

**International Studies Program  
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Decentralization in Peru**

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International Studies Program  
Andrew Young School of Policy Studies  
Georgia State University  
Atlanta, Georgia 30303  
United States of America

Phone: (404) 651-1144  
Fax: (404) 651-4449  
Email: [ispaysps@gsu.edu](mailto:ispaysps@gsu.edu)  
Internet: <http://isp-aysps.gsu.edu>

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# *Constraints to Effective Fiscal Decentralization in Peru<sup>1</sup>*

**Ehtisham Ahmad\* and Mercedes García-Escribano\*\***

*\*London School of Economics and IMF, \*\*Western Hemisphere Department IMF*

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## A. Introduction

Peru over the past quarter of a century presents a veritable laboratory for the evaluation of different approaches to decentralization, and the constraints faced by the different arrangements. The renewed emphasis at the present time is partly a reaction to the abuse of centralized power that was experienced during the Fujimori years in the 1990s, as well as an expression of the political economy equilibria that have emerged in the 2000s. A fundamental difference between the current García administration and the preceding one in the 1980s is the recognition of the importance of macroeconomic stability without which there can be no effective poverty reduction, whether centralized or decentralized.

Learning from the macroeconomic crisis of the late 1980s, the current Peruvian decentralization process, which started in 2002, is based on a concern for maintaining fiscal sustainability—and is based on a gradual approach to addressing geographical disparities, local service delivery and poverty reduction. Based on the relatively limited experience to date with decentralization in Peru (in 2007, local governments carried out 16.5 percent of total primary expenditures of general government compared to about 12 percent in 2002), this paper focuses on an overview of the legal framework and its implementation to date, including the sequencing of spending of the devolution of responsibilities and revenue assignments. We posit that aspects of the incomplete decentralization need to be addressed in order to achieve a more effective and meaningful involvement of local governments in public service delivery and poverty reduction and inequality across regions.

Section B examines the historical background to the current decentralization debate and also provides insights to the limitations of various approaches to decentralization. This historical experience also places in context the overall fiscal framework in Peru, which remains fairly centralized. In this section, we also summarize the legal framework that is the starting point of the current decentralization efforts. Section C reviews the components of the decentralization process—the evolving spending responsibilities, their link to the design of own-source revenues, and the focus of the pending decentralization agenda mostly on revenue-sharing. We discuss natural resource canons, which predate the current decentralization process. We argue that it will be increasingly difficult to comply with the targets of the fiscal responsibility legislation, as sub-national governments are better able to execute their budgets, circumvent earmarking and investment filters. The potential impact of a weak public financial management system on the sequencing of decentralization is discussed. We also emphasize the importance of revising the approach taken with respect to the design and implementation of the fiscal transfer system. Section D concludes.

## B. Background

### Historical cycles

**Successive Peruvian administrations have oscillated between centralized rule and decentralization.** Mayors were popularly elected prior to the period of military rule between 1968 and 1979. The subsequent period of extreme centralization was characterized by increasing disparities between the coast (particularly Lima) and the poorer regions of the *sierra* and *selva*. The 1979 constitutional reforms reinstated municipalities. However, the

attempts to decentralize functions during the first García period in the 1980s were hampered by weak administrative and economic management, and plagued by extensive rent seeking and diversion of resources. Combined with the chaos associated with the macroeconomic crisis, there was little evidence of a reduction in regional disparities or poverty.

The Fujimori administration was, as a reaction, quite centralized. However, there was recognition of the importance of tailoring government programs to local conditions. Indeed, the sub-national administrations were effectively deconcentrated agents of the center, which lacked clearly defined own-responsibilities and sources of financing. Centrally-determined and financed programs, such as FONCODES, were often the major source of activities for local governments. While these were, in principle, designed to reflect local priorities, there were few mechanisms to coordinate at the local or central levels, assess tradeoffs and establish priority spending. The center lacked the full information to make allocations, and there often was a lack of clarity between the spending by specialized agencies like FONCODES and the operations of line ministries and local administrations. Local governments were weak and lacked financing or clear responsibilities. The swing of the pendulum towards centralization, particularly in the latter part of the Fujimori administration, brought with it renewed concerns about rent-seeking and an absence of accountability at all levels of government.

This period showed that centralized provision could be tailored to meet local conditions (as argued by Breton, 2001) yet the lack of political checks and balances allowed the system to be misused with a diversion of funds for the reelection of Fujimori or outright rent seeking.

### **A renewed interest in decentralization**

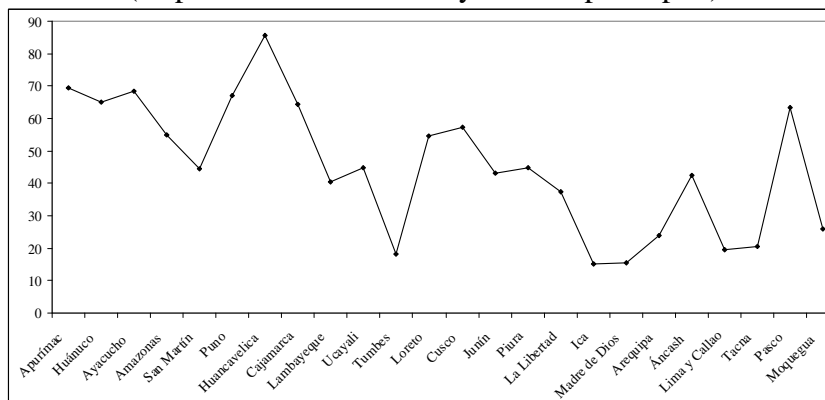
There was a renewed interest in decentralized governance with the election of the Toledo administration in 2002. President García in 2006 also decided to move forward the decentralization process. There was a political-economy recognition that a dispersal of power among regional and local governments provides insurance against a centralized abuse of power and resources, as experienced during the Fujimori years. Yet the concern to maintain macroeconomic stability was predominant—and this was an important lesson from the early 1990s.

There was also a recognition that the centralized period had not been able to adequately address the sizable geographical income disparities. This posed constraints to effective decentralization as disparities in revenue bases, income (expressed as gross domestic product per capita) are quite marked across departments.

In turn, income levels have an impact on the departments' capabilities to respond to differential spending needs of the population. Indeed, there is a clear negative correlation between poverty and income levels across departments (Figure 1). Given the disparities in revenues, and concerns about maintaining macroeconomic stability in a situation of relatively weak administrative capabilities, the Toledo administration took a very cautious approach towards spending responsibilities—establishing strict criteria for devolution and effectively strengthening the overlapping systems of responsibilities that so characterize Latin American

subnational public finances (Ahmad and Brosio, 2008). Further, within departments, poverty rates in rural areas are significantly higher than those in urban areas; also, the poverty rates in the *selva* and *sierra* regions are higher than in the coast.

Figure 1. Peru: Poverty rates across departments in 2007  
(Departments are sorted by income per capita)



Source. INEI. Department income is 2006 data. Population figures correspond to the 2007 census. Poverty rates correspond to “total poverty” definition, and not to “extreme poverty”.

Continuing regional disparities are a challenge to the effectiveness of any decentralization process. Indeed, despite the ongoing reduction in poverty across Peru, regional disparities continue to persist. Poverty declined by about 9.5 percentage points in Peru during 2005-07, but the gains have not been evenly distributed. Urban, *selva* and coast areas benefited the most from the reduction, and across departments, those with poverty rates in the middle range experienced the biggest declines in poverty (Table 1). Regional inequality has not been reduced (or may even have increased), according to statistical measures of inequality.<sup>2</sup> As a result, poverty continues to be the highest in Huancavelica and the lowest in Tumbes, and higher in the *sierra* and *selva* than in the coast.

While recognizing that the equalization of income per capita may not be feasible or desirable, a decentralization framework should ensure and facilitate a minimum, if not a reasonably similar, provision of access to public services to all sections of the population (see Ahmad and Searle, 2006). Otherwise, the decentralization may result in growing imbalances in both incomes and public services.

<sup>2</sup> Measures of inequality dispersion show an increase between 2005 and 2007. Relative mean deviation and the Gini coefficient increased to 0.28 and 0.41 in 2007 from 0.25 and 0.37 in 2005.

Table 1. Peru: Evolution of poverty rates, 2005-07

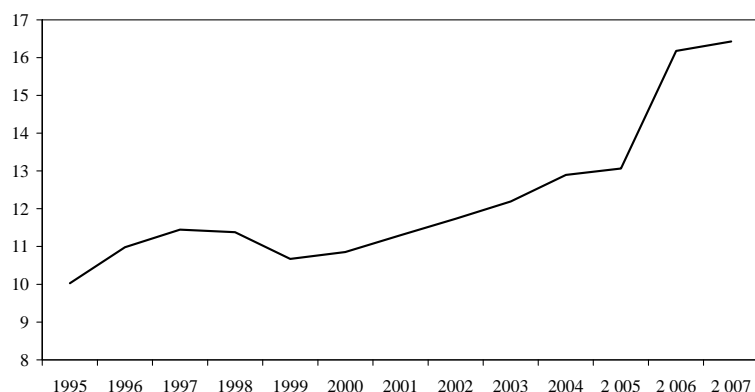
	2005	2007	change
<b>Area</b>			
Urban	36.8	25.7	-11.1
Rural	70.9	64.6	-6.3
<b>Natural region</b>			
Coast	34.2	22.6	-11.6
Sierra	65.6	60.1	-5.5
Selva	60.3	48.4	-11.9
<b>Departments</b>			
Tumbes	16.2	18.1	1.9
Ica	23.9	15.1	-8.8
Arequipa	24.9	23.8	-1.1
Moquegua	30.3	25.8	-4.5
Tacna	30.3	20.4	-9.9
Madre de Dios	30.8	15.6	-15.2
Lima y Callao	32.9	19.4	-13.5
La Libertad	43.0	37.3	-5.7
Lambayeque	44.0	40.6	-3.4
Áncash	48.4	42.6	-5.8
Ucayali	53.1	45.0	-8.1
San Martín	54.1	44.5	-9.6
Cusco	55.6	57.4	1.8
Junín	56.0	43.0	-13.0
Piura	58.6	45.0	-13.6
Amazonas	68.6	55.0	-13.6
Cajamarca	68.8	64.5	-4.3
Loreto	71.5	54.6	-16.9
Pasco	72.9	63.4	-9.5
Apurímac	73.5	69.5	-4.0
Puno	75.2	67.2	-8.0
Huánuco	75.8	64.9	-10.9
Ayacucho	77.3	68.3	-9.0
Huancavelica	90.3	85.7	-4.6
<b>Total</b>	<b>48.7</b>	<b>39.3</b>	<b>-9.4</b>

Source: INEI.

## Decentralization and Overall Fiscal Constraints

Local governments continue to carry out only a small fraction of general government expenditures in Peru despite an acceleration of devolution in recent years. Following a significant increase during the late 1990s, and a subsequent correction thereafter, execution of general government nonfinancial expenditures by local governments increased from 10 percent in 1999 to about 13 percent in 2005 and 16.5 percent in 2007 (see Figure 2 and Table 2).

Figure 2. Percentage of general government primary expenditures executed at the local level, 1995-2007



Source: Staff with BCRP data.

Table 2. Fiscal operations of the general government and local governments

Level of government	(millions of soles)		(in percent of GDP)	
	2003	2007	2003	2007
	(million of soles)			
<b>Revenue</b>				
current	37,259	4,590	69,455	11,672
capital	382	167	386	787
<b>Noninterest expenditures</b>				
current	30,805	2,655	43,407	5,380
capital	5,830	1,765	10,244	3,434
<b>Interest payments</b>	4,538	111	5,934	50
<b>overall balance</b>	-3,532	227	10,256	3,595
	(in percent of GDP)			
<b>Revenue</b>				
current	17.5	2.2	20.4	3.4
capital	0.2	0.1	0.1	0.2
<b>Noninterest expenditures</b>				
current	14.4	1.2	12.7	1.6
capital	2.7	0.8	3.0	1.0
<b>Interest payments</b>	2.1	0.1	1.7	0.0
<b>overall balance</b>	-1.7	0.1	3.0	1.1

Source: BCRP website.

Local operations are financed by both local revenues and central government transfers. Local revenues accounted for about 28 percent of total local government current resources in 2007, and the rest included shared-revenues, such as for natural resources like the canon (which predate the existing decentralization initiative) and specific program transfers. Further, local governments may borrow in the domestic or international markets subject to the fiscal rules on indebtedness stated below. Also, a central government guarantee is needed for external indebtedness operations of sub-national governments (General Law of Public Indebtedness, July 2005). According to the Fiscal Decentralization Law (FDL), domestic or external borrowing by sub-national governments may only be used to finance the execution of investment projects, but not for current expenditures. Despite availability of financing, sub-national governments may incur in payment arrears (that is “floating debt”) reflecting the

earmarking, which is explained in further detail below. The magnitude of sub-national “floating debt” is unknown, but is believed to be growing.<sup>3</sup>

In the medium term, local and regional governments may challenge compliance with the fiscal responsibility legislation. In recent years, as seen in Table 3, the overall primary balance of the local governments has been positive (reflecting their limited capacity to use the sizable canon transfers, which are earmarked to capital spending), thus, helping the consolidated nonfinancial public sector (NFPS) comply with the 1 percent of GDP deficit ceiling stipulated by the Fiscal Responsibility Transparency Law (FRTL). However, as decentralization proceeds and the regional and local governments improve their capacity to prepare and execute investment projects, they are less likely to have an overall fiscal surplus and thus their contribution to the NFPS overall balance is expected to deteriorate. In response, the central government as well as the rest of the general government and public entities would have to improve their fiscal stance in order to offset this deterioration to stay within the FRTL ceiling. Further, as sub-national governments gain more spending responsibilities, more fiscal flexibility by the central government will be needed (for example, to adjust to unexpected revenue shortfalls and hence lower transfers) to ensure compliance with the overall fiscal deficit ceiling. Moreover, as adjustments at the sub-national level become more difficult, so do prospects for coordination to achieve the desired outcomes.

Table 3. Peru: Fiscal Operations of the NFPS  
(percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>NFPS Primary balance</b>	<b>0.3</b>	<b>1.6</b>	<b>2.1</b>	<b>1.2</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.4</b>	<b>1.0</b>	<b>1.6</b>	<b>3.9</b>	<b>4.8</b>
Central government	-0.04	1.07	0.97	0.75	-1.04	-0.60	-0.65	-0.16	0.22	0.59	1.13	3.21	3.38
Rest of general government	0.37	0.26	0.44	0.54	0.14	0.25	0.21	0.17	0.26	0.28	0.29	0.42	1.36
of which local governments	0.06	-0.04	-0.02	0.06	-0.08	0.10	0.05	0.10	0.16	0.14	0.28	0.09	1.07
Public entities	0.00	0.25	0.68	-0.10	0.03	-0.49	0.21	-0.12	-0.05	0.14	0.21	0.28	0.08
Interest payments	3.5	2.7	2.0	2.2	2.4	2.5	2.3	2.2	2.2	2.0	1.9	1.9	1.8
<b>Overall balance</b>	<b>-3.2</b>	<b>-1.1</b>	<b>0.1</b>	<b>-1.0</b>	<b>-3.2</b>	<b>-3.3</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-1.7</b>	<b>-1.0</b>	<b>-0.3</b>	<b>2.1</b>	<b>3.1</b>

Source: BCRP.

Note: regional governments are included together with the central government, since during this period they were deconcentrated organs of the center.

## Incomplete decentralization and the legal framework

### *Background*

Since 2002, when the constitution was amended, a legal framework for a gradual and fiscally neutral decentralization process started to be established. The amendment mandated political and fiscal decentralization, and established three levels of government (national, regional,

<sup>3</sup> This is suggested by selected surveys of municipal operations initiated by the World Bank.

and local) instead of two levels (national and local).<sup>4</sup> This section summarizes the legal decentralization framework and highlights the key aspects that still need to be regulated.

Following the amendment to the constitution, three organic laws were enacted to guide the process of political and fiscal decentralization. The three organic laws that were passed are (1) the Organic Law of Regional Governments of 2002 (Law No. 27867) and (2) the Organic Law of Municipalities of 2003 (Law No. 27972), which defined the organization and responsibilities for these levels of government; and (3) the Framework Decentralization Law of 2002 (Law No. 27783), which mandated a clear, gradual, and fiscally neutral devolution of expenditures and revenues and established stages for the devolution process. In particular, the devolution of responsibilities was to start with social and infrastructure programs, continue with other sectoral functions, and end with the transfer of education and health functions. This law also provides for passing legislation on the creation of regions (resulting from the merger process of regional governments) and incentives for the merging process.

### ***Macroeconomic constraints and decentralization sequencing***

The amendment of the FRTL in 2003 also placed a number of restrictions on sub-national operations in order to ensure macroeconomic stability. These include the following:

- A central government guarantee is required for contracting of external debt by sub-national administrations.
- Such external debt is only to be used to finance public investment.
- The debt-to-current revenue ratio and annual debt service-to-current revenue ratio must be below 100 and 25 percent<sup>5</sup> respectively, for each sub-national government.<sup>6</sup>
- The 3-year average primary balance of sub-national governments must be positive.

In early 2004, the Fiscal Decentralization Law (FDL), (Decree No. 955) was approved with the objective of ensuring a fiscally sound decentralization process. The FDL established a two-stage process for transferring revenues to regional governments. During the first stage, regional governments are to be funded through transfers from the central government, earmarked for certain social programs and infrastructure projects and consistent with the principle of fiscal neutrality.

Regional governments that voluntarily merge to constitute larger regions will qualify to enter the second stage. At this stage, regions will receive 50 percent of certain taxes—in particular,

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<sup>4</sup> There are 1829 municipalities and 26 regional governments in Peru.

<sup>5</sup> This is more restrictive than the limit of 30 percent imposed by the Organic Law on Municipalities and could cause some confusion.

<sup>6</sup> The definition of current revenues used to compute the ratios includes transfers from other levels of government, but excludes the operating balance from previous years, the financing through domestic and external indebtedness operations, and the revenues earmarked to trust funds (*fideicomisos*) (Regulations for the FRTL, November 2004).

indirect taxes (VAT and excises) and the personal income tax—collected in their jurisdictions.

Further, regions will get additional transfers from the center if expenditures (excluding wage bill increases) exceed shared-transfers because of external factors (such as a natural disaster or a drop in regional income). Also, regions will get a bonus (earmarked for investment and maintenance of infrastructure) equal to the increase in tax collections above their potential level resulting from efforts to improve tax administration and reduce tax evasion.<sup>7</sup> According to the law, a bonus to reward efforts to increase revenue collections may also be implemented in the first-stage. In order to ensure fiscal neutrality, the regulations to the FDL of September 2005 clarified that shared-transfers will not exceed the estimated cost associated to the devolved functions. Moreover, the regulations also clarified that fiscal savings resulting from the efficient provision of public functions by regions may be used for investment and maintenance of infrastructure.

In addition to the debt sustainability rules established in the FRTL, the FDL sets additional ceilings on debt service, debt stock (including floating debt), and expenditure growth. These rules include the following:

- The non-guaranteed debt-to-current-revenue ratio and the annual non-guaranteed debt service-to-current-revenue ratio must be below 40 percent and 10 percent, respectively.
- Domestic or external indebtedness operations must be used exclusively to finance investment projects.
- There is to be a 3 percent annual limit on real primary expenditure growth.
- Short-term debt (including floating debt) at end-year cannot exceed one-twelfth of annual current revenues.

Further, the FDL established some reporting provisions for sub-national operations. Regional and local governments must provide the central government their medium-term fiscal projections (indicating the planned external and domestic indebtedness operations), which must be consistent with the three-year Multi-annual Macroeconomic Framework published by the Ministry of Economy and Finance. Also, sub-national governments must report on their quarterly fiscal performance and describe adjustment measures, if necessary, to comply with their annual targets.<sup>8</sup>

The FDL law also envisaged the passage of an Accreditation System Law to establish a system to assess whether regional and local governments meet minimum capacity standards to qualify for the transfer of functions (including personnel) and the corresponding resources.

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<sup>7</sup> Lima and Callao do not need to merge to enter the second stage and get the additional resources.

<sup>8</sup> The FDL establishes that by end-2005, local and regional governments will provide the Ministry of Economy and Finance a fiscal management report, that would report on compliance with the fiscal rules and suggest adjustment measures if necessary to ensure compliance after a two-year period.

The Accreditation Law was approved in July 2004, and implementing regulations were issued in November 2004. The Accreditation System Law also regulates the annual procedure for the devolution process. Based on the responsibilities assigned to sub-national governments in the Organic Law of Regional Governments, Organic Law of Municipalities and the Framework Decentralization Law, the National Decentralization Council (NDC) (and now the *Secretaría de Descentralización*)<sup>9</sup> elaborates an annual transfer plan specifying the functions that may be transferred during that year and the criteria that sub-national governments need to meet in order to qualify for the transfer of the functions and corresponding resources.<sup>10</sup> First, the annual plan is approved by the Council of Ministers, and then, the regional and local governments may request the devolution of functions. Next, the sub-national governments' capacity is assessed, and then, the sub-national governments are certified by the NDC (or now by the *Secretaría de Descentralización*) for the delivery and devolution of additional functions.

### ***Mergers and regional governments***

The Law on Incentives for Integration and Creation of Regions of June 2004 provided incentives for the voluntary merger of regional governments (via referendum) in order to obtain an optimum number of economically viable regions. Referenda were scheduled to take place at end-October 2005, 2009 and 2013. For the 2005 referendum, the NDC had approved technical requests for consolidation of 16 departments into 5 regions.<sup>11</sup> The referendum was negative with 15 of the 16 departments rejecting the proposals, and consequently, none of the regional governments are to merge into regions. The result may have been due to a lack of information for voters, but are more likely reflective of a lack of confidence in regional leaders vis a vis local interests.

Before the FDL regulations were passed, the revenue-sharing arrangements led to perverse incentives. Indeed, under both the FDL and Law on Incentives, the shared-transfers (i.e., the 50 percent of national revenues collected under their jurisdiction) could be interpreted as an automatic transfer or right that was not linked to any spending responsibilities. The lack of clarity in accountability for shared revenues was addressed in the FDL regulations, matching shared-transfers to the cost of devolved functions (as mentioned above). However, this attempt to link transfers to accountability was negated to some extent by the inclusion of an additional incentive in the FDL regulations: each region, created in the 2005 referendum, would have received an annual fixed transfer (\$./210 million, equivalent to 0.08 percent of GDP) during four years. In the event, this provision was not put into play.

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<sup>9</sup> President Garcia's decision to promote the decentralization process led to the creation of the *Secretaría de Descentralización*, directly under *Presidencia del Consejo de Ministros*. The *Secretaría de Descentralización* replaced the NDC and became the entity in charge of guiding the decentralization process.

<sup>10</sup> In turn, the annual plan of the line ministries is based on a five-year sectoral transfer plan prepared by the ministries in coordination with the regional and local governments.

<sup>11</sup> These departments were: Tumbes, Piura and Lambayeque; Ancash, Huánuco, Lima provincias, Pasco, and Junín; Apurímac and Cuzco; Ica, Ayacucho and Huancaavelica; Arequipa, Puno, and Tacna.

***Incomplete decentralization***

The legal framework for decentralization is incomplete, despite the concerted efforts to shore up its underpinnings. This partly reflects the incomplete nature of the decentralization process itself (see Devarajan, Khemani and Shah 2008), and indeed, there is still a need to clarify the functional spending responsibilities of each tier of government (see below). This is, moreover, a critical issue in most Latin American countries. Greater clarity in functional responsibilities is critical in consolidating political accountability at the sub-national level. There needs also to be effective regulations with sanctions for sub-national governments or politicians not complying with their fiscal rules or reporting requirements.

A key lesson from the past quarter of a century appreciated by the centralized and decentralized administration alike is the importance of maintaining macroeconomic stability together with amendments in spending and revenue-raising responsibilities. Thus, additional steps will be needed to ensure a neutral impact of the decentralization process on macroeconomic balances.

The sections below assess key aspects of the likely measures that may be required to ensure macroeconomic neutrality: (1) the assignment of own-source revenues, to ensure sub-national accountability, (2) clarification of sub-national responsibilities, together with significant improvements in sub-national public financial management (with a focus on whether there is complete and standardized information on the activities of all levels of government), and (3) the design of the transfer system considering the disparities in the country. The administrative capacity of sub-national governments to undertake functions needs to be satisfactory, but this also has to be accompanied by strengthened public financial management capacity—indeed, this is needed at all levels of government. Also, at the central level, there is a need to strengthen the accreditation system, to impose monitoring of the quality of the services delivered by sub-national units, and to ensure the consistency of sub-national fiscal operations with their fiscal rules and the overall macroeconomic fiscal framework.

**C. Assignments and Accountability**

In this section, we review the key elements of the decentralization process—starting logically with the functions that sub-national administrations are required to carry out, and the financing arrangements for these assignments. However, much of the political debate is over the sharing of resources, with relatively little focus on the spending responsibilities. This opens up the possibility of overall imbalances, as the central government is left with more responsibilities than commensurate with its revenue shares.

**Expenditure assignments**

The expenditure assignments among levels of government (national, regional and local) are, in principle, regulated by the Framework Decentralization Law. This law specified which functions are exclusively assigned to a particular level of government or are shared among several levels. It also provided for the clarification of the shared responsibilities, either with a new Organic Law of the Executive Power or with sectoral legislation. The new Organic Law of the Executive Power of December 2007 did not address the expenditure assignments

among levels of governments to avoid duplications. Instead, this law indicated that the shared and exclusive responsibilities across levels of government would be determined in the laws of organization and functions of each ministry. These laws are still pending.

The process of decentralization does not appear to be based on the principle of subsidiarity, which has driven similar efforts in other parts of the world. There is, in fact, relatively little discussion of responsibilities at the sub-national level, including policy, and implementation, particularly the hiring and firing of personnel. The legislation does not, at present, assign to local governments the responsibility for either primary education or basic health care—indeed, these are examples of shared responsibilities among levels of government, with the sub-national administrations having relatively little influence or control over these functions. It is noteworthy that under the devolution plan education and health are the last functions to be devolved.

The devolution of functions proceeded gradually during the first years of decentralization. The transfer plan approved in 2003 and with effect in 2004 included specific social and infrastructure programs and most of the sub-national government were certified for these (see Table 4).<sup>12</sup> Starting in 2004, the Accreditation System had to be in place to proceed with the transfer of functions for 2005. The transfer plan approved in May 2004 included functions in the following sectors: agriculture, fishing, tourism, trade, industry, artisans, energy and mining. However, because of delays in passing the implementing regulations of the Accreditation System Law, no further functions were devolved in 2005.

Table 4 Devolution of Functions, 2003

		Program or Project	
		Recipient 1/	Certified 1/
Regional governments	Special programs of INADE	9	8
	Maintenance of rural roads of PROVIAS RURAL	12	4
	Projects of rural electrification	17	17
Local government	Food programs of PRONAA	194	67
	Maintenance of rural roads of PROVIAS RURAL	22	12
	Reconstruction projects of ORDESUR	29	29
	Social infrastructure projects of FONCODES	498	241

Source: PRODES.

1/ Number of governments.

In October 2006, an urgency decree brought forward the devolution of 180 functions (including those that should have been transferred during 2004-06) to regional governments to end-2007 (thus, a total of 4,500 functions).<sup>13</sup> By March 2008, nearly 1,900 functions have been devolved and the accreditation process of another 2,580 is nearly completed. In line with the Framework Decentralization Law, the transfer of functions has been accompanied with the transfer of resources, including workers.

<sup>12</sup> Lacking an accreditation system, a simplified provisional system for the certification of sub-national governments' capacity to deliver some social and infrastructure programs was implemented in 2003.

<sup>13</sup> The 180 functions are exclusive functions specified in the Organic Law of Regional Governments.

The devolution of social and infrastructure programs has also advanced. During 2007, all the local governments that were recipients of PRONAA (a total of 195) were certified. 546 local governments that received FONCODES (of a total of 558) were certified. Pilot programs for the decentralization of primary health as well as initial and primary education are underway.

### **Revenue assignments**

**On the financing side, regional and local governments heavily rely on transfers.** The resources of local governments include local revenues and transfers from the central government, which include shared-revenues (such as for natural resources like canon, which predate the existing decentralization initiative) and specific project transfers (for example, for social programs such as *Vaso de Leche*) (Table 5).<sup>14</sup> Local governments may borrow in the domestic or international markets subject to the fiscal rules on indebtedness stated above.<sup>15</sup> Similarly, regional governments' operations are financed by both transfers and indebtedness operations, but no tax has been created to fund expenditures of this level of government.

### **Own-source revenues**

The design of the Peruvian intergovernmental system does not provide for control over rates or bases by local governments. Local governments do not have discretion over revenues, but instead, all tax policy issues are determined by Congress. Hence, it cannot be said that local governments have own-source revenues. Indeed, even the rates of revenues from "local" taxes (such as the property tax) that accrue entirely to the local governments are centrally determined. In this sense, such revenues are closer in concept to shared revenues (with a 100 percent share) than own-source taxes.

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<sup>14</sup> Local current revenues accounted for 35 percent of total local government current resources in 2005.

<sup>15</sup> A central government guarantee is needed for external indebtedness operations of subnational governments (General Law of Public Indebtedness, July 2005); therefore, external indebtedness operations by subnational governments are counted against the annual limit on indebtedness operations (including guarantees) that the central government may contract or provide in a given year (this limit is established each year in the Annual Public Indebtedness Law).

Table 5. Financing of Subnational Governments

Regional government	Local government
<ul style="list-style-type: none"> <li>• <b>Transfers</b> from the central government: shared-revenues (canons, royalties, and in second stage of the decentralization, 50 percent of VAT, excises and personal income tax) and other transfers (FONCOR, discretionary transfers).</li> <li>• <b>No regional tax</b></li> <li>• <b>Borrowing operations</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Transfers</b> from the central government: shared-revenues (canon, royalties), and other transfers (FONCOMUN, for social programs, other discretionary transfers).</li> <li>• <b>Local tax revenues</b> (property tax, cultural events, vehicles) and <b>non tax revenues</b> (fees, fines, sale of goods and services).</li> <li>• <b>Borrowing operations</b></li> </ul>

Table 6. Current revenue sources of the local governments, 2001-07  
(millions of soles)

	2001	2002	2003	2004	2005	2006	2007
local revenues							
taxes	453	525	595	658	718	726	1,093
nontax revenues 1/ contributions	1,062	1,150	1,213	1,415	1,512	1,392	1,588
contributions	12	5	5	7	7	8	6
transfers							
shared-revenues 2/ other transfers 3/	272	371	638	870	1,624	2,627	5,473
other transfers 3/	1,566	1,669	1,899	2,475	2,452	2,843	3,633
<b>Total</b>	<b>3,365</b>	<b>3,720</b>	<b>4,351</b>	<b>5,424</b>	<b>6,315</b>	<b>7,596</b>	<b>11,792</b>

Source: MEF

1/ Municipal fees, fines, and revenues from the sale of goods and services

2/ Canon and sobre canon.

3/ Foncomún, Vaso de Leche, and other transfers.

Discretion over own-sources of revenues is a necessary condition to engender sub-national accountability and responsibility (Ambrosiano and Bordignon, 2006). A key element in establishing an effective hard budget constraint at the sub-national level of government is that these jurisdictions should have access to own-sources of revenue to use in case of needed adjustments. Further, additional spending should be financed with a burden on the local electorate, so that spending choices are carried out in a responsible manner. This is an essential ingredient, for example, in the operation of participatory budgeting. If, however, the design of the revenue-sharing or transfer systems is such that the local governments are not induced to efficiently use their own-resources, then clearly accountable decisions cannot be assured. This involves control at the margin over the tax-rate structure, (e.g., within bands) or over the bases for particular taxes.

Different arrangements could help bring some discretion over own-source revenues. The legal framework of a unitary state is not, in principle, inconsistent with “room” for own-source revenues at the local level. For instance, Congress could retain control over the rate structures by enacting a band, say for the real estate tax (*predial*), with an upper and a lower bound within which the municipal government would set its particular rate give its spending needs. This could accommodate some of the scope for generating own-source revenues at the sub-national level, while retaining the judicial responsibility for rate setting by Congress. Similar arrangements are possible for other taxes, including those covered under the general revenue-sharing agreement for merging regional governments.<sup>16</sup> Complex revenue-sharing arrangements lead to possibilities for game-play by levels of government, as each tries to maximize its own take. Further, these arrangements may also pose difficulties for tax administration (SUNAT). For example, the allocation of VAT across regional governments is complex since production may take place in one location and final consumption in a different one.

Thus, it would be important to ensure that:

- Sub-national governments have discretion over own-sources of revenues, for example, through rate bands on particular targets.<sup>17</sup>
- Discretion over own-source revenues, as described above, does not necessarily imply that there must be local administration of taxes. Suitable arrangements could involve contracting SUNAT to collect some sub-national taxes—this would be facilitated if there are shared bases, such as “piggy-backing” arrangements for some taxes. Each option should be subject to feasibility and ease of administration.

### **Sharing of natural resources**

A major and increasing source of sub-national revenues are the mining royalty and canons (revenue-shares related to natural resources, particularly for mining and petroleum).<sup>18</sup> The main sources of natural resource transfers in Peru are shown in Table 7, over the period 2001-2007. The recent sharp increase in natural resource revenues is due both to the extensive new operations that have been brought on stream as well as the recent upturn in commodity prices. These revenues are not taken into account in the assignment of spending responsibilities.

The distribution of canon and mining royalties do not help address geographical income disparities. Because these accrue exclusively to producing local and regional governments (which are mainly those with lower poverty rates and higher income per capita as shown in

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<sup>16</sup> While regional governments may get transfers from the central government, including shares of national taxes, no tax has been created for regional governments yet.

<sup>17</sup> However, it is not sufficient to ensure that these revenue-handles will be used, as the incentives may be offset, for example if there are automatic transfers to meet sub-national deficits.

<sup>18</sup> Mining royalties were introduced in January 2005.

Figure 3), the distribution of natural resource revenues may further increase disparities between producing and non-producing areas.

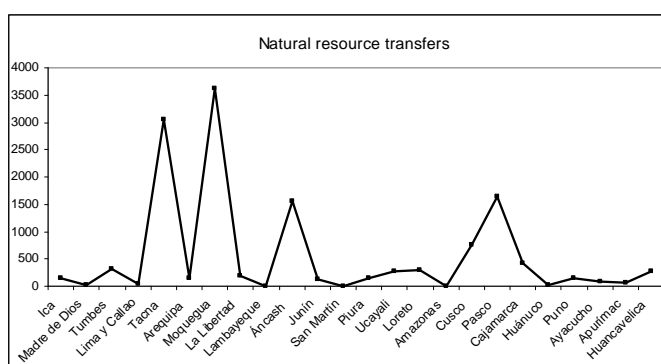
However, within the provinces and regional governments, the natural resources are distributed taking into consideration some of the needs of the local population. Thus, within-region inequality may be addressed in those locations. It is not evident (see Table 12) that inequalities have been significantly reduced by this mechanism, and the reasons for this (including the possibly excessive earmarking discussed below) need to be assessed with additional data.

Table 7. Evolution of natural resource transfers, 2001–07  
(Millions nuevos soles)

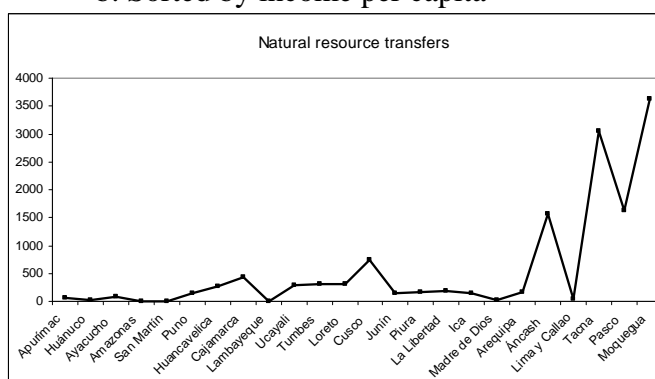
	2001	2004	2007
<b>Canon</b>	423	1,114	6,257
mining canon	81	451	4,824
petroleum canon	341	440	640
gas		73	558
hydroenergetic canon		109	146
fishing		26	84
forestry		1	6
<b>Mining royalty</b>			422
<b>Total</b>	<b>422</b>	<b>1,100</b>	<b>6,680</b>
in percent of GDP	0.22	0.47	1.96

Figure 3. Allocation by department of natural resource transfers, 2007  
(soles per capita)

a. Sorted by poverty rates



b. Sorted by income per capita



Note. Data source INEI. Poverty rates for 2007; income per capita constructed with the income in 2006 and population in 2007. Natural resource transfers comprise canon, mining royalties and the Camisea Development Fund (FOCAM)

## Earmarking

Earmarking in Peru is extensive at the sub-national level and much of this is for investment (see Ahmad and Brosio, 2008, for some Latin American comparison of earmarking). Some shared-revenues are earmarked for investment, such as revenues from the canon, which are fully allocated on an origin basis, but have to be used for capital expenditures. Other earmarked transfers include, for example, FONCOR (the regional government compensation fund), which is also allocated to investment projects but distributed among regional governments taking into account population needs. Other transfers, like Foncomún (the municipality compensation fund), which is distributed according to different criteria including population needs, can be used in part for current expenditures (Table 9).

Earmarking limits operations of regional and local government. Though the global effects of earmarking need to be assessed, the examples presented below of the impact of earmarking on selected municipalities—Lima and Cajamarca—show that earmarking, combined with the virtual absence of own-source revenues and general-purpose transfers (see below), further restricts the autonomous operations of local governments. In addition, since most revenues are earmarked for investment, and in turn, investment projects need to meet some standards, earmarking ensures that the additional revenues received by local governments in excess of short-run spending needs are not dissipated (as the spending devolution lags the revenue-shares). Nonetheless, with the greater sophistication of local governments in preparing and executing investment projects, the level of sub-national spending is likely to rise. Consequently, spending shortfalls at the sub-national level may no longer contribute to meeting the overall targets of the FRTL.

The cases of Lima and Cajamarca presented in Table 10 show that:

- The extensive earmarking together with limited capacity to prepare and execute investment projects, leads to significant **capital under-spending in relation to budgeted resources**. While current spending is fairly close to the budget estimates, earmarked capital spending fell far short of the budgeted amounts by 65 percent in Cajamarca and even lower, by about 45 percent in Lima.
- Earmarking could result in the **building up of arrears**. Capital spending shortfalls and accumulation of cash balances may be accompanied by the buildup of arrears, or “floating debt” if commitments for current spending exceed available non-earmarked resources.

The shortfalls in budgeted spending, whether or not due to earmarking, together with arrears, in many cases has led to political problems for the local governments, as the municipal electorates are not willing to accept situations that appear to reflect poor management (in addition to inadequate design) in the decentralization process.

As decentralization proceeds, it is likely that the earmarking will be moderated, but it is equally clear that the spending devolution must be the focus of further efforts, so that there is a balance between expenditure assignments and the revenues available at the sub-national level.

Table 9. Earmarking of Resources at the Local Government: Cuzco and Cajamarca, 2005  
(Thousand soles)

By Revenues	By Expenditures				Total
	Current	Capital	Debt Service		
<b>Municipality of Cuzco 1/</b>					
Canon	2,498	0	2,498	0	2,498
Foncomun	9,214	2,632	4,300	2,282	9,214
Other municipal fees	3,307	3,307	0	0	3,307
Local-resources	11,674	8,012	3,662	0	11,674
Grants and transfers	625	0	625	0	625
Other transfers from the central government	7,960	1,365	6,595	0	7,960
<b>Total</b>	<b>35,278</b>	<b>15,316</b>	<b>17,680</b>	<b>2,282</b>	<b>35,278</b>
<b>Municipality of Cajamarca 2/</b>					
Canon	15,195		964		964
Foncomun	6,094	1,688	981	55	2,725
Other municipal fees	1,560	1,008	89		1,097
Local-resources	2,213	1,408	3		1,411
Grants and transfers	553		301		301
Other transfers from the central government	488	334			334
<b>Total</b>	<b>26,103</b>	<b>4,438</b>	<b>2,338</b>	<b>55</b>	<b>6,832</b>

Source: Municipality of Cuzco, and Municipality of Cajamarca.

1/ Originally approved budget, 2005.

2/ Fiscal operations, first quarter 2005.

Table 10. Budgets and Spending in Lima and Cajamarca, 2004  
(Thousand of soles)

	Regional Government of Cajamarca			Municipality of Lima		
	Amended budget	Actual spending	Percentage	Amended budget	Actual spending	Percentage
Current	453,621	441,580	97.3	343,132	334,037	97.3
Capital	68,619	44,965	65.5	303,104	131,497	43.4
Debt service				97,740	97,738	100.0

Source: Regional Government of Cajamarca; Lima municipality.

## Managing Sub-national Spending

Many of the shortcomings of Peruvian public financial management (PFM) are also present at the sub-national level, and often difficulties at the centre are magnified at the lower levels due to the more limited human capital and organizational capacity of the sub-national governments. In fact, the decentralization process has added an additional layer of complications that needs to be addressed by the PFM system. In what follows, we discuss some of the basic issues that are relevant to each level of government for enhanced and transparent governance:

- The **fragmented nature of the PFM process** in Peru generates difficulties in coordination and implementation of government policies. There are expectations that

the government financial information system, SIAF, will provide a solution to the governance problems. However, the SIAF is a tool that will only work if the essential institutional and procedural preconditions have been met.

- The existence of large government cash balances of spending agencies at each level of government is an indication of the **lack of an adequately designed Treasury Single Account (TSA)**. The proliferation of government cash balances increases the Treasury's borrowing requirements, fragments information and transparency and weakens controls on spending. The government is working towards the implementation of a TSA for the central government.
- Other PFM shortcomings are the **weaknesses in timeliness, clarity and transparency, and in information flows**. These are due to the use of functional and economic budget classifications which deviate from international standards and are also subject to change from year to year. The chart of account used by the information system, SIAF, does not fully reflect the budget classification, and this poses difficulties in tracking spending according to appropriations. Moreover, the accounting is performed manually and outside the SIAF, leading to the possibility of discrepancies in spending data.
- The **spending control mechanisms are disjointed, relatively weak, and lack clarity**. The problems with SIAF mean that the basic information on which controls should be based is hard to generate.

First, at each level of government there should be a standard budget classification based on international standards for the economic and functional classification of government functions. In line with this recommendation, the government is planning to prepare the 2009 budget following a modernized budget classification. This should be the basis for the tracking of the spending process, and the basis for a full correspondence in the chart of accounts, in order to ensure full transparency and generation of accounted information on a timely basis.

In addition, there needs to be comparable generation of information on government bank accounts, through a system of treasury single accounts for each level of government—this will facilitate effective cash management and minimize the danger of a build-up of idle cash balances in tandem with the development of arrears or borrowing needs. This process needs to be developed at both the central and sub-national government levels.

As discussed below, the full tracking of the stages of the budget process is essential in generating a record of spending and liabilities, including floating debt. The critical issue in the process is the setting of consistent standards for all levels of government. There could be a simplified format for the smallest municipalities with relatively few functions to generate a minimum level of comparable information across all jurisdictions.

### ***Participatory budgets***

A participatory budget (PB) system was created at the local level to allow citizens to participate in the process of identifying and prioritizing investment projects based on local needs. The political emphasis on participatory budgets is a welcome development, but in itself it does not impose a hard budget constraint on the local governments. Instead, PB creates expectations and pressures for additional spending driven by the following factors:

- The timetable set for the discussion and approval of the PB is not aligned with that set for the formulation and approval of the entity's annual budget. In fact, as currently designed, there are mismatches between these two timetables in the sense that the sub-national governments begin to discuss the PB based on data and expenditure ceilings that are incorrect, thus, creating false expectations.
- There is a lack of clear responsibilities or own-source revenues—thus there is no incentive to prioritize according to the intensity and urgency of the need.
- The ability to monitor spending and outcomes is constrained by the limitations of the reporting and information system.
- There are no sanctions for not delivering results.<sup>19</sup> There are also no adequate formal channels for audit.

### ***Debt management and reporting***

Sub-national governments may contract either external or domestic debt subject to the limits on sub-national debt established in the fiscal responsibility legislation (FRTL and FDL). A central government guarantee is required for the external debt of local and regional governments (amended FRTL of 2003, and General Public Debt Law of July 2005); therefore, external indebtedness operations by sub-national governments are counted against the annual limit on indebtedness operations (including guarantees) that the central government may contract or provide in a given year (this limit is established each year in the Annual Public Indebtedness Law). Sub-nationals may contract domestic debt (including floating debt), and the guarantee by the central government is not required.

At present, it is difficult to estimate the extent of debt exposure at the municipal level. The disjointed treatment of debt, together with an absence of a centralized risk register (which should also cover floating debt, guarantees as well as contingent liabilities) makes it difficult to assess compliance with fiscal rules. Indeed, contingent debt (for example, originated from

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<sup>19</sup> The difficulties with special purpose transfers are legendary, and are well known in relation to specific programs in Peru (including the *vaso de leche* program) and similar programs in other countries. Central programs with local implementation are difficult to monitor and the incentives to manage these effectively is generally absent.

trials or judiciary decisions) and floating debt lack adequate recording.<sup>20</sup> The World Bank is undertaking a study of sub-national debt, including floating, in order to assess the magnitude of sub-national debt stock and identify municipalities that might face debt stock problems, including the municipality of Lima. Preliminary conclusions of this study show that unregistered debt is significant (the ratio of unregistered to registered debt is about 4); debt is highly concentrated (in particular, 40 percent of total debt is explained by 20 municipalities); and, a significant number of municipalities do not comply with FRTL rules.

In order to address the loophole in monitoring sub-national debt, the General Public Debt Law mandated the registration of indebtedness operations by all levels of government. The General Public Debt Law requires that regional and local governments register all their indebtedness operations using a debt module in the sub-national government financial information management system (SIAF-GL). As mentioned above, there is an inordinate reliance on a SIAF to address the problems of effective sub-national public financial management. While this is a tool that might eventually help, it cannot address basic flaws in procedures or design. Indeed a poorly defined local SIAF might hinder the improvements in sub-national governance and financial management that are needed for sound decentralization. In addition to the need to establish a registry of sub-national debt, the definition and recording of floating debt (which is not covered under the definition of an indebtedness operation under the General Public Debt Law) still needs to be addressed.

Looking forward, it will be important to establish full information for all sub-national operations, including for sub-national debt. There should be very clear reporting requirements for sub-national governments that build on the standard budget classification, and tracking of all stages of the budget execution process.

### **Transfer design**

The neutrality in the design of the decentralization process in Peru is assumed not to exacerbate geographical disparities. Transfers, either in the first stage or second stage of the decentralization, are to be linked to the devolution of responsibilities (see above). In other words, the magnitude of these transfers is to be calculated when the expenditure assignments are determined. The complexity and difficulties of the arrangements in Peru for fiscal management at all levels of administration may jeopardize the “assumed” neutrality of the transfer system.

Moreover, the range of transfers in Peru increases the risk that the decentralization initiative might exacerbate geographical disparities. Few of the transfers take into account population needs in a comprehensive manner, although different aspects are addressed in different programs. For example, FONCOMUN and FONCOR are distributed among municipalities and regional governments, respectively, based on poverty indicators, demography, unmet basic needs, and capacity to execute investment projects (Table 11 and Figure 4).

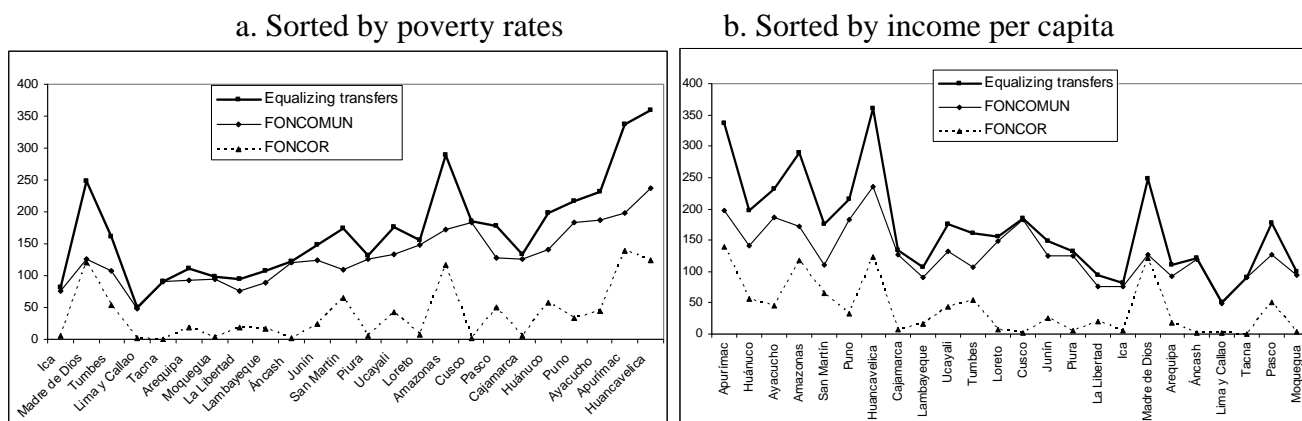
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<sup>20</sup> In some municipalities, such as Cajamarca, floating debt has been accompanied by a build-up of cash deposits at the same time, due to the earmarking of canons and transfers.

Table 11. Peru: Equalization transfers

	Origin	Amount in 2007	Use	Distribution
Regional Compensation Fund (FONCOR)	Privatization, concession receipts and ordinary resources of the treasury.	S./ 550 million (0.16 percent of GDP)	Earmarked to capital expenditures.	The formula was changed in 2008 to make the allocation more equalizing. Now, it takes into consideration population, poverty rate, unmet basic needs, geographical location, and performance indicator related to the execution of investment projects.
Municipal Compensation Fund (FONCOMUN)	Collections from the tax for the promotion of municipalities (2 percentage points VAT surcharge).	S./ 2,805 millions (0.8 percent of GDP)	Financing either capital or current expenditures.	Takes into consideration poverty rate, population, infant mortality and gaps in meeting basic needs.

Figure 4. Allocation by department of the equalizing transfers, 2007 (soles per capita)



Note. Data source INEI. Poverty rates for 2007; income per capita constructed with the income in 2006 and population in 2007. The allocation of FONCOR uses the distribution coefficients approved for the fiscal year 2008.

In principle these transfers should contribute to the reduction of selected aspects of regional inequalities. The overall effects of the individual transfers need to be assessed in an integrated framework. Table 12 shows the results of the regression of the change in poverty rates between 2005 and 2007 using the magnitude of natural resource and other transfers received by a department as explanatory variables. There is no evidence that natural resource transfers or others have led to a decline in poverty rates. These results could be due to inadequate earmarking and monitoring of the use of funds, such as FONCOR and FONCOMUN, or other inefficiencies in the use of public resources. There may also be a lack of accountability in the use of transfers, particularly with natural-resource related funds that tend to go to specific regions that may have limited absorption and management capacities.

There is also public concern that natural resource transfers may increase regional disparities. In response to this concern, the Regional and Local Investment Fund (*Fondo de Promoción a la Inversión Pública Regional y Local*, FONIPREL) was created in 2007. Subnational governments could bid for FONIPREL resources to cofinance social and investment projects that aim to address infrastructure gaps. FONIPREL amounted to S./ 650 million in 2008, of which 360 have been assigned.

Table 12. Peru. Relationship between poverty and transfers

	Decline in poverty rate between 2005 and 2007
Poverty rate in 2005	0.11 (1.79)*
log (transfers_natural resource)	-1.14 (2.45)**
log (transfers_others)	-5.54 (1.91)*
Constant	35.67 (2.62)**
Observations	23
Adjusted R-squared	0.2

Note. Data for departments. Other transfers include FONCOR and FONCOMUN. Natural resource transfers comprise canon, mining royalties and the Camisea Development Fund (FOCAM).

Part of the response for Peru may well be the simplification of earmarked transfers, together with increased monitoring and evaluation by the center, as well as the establishment of an “equalization” framework, based on objective criteria that also could enhance the incentives for more responsible subnational governance. The establishment of an “equalization transfer system” is an integral part of the design of an effective decentralization program in many parts of the world. Recent practices (from Denmark and Switzerland to China) suggest that consideration be given to a mechanism that takes into account the differential costs of the provision of services (particularly important in a country with the difficult topography and linguistic differences of Peru), as well as the capacity to raise own-source revenues. Details of international experiences and models are summarized in Ahmad (1997) and Ahmad and Searle 2006.

#### D. Concluding remarks

There is much to be learnt from the Peruvian experiences of the past quarter of a century of swings in the pendulum of centralization and decentralization.

One of the main results, taken to heart by successive governments with vastly differing political persuasions is that any decentralization effort in Peru has to be based on prudent considerations of fiscal sustainability.

It is also clear that decentralization without effective assignments or monitoring capabilities is likely to fail. Nonetheless, the Toledo approach to “incomplete” decentralization did not get to grips with effective accountability or improvements in service delivery and poverty reduction. Both are needed in order to consolidate the decentralization process.

It is clear that additional work is needed in order to deepen the decentralization process and strengthen the incentives for effective sub-national governance. This involves clarifying functional spending responsibilities, and making sub-national administrations responsible for the functioning of various sectors, together with the greater reliance on own-source revenues. This has to be accompanied by a set of more transparent and equitable transfer mechanisms to avoid that regional disparities are exacerbated.

In addition, there has to be a significant strengthening of sub-national administrative capability to ensure an efficient provision of decentralized public services, together with the requirement of standardized information on operations on all government operations, including on floating debt and the buildup of commitments.

Moreover, the sequencing of measures has to be effectively managed in order to maintain the prudent macroeconomic stability and growth path that have stood Peru in such good stead in the recent past.

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