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Expanding Local Revenues for Promoting Local Development*

Jaime Bonet**, Vicente Fretes Cibils***

Latin America (LA) suffers from significant imbalances in fiscal decentralization that constraints local development. As the decentralization process deepened in the region, spending by subnational governments (SG) as a percentage of total government expenditure grew from 20 percent in 1985 to about 30 percent in 2010. In contrast, the percentage of own-source revenue collected by these governments remained unchanged at about 10 percent of the national total. This difference between subnational government spending and revenue creates high vertical fiscal imbalances in most economies, leaving them heavily dependent on transfers from national to local governments—almost two-thirds of subnational revenue is transferred from national governments; and makes local government finances more vulnerable and less predictable.

To promote local development and fulfill the growing demand for local services arising from urbanization, this article argues that SG in LA should take more responsibility for generating own-revenues. Why is greater fiscal responsibility at the subnational level desirable? First, it

* This article draws on Chapter 5—Local Taxes for Local Development in More than Revenue by Corbacho, Fretes Cibils, Lora, Eds (2013).

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i This figure is an average of Argentina, Brazil, Bolivia, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela. In the large Latin American economies, subnational governments administer approximately half of national public investment.

ii The only exception to this trend is Brazil, where subnational revenue accounts for almost 30 percent of the national total.

iii Latin America and the Caribbean is the most urbanized developing region in the world—in 2010 almost 80 percent of its population lived in cities—and urban growth is expected to continue (United Nations 2008). Urbanization imposes heavy demands
grants authorities greater fiscal policy autonomy. Second, it reduces
dependence on central government transfers. And third, it increases the
efficiency and transparency of spending, as taxpayers that pay taxes
tend to demand more accountability from their leaders.

Keywords: fiscal decentralization, vertical fiscal imbalances,
transfers, own-revenues, transparency and local development
JEL classification: H7 (State and Local Government-Intergovernmental
Relation)

América Latina presenta un desbalance notorio en la descentralización
dependencia de los gobiernos sub-nacionales como porcentaje del gasto público total
fiscal, lo cual restringe el potencial del desarrollo local. Mientras que el gasto
del 20% en 1985 al 30% en 2010,iv el porcentaje de ingresos propios
de los gobiernos sub-nacionales como porcentaje del gasto público total
recaudado por estos gobiernos permaneció estancado (alrededor del 10% del
pasó del 20% en 1985 al 30% en 2010,viv el porcentaje de ingresos propios
total nacional). Esta diferencia entre los gastos ejecutados y los ingresos
recaudados por los gobiernos sub-nacionales genera desbalances fiscales
verticales muy abultados en la mayoría de las economías, creando una
fuerte dependencia de las transferencias de los gobiernos nacionales a los
locales—casi dos tercios de los ingresos sub-nacionales son transferencias
que se reciben del gobierno nacional—lo cual suscita vulnerabilidad e
incertidumbre en las finanzas públicas locales.

Para promover el desarrollo local y poder atender la creciente demanda
de infraestructura y servicios locales que surge de la continua
urbanización,v este artículo argumenta que los gobiernos sub-
nacionales de América Latina y el Caribe deben asumir una mayor

on local governments for provision of public services and infrastructure. For example,
between 80 and 120 million people in the region lack adequate water provision and
between 100 and 150 million have no access to proper sanitation (Satterthwaite and
McGranahan 2007).

iv Esta cifra es un promedio de Argentina, Brasil, Bolivia, Chile, Colombia, Ecuador,
México, Perú y Venezuela. En las grandes economías latinoamericanas los gobiernos
subnacionales manejan aproximadamente el 50% de la inversión pública nacional.
v La única excepción a esta tendencia ha sido Brasil, en donde la recaudación subnacional
representa el 29% del total nacional.
vi América Latina y el Caribe es la región en desarrollo más urbanizada en el mundo
(en 2010, casi el 80% de su población residía en las ciudades), y es de esperarse que
responsabilidad en la generación de ingresos propios. ¿Por qué la mayor responsabilidad fiscal a nivel sub-nacional es deseable? Primero, las autoridades sub-nacionales tendrían mayor autonomía para tomar e implementar decisiones de política. Segundo, reduciría la dependencia de las transferencias del gobierno central. Y tercero, aumentaría la eficiencia y la transparencia en el gasto, dado que el pago de impuestos induce a los ciudadanos a exigir una mayor rendición de cuentas a sus gobernantes.

**Tax Decentralization—Benefits and Costs**

The literature of fiscal federalism recognizes the benefits of granting autonomy to subnational governments to make decisions about the level and composition of their revenue. These benefits can be grouped into four categories:

**Efficiency.** It is preferable to transfer to subnational governments those taxes and charges that they can administer more efficiently than the central government. For example, in the case of taxes on property and motor vehicles, subnational governments can know and manage their respective tax bases better. The same principle applies to charges for services that subnational governments manage.

**Predictability.** Financing with their own-source revenue allows subnational governments to have more predictable revenue, in contrast to transfers, which are usually more volatile (especially when based on natural resources). Moreover, a stronger local tax base allows for preparation of more realistic budgets, as well as a more adequate response to the needs of urban services.

**Accountability.** Subnational taxation also favors accountability to the community, since it creates incentives for citizens to exercise control over the use of resources. By making the costs of services and subnational investment visible to the electorate, politicians feel pressured to report

el crecimiento urbano continúe (Naciones Unidas, 2008). Esto genera fuertes demandas sobre los gobiernos locales para la provisión de servicios públicos e infraestructura: por ejemplo, entre 80 millones y 120 millones de personas en la región carecen de una adecuada provisión de agua, y entre 100 millones y 150 millones no tienen acceso a servicios de saneamiento apropiados (Satterthwaite y McGranahan, 2007).
information on revenue and spending more transparently. In turn, transparency promotes improvements in fiscal management and provision of local public services.

**Preferences.** Finally, subnational taxation leads to resource allocation that takes citizens’ preferences more closely into account.

Despite these benefits, there are economic, institutional, and political constraints, limiting subnational tax collection.

**Economic constraints.** Tax bases are unevenly distributed across regions and economies that lead to inequalities among subnational governments, constraining their capacity to finance and provide public goods and services. In addition, tax payers tend to move within a country, which reduces the collection discretion of subnational governments and can result in tax competition between jurisdictions.

**Institutional constraints.** Subnational tax collection is limited by the capabilities of the subnational tax administrations and the small scale at which many of them operate. High compliance costs for taxpayers that operate in several jurisdictions also limit collection. These costs increase significantly in the absence of a common legal framework and provisions to reduce differences among subnational tax laws.

**Political constraints.** Subnational tax revenue is limited by central governments’ control over the most important tax bases and their power over subnational governments due to fiscal dependence. For their part, subnational governments are rarely willing to assume the political costs and administrative difficulties involved in levying local taxes and being more directly accountable to the public for allocating public resources.

The balance between the benefits and costs of tax decentralization in each country and time period necessarily reflects these economic, institutional, and political conditions. These factors affect the composition of subnational revenue between own-source resources, shared taxes, and transfers, as well as the design of each tax, charge, or contribution.

**Fiscal Federalism in Latin America—Stylized Facts**

In Latin America, expenditures by subnational governments far exceed own-source revenue, producing larger vertical imbalances than in other regions of the world: twice those of Eastern Europe and over three times those of Asia. This reflects a combination of higher spending and very low subnational tax revenue in Latin America (figure 1).
Some Latin American countries with centralized tax systems—Chile, El Salvador, and Panama—have insignificant imbalances, averaging less than 1 percent of GDP in the 2000-09 period (figure 2). In contrast, countries with a federal structure and more mature processes of tax decentralization—Argentina, Brazil, and Mexico—have substantial gaps of around 8 percent of GDP. The gaps of countries in intermediate stages of the decentralization process are less inflated but still substantial.

During the 2000s, some countries sped up the process of spending decentralization, but subnational governments fell behind in raising their own revenue, which resulted in higher vertical imbalances. In Bolivia, Ecuador, and Peru, the difference between the spending and revenue of subnational governments doubled between the beginning and end of the decade. In contrast, in Argentina, Chile, and Panama, there were no significant changes (table 1).

With the exception of Brazil, in countries where relatively more progress has been made in decentralizing spending, subnational governments are
Figure 2. Size and Financing of Subnational Government Spending, Latin America, 2000-10 (percentage of GDP)

Table 1. Size and Financing of Subnational Government Spending, Latin America, 2000 and 2010 (percent of GDP)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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<td>6,3</td>
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<td>2,5</td>
<td>2,7</td>
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<td>7,5</td>
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<td>1,3</td>
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<td>0,2</td>
<td>0,3</td>
</tr>
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<td>2,0</td>
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<td>1,4</td>
<td>3,2</td>
<td>6,6</td>
</tr>
</tbody>
</table>

Source: IDB (2012).

Note: Vertical imbalance is the difference between spending and own-source revenue.
heavily dependent on central government transfers (figure 3). This situation is evident in countries where a large part of central government revenue is derived from natural resources — especially Bolivia, Mexico, Peru, and Venezuela. Transfers in these countries risk replicating the volatility of national tax revenue at the subnational level.

Figure 3. Composition of Total Revenue of Subnational Governments, Latin America, 2000-10 (percent)

Source: IDB (2012).
Note: All values are period averages. The periods vary for the following countries: Chile (2001-10); El Salvador (2004-10); Panama (2000-10).

SUBNATIONAL REVENUES—STATUS
Even by the modest standards of the region, many Latin American countries have serious deficiencies in subnational tax collections, based on their level of per capita income (figure 4).

Mexico and Brazil have similar per capita GDPs, but Brazilian subnational tax revenue is 20 times higher than Mexico’s. Guatemala and Bolivia have a relatively similar level of development; however, Bolivia’s subnational revenue is five times Guatemala’s. In addition to Mexico and Guatemala—Costa Rica and Panama have an untapped potential of subnational tax revenue close to 1 percent of GDP, while El Salvador, Paraguay, and Peru could increase their subnational revenue by 0.6 to 0.8 percent of GDP to catch up with their Latin American peers (figure 5). These comparisons indicate how far some countries could move ahead with
Figure 4. Subnational Tax Collection and Per Capita GDP, Latin America, 2010

Source: Authors’ estimates based on IDB and CIAT (2012) and IMF (2011).

Figure 5. Tax Gap of Subnational Governments, Latin America, 2010 (percentage of GDP)

Source: Authors’ estimates based on IDB and CIAT (2012) and IMF (2011).
local taxes using existing tax powers and emulating successful experiences in other countries.

The subnational tax structure in Latin America focuses on taxes on economic activity, which generates distortions in some markets for goods and service (table 2). For example, in Argentina, the gross receipts tax (*impuesto sobre ingresos brutos*), which taxes sales on all stages and activities, results in multiple taxation (Artana et al. 2012). And, in Colombia, the tax on industry and commerce imposes double taxation on the industrial sector (Zarama 2005).

<p>| Table 2 Composition of Subnational Taxes, Latin America, 2000-10 (percent) |
|---------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|</p>
<table>
<thead>
<tr>
<th>Property</th>
<th>Economic activity</th>
<th>Payroll</th>
<th>Vehicle</th>
<th>Property transfers</th>
<th>Fuel</th>
<th>Sporting and cultural events</th>
<th>Gambling</th>
<th>Other</th>
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<td>0</td>
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<td>1,6</td>
<td>0</td>
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<td>Colombia</td>
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<td>0</td>
<td>2,3</td>
<td>0</td>
<td>3</td>
<td>34,3</td>
</tr>
<tr>
<td>Mexico</td>
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<td>1,8</td>
<td>18,0</td>
<td>0</td>
<td>0,1</td>
<td>0,6</td>
</tr>
<tr>
<td>Panama</td>
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<td>59,7</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>40,3</td>
</tr>
<tr>
<td>Peru</td>
<td>54,1</td>
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<td>0</td>
<td>7</td>
<td>0</td>
<td>1,6</td>
<td>5,7</td>
<td>15,9</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2,3</td>
<td>97,0</td>
<td>0</td>
<td>0</td>
<td>0,2</td>
<td>0</td>
<td>0,5</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: IDB (2012).


In Brazil, the effective rates of the tax on consumption of goods and services (ICMS), which is the largest revenue raiser, vary widely among goods and services and from one district to another. This has led to “fiscal war” between states and high administrative costs for taxpayers (Terminassian 2012). In Mexico, the main revenue raiser for the states—payroll tax—distorts the formal labor market, encouraging expansion of the informal labor market and negatively affecting productivity and economic development (Díaz-Cayeros and McLure 2000).

Property taxes generate little revenue in Latin America, and they occupy a secondary position among subnational governments’ own-source
revenue, with the exception of Peru where they rank first in tax revenue raised by local governments.

A miscellaneous set of minor taxes represent a significant fraction of subnational revenue in several countries. In Mexico, the “other taxes” category includes taxes on real estate purchases and advertising, and a payroll surcharge. In Colombia, this category covers tax stamps, taxes on sports and entertainment events, and a contribution from public contractors.

In most countries, subnational governments have limited taxation powers. In many cases, local taxes are determined by national legislation, resulting in a waste of potential revenue. For example, property taxes are often underexploited because of delays in assessing property, which is a central government responsibility, or because the national authorities set very low rates.

Tax collection between the two levels of government—regional (state, provincial, or departmental) and local (municipality)—is asymmetric (figure 6) due to the roles assigned to the administrative system in each country. In federal countries—Argentina, Brazil, and Mexico—regional governments have greater power and resources (and raise more revenue). In unitary countries, local governments are the main collectors of subnational revenue.

Figure 6. Composition of Subnational Own-Source Revenue by Level of Government, 2000-10 (percent)

Source: IDB (2012).

Note: All values are period averages. The periods vary for the following countries: Chile (2001-09); El Salvador (2004-07); Panama: (2000-08).
In most countries, the unequal distribution of tax bases results in the concentration of subnational revenue in a few areas. Four cities in Bolivia (La Paz, Santa Cruz, Cochabamba, and El Alto) raise almost three-quarters of total municipal revenue. In Colombia, five cities (Bogotá, Medellin, Cali, Barranquilla, and Cartagena) collect almost two-thirds of total municipal revenue. In Ecuador, two cities (Quito and Guayaquil) raise about half of municipal tax revenue. In Argentina, almost two-thirds of total subnational revenue is collected from the province and city of Buenos Aires. And this level of collection is similar in Peru, from Lima; and in Brazil, from four Brazilian states (Sao Paulo, Minas Gerais, Rio de Janeiro, and Rio Grande do Sul).

These results also reflect asymmetries in the tax effort inside each country and region. In Colombia in 2009, the average efficiency of collection of property taxes was about 46 percent of collection potential, while for industry and commerce it was about 30 percent (Sánchez et al. 2011). There is also considerable dispersion between Colombian regions: as a proportion of their economic activity, the Andean region collected twice as much as the Caribbean region.

In Mexico in 2011, exploitation of potential tax revenue (relative to a hypothetical optimum calculated with econometric methods) fluctuated between about 2 percent in Campeche State to over 90 percent in the State of Mexico (Castañeda and Pardinas 2011). Average efficiency in municipal governments ranges from 45 percent in the center of the country to over 60 percent in border areas. In Argentina, the subnational tax effort of Catamarca, Formosa, and Tucumán provinces is greater than the provinces of Entre Ríos and Santa Fe (Artana et al. 2012). In Brazil, differences in collection of property taxes reflect a clear geographic pattern: the South and Southeast perform better than the North and Northeast (De Cesare, Dantas, and Portugal 2012).

**Proposing Reforms**

When it comes to reforms to strengthen subnational governments’ capacity to raise their own revenue, one size does not fit all. Reforms must internalize the peculiarities of the various subnational government entities, including differences in the depth and system of tax decentralization. They must take into account the distortions caused by the existing tax system, and the limitations of alternative systems. In particular, they must factor in the high degree of informality in Latin American economies and the challenges this poses for tax collection. Public support for taxation
depends, among other factors, on taxpayers having access to essential public services and adequate infrastructure. But this is difficult when segments of cities are occupied by slums and similarly large percentages of the population work in the informal economy. Including these marginalized sectors in tax collection is one of the main challenges facing subnational taxation.

Subnational revenue must be increased not only to reduce vertical imbalances but also to stabilize local spending, especially in countries that depend on highly volatile transfers from central governments. To boost revenue, some countries need to improve the return from existing taxes, while others need to create new tax bases, especially for regional governments. Additionally, in several countries, reforms must reduce the distortions produced by some existing taxes, such as the gross receipts tax in Argentina, the ICMS in Brazil, and the payroll tax in Mexico. Apart from reforming local taxes themselves, other complementary reforms are desirable, particularly the systems for transferring revenue from national to subnational governments, since these transfer systems can weaken local tax efforts.

Exploiting Property and Valorization Taxes

The **tax on urban and rural property** is greatly underutilized in Latin America, yet it is the number one candidate for increasing local tax collection in most jurisdictions. Receipts from this tax reached barely 0.37 percent of GDP during the 2000s, about half the figure in other developing countries and only one-sixth of what is collected in OECD countries (Sepúlveda and Martínez-Vázquez 2009).

In Brazil, with some improvements in administrative tax management, revenue from property taxes could triple (De Cesare et al. 2012). In Colombia, correcting the number and value of properties and maintaining the effective rate of recent years could double receipts from property taxes (Sánchez and España 2012).¹

Administration of property taxes is complex. Most local governments are not in a position to independently develop or improve a global operating model and would have to devote considerable resources to improving tax collection capacity. The use of advanced technologies to keep the property registry updated and improve collection may be technically and financially unsustainable.

¹ This estimate should be treated with caution because updating the property registry may also affect the effective rate.
Political economy concerns also play an important role in the design and operation of property taxes. In Costa Rica, the balance of political power in municipal councils has led to higher revenue from the property tax in the cantons (Robalino et al. 2012). However, in the year prior to elections, receipts from this tax have typically fallen, especially in municipalities where the mayor and council were aligned with the ruling national party. Likewise, in Colombia, the probability of approving updated property values for the tax is higher when a larger number of parties are represented on the municipal council (Sánchez and España 2012). Property taxes in Mexican municipalities raise more revenue when there is a higher level of political competition, and raise less revenue when the mayor and governor belong to the same political party (Castañeda and Pardinas 2011).²

Given all these factors, the options for viable policy reforms fall into three areas: technical and administrative support for municipalities with the greatest relative deficiencies; development of strategies for municipalities with greater capacity; and complementary national reforms covering all municipalities.

The first group of policies includes setting up of a national body or agency to support the less capable municipalities. This agency would provide administrative support to develop competent local governments by providing standards, supervision, training, and technical assistance. The advice would not be binding, and each municipality would have flexibility in using the services offered.

For municipalities with more administrative capacity, few options could be considered, including (i) integrating the property registry with other databases managed by the organizations responsible for social policy, public services, and public registries, nationally and locally; (ii) combining traditional methods of property registration and valuation with self-reporting and self-assessment; (iii) adopting solutions to maximize the use of information in local government, creating a single property register and updating citizens’ personal data, which would be available to all municipal offices; (iv) maintaining property valuations close to market value by making selection of the valuation method more flexible; (v) disseminating information on property valuation to taxpayers, building

² Bonet and Rueda (2012) found a similar relationship in the case of the tax revenue of the Mexican states: receipts are lower when the governor and the president are from the same party.
confidence in the tax system; and (vi) recognizing the importance of the tax payment system as an important part of the process.

National reforms to complement these local efforts include: applying legal measures to ensure regular property valuation; eliminating the political control exercised by the municipal legislative body over property valuations; defining minimum standards, close to market values, for national valuations, guaranteeing an acceptable level of inter-regional equity; integrating public registries and municipal land registries; using tax incentives to ensure that intergovernmental transfers guarantee more resources for local governments, increasing their own-source tax receipts; and integrating rural and urban property taxes.

Another option is to charge for the betterment arising from public investment by local governments—a valorization tax. Based on the benefits provided in a given geographical area, the local government can charge for improvements to property that has benefitted from public investment. This tax tends to be a single payment in a specific period of time to cover all or part of the investment.

Although this tax exists legally in most countries of the region, it is rarely implemented because it demands considerable local institutional capacity and because the public often resists it. However, as seen in Colombia, where this instrument has a long history of continuous (if irregular) application, it can be an important source of tax resources in some cities.³

**Strengthening Tax Agencies**

The capacity of subnational tax administrations is a serious constraint to increasing local revenue. The semiautonomous tax administration agencies that have been set up in some municipalities and regions have proved to be useful for this purpose. For example, the establishment of the Tax Administrative Service (SAT) in some Peruvian municipalities was an important step toward increasing municipal tax receipts. The revenue of municipalities that adopted SAT grew at an annual average of around 10 percent between 1998 and 2007, while those outside the system grew only 7 percent. This revenue increase seems to stem from less political interference in the administrative process, combined with a more client-oriented

³ In 2011, collections from an improvement tax generated financing for almost $1 billion in public works for Bogotá. Eight other intermediate cities achieved substantial amounts of financing (Borrero Ochoa 2011).
management that is more aware of customer service and less tolerant of corrupt practices.4

Assigning New Tax Handles
To achieve an increase in own-source revenue, new tax bases need to be assigned to subnational governments in some countries. This would be particularly effective in the case of the intermediate governments (i.e., provincial, regional) in Bolivia, Colombia, Peru, and Venezuela. In these countries, while municipalities have relatively strong tax bases, provinces, states, departments and regions have very inelastic bases with limited collection capacity.

The ideal characteristics of a subnational tax are: a relatively stable tax base; equitable distribution of the tax base between states or regions; significant revenue potential; efficiency, which means low risk of creating distortions and negative externalities (in the same or in other regions); low sensitivity to economic fluctuations and other exogenous factors; low administrative costs; and low compliance costs—table 3 evaluates how various types of subnational taxes fare in terms of these characteristics. No single tax option is clearly superior to the others. For example, VAT enjoys very extensive collection potential but carries high administrative and compliance costs, which distort the location of companies. Payroll taxes have medium revenue potential and low administration and compliance costs, but can negatively impact efficiency and are very sensitive to the economic cycle. Property taxes, despite offering strong collection potential and a fixed base, incur high administration costs. The final decision as to which tax to adopt will depend on the particular conditions in each country, including the need for subnational revenues. The arguments for and against the subnational administration of certain taxes are discussed in greater detail below.

Direct Taxes
Creating a surcharge on national income tax (or subnational personal income tax) could reduce the fiscal dependence of small municipalities with tax collection problems. The mechanism would require every municipality to impose a surcharge on national income tax within a range set by the central government. The autonomy granted for fixing the surcharge would offer the benefits of direct competition between

4 For more information, see von Haldenwang et al. (2009).
Table 3. Pros and Cons of Possible Subnational Taxes

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<tr>
<th>Tax</th>
<th>Base with little mobility</th>
<th>Efficiency</th>
<th>Equitable distribution of base</th>
<th>Collection potential</th>
<th>Insensitivity to cycle</th>
<th>Ease of administration</th>
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<td>Improvements tax</td>
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Source: Authors’ compilations.

... = not a salient feature of the tax.

governments. Municipalities could help improve national tax collection by exchanging information with the central government and cooperating with inspections. The competition between municipalities would also benefit citizens by improving the quality of public services.

The return from this surcharge, however, would be limited by the low receipts from this tax. In the last 20 years, personal income tax in the region has contributed around 2.5 percent of GDP (see chapter 7). The impact of this proposal would also be limited by the existence of high
nontaxable minimums on national income, relatively high marginal rates, high levels of informality, and complex administration of the tax.\footnote{A surcharge on the national corporate income tax is not generally recommended for several reasons, including inefficiencies (it is exportable to outside the taxing jurisdiction and could promote unfair/predatory/competition), sensitivity to economic cycles, concentrated taxable base, and high administrative and compliance costs.}

Although the surcharge on national income tax would not raise a significant amount of resources in the short term, it could become a significant source of funds in those municipalities with inadequate management capacity. For example, in Venezuela, a 1 percent surcharge would bring in revenue equivalent to 8 percent of municipalities’ own-source revenue (Ríos, Ortega, and Scrofina, 2011). In Bolivia, a 1 percent surcharge on national income tax would yield revenue of between 0.08 percent and 0.13 percent of GDP, depending on whether the minimum base for application was four or two minimum wages, respectively (Brosio 2012).

**Good and Services Taxes**

A retail sales tax offers another alternative for raising new subnational revenue. Some Latin American countries have experimented with excise taxes on sales of products such as liquor, tobacco, and gasoline. A single-phase sales tax charged to final consumers can be an improvement over taxes on production and sales imposed on companies in many countries because it does not have the “cascade” effects of multiple taxation. However, this type of tax is not easy to administer due to the high rate of informality prevalent in the economies of the region\footnote{The average rate of informality in Latin America and the Caribbean was approximately 35 of GDP percent from 1999 to 2007, with a low of 20 percent of GDP in Chile and a high of 66 percent of GDP in Bolivia (Schneider et al. 2010).} and because retail sectors are often very “atomized” and have little capacity to properly maintain the accounting records required for control. This tax would probably be viable in countries with lower levels of informality where formal commerce is more prevalent.

In addition, the tendency to grant exemptions from wholesale taxes would severely erode the collection capacity of these taxes. Lastly, results for Colombia suggest that the application of a sales tax to raise local revenue would have a greater impact in the more developed regions. This could intensify inequalities within countries, although the disparities
would be less than that caused by taxes based on production or income (Sánchez, España and Zenteno 2011).

A **subnational VAT (or a surcharge on existing national VAT)** promises higher revenue potential than some other alternatives. For example, if Venezuela applied a 1 point surcharge on VAT, it could generate a 13 percent increase in the revenues of the states (Ríos et al. 2011). However, the increase would be unequal across states since it would benefit the states with large urban populations to the detriment of the more rural states. In Mexico, a surcharge on VAT would have a similar impact, without broadening the tax base and redefining the criteria for allocation of revenue sharing. It would also negatively impact the distribution of revenue between Mexican states (Castañeda and Pardinas 2011).

Although VAT’s capacity to generate tax revenue is well known, the Brazilian experience illustrates the practical problems posed by this tax at the subnational level. The difficulties of maintaining good records of commercial transactions between states with different tax systems complicate administration of a subnational VAT and result in high compliance costs.

A **corporate value added tax** would be similar to the Regional Tax on Productive Activities (IRAP) created in Italy in 1998. The IRAP base is basically the same as the traditional VAT, calculated as the difference between sales revenue and the sum of all purchases and depreciation. IRAP is, therefore, a tax levied on a VAT-based source. The rate applied by the Italian central government is 4.25 percent, which the regions may increase or decrease by one percentage point. IRAP contributes about 2.5 percent to Italian GDP.

Application of this type of tax could generate significant subnational revenue in some countries in Latin America. It would be relatively easy to administer because taxpayers are currently paying VAT. However, to collect the tax, subnational governments would require a certain level of administrative capacity, which in many cases is lacking. It is also likely that only a portion of this tax could be used as credit against corporate taxes in other countries, which would be a disincentive to foreign investment. Moreover, this type of VAT acts in favor of imports and against domestic production and exports because it is not deductible from the tax base. Lastly, it is an additional tax on labor, and therefore could produce undesirable effects on wages, employment, and informality.

**Excise taxes** offer another possible source of new tax revenue for subnational governments. Alternatives include a surcharge on national
excise taxes, a tax on public services such as electricity and mobile phones, a regional and/or local fuel tax, and a tax on tourism. Where these taxes have been implemented, they generate moderate amounts of revenue with low administrative and compliance costs for taxpayers. Moreover, these taxes can be attractive because taxation on public services creates fewer distortions due to the low price elasticity of demand.

However, these taxes should be used with caution since they can discourage consumption of goods and services with positive externalities. Taxes on sales of certain inputs, such as fuel and electricity, also affect production costs in industries where they are used intensively, with a consequent loss of competitiveness. To reduce economic distortions, residential electricity consumption should be the main tax base, as shown in Peru (Canavire-Bacarreza, Martínez-Vázquez and Sepúlveda 2012).

**Green taxes**

Green taxes, also known as environmental taxes, can be an innovative source of subnational revenue. Since many of the negative effects on the environment are localized, a wide range of green taxes can be applied by subnational governments to mitigate these effects (see chapter 11). Examples are taxes on air pollutants such as carbon dioxide (CO₂), sulfur dioxide (SO₂), nitrogen dioxide (NO₂) and fuels; on transport in the form of a tax on car sales or traffic; and on waste products such as tires, beverage containers, plastic bags, and batteries, among others.

One of the most interesting green taxes is a congestion charge in cities. Establishing tolls for entering congested areas in a city or to access certain routes can be a way to reduce the negative externalities of traffic, such as congestion, accidents, and pollution. Another attractive alternative for local governments is charging for management of solid and liquid waste to cover handling costs and discourage their generation.

Although their collection potential may be limited in the short term, green taxes can help correct externalities, make the development of cities more fiscally and environmentally sustainable, and facilitate provision of certain local services.

**Other Reforms**

A number of complementary reforms would further strengthen subnational taxation. These range from reforms of existing transfer systems, to changes in the systems for allocating revenue from nonrenewable natural resources and development of revenue stabilization mechanisms.
The existing transfer systems discourage the tax effort of subnational governments in many countries in the region. In Argentina, discretionary transfers reduce own-source revenue and stimulate more public investment (Artana et al. 2012). In Peru and Venezuela, transfers to subnational governments of revenue from natural resources adversely affect the local tax effort (Canavire-Bacerreza et al. 2011; Ríos et al. 2011). In Colombia, transfers decrease the likelihood of updating municipal property registries (Sánchez and España 2012).

The reforms needed in this area include clear ground rules that create incentives for the subnational tax effort and simplification of the transfer system. Systems that attempt too much at the same time end up failing.

Transfers from exploitation of nonrenewable resources create severe interregional distortions. Besides the evident regional inequalities in income distribution, the extreme variability of the prices of oil and certain minerals also result in extreme volatility in the public finances of the beneficiary regions. To correct these limitations, the rules for distribution of revenue from mineral and hydrocarbon production must establish distribution systems for all regions; implement savings schemes to smooth subnational expenditures financed by those revenues; and implement systems to monitor and control the use of resources, which should be linked to the outcome indicators of the projects financed.

In most countries, transfers are determined by current government revenues, which tend to fluctuate sharply with the domestic economic cycle and with the prices of some export products. Through this transmission channel, the resources of subnational governments are subject to uncertainty and volatility. The procyclical nature of transfers to subnational governments reinforces the procyclical behavior of national fiscal policies and intensifies fiscal crises. As a result, subnational governments need a stabilization and savings system to correct the volatility of transfers.

**Conclusion**

Subnational tax revenue has great potential. Apart from helping finance local spending, it could improve the accountability and transparency of subnational fiscal management. But this potential is difficult to exploit. Proposals for reform of subnational tax systems aim to improve the use of existing tax powers, especially in relation to property taxes, both rural and urban. The reforms also seek to strengthen subnational tax adminis-
Subnational governments can also benefit from new taxes through surcharges on existing national income and consumption taxes or new excise and/or green taxes.

There is no single recipe for implementing these suggestions because they depend on the degree of economic and social development at the national and local level, the capacity of subnational governments, and political constraints. The final objective of any reform must be to boost local development. Consequently, in addition to assuring effective collection, any reform must consider economic efficiency, distributive equity, and environmental sustainability.
References


