municipalities, and nobody feels that there is a missing level of government. 28

This statement is justified by the economic and demographic geography of the countries concerned, which has changed drastically over the past century. Nowadays, most of the people live in cities, and urban activities are the core economic activities of the country. Urban areas, not regions, need to be managed. Then, introducing an intermediate level of government means paying for the administrative costs of any government, and finding out an appropriate set of taxes to allocate to that government. 28

In Chile, *Paraguay* and Bolivia, the transformation of regional administrative units of the central government into full-fledged regional government, is hard to justify—even though there are very strong, probably irresistible, political pressures to do so. In Argentina, the power of provinces is so great that it would be ridiculous to advocate their elimination. Yet, the idea that future changes should favor the weak municipalities, possibly at the expense of the rich provinces, makes sense. 28

For decentralization to work, elected officials must be able to, and have incentives to, efficient and responsible behavior. Their terms must be sufficiently long to enable them to conduct policies that will take some time to bear fruits: 3 years is not enough, 4 years is better but a bit short, 5 years is appropriate, but 6 years may not be too much. Councils and 28

mayors must be re-electable for several terms. If they are not good, the voters should get rid of them; but if they are good, why not keep them? 29

The rules should also make impossible (or very rare and difficult) conflicts between councils and mayors. When councils and mayors are elected independently, there is the risk that the mayor will not belong to the same party as the majority of the council. This breeds conflicts, paralysis, frequent changes of mayors, irresponsibility, and lack of clarity for the electorate. This might be good for politicians and political life, but it is bad for economic development and urban management. When they vote, voters should know for what mayor they vote, and their choice should be respected during the entire term. This might raise some political and even constitutional questions. But there are often technical answers to these questions. In France, for instance, to elect councilmen, people vote for political lists; the number 1 on each list will be the mayor if his/her list wins; and the list that gets the largest number of votes obtains automatically at least 50% of council members. Thus people know for whom they vote, and the mayor is sure to be supported by at least 50% of the council. 29

The share of sub-national taxes in decentralized governments resources must be as high as possible. Only a substantial share of own taxes will induce decentralized governments, under the pressure of their electorate, to behave responsibly. Decentralization cannot be: “you, central government, raise the

money—and get the political blame that comes with it— whereas we, local governments, spend it — and reap the political benefit that comes with it”. The famous 18th century motto, “no taxation without representation” can be held to mean: “no representation without taxation”. 29

Unfortunately, there are severe limits to the amount of sub-national taxes that can reasonably be raised by decentralized governments, both because most taxes cannot easily be decentralized (vertical gap), and because there are great differences in tax capacity between the various decentralized governments (horizontal gap). This is no reason not to exploit fully existing possibilities. Property taxes exist everywhere in Mercosur countries. Automobile taxes (a form of property taxation) could be introduced where they do not exist yet. Business or sales taxes are not perfect as local taxes, but they are better than nothing. Income tax could also be introduced, as an addition to national income taxes for example. 29

In many, indeed most, cases, decentralized governments are not allowed to change the rate of their own taxes. There is no good justification for that. Rate setting is one of the basic prerogatives of a government. It makes it possible for this government to develop a fiscal policy: to increase taxes and expenditures, or on the contrary to decrease both, and to present it to the choice of voters. Without the freedom to set rates, local taxes are hardly taxes at all: local governments just pocket what the central government has decided they should have. This is very much the definition of a transfer. Local tax assessment or collection, by contrast, is much less important. It is usually allocated to decentralized governments that often use it as a (bad) proxy for rate setting. But assessment and collection are in a sense technical task. They could be undertaken by higher levels of governments (on behalf of local governments) or even be contracted out. 29

It is occasionally argued that sub-national governments cannot be trusted for rate setting, because some at least might end up deciding extremely high or extremely low rates that would inflict serious damages upon their or other jurisdictions. If this is the case (which is doubtful), then a compromise solution is to let decentralized governments decide tax rates within prescribed upper and lower limits.

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In many Mercosur countries, elected councils decide themselves the salaries of mayors and councilmen. This is done in the name of respectable principles. But in practice, it leads to excesses that undermine the credibility of decentralized governments. The central government could introduce norms governing such salaries. These norms could be (as is the case in France for instance) a function of the size of the decentralized government. The central government already decides on the number of council members, which is often a function of city size. These norms are well accepted, and not seen as violation of the basic rights of sub-national governments. 30

A major weakness of decentralized governments in Mercosur countries is the relatively low level of competence of administrators. This is in part due to the generalized spoils system that prevails. At every change in the political persuasion of the mayor or governor, a very large number of administrators, and certainly the heads of services, are fired, and replaced by people politically close to the mayor. Some may be technically competent; others may not. Politicians, not technicians, administer decentralized governments. This is not desirable. It discourages talented people from carriers in local administration, and therefore lowers the average quality of the staff. It is wasteful: the new team spends the first year trying to understand what the problems are, the second year to start policies, and the third year to prepare the incoming election —since their fate depends much more upon the results of this election than upon the effectiveness of their policies. Admittedly, a new boss wants his new policies to be implemented, not betrayed, by his/her administration. However, the same problem arises in a private enterprise. And yet a newly appointed CEO usually changes very few people at the higher echelons of his/her enterprise, and none at the lower echelons. He brings with him, at best, a few advisors, and expects his staff to implement the new policy directions he decides.

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The way the accounts of decentralized governments are presented leaves much to be desired. At best, it is done along purely legalistic lines. This makes it difficult, not to say impossible, to know what purposes are served by expenditures, much less to find out whether stated objectives are being reached. Local citizens or analysts cannot properly appreciate the effectiveness of municipal management. A remarkable effort has been made in several countries, such as Brazil or Argentina, to

put available municipal finance data on the web (one finds on line more information on Brazilian municipalities than on French or British municipalities). But what can be found is not always very meaningful. 30

More should be undertaken to improve, that is to simplify and to modify, reporting frameworks. These frameworks have often been in use for decades or even centuries. The concepts or words used do not throw light on to-day's realities. An extreme case is offered 30

by Argentina. Public finance reports distinguish between "tax resources" (*recursos tributarios*) and "non tax resources" (*recursos no tributarios*). This sounds clear and simple enough. A closer look, however, shows that "non-tax resources" refer mostly to older "fees" (*tasas*) originally collected for public services or inspections, which have become compulsory, are based on property or business activities, are not related directly to services provided, and are not even ear-marked for specific purposes. They are in reality taxes, and should be called as such. The opposite happens with the resources described as "tax resources". They consist mostly of a *co-participación*, of a share of taxes decided and collected by an upper level of government. For the recipient government, these resources do not have the characteristics that define a tax. They are in reality transfers, and should be called as such. The vocabulary used therefore is completely misleading: "non-tax resources" are actually taxes, and "tax-resources" are actually transfers! 31

It would also be desirable to develop auditing by specialized bodies, and to promote evaluation by independent institutions or individuals. In many cases, there are courts of accounts at the national or regional level to oversee and certify decentralized governments accounts. Their function, when fulfilled, is usually purely legalistic. They refrain from analysis of trends, comparisons with other jurisdictions, or projections. The lawyers that staff them would, in most cases, be ill prepared to undertake such tasks. Yet, the need for independent and trustworthy evaluations is great. This gap is in part filled by rating agencies. But rating agencies only rate a very limited number of decentralized governments; and they do so from the limited angle of ability to repay loans. 31

Transfers, as mentioned, are the main pillar of fiscal decentralization, and deserve more attention than they usually obtain. The total amount of transfer is usually determined as a fixed share of the resources of the upper level of government. There is nothing wrong with that. Only two points should be added. One is that it might be desirable to introduce some flexibility in the share to be transferred: not just 16%, but 14%-18%. This would imply a cost in uncertainty to the recipient governments, but it would imply a gain in flexibility to the giving government. The other point is that the larger the pool of tax and non-tax resources to which the percentage is applied, the better. It is better for decentralized governments to have 10% of all central government resources than to have 50% of a few selected taxes of the central government. The reason is that different taxes may have a different cyclical behavior, and therefore that the total amount of taxes is likely to be more stable than just a few taxes. 31

What leave most to be desired are the allocation formulae, the way the total amount of transfer is distributed between the various decentralized governments. In practically all cases, the allocation is not discretionary, but made by means of a pre-determined formula. This is very desirable. But the formulas, which have usually evolved as a result of complex political negotiations over the course of time, are generally very crude. Transfers should aim at reducing vertical and horizontal imbalances. The mere existence of a transfer contributes to the reduction of the vertical imbalance. But transfer formulae should be such that horizontal imbalances are also corrected. 31

The most important one is differences in tax capacity, or tax bases per capita. Those decentralized governments that have lower tax bases should receive higher transfers, all other things equal. Tax base (or rather the inverse of tax base, or the 31

difference with the average tax base) should therefore be a criteria appearing in the allocation formula. 32

A second imbalance to be corrected refers to differences in "needs". This is a delicate concept, not much liked by economists. Yet, common sense suggests that some decentralized governments have greater needs (per capita) than others: because they are poorer, because they lack natural resources,

because they have larger (and more costly) cities, etc. Trying to integrate these differences in allocation formulae is desirable, although difficult.³²

Organize and control sub-national borrowing 32

There are two very different types of municipal borrowing: (i) loans used to finance revenue-producing investment projects, such as a toll bridge, or a parking garage, and (ii) loans to finance the supply of public or merit goods, such as schools or health clinics. 32

The first type of borrowing does not raise great difficulties. If the discounted value of the revenue stream to be produced by the project is larger than its costs -- or more precisely if the financial rate of return of the project is greater than the interest rate -- then it is desirable and healthy that borrowing finance investment. In such a case, a municipality is like a commercial enterprise, and borrowing is not dangerous. Subject to liquidity constraints, and to a margin of protection from the uncertainties and risks of financial rates of return analysis, one can even say that borrowing for such projects is highly desirable. The more a municipal government borrows for such projects (with a high financial rate of return), the better. They will provide the money to repay interest and principal. The only question that should be asked is: should not such projects be undertaken by private companies rather than by municipal governments? The a priori hypothesis is that private companies will be more efficient than municipal governments at managing such projects, and that the projects should rather be privatized --with public control and supervision when and where appropriate. There may be cases, however, when control or supervision are considered too difficult or/and too costly, and when public ownership is an option. 32

The second type of borrowing, for non-revenues producing activities, is more contentious. In this case, excessive hopes are often placed by local politicians in local borrowing, as if it could magically become a permanent resource, and become a low-cost alternative to taxation, transfers or charges. At best, borrowing buys time, but it has to be repaid out of future permanent resources. It is particularly appropriate in municipalities or regions which are growing fast, in terms of population and output. But this is generally not the case of Mercosur sub-national governments, at least in terms of population. The population of most municipalities is no longer increasing fast in highly urbanized and demographically mature countries. This being said, there is scope for a better organized borrowing system. Three ideas might be considered. 32

First, specialized municipal banks or funds are an option. The example of Paracidade in Parana sounds quite convincing. It has been able to identify local borrowing needs and to provide advice and tutoring in addition to finance. Lending to municipalities is a specialized job that most ordinary or commercial banks are not well equipped to undertake. The example of Cr dit Local de France, later Dexia, in France is 32

quite interesting in this respect. CLF started as a public institution that had a sort of legal monopoly on local lending in France. Over the course of time, this monopoly was eliminated, and all banks could engage in local lending. It was expected that commercial banks would take a large share of the market. Many tried to do so. Few succeeded. CLF, now Dexia, remained the dominant lender to French sub-national governments. 33

Second, subsidized borrowing is also an option. Should loans to municipal governments benefit from concessionary rates? There are pros and cons. On the "yes" side, one can note that only a handful of municipal governments will, in today's Mercosur, be in a position to borrow at market rates. Subsidized loans could substantially increase that number. One can also note that society at large benefits from many municipal investments. As mentioned above, these benefits are in the nature of externalities, with municipal governments recuperating only a (small) share of the additional welfare created by their investments. As in all cases of positive externalities, a subsidy is justified. In fact, subsidized loans to municipalities have been utilized in many now developed countries, particularly when they were urbanizing. This has been the case in France until the 1970ies. One could even say that this has been for long the case in the USA: interests on municipal bonds were exempt from the federal income tax, which made it possible for municipalities to borrow at below market rates. 33

On the "no" side, it can be said that subsidized loans tend to evict out non subsidized loans: why would a municipal government take a loan with an interest rate of 8% if it can have access to a loan with an interest rate of 4%? Discriminating within municipal governments (identifying those that will benefit from subsidized loans and those that will not) is technically difficult, and inefficient in the sense that it does not induce beneficiary municipal governments to improve their situation and to "graduate". Subsidized loans can also be unfair. The lower interest rate is a subsidy that will be distributed pro rata the amount of borrowing. The more a municipal government borrows, the more it receives in subsidies. But those that borrow most are usually the richest. Subsidized loans amounts to a subsidy to the rich. Subsidized loans are also criticized because they can distort resource allocation. If and when utilized by municipal governments to finance revenues-producing investments, subsidized loans will increase the financial rate of return of the project. This may promote projects that should not be undertaken because they have neither a sufficiently high rate of return nor positive externalities -at the expense of other, more socially desirable, projects. Finally, there is the question of financing the subsidy. Even if this is done with foreign resources, it will be done with resources that have an opportunity cost, and could have been utilized to other —equally or more useful— purpose. 33

Third, some central government controls and constraints on sub-national government borrowing are generally required. This is not much in line with the idea and the ideals of decentralization. But there are good justifications for such constraints. The central government has the responsibility of managing the macro-economic situation of the country, which can be affected by excessive of inefficient sub-national borrowing. Then, in practice, central governments are often obliged to bail out (at least in part) defaulting sub-national governments. They cannot let a municipality go bankrupt and stop providing some basic services: the members of this municipality are also citizens of the nation. The more generous bailing out is, the more widespread it becomes. If lending to municipalities is a risk-free activity, then lenders are encouraged to make bad loans. This justifies the imposition of some central government controls over sub-national borrowing. Some 33

balance has to be struck between the dangers of bailing out and the dangers of imposing controls.

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As we have seen, the functions of the various levels of governments are often not clearly defined. Hence the temptation to clarify who should be responsible for what. Efforts to clarify responsibilities cannot do harm, but not too much should be expected from it. Many functions will require some inputs from various levels of government. Take education, for instance. Municipal governments, who are closer to the people, should certainly play a role, particularly for primary education. However, central governments, which are responsible for the overall level of education and skill in the country, cannot ignore the content of the education provided to citizens by lower level governments. Regional governments may be in a good position to make some purchases or construction (to benefit from economies of scale), or to prevent and correct spatial disparities in the quality of education provided. In Chile or Uruguay, when some services like education or health or welfare are provided by the central government, it is common for municipal governments (when they can afford to) to complement and improve the level of service (by providing an additional nurse here or an additional class room there), because they know that this is what their constituents want. 34

Rather than trying to prevent the need for co-operation by defining strict roles for each level of government, it is therefore more important to organize the unavoidable joint provision of public services by the various levels of governments. This vertical co-ordination, as it is called, is no simple task. It may be achieved by means of specific earmarked transfers, of expenditures floors or ceilings imposed by upper levels of government, by the sharing of information and experiences, by regular formal and informal Councils. 34

Even more important than vertical co-ordination is horizontal co-operation, the joint provision of services by the various municipalities that comprise a functional urban area. As we have seen, one the striking features of decentralization in Mercosur countries, is the near total absence of institutions and mechanisms at the urban or metropolitan level—in countries where urban areas play a key economic role and where urban areas are usually fragmented in many municipalities. This fragmentation makes it difficult to ensure the adequate provision of certain urban public services like transportation, water, waste disposal, health, education, that have an obvious metropolitan dimension. 34

One solution —most probably not the best— would be to press for metropolitan governments. They would either replace existing municipalities, or constitute an additional level of government. In both cases, this would create serious political and economic difficulties. In particular, the elected mayor of an agglomeration that comprise one-third of the total population and produces one-half of the total output, would have such a political weight that he/she would be a rival to the elected president of the country.³⁴

A more appropriate, and modest, solution is to create, for the major functions, groupings or consortia or syndicates of municipalities. There could be such a grouping for transport, for instance, that would be empowered (by the municipalities themselves, with ³⁴

the help of upper levels of government) to define a unified transport policy, to make transport investments, or to negotiate contracts with transport private enterprises. Such a system functions in France (where fragmentation is even more important than in Mercosur countries) in a satisfactory fashion. There could be similar groupings for planning, for water supply, for waste collection and disposal, or for health services; and the perimeters of these various groupings need not even be the same. Such institutions are not a panacea, but they can go a long way to provide services at the appropriate scale, and therefore to improve the efficiency of cities —and of the economy in countries that consist mostly of cities. ³⁵

VI — Conclusions ³⁵