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A Perspective on Recent Developments and  
Future Challenges**

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# *Fiscal Decentralization in Peru: A Perspective on Recent Developments and Future Challenges\**

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## **Abstract**

Decentralization is a fairly recent process in Peru that has been driven by a mixture of democratization, state modernization, increased accountability in service delivery, and regional economic development objectives. Politics has also played an important role. Overall, the general approach to decentralization reform in Peru has been cautious and conservative and by design its implementation has been gradual. With hindsight there were several important missteps that could have been avoided. There are other important aspects that will require substantial reform efforts in the coming years, including the formation of macroregions and how to undo the important negative consequences of the canon system. Peru is today at a stage where the question is what final form of decentralization to adopt. This paper provides a blueprint for achieving a more efficient and equitable decentralization system in the country.

\*This paper, in part, draws upon and updates the findings of a series of reports over the last three years coauthored with Juan Luis Gómez and Cristian Sepúlveda produced for the Ministry of Economy and Finance of Peru and sponsored by the Corporación Andina de Fomento. The author is grateful to Gabriel Leonardo and Janet Porras for research assistance and to Roy Bahl and Geeta Sethi for helpful comments.

## 1. Introduction

Decentralization is a fairly recent process in Peru. It began in 2002 with an amendment to the Constitution declaring the decentralized nature of the Peruvian State, and with Legislative Decree No. 955, the Fiscal Decentralization Law. Although there had been previous attempts to decentralize,<sup>1</sup> under the administration of President Toledo,<sup>2</sup> the country plunged, without much national debate, into an accelerated timetable of legislation which, over the last decade, has produced an extensive legal framework covering most aspects of the system of intergovernmental fiscal relations. As a result, each tier of subnational government (regional and local) in the aggregate commanded about one-fifth of total public expenditures in 2009.

The official political discourse for decentralization has not been different in Peru from that of other countries that have decentralized with a mixture of democratization, state modernization, increased accountability in service delivery, and regional economic development objectives.<sup>3</sup> However, since the 1970s, the objective of regional development, in particular, has been paramount in the several attempts to decentralize Peru and in the current process of the last 10 years (see Rühling 2008). It reflects a national concern about the concentration of wealth and population around the Lima metropolitan area and the lack of development and often poverty on the periphery, which is most of the rest of the country.

As has also happened in many other countries that have decentralized, the current process of decentralization in Peru got started as a reaction to political centralism, in its most recent incarnation in Peru at the hands of the Fujimori regime. Political economy interests and plain politics have been of paramount importance in the pace and depth of the decentralization process in Peru. In particular, the outcomes of municipal elections, which repeatedly turned out to be contrary to the plans of the elected president, have played an important role in pronounced policy shifts toward decentralization. The defeat of President Fujimori's candidates in the municipal elections of January 1993 was a significant motivating factor in his draconian recentralization reforms, which turned into a lost decade for the decentralization process. Similar developments took place under Presidents Toledo (2002–06) and García (2007–11), with both chief executives being at first strong proponents of decentralization reforms, and then turning against the process after a failure of their parties in municipal elections.<sup>4</sup>

Overall, the general approach to decentralization reform in Peru has been cautious and conservative, drawing important lessons from previous mistakes made in other Latin American

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<sup>1</sup> Peru had previously embarked on decentralization reforms but never with lasting impacts. For the most part, the country was ruled from a centralist paradigm, and formal and less formal calls for decentralization were practically ignored. For example, the 1933 Constitution's provision for elected local councils was ignored, except during President Belaunde's two terms (1963–68 and 1980–85), but even then with little devolution of responsibilities (see Rühling 2008).

<sup>2</sup> In a short period—2002 to 2004—11 major decentralization laws were passed. However, this was all done without the benefit of an overall strategy paper or “white paper” laying out the long-term vision for the decentralization process and being updated at each stage of the reform.

<sup>3</sup> Several studies have analyzed different aspects of Peru's decentralization process. See, for example, Aragón and Gayoso (2005), Ahmad and García-Escribano (2006 and 2011), Rühling (2008), and World Bank (2010).

<sup>4</sup> See, for example, World Bank (2010) and Rühling (2008).

countries in the recent past (see Martinez-Vazquez 2010). From the very start, there was particular emphasis on avoiding runaway subnational borrowing and bailouts leading to macroeconomic instability. Also from the start, there was emphasis on avoiding the ballooning of public employment expenditures and duplication of services, which had happened in other Latin American countries by decentralizing first revenues in some form of revenue sharing without an explicit reassignment of expenditure responsibilities from the central agencies to decentralized governments. To a large extent, those goals have been accomplished in Peru.

By design, the implementation of the decentralization program was intended to be gradual. This was especially the case in the devolution of responsibilities against a system of accredited capacity by subnational governments. The process was also to be gradual in the creation of a new layer of regional governments, or macroregions, as the result of the amalgamation of several departments—the existing intermediate level of (deconcentrated) government. On paper, the delivered graduated approach looked like a good strategy. In practice, however, implementation ran into significant problems with the sequencing and timing of the reforms.

With the hindsight of the experience of the last decade, there were several important missteps that could have been avoided.

First, the lack of administrative capacity of many subnational governments and the requirements of the accreditation process required heavy investing by the central authorities to create that capacity. However, the capacity-building programs failed to deliver or were never implemented and, not surprisingly, central government line ministries and agencies did not prove to be supportive of the decentralization process. This meant that by 2006 many of the expenditure responsibilities planned for decentralization had not been devolved. This led to President García's "decentralization shock" policy in 2006, which was meant to accelerate the devolution of expenditure responsibilities, ready or not. Today, many local governments in Peru remain highly fragmented and with little capacity to collect revenues and implement efficient service delivery.

Second, perhaps the most important miscalculation in the implementation sequence for decentralization was to delay the referendum for the creation of the macroregions to 2005, after having elected in 2002 regional (departmental) governors and introduced regional governments in each department. The regional governments received, in a first stage, transfers "corresponding" to the expenditure assignments already devolved, and, as an incentive for the amalgamation of departments, the plan was for the new macroregions to receive, on a derivation basis, 50 percent of the majority of the national taxes (including the corporate income tax [impuesto a la renta de tercera categoría], the personal income tax [impuesto a la renta de las personas naturales], and the value-added tax [impuesto general a las ventas]) collected in their territories.

All this meant that the newly elected governors would need to sacrifice their tenure in office to achieve the amalgamation of several departments into a macroregion. Predictably, the new elected governors opposed the amalgamation. President Toledo's lukewarm support appears to have contributed to the sound rejection of the referendum for the creation of the macroregions. Even though there were plans to hold a second referendum, these plans have been postponed

indefinitely. The result has been to leave the intermediate level of decentralized governance in Peru just half-built. Even though additional expenditure responsibilities have been transferred, as will be seen, much of what has been done can be considered part of a deconcentrated system with the still heavy influence of line ministries and other central agencies. On the revenue side, the planned 50 percent revenue sharing, of course, did not materialize. In addition, there were never plans and there are still no plans, to provide the regional governments with a minimum of revenue autonomy; regional governments remain completely financed by central transfers and revenue sharing from extractive industries.

Third, the seeds for the most disruptive aspect of the decentralization system in Peru nowadays—the canon<sup>5</sup>—were planted in 1993 with the “mineral canon” and as early as 1973 with the “oil canon” involving introduction of revenue sharing arrangements of rents from the exploitation of natural resources among the central government, local governments and, to a lesser extent, the intermediate level of government, the departments. This was long before the start of the current decentralization process in 2002, but the decentralization strategy did nothing to correct it at the time. However, in all fairness, the potential dangers associated with the canon were not that easy to detect before the upward spiral in the world prices of natural resources in the second half of the 2000s.

One of the most serious consequences of the canon has been a virtual explosion in fiscal disparities across local and regional governments. Because the level and design of local and regional transfers have not been able to offset the highly uneven distribution of canon funds, the decentralization process in Peru is failing to deliver on one of its most cherished national goals for decentralization, with significant historical roots, of reducing regional economic disparities in the country.<sup>6</sup> Another consequence of the canon has been to reduce the overall efficiency of public expenditures, again diminishing another stated goal of decentralization. With the enormous increases in fiscal resources, the subnational governments’ recipients of canon funds have been under heavy pressure from the central authorities and civil stakeholders to disburse those funds. Because the canon funds are earmarked for capital infrastructure projects, this has made it even more difficult for subnational authorities to spend the funds in a timely and efficient manner.<sup>7</sup> So far, it has been politically infeasible to even consider a direct reform of the canon system because of the extremely strong opposition of the local and regional governments that now benefit from the system. Finding a solution to this issue remains the greatest challenge to Peru’s decentralization process.

There are still other important aspects of the decentralization process that remain problematic and that will require substantial reform efforts in the coming years. For example, expenditure assignments still lack clarity, and subnational governments at all levels are highly dependent on central government transfers. This deprives Peru’s decentralization system of adequate levels of accountability and fiscal responsibility. The systems of transfers are also in need of a serious

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<sup>5</sup> The canon, sobrecanon, and royalties are the major natural resource sources of transfer, discussed in detail later in the chapter. We will follow the convention of abbreviating all those sources under the name of canon.

<sup>6</sup> However, at one level, the canon has distributed wealth to some, just a few, areas on the periphery of the country away from the Lima region.

<sup>7</sup> In particular, see the World Bank (2010) for an extensive discussion of this point.

overhaul, in part to address the acute interjurisdictional fiscal inequalities arising from the canon system.

## 2. Territorial Vertical Structure of Government

### *Current vertical structure and political organization*

The vertical structuring of decentralized government is an unfinished project in Peru. This is true at the regional level, with the failure to constitute the macroregions, and at the local level, due to the high level of municipal fragmentation. The macroregions issue continues to hold hostage the advancement of the other aspects of decentralization in the country. It is quite urgent, therefore, that the territorial structure of government be addressed on a more permanent basis

The territorial composition of Peru includes, at the intermediate level, 24 regions (or departments) plus the Constitutional Province of Callao; and at the local level, 1,834 municipalities, of which 195 are provincial municipalities and the rest district municipalities.<sup>8</sup> All regional and local governments approve their own budgets. The dual coexistence at the same local level of provincial and district municipalities is a peculiarity of Peru's vertical government structure. The basic statistics for jurisdiction size by population and area for regional and local governments are presented in table 5.1.

**Table 5.1 Jurisdiction Size by Level of Government**

	Number	Population			Area (km <sup>2</sup> )		
		Maximum	Minimum	Median	Maximum	Minimum	Median
Regional Governments:							
Departments	25	1,630,772	92,024	669,973	368,852	4,657	35,903
Municipal (local) governments:							
Provinces	195	861,746	3,415	56,497	119,859	264	3,207
Districts	1,638	276,921	108	4,402	34,943	2	235

Source: PRODES 2007.

Note: km<sup>2</sup> = square kilometers.

Regional governments vary significantly in area size, from 370,000 square kilometers for Loreto to 4,657 for Tumbes, with the median at approximately 36,000 square kilometers (see table 5.1). With the exception of the Metropolitan Municipality of Lima, the differences in population size are less pronounced, but nevertheless are still quite large. There are also wide variations in the population and area of municipal governments (table 5.1). The governance structure in the area

<sup>8</sup> Provincial municipalities have the same expenditure responsibilities as district municipalities but, in addition, provincial municipalities have several other service responsibilities that extend to the district municipalities within the provincial boundaries. However, district municipalities do not depend hierarchically on the provincial municipalities (as mandated by the Ley Orgánica de Gobiernos Municipales). The provincial municipalities are also responsible for the provision of services in a large number of villages (centros poblados).

of Lima is complex due to the fact that there are overlapping jurisdictions of different levels (see box 5.1).

### **Box 5.1 Government Structure of Lima and its Demographic and Economic Significance**

In the Lima area there are a number of overlapping government units that have the same name—Lima—which makes things a bit confusing. It helps to recall that the administrative structure of Peru contains regions (or departments), provincial municipalities, and district municipalities. Each region or department is typically composed of several provincial municipalities. A provincial municipality has authority over its respective territory and also the “center” district municipality in the province. In other words, the mayor of a provincial municipality is also the mayor of the center district.

In the province of Lima, the provincial municipality (also called Metropolitan Municipality of Lima [MML]) has its “center” in the Lima district.

In the region (department) of Lima, the regional government does not have authority over the province of Lima. The election of regional authorities in the region of Lima does not include the province of Lima, but rather only the other nine remaining provinces of the Lima region. The regional seat or capital city of the Lima region is Huacho.

In effect, the provincial municipality of Lima (MML) has a special regime that combines district, provincial, and regional competences. The Lima district (Cercado de Lima) is run directly by the MML, since it is the center district. The Lima Metropolitan Council exercises powers and functions equivalent to the Regional Council, and the mayor of the MML exercises the powers and functions equivalent to the Regional President. As part of its provincial competences, the MML has responsibilities over the 43 districts that are part of the province of Lima. Also, as part of its district responsibilities, the MML is in charge of collecting the property taxes in the Lima district.

Finally, the denomination “Metropolitan Lima” refers to the geographic area that includes the 43 districts of Lima Province and the six districts of the Constitutional Province of Callao. Metropolitan Lima has a significant presence in the population and the economy of Peru. With about 0.2 percent of the land area of the country, Metropolitan Lima represents over 40 percent of Peru’s GDP and about one-third of its total population.

The most important issue in the organizational structure of municipal governments is the high level of fragmentation. Table 5.2 provides an overview of the level of municipal fragmentation in Peru. More than half of the municipalities have populations under 5,000, and just under 11 percent (200 municipalities) have populations under 1,000. To give some perspective, Peru has a higher level of municipal fragmentation than, for example, its neighbors Bolivia and Ecuador. With an average population of 15,000, the average municipality in Peru is about half the size of the average municipality in Bolivia and one-third the size of the average municipality in Ecuador. Internationally, only a few highly fragmented countries, like France and Spain, have smaller average municipal sizes.

**Table 5.2 Population Distribution at the Municipal Level**

Population	Districts		Provinces	
	Number	Percent	Number	Percent
0–1,000	201	11.0	0	0.0
1,000–5,000	777	42.4	1	0.5
5,000–10,000	368	20.1	8	4.1
10,000–50,000	377	20.6	67	34.4
>50,000	110	6.0	119	61.0
Total	1,833	100.0	195	100.0

*Source:* Instituto Nacional de Estadística e Informática, 2005 Census.

The level of local fragmentation varies significantly by region. Amazonas, Apurímac, and Huancavelica, with a municipal average of 5,000 inhabitants, stand at one-third of the national average, and actually 18 of the 25 regions or departments (72 percent) do not reach the national average of 15,000 inhabitants. The high concentration of population in Callao and Lima explains the higher municipal average; in Callao the average population of municipalities is over 120,000 (table 5.3).

**Table 5.3 Average Size of Municipalities by Department**

Departments	Average Population	Average Area (km <sup>2</sup> )
Amazonas	4,497	436
Ancash	5,804	193
Apurímac	5,000	240
Arequipa	10,126	541
Ayacucho	5,272	359
Cajamarca	10,081	238
Callao	120,257	21
Cusco	10,055	595
Huancavelica	4,597	219
Huánuco	8,724	424
Ica	14,401	444
Junín	9,039	285
La Libertad	16,833	268
Lambayeque	27,648	347
Lima	44,619	191
Loreto	15,831	6,360
Madre de Dios	6,826	6,093
Moquegua	7,193	684
Pasco	8,937	817

Piura	23,522	499
Puno	10,602	549
San Martín	7,998	589
Tacna	9,196	519
Tumbes	12,444	253
Ucayali	23,220	5,657

*Source:* Instituto Nacional de Estadística e Informática, Censo 2005.

*Note:* km<sup>2</sup> = square kilometers.

Politically, Peru is a unitary unicameral state, with a Congress composed of 120 members whose election coincides with the presidential election every five years.<sup>9</sup> Regional and local elections are held every four years, and provincial municipality governments elect at least one representative to the regional legislature.<sup>10</sup> Although municipal elections have been held on and off for many years, regional elections have been held since 2002.

From the viewpoint of political coordination, the Assembly of Regional Governments, which has a rotating presidency, has become an important element in the decentralized institutional system of Peru, in active dialogue with the President of the Republic.

### ***Main challenges and issues with the vertical administrative structure***

The three main challenges in the current vertical government structure are:

- A high level of municipal fragmentation
- The difficult consolidation of the regional (or departmental) governments into macroregional governments
- Lack of clear boundary demarcations at the local and regional levels.

(i) The high level of municipal fragmentation represents a source of inefficiencies in the delivery of public services when economies of scale are not sufficiently exploited. However, to some extent, this cost may be offset by the higher levels of political representation and presumably more accountability associated with the current smaller local governments and the potentially higher transaction costs associated with large jurisdictions.<sup>11</sup>

From the start of the decentralization process in 2002, there has been considerable effort to achieve some degree of consolidation among small municipal governments. In a first line of activity, through the enactment of the Municipal Amalgamation Law of 2007 (Ley de Fusión de Municipios), special fiscal incentives have been offered for the consolidation of municipalities with a joint population of at least 8,000 inhabitants in the case of two district municipalities and

<sup>9</sup> Among the Congressional representatives, 25 are elected representing each of the regions, and the rest are elected by electoral districts on the basis of population.

<sup>10</sup> In the case of Callao, each district municipality elects a regional representative.

<sup>11</sup> Although, typically, the benefits of jurisdictional amalgamation are taken for granted, there is not much significant empirical evidence on the size of those benefits (Carr 2004; Dollery and Robotti 2008).

12,000 inhabitants in the case of three district municipalities.<sup>12</sup> The fiscal incentive consists of a premium of 50 percent of the Municipal Compensation Fund (FONCOMUN) transfers (the most important transfer from the central to local governments, discussed below) over the amount that would be received by the nonamalgamated municipalities over 15 years.<sup>13</sup> However, to date there have been no takers. Reasons given for this include the lack of information among municipal authorities, the more recently approved regulations to the law, or simply the lack of salience of the fiscal incentives offered, especially to those municipalities flush with funds from the canon. In addition, no doubt political incentives have also played a role; mayors are naturally reluctant to lose their jobs in the process. Constituencies may have also been reluctant to support the amalgamation because of perceived losses in representation.

In a second line of activity, Peru introduced the Local Government Association Law (*Ley de Mancomunidades*) in 2007, which regulates the voluntary association of district municipalities for service delivery and infrastructure projects. This law also regulates the delegation of expenditure responsibilities to other municipalities or upper-level government agencies. This newer initiative is still to be fully tested, but it promises to offer a solution to the fragmentation problem.

(ii) From the start of the decentralization process in 2002, there has also been considerable effort made, but also errors, to consolidate departments or regions into macroregions. In fact, the territorial reorganization of Peru into macroregions early became one of the fundamental design pieces of decentralization reform. However, the regional referendums held in 2005 to gain popular approval for the consolidation of the existing departments into macroregions were overwhelmingly negative, with the result that the previous regional and departmental structure remained completely unchanged. Therefore, the decentralization process at the regional level has continued on the basis of the existing departments but at a much slower speed. The Law on the Foundations of Decentralization (*Ley de Bases de la Descentralización*) anticipated that, if the 2005 referendums were to be negative, new referendums would be called in 2009 and 2011. Those new referendums, however, were never called, and any new referendums have been delayed indefinitely.

The Law on the Foundations of Decentralization defines the macroregions as territorial sustainable units with historical, administrative, economic, cultural, and environmental links, but does not offer a clear rationale or explicit objectives for the consolidation of departments into macroregions. Supposedly, the main argument for the macroregions was one of efficiency in administration and better coordinated policies vis-à-vis the more fragmented departments (or current regions). It was left to the Law on Incentives for the Integration and Conformation of Regions (*Ley de Incentivos para la Integración y Conformación de Regiones*) to provide explicit

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<sup>12</sup> The 8,000 and 12,000 inhabitants correspond to the minimum population bases required for the creation of new municipal districts by the Law of Territorial Demarcation. These population sizes may be adequate to attain economies of scale for some local public services, but not for others requiring large amounts of infrastructure.

<sup>13</sup> Those funds, however, would need to be spent only on infrastructure.

fiscal incentives for the integration and the creation of Committees of Interregional Coordination as the vehicles for managing the consolidation of departments.<sup>14</sup>

The fiscal incentives to regional consolidation included additional sources of financing, easier access to credit, and tax advantages for enterprises located in the new region for contracts with the central government. The most important advantage offered was the 50 percent tax sharing for the new regions allocated by formula in three major national taxes: the value-added tax,<sup>15</sup> the personal income tax, and excise taxes (*impuesto delectivo al consumo*). However, the apparent generosity of these incentives was considerably diminished once it was made clear that this funding had to cover the costs of the services already being offered by the central government agencies in the constituent departments (existing regions). The 50 percent sharing would come as a substitution for the existing direct central government transfers that were covering the costs of those services.

Fiscal incentives or not, however, the referendums for integration were soundly defeated. Besides the potential weakness of the fiscal incentives, there were other powerful reasons behind the defeat. Most important were the negative political incentives for the existing department heads who would have lost their office and jobs had the referendums passed (World Bank 2010). President Toledo is also reported to have supported the referendums only lukewarmly (Rühling 2008).

Because of the extremely low prospects at the present time of holding successful referendums for the integration of the new macroregions, in practice, the process of fiscal decentralization reform has gone on but, nevertheless, clearly burdened at the regional level by the failure to reach that critical stage envisioned in the original decentralization strategy. As we will see in this chapter, there has been more progress on the side of transferring responsibilities to the departments and regions but little progress on the revenue side, with no tax assignments and just an increase in transfers for capital purposes.

(iii) The demarcation of boundaries remains an unresolved issue at the local level. The National Directorate of Territorial Demarcation, as reported in World Bank (2010), indicates that about 80 percent of district municipalities and 92 percent of provincial municipalities still have no permanently defined boundaries. This has the potential of becoming a source of conflict, especially among local governments located in natural resource deposits.

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<sup>14</sup> The Law on Incentives required that proposals for macroregions must be based on a technical study documenting the viability of the new region in terms of a number of criteria including integration of roads and communications, economic competitiveness and socialization, and presence of universities. See Friz Burga (2008) for further discussion of this legislation.

<sup>15</sup> Excluding the *Impuesto de Promoción Municipal*, whose revenues are earmarked to the FONCOMUN transfer.

### 3. Expenditure Patterns and the Assignment of Expenditure Responsibilities

#### *Decentralized expenditure patterns*

The most visible impact of the fiscal decentralization process in Peru is in the rise of subnational expenditures as a share of total expenditures. While regional expenditures have declined slightly, municipal expenditures have been expanding (largely related, as we see below, to the increase in funding from the canon transfer from natural resources) and have come to represent around 40 percent of total capital expenditures and over 13 percent of total current expenditures (table 5.4). The lack of increase in regional expenditures is related to the lack of devolution of additional responsibilities that were planned with the (eventual) introduction of the macroregions.

Subnational governments (regional and local governments combined) represented about 35 percent of current total expenditures during 2005–10. From an international perspective, this puts Peru at an intermediate level of decentralization, especially if we consider, as discussed later, that a considerable share of regional government expenditures are not really decentralized but rather deconcentrated expenditures.

It is notable that during 2005–10, the combined share of regional and local governments in total capital expenditure in Peru was, on average, over half of all capital expenditure, with about 27 percent corresponding to local governments and about 24 percent to regional governments.<sup>16</sup> Clearly related to the increases in revenues from the canon, the share of local governments in capital expenditure reached 37 percent in 2010. With an additional 24 percent of capital expenditures spent by regional governments in 2010, Peru is among those countries with highly decentralized public capital expenditures (table 5.4).

It is also notable that during 2005–10, the combined share of regional and local governments in total capital expenditure in Peru was, on average, over half of all capital expenditure. Clearly related to the increases in revenues from the canon, the share of local governments in capital expenditure reached 37 percent in 2010 while the share of regional governments was 24 percent (table 5.4).

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<sup>16</sup> Capital expenditures are defined as those for long-lived assets or those convertible into long-lived assets such as feasibility studies.

**Table 5.4 Shares in Total Expenditures by Level of Government** (in percent)

	2005	2006	2007	2008	2009	2010	Avg. 2005–10	% change 2005–10
<b>Capital Expenditures</b>								
Central Government	75	72	40	34	32	40	49	-47.4
Regional Governments	25	28	26	22	23	23	24	-5.9
Local Governments	n.a.	n.a.	34	45	45	37	40	10.1
Total	100	100	100	100	100	100		
<b>Current Expenditures</b>								
Central Government	74	75	66	67	66	66	69	-10.5
Regional Governments	26	25	23	20	20	19	22	-26.0
Local Governments	n.a.	n.a.	11	13	14	15	13	31.5
Total	100	100	100	100	100	100		
<b>Debt service</b>								
Central Government	100	100	98	98	96	96	98	-4.3
Regional Governments	0	0	0	0	0	0	0	-2.0
Local Governments	n.a.	n.a.	2	2	4	4	3	181.2
Total	100	100	100	100	100	100		
<b>Total Expenditures</b>								
Central Government	81	79	65	60	57	60	67	-25.8
Regional Governments	19	21	20	18	19	19	19	-3.8
Local Governments	n.a.	n.a.	15	22	24	21	21	40.0
Total	100	100	100	100	100	100		

*Source:* Prepared using data from the Economic Transparency Portal, MEF.

*Note:* n.a. = not applicable.

Note that in 2010, subnational governments represented only 4 percent of debt service expenditures (table 5.4); this reflects the current limitations on subnational borrowing. However, these official debt figures do not account for the so-called “floating debt” (“deuda flotante”), which includes arrears to providers and other short-term debt for which there is currently no detailed information. These and other debt issues are discussed further below.

The evolution of the shares in total expenditures for the three levels in table 5.4 tells a clear story of decentralization in Peru over the last five years. The local governments’ share increased 40 percent, mostly at the cost of a 25.8 percent decrease in the central government’s share and a 3.8 percent decrease in the regional government’s share.

The functional composition of expenditures at the regional level (table 5.5) shows the relative importance of education in the budget, which was about 36 percent in 2010, down from 52 percent in 2005. This reflects the additional expenditure assignments to regional governments and the increase in importance of other responsibilities such as capital expenditures on infrastructure financed by regional canon funds. Still, the social sectors (education, health, and social assistance) represented about 70 percent of total regional expenditures in 2010.

The most pronounced increases in public expenditures have been, as one would expect, in those regions most directly benefiting from the canon transfers, such as Ancash, Cajamarca, La Libertad, and Cusco (table 5.6). Lima has also experienced growth due to the greater availability of own revenues. However, the relatively low recorded expenditure for Lima is due to the lack of transfer of expenditure responsibility in key areas, such as health. In addition, the metropolitan area of Lima benefits directly from expenditures undertaken by the central government considerably more than other regions, and those expenditures do not show in Lima's budget. Thus, for comparison purposes, it is important to pay close attention to these issues.

**Table 5.5 Functional Composition of Expenditures at the Regional Level (in nuevos soles and percent)**

	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
Justice	—	2,634,898	929,781	6,634,075	9,443,638	5,283,296	—	0.0	0.0	0.0	0.1	0.0
Administration	416,843,555	456,259,161	521,896,013	874,208,668	1,058,427,879	1,008,790,573	4.3	4.0	3.7	5.3	5.7	5.1
Agriculture	396,756,709	618,274,007	966,450,901	1,064,260,668	1,322,854,503	1,165,486,543	4.1	5.4	6.8	6.5	7.1	5.8
Social Services	1,454,589,079	1,439,777,491	1,531,957,257	1,527,748,068	1,609,844,703	1,622,169,430	15.0	12.6	10.8	9.3	8.6	8.1
Communications	962,260	1,336,058	986,758	5,737,184	10,283,480	6,782,794	0.0	0.0	0.0	0.0	0.1	0.0
Defense	5,127,150	37,373,609	108,382,214	125,522,149	149,522,446	229,359,087	0.1	0.3	0.8	0.8	0.8	1.2
Education	5,001,393,479	5,521,089,935	6,192,925,180	6,717,620,232	7,128,330,085	7,232,879,058	51.6	48.3	43.7	41.1	38.2	36.3
Energy	76,265,978	184,051,565	355,931,360	300,040,636	225,942,899	286,981,004	0.8	1.6	2.5	1.8	1.2	1.4
Commerce	47,962,761	73,501,344	88,912,185	97,715,298	117,221,403	88,727,969	0.5	0.6	0.6	0.6	0.6	0.4
Fishing	32,553,587	39,915,615	46,879,842	114,799,384	65,549,124	54,162,640	0.3	0.3	0.3	0.7	0.4	0.3
External Affairs	—	199,000	—	99,600	926,740	33,417	—	0.0	—	0.0	0.0	0.0
Health	1,655,895,118	2,199,567,210	2,662,429,567	3,239,635,026	3,857,418,072	5,189,127,710	17.1	19.2	18.8	19.8	20.6	26.0
Labor Relations	18,366,244	19,511,450	21,410,665	24,785,886	29,702,395	30,861,750	0.2	0.2	0.2	0.2	0.2	0.2
Transport	549,805,423	772,434,393	1,606,582,709	2,227,215,181	2,951,392,307	2,848,396,032	5.7	6.8	11.3	13.6	15.8	14.3
Housing	44,371,277	69,073,584	52,708,901	28,949,693	46,143,773	43,694,398	0.5	0.6	0.4	0.2	0.2	0.2
Environment	—	—	—	—	98,821,066	113,802,158	—	—	—	—	0.5	0.6
<b>Total</b>	9,700,892,620	11,434,999,320	14,158,383,333	16,354,971,748	18,681,824,513	19,926,537,859	100.0	100.0	100.0	100.0	100.0	100.0

Source: Economic Transparency Portal, MEF.

Note: — = not available.

**Table 5.6 Expenditures by Regional Government (in nuevos soles and percents)**

Region	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
Amazonas	188,348,645	222,008,351	305,467,566	357,468,973	380,236,068	417,986,003	1.9	1.9	2.2	2.2	2.0	2.1
Ancash	540,071,926	686,850,659	1,146,935,801	1,580,787,240	2,173,502,254	2,110,024,052	5.6	6.0	8.1	9.7	11.6	10.6
Apurimac	244,334,894	271,893,594	325,705,296	397,941,319	448,633,438	658,202,985	2.5	2.4	2.3	2.4	2.4	3.3
Arequipa	578,965,737	671,113,829	773,859,407	899,118,730	1,042,506,440	1,055,360,058	6.0	5.9	5.5	5.5	5.6	5.3
Ayacucho	353,008,938	426,028,523	513,061,587	534,002,797	598,927,492	720,851,208	3.6	3.7	3.6	3.3	3.2	3.6
Cajamarca	649,748,595	780,752,061	967,332,189	964,615,095	1,046,912,953	1,290,529,582	6.7	6.8	6.1	5.9	5.6	6.5
Callao	357,764,968	398,340,647	445,291,758	489,340,860	723,735,588	684,544,489	3.7	3.5	3.2	3.0	3.9	3.4
Cusco	557,123,891	732,487,674	967,903,066	1,073,197,926	1,171,297,081	1,153,070,875	5.7	6.4	6.8	6.6	6.3	5.8
Huancavelica	276,389,857	310,557,225	419,217,928	480,822,112	486,951,266	602,282,208	2.9	2.7	2.9	2.9	2.6	3.0
Huánuco	292,414,155	321,063,975	373,164,598	437,529,412	451,836,082	604,776,560	3.0	2.8	2.6	2.7	2.4	3.0
Ica	374,366,746	411,136,799	451,692,212	496,516,003	533,525,021	568,285,328	3.9	3.6	3.2	3.0	2.9	2.9
Junín	588,854,985	667,288,830	772,286,859	822,294,102	861,334,996	845,402,556	6.1	5.8	5.5	5.0	4.6	4.2
La Libertad	647,396,792	690,771,056	823,043,107	965,426,112	1,036,726,276	1,165,028,246	6.7	6.0	5.8	5.9	5.5	5.8
Lambayeque	388,922,437	534,611,751	486,746,640	535,603,903	560,428,707	680,325,582	4.0	4.7	4.1	3.3	3.0	3.4
Lima	317,767,269	363,626,964	516,267,494	751,313,313	926,937,364	1,080,862,232	3.3	3.2	3.2	4.6	5.0	5.4
Loreto	606,269,381	677,482,167	741,921,163	810,765,274	840,360,322	1,047,209,315	6.3	5.9	5.2	5.0	4.5	5.3
Madre de Dios	76,302,219	85,716,962	131,108,384	188,225,059	277,122,399	282,414,810	0.8	0.8	0.9	1.2	1.5	1.4
Moquegua	180,742,571	275,004,592	371,115,444	441,761,749	450,176,034	415,620,999	1.9	2.4	2.6	2.7	2.4	2.1
Pasco	167,304,727	191,797,511	341,562,047	460,307,834	464,055,574	370,754,716	1.7	1.7	2.4	2.8	2.5	1.9
Piura	637,667,639	756,266,823	851,766,133	872,428,830	1,080,405,075	1,128,917,373	6.6	6.6	6.0	5.3	5.8	5.7
Puno	589,998,320	669,737,595	769,622,625	832,498,705	976,388,546	1,041,428,502	6.1	5.9	5.4	5.1	5.2	5.2
San Martín	376,734,991	444,021,437	629,791,148	626,976,624	610,568,719	641,397,562	3.9	3.9	4.5	3.8	3.3	3.2
Tacna	245,465,130	318,655,285	426,114,050	613,725,019	726,760,685	534,556,206	2.5	2.8	3.0	3.8	3.9	2.7
Tumbes	173,658,093	208,337,742	239,907,280	249,803,709	295,283,660	375,334,595	1.8	1.8	1.7	1.5	1.6	1.9
Ucayali	277,829,748	300,451,877	367,499,551	472,501,048	517,212,473	451,371,817	2.9	2.6	2.6	2.9	2.8	2.3
Munic. Met. de Lima	13,439,966	18,995,391	66,709,158	78,320,495	187,347,007	332,466,287	0.1	0.2	0.5	0.5	1.0	1.7

<b>Totals</b>	9,700,892,620	11,434,999,320	14,158,383,333	16,354,971,748	18,681,824,513	19,926,537,859	100.0	100.0	100.0	100.0	100.0	100.0
<b>Max</b>	649,748,595	780,752,061	1,146,935,801	1,580,787,240	2,173,502,254	2,110,024,052	6.7	6.8	8.1	9.7	11.6	10.6
<b>Min</b>	13,439,966	18,995,391	66,709,158	78,320,495	187,347,007	282,414,810	0.1	0.2	0.5	0.5	1.0	1.4
<b>Coef. of Variation<sup>a</sup></b>	0.51	0.51	0.49	0.51	0.56	0.52	0.51	0.51	0.49	0.51	0.56	0.52

Source: Economic Transparency Portal, MEF.

Note: a. The ratio of the standard deviation to the mean of the distribution.

There are significant disparities among the regions in per capita expenditures. The regions of Madre de Dios and Moquegua lead the ranking with 2,578 and 2,573 soles, respectively, for 2010, with Lambayeque at the bottom end at 611 nuevos soles in 2010, less than one-fourth of those in Moquegua and Madre de Dios (table 5.7). While per capita expenditures for these two regions more than doubled during a five-year period, other regions such as Ancash and Apurímac have seen larger increases. The coefficient of variation increased through 2009 and decreased the last year for which data were available.

**Table 5.7 Per Capita Regional Expenditures** (in nuevos soles)

<b>Region</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Amazonas	501	590	812	951	1,011	1,112
Ancash	508	646	1,078	1,486	2,044	1,984
Apurímac	605	673	806	985	1110	1,628
Arequipa	502	582	672	780	905	916
Ayacucho	576	696	838	872	978	1177
Cajamarca	468	563	627	695	754	930
Callao	408	454	508	558	825	781
Cusco	476	625	826	916	1,000	984
Huancavelica	608	683	912	1,057	1,071	1,324
Huánuco	384	421	490	574	593	793
Ica	526	577	641	697	749	798
Junín	478	541	627	667	699	686
La Libertad	400	427	509	597	641	720
Lambayeque	349	480	525	481	504	611
Loreto	680	760	832	909	942	1,174
Madre de Dios	696	782	1,197	1,718	2,530	2,578
Moquegua	1,119	1,702	2,297	2,735	2,787	2,573
Pasco	597	684	1,218	1,641	1,655	1,322
Piura	380	451	508	520	645	673
Puno	465	528	607	656	770	821
San Martín	517	609	864	860	838	880
Tacna	850	1,103	1,476	2,125	2,517	1,851
Tumbes	867	1,040	1,198	1,247	1,474	1,874
Ucayali	643	695	850	1,093	1,197	1,044
Totales	354	417	516	596	681	727
Max	1,119	1,702	2,297	2,735	2,787	2,578
Min	349	421	490	481	504	611
<b>Coef. of Variation<sup>a</sup></b>	0.32	0.40	0.46	0.53	0.56	0.47

Source: Economic Transparency Portal, MEF.

Note: a. The ratio of the standard deviation to the mean of the distribution.

The functional composition of expenditures at the local level (table 5.8) shows that the relative importance of education, health, and social services combined represented 30 percent of total expenditures in 2010, followed by “administration” (25.7 percent) and transport and

communications (20.6 percent). While education and social services expenditures have declined somewhat in relative importance, health services expenditures have increased. The most pronounced public expenditure increases have been in the municipalities of those regions directly benefiting from the canon transfers, such as Ancash, Arequipa, and Cusco (table 5.9). In addition, Lima has also experienced a significant increase in public expenditures, but unrelated to the canon transfers and, rather, based on a strong own tax base and central government transfer funds.

**Table 5.8 Functional Composition of Expenditures at the Local Level** (in nuevos soles and percentages)

Function	2007	2008	2009	2010	2007	2008	2009	2010
Administration	3,040,345,733	4,989,005,195	5,603,866,393	5,880,627,313	27.3	25.1	23.6	25.7
Public Security	—	—	527,743,781	545,556,275	—	—	2.2	2.4
Commerce	334,013,043	567,421,509	686,686,453	545,838,402	3.0	2.9	2.9	2.4
Agriculture	439,455,937	1,169,533,390	1,453,203,063	1,325,254,280	3.9	5.9	6.1	5.8
Fishing	11,775,707	44,259,564	45,955,558	27,682,505	0.1	0.2	0.2	0.1
Energy	202,169,602	379,608,872	411,971,315	316,440,563	1.8	1.9	1.7	1.4
Transport & Communications	2,686,776,967	4,547,765,020	5,178,380,836	4,723,583,582	24.1	22.9	21.8	20.6
Environmental Prot.	—	—	1,745,132,574	1,711,157,806	—	—	7.4	7.5
Housing	347,031,151	647,904,350	697,077,768	536,869,313	3.1	3.3	2.9	2.3
Health	1,935,233,075	3,277,128,012	2,860,778,684	2,838,586,296	17.4	16.5	12.1	12.4
Education & Culture	847,816,285	2,206,432,067	2,892,815,873	2,702,741,766	7.6	11.1	12.2	11.8
Social Services	1,283,674,591	2,044,404,347	1,327,693,385	1,264,352,974	11.5	10.3	5.6	5.5
Debt service	—	—	304,769,446	468,663,751	—	—	1.3	2.0
<b>Total</b>	11,128,292,091	19,873,462,326	23,736,075,129	22,887,354,826	100.0	100.0	100.0	100.0

Source: Economic Transparency Portal, MEF.

Note: — = not available.

**Table 5.9 Local Government Expenditures Aggregated by Region** (in million soles and percentages)

Region	2007	2008	2009	2010	2007	2008	2009	2010
Amazonas	49,731,629	166,732,926	230,596,638	188,785,035	0.4	0.8	1.0	0.8
Ancash	702,804,982	2,328,097,085	2,602,575,696	2,038,526,423	6.3	11.7	10.9	8.8
Apurimac	85,901,048	228,299,245	322,020,541	303,887,206	0.8	1.1	1.3	1.3
Arequipa	382,941,585	931,077,389	1,320,117,719	1,307,201,222	3.4	4.7	5.5	5.6
Ayacucho	205,354,792	400,397,126	541,192,840	552,212,691	1.8	2.0	2.3	2.4
Cajamarca	544,659,117	906,107,987	949,835,732	1,287,935,591	4.9	4.5	4.0	5.5
Callao	347,738,151	434,840,762	476,404,104	464,382,348	3.1	2.2	2.0	2.0
Cusco	826,536,424	1,693,685,791	1,877,428,801	1,917,426,819	7.4	8.5	7.8	8.3
Huancavelica	105,907,212	427,362,070	535,926,632	551,050,128	0.9	2.1	2.2	2.4
Huanuco	131,912,620	305,318,256	433,365,391	430,768,959	1.2	1.5	1.8	1.9
Ica	220,354,832	393,224,585	539,863,957	613,124,322	2.0	2.0	2.3	2.6
Junin	356,953,441	753,335,915	897,235,582	816,757,610	3.2	3.8	3.8	3.5
La Libertad	365,200,282	791,460,008	1,047,101,683	1,240,453,807	3.3	4.0	4.4	5.3
Lambayeque	183,805,933	343,554,011	505,721,330	531,008,102	1.6	1.7	2.1	2.3
Lima	3,113,393,717	4,003,179,471	4,770,153,752	5,016,687,082	27.8	20.1	19.9	21.6
Loreto	360,313,189	465,980,293	518,333,973	445,580,937	3.2	2.3	2.2	1.9
Madre de Dios	16,075,818	41,336,427	59,183,875	64,479,675	0.1	0.2	0.2	0.3
Moquegua	665,915,993	782,182,677	743,799,552	670,215,858	5.9	3.9	3.1	2.9
Pasco	229,945,130	700,825,059	813,488,838	470,172,783	2.1	3.5	3.4	2.0
Piura	574,450,526	915,277,178	1,117,431,205	1,041,478,232	5.1	4.6	4.7	4.5
Puno	248,332,171	739,156,976	1,015,934,934	939,668,513	2.2	3.7	4.2	4.0
San Martín	157,940,662	210,431,131	292,810,945	319,592,651	1.4	1.1	1.2	1.4
Tacna	1,004,663,593	1,425,253,777	1,567,336,740	1,087,966,790	9.0	7.1	6.6	4.7
Tumbes	90,583,537	190,668,711	208,643,174	195,504,135	0.8	1.0	0.9	0.8
Ucayali	156,875,707	295,677,470	349,571,495	392,487,907	1.4	1.5	1.5	1.7
<b>Total</b>	11,128,292,091	19,873,462,326	23,736,075,129	22,887,354,826	100.0	100.0	100.0	100.0
<b>Min</b>	16,075,818	41,336,427	59,183,875	64,479,675	0.1	0.2	0.2	0.3
<b>Max</b>	3,113,393,717	4,003,179,471	4,770,153,752	5,016,687,082	27.8	20.1	19.9	21.6
<b>Average</b>	445,131,684	794,938,493	949,443,005	915,494,193	4.0	4.0	4.0	3.9
<b>Coeff. of Variation<sup>a</sup></b>	0.73	0.94	0.96	0.92	0.73	0.94	0.96	0.92

Source: Economic Transparency Portal, MEF.

Note: a. The ratio of standard deviation to the mean of the distribution.

There are significant disparities in per capita expenditures among municipalities aggregated by region (table 5.10). After Lima with 5,976 nuevos soles in 2010, the municipalities in the regions of Moquegua and Tacna lead the ranking with 4,149 and 3,767 nuevos soles, respectively, for 2010, with municipalities in San Martín and Lambayeque at the bottom end at 439 and 477 nuevos soles, respectively, in 2010. This means that the average municipal resident in San Martín has just about 10 percent of the expenditure per capita of municipal residents in Moquegua. Also, these disparities have been getting worse, with the coefficient of variation increasing by over 50 percent from 2007 through 2010.

**Table 5.10 Per Capita Local Government Expenditures Aggregated by Region** (in nuevos soles)

Region	2007	2008	2009	2010
Amazonas	132	443	613	502
Ancash	661	2,189	2,447	1,917
Apurimac	213	565	797	752
Arequipa	332	808	1,146	1,134
Ayacucho	335	654	884	902
Cajamarca	392	653	684	928
Callao	397	496	543	530
Cusco	706	1,446	1,603	1,637
Huancavelica	233	940	1,178	1,212
Huanuco	173	401	569	565
Ica	310	552	758	861
Junin	290	611	728	663
La Libertad	226	489	648	767
Lambayeque	165	309	454	477
Lima	3,709	4,769	5,682	5,976
Loreto	404	523	581	500
Madre de Dios	147	377	540	589
Moquegua	4,122	4,842	4,605	4,149
Pasco	820	2,499	2,901	1,677
Piura	343	546	667	621
Puno	196	583	801	741
San Martín	217	289	402	439
Tacna	3,479	4,935	5,427	3,767
Tumbes	452	952	1,042	976
Ucayali	363	684	809	908
<b>Average</b>	753	1,262	1,460	1,328
<b>Min</b>	132	289	402	439
<b>Max</b>	4,122	4,935	5,682	5,976
<b>Coeff. of Variation<sup>a</sup></b>	0.65	0.87	0.94	0.99

Source: Economic Transparency Portal, MEF.

Note: a. The ratio of standard deviation to the mean of the distribution.

### *Issues with current expenditure patterns*

The following considerations regarding expenditure composition are important.

***Decentralized versus deconcentrated expenditures at the regional level.*** A considerable part of the regional government expenditures must be considered deconcentrated—as opposed to decentralized—expenditures (World Bank 2010). This means that subnational governments have no discretion over those expenditures. The share of deconcentrated spending channeled through the “regional directorates” of central ministries and agencies was estimated by the World Bank (2010) to be over two-thirds of the total regional spending. Thus, even though subnational governments account for more than half of expenditures on education and health, most of those correspond to the wages and salaries paid to teachers, health workers, and so on as

deconcentrated expenditures. Because central line ministers and agencies have the discretion to manage their deconcentrated expenditures, there are differences by sector and even by region and department on the split between deconcentrated and decentralized expenditures. The canon transfers also play a role in the split between deconcentrated and decentralized spending. Since canon funds can be spent at the discretion of subnational governments (with the restriction of being for capital infrastructure), the share of decentralized expenditures tends to be higher for subnational governments that are recipients of canon funds.

***Capital spending earmarks and efficiency at the regional and local levels.*** At both the regional and local levels, the requirements and heavy emphasis of current laws on spending a high share of available funds on capital expenditures is likely to have a negative impact on the efficiency and quality of public services. The decentralization framework appears to ignore the fact that current expenditure can be of equal importance in the production and efficient delivery of public services. In recent years, there has been pressure from the central authorities concerning the slow rate of disbursement by subnational governments, especially by those benefiting from the large increases in the canon transfers. The slow disbursement is related in large measure to the requirement that those funds are spent on capital infrastructure; the rush to disburse has been hurting overall expenditure efficiency (World Bank 2010).

***Fiscal disparities at the regional and local levels.*** The writings of the Peruvian intelligentsia at the beginning of the last century (Rühling 2008) show a considerable impetus at the national level through the decades for the development of the Peruvian hinterlands and reducing or eliminating regional disparities. The reduction of regional disparities has been one of the goals of the decentralization process in Peru that started in 2002. Thus, an important question is why the decentralization process has not been successful in reducing those geographic disparities. In fact, because of the way it has been structured, the decentralization process has actually contributed to an increase in regional and municipal disparities.

### **The assignment of expenditure responsibilities**

#### *The allocation of expenditure competencies in the law*

The Decentralization Bases Law (Ley de Bases de la Descentralización) of 2002 specifies the need to establish a clear division of expenditure responsibilities to promote the accountability of public officials to their constituencies. This law adopts the principle of “subsidiarity” (which says that responsibilities should be assigned to the lowest level of government capable of efficiently providing the service), and establishes three fundamental categories of assignments: (a) exclusive responsibilities, (b) shared or concurrent responsibilities, and (c) delegated responsibilities. The Decentralization Bases Law also establishes that the process of transfers of responsibilities to subnational governments needs to be sequential over time, expenditure-neutral (causing no increases in total expenditures), and fully funded (all responsibilities must be accompanied by the necessary financial resources for service provision).

The exclusive and concurrent expenditure responsibilities of subnational governments are outlined in the Decentralization Bases Law. Box 5.2 lists the assignments to regional governments in the Decentralization Bases Law and box 5.3 lists the assignments to local

governments. More concrete aspects of the assignments are mandated in the Organic Law of the Executive Power (Ley Orgánica del Poder Ejecutivo), the Organic Laws of the Regional and Municipal Governments, and sectoral laws and ministerial decrees.

**Box 5.2 Expenditure Assignments to Regional Governments in the Decentralization Bases Law, 2002**

*Exclusive Competencies*

- Approve its organization and budget.
- Promote and execute public investment projects of regional scope.
- Develop the Regional Socioeconomic Development Plan.
- Design and implement regional programs for economic corridors and intermediate cities.
- Promote the creation of regional businesses and economic units.
- Facilitate export activities.
- Develop tourist attractions.
- Develop economic development alliances.
- Manage land owned by the state in the region.
- Organize and approve territorial demarcation studies.
- Promote the modernization of small and medium enterprises.
- Promote the sustainability of forest resources.
- Other.

*Concurrent Competencies*

- Education: management of preschool, primary, secondary, and higher nonuniversity education programs.
- Public health.
- Promotion, regulation, and management of economic activity at the regional level.
- Sustainable management of natural resources.
- Preservation and management of protected natural areas.
- Promotion of cultural activities.
- Promotion of employment.
- Promotion of citizen participation.
- Other.

*Source:* Decentralization Bases Law.

**Box 5.3 Expenditure Assignments to Municipal Governments in the Decentralization Bases Law, 2002**

*Exclusive Competencies*

- Plan and promote local urban and rural development.
- Regulate zoning, urban development, territorial planning, and human settlements.
- Regulate and manage local public services.
- Approve its organization and budget.
- Develop and approve the local development plan.
- Promote and execute public investment projects of local scope.
- Approve and facilitate the mechanisms for the participation, collaboration, and control by residents of municipal activities.
- Issue regulations.
- Other.

*Concurrent Competencies*

- Education: participating in the management of education services as established in the law.
- Public health.
- Culture, tourism, sports, and recreation.
- Preservation and management of local natural reserves and protected areas.
- Citizen safety.
- Conservation of archeological and historical monuments.
- Mass transport and urban transit.
- Housing and urban renovation.
- Management of social programs.
- Management of solid waste.
- Others as delegated.

*Source:* Decentralization Bases Law.

The most important omission in the current legislation is a clear reference to what functions can be “delegated,” the third main category identified in the Decentralization Bases Law. The wording of current assignments is such that there are overlaps of several exclusive and concurrent responsibilities of regional and local governments. The Organic Laws of Regional and Local Governments also repeat and rephrase the assignments in the Decentralization Bases Law but also introduce confusion by listing similar delegated responsibilities for the two levels of government. This is clearly the case, for example, in the area of territorial planning and land use. Overall, there are too many shared or concurrent responsibilities in the assignments of expenditure responsibilities to regional and local governments.

One of the defining features of expenditure assignments in Peru has been the gradual transfer of expenditure responsibilities to regional and local governments. This approach was adopted early in the reform process to address the problem of insufficient administrative capacity of subnational governments. This process has been regulated in the 2004 Law of the Accreditation System (*Ley del Sistema de Acreditación*). The process was initially implemented by the National Council for Decentralization (*Consejo Nacional de Descentralización*) and is currently conducted by the National Office for Decentralization (*Secretaría Nacional de la Descentralización*), which took over the functions of the National Council for Decentralization.<sup>17</sup> To a large extent, the process has been one of devolution of expenditure responsibilities from the line ministries to the regional governments and has consisted of three stages:

- Certification of the prerequisites required for the assumption of functions
- Accreditation for meeting the prerequisites
- The actual implementation of the transfer of responsibility identifying the financing needs for delivering the transferred functions.

After a slow start in the transfer of the functions listed in the 2003 Organic Law of Regional Governments (*Ley Orgánica de Gobiernos Regionales*), the “decentralization shock” of President Alan García included a deadline for the transfer of the 185 functions, which at the end of 2006 still had not been transferred to the regional governments. This deadline was first extended to December 2008. In reality, some of the functions were transferred after that date. According to the report sent by the Presidency of the Cabinet of Ministers to the Congress in May 2009, about 95 percent of the functions had been transferred, involving over 8,000 specific functions.

The slow process in the transfers of expenditure responsibilities has been associated with some degree of institutional instability. One element of President Toledo’s reform was to create the National Council of Decentralization, designed to lead the devolution of responsibilities and also serve as a forum for intergovernmental consensus building on decentralization issues. In practice, there were strong disagreements between the National Council and central government agencies, in particular the Ministry of Economy and Finance (MEF), on the speed and content of the decentralization process. Some of these disagreements involved positions taken by the MEF that were not always well informed. For example, the MEF at some point seems to have taken the position that the financing of regional governments would have to be all transfer based or all own-revenue based. However, this position flies in the face of the theory of decentralization and best international practice. In the end, the National Council of Decentralization lost the battle, and after a period of relative inactivity and ineffectiveness, in 2007 under President García’s mandate it was subsumed into a Secretariat of Decentralization as part of the Presidency of the Council of Ministers. This new institution had no direct representation of subnational authorities. Unofficially, the National Association of Regional Governments (*Asociación Regional de Gobiernos Regionales*) has become the representative of regional government interests in the decentralization process, and it held periodic meetings with President García. At the local level, the several municipal associations have not been able to play a similar role.

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<sup>17</sup> The National Office for Decentralization is one of the three offices (*secretarías*) attached to the Presidency of the Cabinet of Ministers (*Presidencia del Consejo de Ministros*).

### *Main issues and problems with expenditure assignments*

The process of expenditure assignments still suffers from a number of problems, including the following.

***Delegated functions continue to be undefined.*** An important issue is what (concurrent) functions or additional functions can be “delegated” to regional and local governments. In a unitary system of government, as in Peru, in theory practically all sorts of functions could be delegated. However, this distinction is typically of utmost importance in deciding how to finance concurrent responsibilities. In the case of delegated responsibilities, central authorities can play a bigger role in regulating the service and establishing standards, but they must also assume responsibility for their financing using, for example, conditional transfers to the subnational governments charged with their implementation.

***Despite some progress, expenditure assignments continue to lack clarity.*** In an effort to further clarify expenditure assignments, the National Office for Decentralization (Secretaría Nacional de la Descentralización) has completed a full draft of expenditure assignments in the form of a large matrix. The matrix offers a multidimensional classification of assignments at the different levels of government.<sup>18</sup> Some parts of the matrix have been officially approved; for example, a decree of May 2011 issued the matrix of responsibilities for the transport and communication sector at the national, regional, and local levels. However, and significantly, the matrix excludes all aspects related to responsibilities for financing. In addition, despite the progress made, the matrix does not really help clarify the issue of concurrent responsibilities in any substantial way. The reason is that the matrix inserts verbatim without elaboration the text that had been previously used in the laws and decrees on this matter. Therefore, the murkiness of concurrent expenditure assignments continues to exist. In particular, the matrix still contains a high number of functions for which the responsibilities of different levels are identical except for their geographic or jurisdictional scope. The matrix still also contains a certain degree of overlapping responsibilities for regional and local governments that could be easily clarified. In spite of the adoption of the principle of subsidiarity in the Decentralization Bases Law, the design and regulation in all sectoral functional areas is actually reserved for the central government, thus diminishing the depth of decentralization and the real autonomy of subnational governments (see World Bank 2010).

***The respective roles of deconcentrated and decentralized units at the regional level still need to be clearly delineated.*** Not unrelated to the lack of clarity in expenditure assignments, the daily operations of deconcentrated central government agencies and decentralized units, especially at

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<sup>18</sup> The draft matrix defines for each line ministry at the central level, regional and local government “competencies” and “essential processes.” For each “essential process,” the matrix identifies “functions” in the areas of (a) norming, regulation, and policy; (b) planning; (c) administration and execution; and (d) supervision and evaluation. This work reflects a compilation effort based on existing decrees (Decretos Legislativos) and organic laws (Leyes Orgánicas de los Gobiernos Regionales y Municipales). A significant value added of the draft matrix is to concentrate in a single place a dispersed body of laws and regulations. But because the matrix is a compilation of existing decrees and organic laws, it does not add any information that does not already exist in those documents. Thus, for example, the omission of financing responsibilities in the matrix is due to the fact that the existing decrees and organic laws do not address financing responsibilities.

the regional level, continues to be confused. Prior to decentralization, many functions of sectoral ministries had been deconcentrated to regional directorates and local management units. Although many of these offices were incorporated into the regional and local levels with the decentralization process, in reality they mostly follow the instructions and directions of line ministries (World Bank 2010).<sup>19</sup> In some cases, such as education, additional institutional complexity is added through the role played by community participation organizations (for example, Participative Educational Councils at the regional, local, and school levels).<sup>20</sup> For the time being, the subordination of the regional directorates to the regional management bureaus still appears to be more nominal than factual, with regional directorate employees keeping a closer allegiance to their prior line ministries than to their regional bosses. Line ministries appear to play along, reluctant to renounce their authority and claiming lack of administrative capacity in regional governments.

This dichotomy continues to be reinforced by the structure of the budget financing sources. The financing and expenditure program of the regional directorates are predefined in the central government budget and cannot be modified in any way by the regional governments. Similarly, the fees and charges collected by the regional directorates do not flow to the regional government treasuries but instead remain with the directorates. Clearly, these arrangements, even if they can be expected to be transitional, continue to limit in significant ways the autonomy of regional governments and reduce the potential gains from decentralization. Regional governments have been vocal about the lack of autonomy regarding their budgets.

***Insufficient coordination and dialogue between the different levels of government in concurrent responsibilities.*** With so much overlap in expenditure responsibilities, there is much need for coordination among central and regional authorities and regional and local authorities. However, at the main point of contact between central and regional officials, the “regional directorates,” there is still more competition than coordination between the regular staffers that came from the deconcentrated units (and who consider themselves line ministry employees) and the new appointees by the regional offices (World Bank 2010). Furthermore, there are basically no mechanisms to coordinate the regional and local governments; in many ways these two levels actively compete with each other.

***Lack of a specific mechanism for the resolution of conflicts in expenditure assignments.*** With the exception of presenting a demand before the Constitutional Court, currently the

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<sup>19</sup> The regional directorates of each sectoral ministry were deconcentrated agencies, which were incorporated with the 2006 “decentralization shock” into the the regional governments’ Regional Management Office, with regional presidents having the power to designate the head of the regional directorates. However, the central government agencies still set the budget of the regional directorates, and the regional authorities, including the regional president, have no power to modify those budgets. The current situation is one of de facto double subordination of regional directorates to central and regional authorities. The typical structure of regional governments is based on “management bureaus” (Gerencias Regionales), which contain the regional directorates (Direcciones Regionales, the prior deconcentrated units of line ministries) and “thematic divisions” (Divisiones Temáticas). The management bureaus and the regional directorates control executing units (schools, health centers, and so forth).

<sup>20</sup> Actions have been taken to address some of the issues. For example, the Managemnet Municipalization Plan introduced with President Alan García’s “decentralization shock” would empower municipalities to hire teachers and administrative personnel, design local education programs, diversify the curriculum, build and maintain schools, and so on. However, this process just got started and the final stage is not until 2015 (World Bank 2010).

decentralization laws have no explicit administrative mechanism to address conflict resolution in expenditure assignments. On a daily basis, sectoral specialists in the National Budget Office (Dirección Nacional de Presupuesto Público) work to clarify possible conflicts, and the most serious issues have been addressed in the (informal) meetings between the President of the Republic and the regional presidents. In practice, the few demands presented before the Constitutional Court have been resolved most of the time in a reasonable period of six months.

***Estimating the expenditure needs associated with the transfer of functional assignments.*** A positive aspect of the process of the transfer of functional assignments has been the inclusion of a methodology to estimate expenditure needs and financial requirements derived from the new expenditure responsibilities. Essentially this process has been implemented using a historical costs methodology plus allowing input from the regional governments, line ministries, and other stakeholders, and finally decided by the MEF on the basis of two criteria: cost neutrality and no new personnel for service delivery.

The use of a historical cost methodology is a reasonable approach for getting started with the required funding for newly transferred responsibilities. However, it can lead to problematic results in future years, especially if the initial estimates did not accurately reflect spending needs and if the historical geographic distribution of services was not fair. Because of dynamic changes in population size and composition, prices, and so forth, typically it is necessary to adopt other methodologies that can adapt to changing conditions. Examples of those alternative methodologies will be discussed in the transfers section below.

#### **4. Revenue Assignments**

##### ***Revenue patterns***

As discussed, subnational governments represent a substantial share of total public expenditures—around 36.6 percent in 2008. In contrast, the decentralization of revenue sources still remains insignificant. Among subnational governments, regional governments have practically no own revenues or tax bases assigned to them. Local governments, as we will see, have their tax bases (mainly property and vehicle taxes) but raise relatively low revenues and have no authority over the bases or rates of those taxes, since those are determined by the central authorities. In 2008, the share of own revenues over total expenditures at the subnational level was under 13 percent, with the local governments (provincial and district municipalities), of course, collecting most of these revenues.

The result is a very high level of transfer dependence of subnational governments in Peru. Table 5.11 presents the budgets of the different levels of government following the classification of the National Directorate of Public Accounting (Dirección Nacional de Contabilidad Pública), the official source of public budget accounts in Peru. A potentially misleading aspect of this reporting is that regional governments are the recipients of “ordinary resources,” which are not classified as revenue sources of the regional governments, but which nevertheless finance an important proportion of public expenditures at the regional level. Therefore, the negative “financial results” shown for all subnational governments in 2002 and only for regional

governments in 2008 (bottom of table 5.8) are, in reality, covered by these other transfers from the central government.

**Table 5.11 Composition of Revenues by Level of Government, 2002 and 2008**

(in millions of nuevos soles, and percent shares of total expenditures)

	2002				2008					
	Central Government (%)		Subnational Governments (%)		Central Government (%)		Regional Governments (%)		Local Governments (%)	
<b>Own Revenues</b>	<b>24,939</b>	<b>116.6</b>	<b>1,530</b>	<b>11.0</b>	<b>60,438</b>	<b>136.0</b>	<b>459</b>	<b>3.7</b>	<b>2,688</b>	<b>20.4</b>
Taxes and contributions	22,429	104.9	731	5.2	51,470	115.8	14	0.1	1,406	10.7
Charges and fees	965	4.5	966	6.9	3,922	8.8	222	1.8	1,583	12.0
Capital Revenues	1,350	6.3	41	0.3	325	0.7	14	0.1	25	0.2
<b>Transfers<sup>a</sup></b>	<b>-240</b>	<b>-1.1</b>	<b>1,436</b>	<b>10.3</b>	<b>-827</b>	<b>-1.9</b>	<b>2,365</b>	<b>19.0</b>	<b>8,629</b>	<b>65.4</b>
Tax on extractive industries			793	5.7			1,669	13.4	5,145	39.0
<b>Net Financial Debt</b>	97	0.5	-51	-0.4	-844	-1.9	67	0.5	120	0.9
<b>Accumulated Balances</b>	267	1.2	466	3.3	5,317	12.0	2,669	21.4	5,170	39.2
<b>Total Revenues</b>	<b>26,414</b>	<b>123.5</b>	<b>3,421</b>	<b>24.6</b>	<b>64,409</b>	<b>144.9</b>	<b>5,574</b>	<b>44.7</b>	<b>16,633</b>	<b>126.1</b>
<b>Total Expenditures</b>	<b>21,383</b>	<b>100.0</b>	<b>13,933</b>	<b>100.0</b>	<b>44,456</b>	<b>100.0</b>	<b>12,479</b>	<b>100.0</b>	<b>13,194</b>	<b>100.0</b>
<b>Financial Result</b>	5,032	23.5	-10,512	-75.4	19,953	44.9	-6,905	-55.3	3,439	26.1

Sources: MEF and DNCP.

Note: a. The full amount of property income of regional and municipal governments during 2002 (usually reported as current revenues in the Peruvian accounting system) is assumed to correspond to transfers from canon, sobrecanon, and royalties.

The most important thing to highlight is that the current situation with revenue assignments (and mobilization) is starkly different for regional and local governments. Even though regional governments have been given additional expenditure responsibilities, they have not yet been assigned any autonomous tax revenue sources.

#### *The composition of regional revenues*

In the grand design of revenue assignments, Decree No. 955, the Fiscal Decentralization Law of 2004 introduced (as an incentive for the formation of macroregions) a hefty 50 percent revenue sharing for the new regions in the national value-added tax, and the personal income tax (in some categories). As mentioned, this revenue sharing never materialized because of the rejection of the macroregions in the 2005 referendum. However, what is most notable is that the grand design never included any degree of tax autonomy for regional governments.

The composition of regional government revenues is shown in table 5.12. Note that in some years, there are revenues from own taxes—around 1 percent of total regional revenues in 2005 and 2006—corresponding to a special levy charged by some regions on goods originating in tax-free zones. Practically all regional revenues come from other sources, and their composition has

not changed significantly in the last decade. Two sources, central transfers and income from own assets, represented 85 percent of all regional revenues in 2008, as shown in table 5.12. The revenues from the canon, sobrecanon, and royalties are included in the “income from assets” category and represent the most important source of capital grant financing at the regional level.

**Table 5.12 Revenues of Regional Governments, 2004–08**  
(percent of total revenues)

	2004	2005	2006	2007	2008
	(%)	(%)	(%)	(%)	(%)
<b>Current Revenues</b>	53	57	73	65	67
Contributions	0	0	0	0	0
Taxes	0	1	1	0	0
Fines	0	0	1	0	0
Other current revenues	1	1	3	4	6
Service charges	8	7	7	4	4
Income from own assets (including canon)	32	40	54	53	52
Fees	3	3	3	2	2
Sales of goods	7	5	5	3	3
<b>Capital Revenues</b>	1	1	1	1	0
Repayments	0	0	0	0	0
Other capital revenues	0	0	0	0	0
Sales of assets	0	0	1	1	0
<b>Transfers</b>	46	42	26	34	33
<b>Total (excepting the financing of budget balances)</b>	100	100	100	100	100

Source: MEF 2010.

A more detailed account of the category of “income from own assets” is given in table 5.13. This includes income from financial assets (mostly in the form of interest from bank deposits) and income from the canon, sobrecanon, and royalties; the latter represent between 78 and 90 percent of total income from own assets. In a standard classification of revenues, the canon, sobrecanon, and royalties would be considered revenue sharing and, therefore, a part of transfers. The canon from mineral resources and oil are the largest items in “income from own assets.”

**Table 5.13 Regional Income from Own Assets, 2004–08** (in nuevos soles and percents)

	2004	2005	2006	2007	2008
<b>Total</b>	449,227,602	726,884,857	1,097,670,363	2,076,871,031	1,900,394,298
	(%)	(%)	(%)	(%)	(%)
Financial Assets	1.07	0.82	1.23	2.44	2.89
Interest	0.04	0.00	0.00	0.04	0.04
Interest from banks	0.95	0.78	1.20	2.39	2.83
Interest from loans	0.08	0.04	0.03	0.01	0.01
Other	0.00	0.00	0.00	0.00	0.00
Real Assets	99.02	99.07	98.90	97.70	97.11
Building leasing	0.12	0.09	0.07	0.03	0.05
Other leasing	0.99	0.31	0.25	0.20	0.37
Rental property	1.98	1.24	0.98	0.59	0.62
Canon from forests	0.05	6.33	0.14	0.07	0.05
Canon from gas	4.06	10.97	8.98	7.52	9.91
Canon from hydropower	5.75	3.72	2.94	1.80	1.48
Canon from minerals	23.73	30.07	40.16	62.17	51.02
Canon from fishing	2.24	1.00	1.16	0.50	0.77
Canon from oil	29.98	23.82	19.31	10.46	14.73
Canon from					
Telecommunications	0.00	0.00	0.00	0.00	0.00
Concessions	0.50	0.30	0.22	0.13	0.13
Right-of-way contracts	0.01	0.01	0.01	0.00	0.01
Annual fees for mineral					
exploitation rights	0.00	0.00	0.00	0.00	0.01
Other	0.09	0.04	0.03	0.04	0.07
Participation in contracts	0.00	0.00	0.00	0.00	0.00
Royalties	0.00	0.21	0.00	0.00	0.00
Royalties FOCAM	0.00	0.00	2.88	1.64	1.92
Royalties mineras	0.00	0.00	5.22	3.50	3.45
Customs revenues	17.35	12.71	10.23	6.29	8.04
Sobrecanon from oil	12.20	8.23	6.32	2.75	4.48
Profits of public					
enterprises	0.00	0.00	0.00	0.00	0.00
Other	-0.10	0.11	-0.13	-0.14	0.00
Exchange rate					
differential	-0.11	0.06	-0.15	-0.15	-0.01
Other	0.01	0.06	0.01	0.01	0.01

Source: MEF 2010.

Regional revenues categorized as transfers on average represented 36 percent of total regional revenues during 2004–08. At the start of the period, practically all transfers came from “internal: public sector” transfers, in particular, the Regional Equalization Fund (Fondo de Compensación Regional, FONCOR) capital transfer (covered in the next section). From 2006 on, transfers from “internal: nonpublic sector,” in particular, donations from the National Fund for Labor Training and Employment Promotion (Fondo Nacional de Capacitación Laboral y de Promoción del Empleo, FONDOEMPLEO) and profits from public corporations, represented over half of total transfers (table 5.14).

**Table 5.14 Regional Government Transfers Structure, 2004–2008**  
(in nuevos soles and as percent of yearly total)

	2004	2005	2006	2007	2008
<b>Total</b>	641,491,485	755,964,681	527,250,702	1,329,530,664	1,213,242,227
	(%)	(%)	(%)	(%)	(%)
External sources	3	3	5	1	2
Internal: Nonpublic sector (including FONDEMPLEO and Public enterprise profits)	0	0	30	54	52
Internal: Public sector (including FONCOR)	97	97	65	45	46
Other	0	0	0	0	0

Source: MEF 2010.

**Table 5.15 Composition of Regional Revenues, 2004, 2006, 2008, and 2009**  
(in millions of nuevos soles, and percent shares of current and capital revenues)

	2004	%	2006	%	2008	%	2009 <sup>a</sup>	%
<b>Own Revenues</b>	<b>303</b>	<b>21.9</b>	<b>421</b>	<b>17</b>	<b>632</b>	<b>14.5</b>	<b>730.2</b>	<b>18.6</b>
Taxes and contributions	2	0.2	13	0.5	13	0.3	9.1	0.2
Charges and fees	160	11.6	199	8	217	5	384.5	9.8
Other	141	10.2	209	8.5	402	9.2	336.6	8.6
<b>Transfers (net of ordinary resources)</b>	<b>1,070</b>	<b>77.3</b>	<b>2,026</b>	<b>82</b>	<b>3,708</b>	<b>85.2</b>	<b>3,176</b>	<b>81.0</b>
Canon, sobrecanon, and royalties	350	25.3	956	38.7	1,669	38.3	1,714.3	43.7
Mining canon	107	7.7	441	17.8	970	22.3	933.1	23.8
Oil canon and sobrecanon	189	13.7	281	11.4	365	8.4	190.4	4.9
Gas canon	18	1.3	99	4	188	4.3	193.2	4.9
Other canon and royalties	36	2.6	136	5.5	146	3.3	397.6	10.1
Custom duties	78	5.6	112	4.5	153	3.5	128.5	3.3
FONCOR	360	26	430	17.4	674	15.5	—	0.0
Others	281	20.3	527	21.3	1,213	27.9	1,333	34.0
<b>Current Revenues (net of ordinary resources)</b>	<b>1,373</b>	<b>99.2</b>	<b>2,447</b>	<b>99</b>	<b>4,340</b>	<b>99.7</b>	<b>3,906</b>	<b>99.6</b>
Capital revenues	11	0.8	25	1	14	0.3	17	0.4
<b>Current and Capital Revenues</b>	<b>1,384</b>	<b>100</b>	<b>2,472</b>	<b>100</b>	<b>4,354</b>	<b>100</b>	<b>3,923</b>	<b>100</b>

Sources: MEF and DNCP.

Note: a. FONCOR data not available for 2009.

— n.a. = not available.

Table 5.15 presents a conventional classification of regional revenues excluding “ordinary resources,” the gap-filling transfer regional governments receive at the end of the fiscal period to finance the deconcentrated regional directorate budgets. We can see there that the most important transfer program in 2009 was from extractive industries (canon), representing more than 44

percent of total revenues.<sup>21</sup> The FONCOR, the equalization transfer program at the regional level, is also a significant revenue source, but in 2008 it contributed less than half of the revenues coming from the canon (data for 2009 were not available). But note that in 2004, before the rapid increase in the international prices of natural resources preceding the global financial crisis, the revenues from the canon and those from FONCOR were roughly equivalent. In all, the relative importance of revenues from extractive industries increased significantly during the period, reflecting the rising trend in international prices for Peruvian natural resource exports.

Significantly, the relative importance of the different revenue sources varies considerably across regions (table 5.16). However, some general patterns can be identified. For example, we can identify a large group that is highly dependent on transfers. Current transfers represented over 95 percent of regional revenues in Cajamarca, Callao, Cusco, Ica, Loreto, and Tacna in 2008. The regional governments that are relatively less dependent on transfers include the Metropolitan Municipality of Lima (52 percent of total), Arequipa (81 percent), and Amazonas (82 percent).

Canon funds are the main source of revenue in the regions of Ancash, Moquegua, Pasco, and Tacna, representing over 77 percent of total revenues. The geographic location of the regional governments clearly conditions their revenue structure. Location matters for natural resource deposits and also for the presence of international borders. For example, in 2008 Callao, as the international seaport of the country, received 18 percent of its resources from customs revenues.<sup>22</sup>

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<sup>21</sup> Note that taxes and contributions consist exclusively of import duties collected by the region of Tacna.

<sup>22</sup> The “customs revenues” corresponds to 2 percent of the revenues collected at customs offices and shared with the provincial and district municipalities where the customs offices are located. Callao has the most important seaport and airport in the country and, therefore, the largest customs revenues. Ten percent of the customs revenues in Callao are earmarked to a provincial education fund.

**Table 5.16 Regional Governments Current and Capital Revenues, 2008**

Regions	Am azo nas	Anc ash	Apu rim ac	Are quip a	Aya cuc ho	Caj ama rca	Call ao	Cus co	Hua nea velic a	Huá nuc o	Ica	Juní n	La Libe rtad
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
<b>(1) Taxes</b>	0	0	0	0	0	0	0	0	0	0	0	0	0
On wealth	0	0	0	0	0	0	0	0	0	0	0	0	0
On production and consumption	0	0	0	0	0	0	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>(2) Contributions</b>	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>(3) Nontax Revenues</b>	10	1	2	3	2	1	1	1	1	2	2	3	4
Fees	0	0	0	1	0	0	0	0	0	0	0	1	1
Sales of goods	0	0	1	1	0	0	0	0	0	1	1	1	1
Service charges	0	0	0	1	1	0	0	0	0	1	1	1	2
Rental property (excluding the canon)	0	0	0	1	0	0	0	0	0	0	0	0	0
Fines	0	0	0	0	0	0	0	0	0	0	0	0	0
Other current revenues	9	0	0	0	0	0	0	0	0	0	0	0	0
<b>(4) Current Transfers</b>	82	90	84	81	91	98	99	97	89	89	96	94	90
Canon	36	77	7	32	13	53	56	69	37	11	29	28	43
Annual fees for mineral explt.	0	0	0	0	0	0	0	0	0	0	0	0	0
Customs revenues	0	0	0	0	0	0	18	0	0	0	0	0	0
“Recursos ordinarios” (Ordinary resources excluding FONCOR)	41	13	73	48	73	43	24	27	49	71	64	62	45
Other public transfers	5		5	2	5	3	1	2	3	7	2	4	2
<b>(5) Current Revenues (1+2+3+4)</b>	91	91	86	85	93	99	100	98	90	91	98	97	94
<b>(6) Capital Revenues</b>	9	9	14	15	7	1	0	2	10	9	2	3	6
Sales of assets	0	0	0	0	0	0	0	0	0	0	0	0	0
Capital transfers (including FONCOR)	9	9	14	15	7	1	0	1	10	9	2	3	5

	Lam baye que	Lim a	Lore to	Mad re de Dios	Moq uegu a	M. M. Lim a	Pasc o	Piur a	Pun o	San Mar tín	Tac na	Tum bes	Uca yali
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
<b>(1) Taxes</b>	0	0	0	0	0	0	0	0	0	0	1	0	0
On wealth	0	0	0	0	0	0	0	0	0	0	0	0	0
On production and consumption	0	0	0	0	0	0	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0	1	0	0
<b>(2) Contributions</b>	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>(3) Nontax Revenues</b>	5	3	2	14	1	0	1	3	1	4	1	2	9
Fees	0	0	0	0	0	0	0	1	0	0	0	0	0
Sales of goods	1	1	1	0	0	0	0	1	0	0	0	0	0
Service charges	2	1	0	0	0	0	0	1	0	1	0	1	0
Rental property (excluding the canon)	1	0	0	0	0	0	0	0	0	0	0	0	0
Fines	0	0	0	0	0	0	0	0	0	0	0	0	0
Other current revenues	0	1	0	13	0	0	0	0	0	3	0	0	7
<b>(4) Current Transfers</b>	0	0	0	0	0	0	0	0	0	0	0	0	0
Canon	82	94	97	82	95	53	94	93	92	90	97	94	89
Annual fees for mineral explt.	20	39	52	49	86	22	70	32	31	59	85	30	62
Customs revenues	0	0	0	0	0	0	0	0	0	0	0	0	0
Recursos ordinarios (Ordinary resources excluding FONCOR)	0	0	0	0	0	0	0	0	0	0	0	0	0
Other public transfers	59	52	41	32	10	31	22	53	59	29	11	61	26
<b>(5) Current revenues (1+2+3+4)</b>	3	3	3	0	0	0	1	8	2	2	0	3	2
<b>(6) Capital revenues</b>	87	97	99	96	96	54	95	96	93	94	99	96	98
Sales of assets	0	0	0	0	0	0	0	0	0	0	0	0	0
Capital transfers (including FONCOR)	13	3	1	4	4	46	5	6	7	6	1	4	2

Source: MEF 2010.

In summary, regional governments rely almost fully on transfers from the central government. In those regions with natural resource deposits, canon revenues are more important than any other type of transfer, including those from the capital transfer, FONCOR. Neither own tax revenues, which are practically nonexistent (with the exception of special customs charges), nor nontax revenues (fees, charges, and so forth), are important.

#### *The composition of local revenues*

Revenue assignments to municipal governments are regulated by Law Decree No. 776, which establishes taxes on property as the main tax revenue source for provincial and district municipalities. Provincial municipalities are assigned the tax on vehicle property, and district municipalities are assigned the tax on land and buildings and the tax on

property transfers (alcabala). Table 5.17 summarizes the composition of current revenues at the municipal level. Even though municipalities enjoy a certain degree of tax autonomy that is absent at the regional level, the revenues actually collected from these sources do not amount to much. In particular, total own tax collections have been historically lower than the sum of charges and fees, which includes street cleaning, road tolls, parks maintenance, public safety services, and construction permits.

**Table 5.17 Composition of Current Revenues at the Municipal Level, 2004, 2006, 2008, and 2009** (in millions of nuevos soles, and percent shares of current revenues)

	2004	%	2006	%	2008	%	2009	%
<b>Taxes</b>	<b>638</b>	<b>11.1</b>	<b>720</b>	<b>9.6</b>	<b>1,296</b>	<b>9.9</b>	<b>1,480</b>	<b>10.4</b>
Property	532	9.3	627	8.4	1,130	8.6	1,227	8.6
Vehicle property	61	1.1	57	0.8	95	0.7	100	0.7
Property (land and buildings)	407	7.1	462	6.2	615	4.7	735	5.2
Property transfer (alcabala)	64	1.1	108	1.4	421	3.2	393	2.8
Others	106	1.8	93	1.2	166	1.3	252	1.8
<b>Other Own Revenues</b>	<b>1,441</b>	<b>25.1</b>	<b>1,407</b>	<b>18.8</b>	<b>1,963</b>	<b>15</b>	<b>2,339</b>	<b>16.4</b>
Charges and fees	1,032	18	1,010	13.5	1,336	10.2	1,694	11.9
Others	409	7.1	396	5.3	627	4.8	645	4.5
<b>Transfers</b>	<b>3,670</b>	<b>63.8</b>	<b>5,369</b>	<b>71.6</b>	<b>9,813</b>	<b>75.1</b>	<b>10,405</b>	<b>73.2</b>
Canon, sobrecanon, and royalties	705	12.3	2,428	32.4	5,145	39.4	5,352	37.6
Mining canon	324	5.6	1,248	16.6	3,341	25.6	3,528	24.8
Mining royalties	0	0	299	4	401	3.1	417	2.9
Oil canon and sobrecanon	220	3.8	381	5.1	579	4.4	432	3.0
Gas canon	54	0.9	297	4	546	4.2	658	4.6
Other canon and royalties	107	1.9	203	2.7	277	2.1	317	2.2
FONCOMUN	1,729	30.1	2,323	31	3,257	24.9	3,709	26.1
Others	1,236	21.5	618	8.2	1,411	10.8	784	5.5
<b>Current Revenues</b>	<b>5,749</b>	<b>100</b>	<b>7,495</b>	<b>100</b>	<b>13,073</b>	<b>100</b>	<b>14,224</b>	<b>100.0</b>

Sources: MEF and DNCP from Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda 2011.

Therefore, there is also a high degree of dependency on intergovernmental transfers at the local level. Overall, transfers represented almost three-quarters of the municipal budget in 2009. Transfer revenues from extractive industries (canon) and the municipal compensation transfer fund (FONCOMUN) are the two most important sources, representing around 37 percent and 26 percent of municipal revenues, respectively, in 2009.

Capital revenues represent a small share of municipal budgets. As shown in table 5.18, capital revenues have oscillated between 3 and 4 percent of total revenues and correspond mostly to capital transfers from the central government.

**Table 5.18 Capital Revenues of Municipal Government, 2006–08**  
(in nuevos soles and as a percent of total revenues)

	2006	%	2007	%	2008	%
<b>Total Capital Revenues</b>	<b>291,898,653</b>	<b>3.9</b>	<b>295,212,994</b>	<b>2.4</b>	<b>401,401,123</b>	<b>3.0</b>
Capital transfers	262,058,301	3.5	284,176,993	2.3	375,999,029	2.8
Sales of assets	29,495,989	0.4	10,880,591	0.1	25,249,067	0.2
Other	344,362	0.0	155,410	0.0	153,026	0.0

Source: MEF.

### Tax assignments and revenue mobilization

Tax assignments at the municipal level are regulated by the Law on Municipal Taxation (Ley de Tributación Municipal) of 1993. The law assigns to district municipalities the property tax on land and buildings (impuesto predial), the property transfer tax (alcabala), the local entertainment tax (except for sports), and the tax on games (except for lotteries). For provincial municipalities, the 1993 law assigns the vehicle tax and the tax on betting and lotteries. In addition, Law Decree No. 776 establishes the tax rates to be applied in each case and the sharing of collections between provinces and districts. A summary of these regulations is presented in table 5.19. From that information it is clear that local governments in Peru are given no autonomy to either define the tax bases or set the rates for the taxes assigned them. All these decisions are made centrally. Therefore, local discretion about how much to collect taxes is constrained to the realm of tax administration and enforcement efforts.

**Table 5.19 Main Features of Municipal Tax Revenue Assignments**

District Municipalities	Revenue Shares		Tax Rates
	Districts	Provinces	
Tax on land and buildings	100% (5% for cadastre maintenance)	0%	< 15 UIT: 0.2% (or 15–60 UIT: 0.6%) > 60 UIT: 0.6% 1.0%
Property transfers (alcabala)	50%	50% (to Municipal Investment Fund)	3% (first 3 UIT exempted) <sup>a</sup>
Games (pinball, bingo, etc.)	100%	0%	10%
Public shows	100%	0%	Bullfighting: 5% Horse racing: 10% Others: 15%
Provincial municipalities:			
Vehicle property	0%	100%	1% (minimum: 1.5% UIT)
Betting	40%	60%	20% (horse racing: 12%)
Games (lotteries)	0%	100%	10%

Source: Gómez, Martínez-Vázquez, and Sepúlveda 2010, based on Law Decree No. 677.

Note: a. The UIT (Tributary Tax Unit, Unidad Impositiva Tributaria) is a monetary measure used to set the

value of taxes, fees, penalties, and other legal payments. Since 2006, the UIT has increased 50 nuevos soles per year, reaching 3,600 nuevos soles (US\$1,283 on December 31, 2010), in 2010. The same value was used in 2011.

The lack of true tax autonomy is not the only obstacle to local revenue mobilization in Peru. Many municipalities, especially those in rural areas, lack the administrative and technical capacity to collect significant amounts of revenues from the taxes that have been assigned to them. In reality, many local governments do not have a complete cadastre of properties, and many of the existing cadastral records have not been regularly updated. Taxpayer morale and official attitudes also play a role. A good share of the population still does not appear to fully understand or accept their role in supporting the financing of the local public goods and services they receive. Often, local authorities accept, rather passively, the fundamentally voluntary contributions of taxpayers (Alfaro and Rühling 2007).

The lack of revenue mobilization continues to be a reality at the local level. Table 5.20 presents annual collections for municipal taxes for 2006–09. The real estate property tax is by far the most important municipal tax (at almost half of municipal tax revenues for 2009), even though the property transfer tax (alcabala) has been rapidly gaining importance, representing almost one-quarter of total collections in 2009. But the fact is that most municipal governments, including those receiving or not receiving canon revenues, are not making good use of their own revenue sources.

**Table 5.20 Municipal Tax Collections, 2006–09** (in nuevos soles)

	2006	%	2007	%	2008	%	2009	%
<b>On property</b>	<b>627,250,136</b>	<b>86.4</b>	<b>965,758,839</b>	<b>88.4</b>	<b>1,130,141,727</b>	<b>86.3</b>	<b>1,227,364,075</b>	<b>83.3</b>
Real estate property (predial)	462,317,304	63.6	552,200,650	50.5	614,593,810	46.9	734,904,183	49.9
Property transfer (alcabala)	108,162,028	14.9	346,571,980	31.7	420,630,736	32.1	392,464,228	26.7
Vehicles	56,770,803	7.8	66,986,209	6.1	94,917,181	7.2	99,995,664	6.8
<b>On production and consumption</b>	<b>55,290,116</b>	<b>7.6</b>	<b>85,172,945</b>	<b>7.8</b>	<b>121,802,048</b>	<b>9.3</b>	<b>122,547,794</b>	<b>8.3</b>
Slot machines	26,270,728	3.6	55,502,776	5.1	93,806,862	7.2	88,626,705	6.0
Entertainment	14,914,489	2.1	16,611,346	1.5	15,505,283	1.2	19,425,208	1.3
Casinos	4,477,589	0.6	5,717,420	0.5	6,521,192	0.5	6,333,878	0.4
Games	8,996,343	1.2	6,626,010	0.6	5,386,495	0.4	7,617,112	0.5
Gambling	624,676	0.1	715,391	0.1	582,215	0.0	544,891	0.0
<b>Other</b>	<b>43,804,601</b>	<b>6.0</b>	<b>41,716,223</b>	<b>3.8</b>	<b>58,187,414</b>	<b>4.4</b>	<b>122,666,345</b>	<b>8.3</b>
<b>Total Municipal Taxes</b>	<b>726,344,853</b>	<b>100.0</b>	<b>1,092,648,006</b>	<b>100.0</b>	<b>1,310,131,189</b>	<b>100.0</b>	<b>1,472,578,214</b>	<b>100.0</b>

Source: MEF.

The use of fees and charges is also regulated by the Law on Municipal Taxation (Ley de Tributación Municipal) of 1993. Unlike taxes, fees and charges are voluntary payments for receiving particular services. This source of revenue is as important as local taxes. Table 5.21 provides the breakdown of the different fees (related to regulation and control activities) and charges directly related to service provision that are being used and their relative importance.

**Table 5.21 Fees and Charges at the Municipal Level, 2006–09** (in nuevos soles)

	2006	%	2007	%	2008	%	2009	%
<b>Fees (for)</b>	<b>871,715,561</b>	<b>86.3</b>	<b>1,021,256,915</b>	<b>87.0</b>	<b>1,166,050,405</b>	<b>87.3</b>	<b>691,982,988</b>	<b>90.3</b>
Health	258,589,516	25.6	309,804,301	26.4	332,196,286	24.9	10,141,940	1.3
Housing	176,994,535	17.5	213,252,026	18.2	252,727,251	18.9	134,461,473	17.5
Transport and communications	166,661,147	16.5	191,713,287	16.3	231,240,774	17.3	247,040,361	32.2
Industry, mining, and commerce	70,120,265	6.9	80,338,047	6.8	92,229,241	6.9	109,451,780	14.3
General administration	49,045,887	4.9	55,942,119	4.8	59,671,883	4.5	89,633,395	11.7
Education	15,454,124	1.5	16,139,945	1.4	17,745,850	1.3	16,572,487	2.2
Agriculture	2,883,240	0.3	4,090,088	0.3	5,804,802	0.4	6,917,528	0.9
Justice and police	12,080	0.0	1,425	0.0	0	0.0	9,629,600	1.3
Other	131,954,766	13.1	149,975,677	12.8	174,434,318	13.1	68,134,424	8.9
<b>Service charges (for)</b>	<b>138,611,065</b>	<b>13.7</b>	<b>152,244,243</b>	<b>13.0</b>	<b>169,978,425</b>	<b>12.7</b>	<b>74,285,024</b>	<b>9.7</b>
Health	22,943,536	2.3	17,469,438	1.5	22,966,701	1.7	16,852,192	2.2
Education, recreation, and culture	8,127,323	0.8	17,321,162	1.5	22,026,253	1.6	33,985,539	4.4
Transport, communications, and storage	9,980,146	1.0	9,660,404	0.8	10,211,523	0.8	22,131,506	2.9
Agriculture and minerals	825,655	0.1	844,196	0.1	946,184	0.1	1,315,787	0.2
Industrial	245	0.0	2,539	0.0	16,602	0.0	0	0.0
Other	96,734,159	9.6	106,946,504	9.1	113,811,161	8.5	0	0.0
<b>Total</b>	<b>1,010,326,626</b>	<b>100.0</b>	<b>1,173,501,158</b>	<b>100.0</b>	<b>1,336,028,830</b>	<b>100.0</b>	<b>766,268,012</b>	<b>100.0</b>

Source: MEF.

The variations in per capita own revenue collections are very large. Table 5.22 shows the basic statistics for own revenues per capita for all 1,834 municipalities in Peru for 2008. Own revenues are composed of (a) local taxes on property (property, property transfers [alcabala], and vehicle taxes), (b) other local taxes on production and consumption items that account for little revenue, (c) fees, and (d) charges from service delivery. Interestingly, all these types of own revenues appear to follow similar distributions across municipal governments, in revenues per capita and in their low median values—under 2 nuevos soles per capita—indicating the high number of municipalities that do not collect any own revenues. The high coefficients of variation for all sources reflect differences in tax bases and effort; while some local governments make an effort to collect own revenues, many others simply rely on intergovernmental transfers. Table 5.22 clearly indicates an asymmetric distribution of revenue raising, with a high concentration in metropolitan Lima.

**Table 5.22 Per Capita Own Revenues at the Municipal Level—Basic Statistics, 2008** (in nuevos soles)

	<b>All Property Taxes (incl. vehicle tax)</b>	<b>Total Taxes</b>	<b>Fees</b>	<b>Service Charges</b>	<b>Total Own Revenues Per Capita</b>
Maximum (municipality)	1,083.0 (Lima)	1,230.4 (Lima)	1,071.5 (San Isidro - Lima)	1,425.7 (Machupicchu - Urubamba)	2,386.7 (Lima)
Median	0.4	0.5	1.7	2.0	19.3
Mean	11.6	12.5	11.3	7.3	52.8
Standard deviation	53.7	58.8	56.0	40.3	156.0
Coefficient of variation <sup>a</sup>	4.6	4.7	4.9	5.5	3.0

Source: MEF.

Note: a. The ratio of the standard deviation to the mean of the distribution.

Certain issues are salient in terms of revenue performance. While broadly recommended and used as a main local revenue source, the real estate property tax in Peru performs far below international standards.<sup>23</sup> Table 5.23 shows the productivity of the property tax for a number of selected regions of the world and selected Latin American countries. The Organisation for Economic Co-operation and Development countries appear to be the ones taking the most advantage of this revenue source, with a ratio of property tax collections to GDP of over 2 percent during 2000–04. It is true that the property tax base can be expected to be greater in developed countries, but the productivity of the property tax in Peru, at 0.17 percent of GDP, is low even when compared to similar countries in Latin America, which on average collect almost three times as much as does Peru. In the region, only Ecuador and Guatemala exhibit a lower property tax performance than Peru.

**Table 5.23 Property Tax Collections as a Share of GDP, Selected Regions and Countries, 1990–2007** (in percent)

	<b>International Averages<sup>a</sup></b>		<b>Selected Latin American Countries</b>		
	<b>1990–99</b>	<b>2000–04</b>	<b>1990–99</b>	<b>2000–07</b>	
All countries	0.75 (59)	1.04 (65)	Argentina	0.63	0.53
OECD countries	1.44 (16)	2.12 (18)	Bolivia	—	0.65
Transition countries	0.54 (20)	0.68 (18)	Brazil	0.32	0.43
Developing countries	0.42 (23)	0.60 (29)	Chile	0.60	0.66
<b>Latin America</b>	<b>0.36 (8)</b>	<b>0.37 (10)</b>	Colombia	0.36	0.50
			Ecuador	0.12	0.13
			Guatemala	0.08	0.14
			Mexico	0.18	0.18
			Paraguay	0.36	0.39
			<b>Peru</b>	<b>—</b>	<b>0.17</b>
			Uruguay	0.61	0.71

Sources: Bahl, Martinez-Vazquez, and Youngman 2008; and Sepúlveda and Martinez-Vazquez 2011.

Note: a. Parentheses display the number of countries considered in each sample average.

— = negligible.

<sup>23</sup> There is an extensive literature supporting the assignment of the property tax to local governments; see Oates (1999); and Bahl, Martinez-Vazquez, and Youngman (2008, 2010).

It is not entirely clear what is behind the low revenue mobilization performance of Peru's municipalities. In a 2011 paper, Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda find, for the most part, a positive relation between transfers and total own revenue collections for Peru's municipalities. The only exception, although not consistent, is for the FONCOMUN transfer, where the impact is negative.<sup>24</sup> Overall, these authors find that the effect of total transfers on total own revenue collections is positive and robust for the entire group of municipalities and separately for the subgroups of district and provincial municipalities. In addition, they find that the effect of total transfers on total own revenue collections is dominated by the behavior of nontax revenues. In particular, it appears that canon transfers have a positive effect on the level of revenue collection, and particularly on the nontax component of revenue collection. The causes for this relationship are not clear, but Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda speculate that it might be related to a greater capacity of subnational governments receiving the canon to provide public services and charge for them, with a greater demand for these services, a greater ability to pay on the part of the population, or both.

#### *Issues with revenue assignments and patterns*

The overall low degree of revenue autonomy or, similarly, the high degree of dependence on intergovernmental transfers of subnational governments in Peru, exposes the system to serious weaknesses. Most important, the dependency on revenues from transfers limits the efficiency and accountability of subnational governments. It also reduces the overall level of fiscal responsibility of subnational governments because it is unlikely that subnational authorities will perceive the correct marginal cost of public funds when their cost is simply to ask for more funds from the central government. A transfer-dependent system poorly complements the emphasis on a hard budget constraint and borrowing discipline introduced in other elements of Peru's decentralization design.

#### *Local government issues*

Local government issues include the following.

***Low levels of revenue mobilization at the local level.*** Local governments have low levels of revenue autonomy but, in addition, they do not use the revenue autonomy they do have very well. One source of this problem is the low level of administrative capacity due to the lack of resources to modernize the administrative process and low skills of local personnel. Other factors play a role, including a low taxpaying culture and poor performance of local officials. Periodic amnesties are common. Of course, all these problems tend to be more acute in smaller and rural municipalities. Thus, there is ample room for building administrative capacity and improving revenue collections. Some of these problems have been addressed with the creation of semiautonomous Tax

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<sup>24</sup> The evidence on the impact of transfers on tax effort in prior studies is mixed, with Aragón and Gayoso (2005) finding a negative relationship and Melgarejo and Rabanal (2006) finding a mostly positive relationship.

Administration Agencies (SATs) in a number of large municipalities (see box 5.4). The question remains whether the SATs can be introduced in smaller municipalities.

**Box 5.4 The Tax Administration Agencies (SATs)**

The problems with local tax administration capacity were acknowledged earlier during the process of administrative deconcentration. In 1996, a SAT was introduced in Lima. Its good performance led to the introduction of new SATs in Trujillo in 1998, in Piura in 1999, and later in Ica, Huancamayo, and other municipalities, nine in all.

The SATs are local tax administration agencies under the municipal governments and enjoy a high degree of financial and administrative autonomy. Typically, they are financed with a share of collected taxes and fines (ranging from 3 to 10 percent.)

Generally, while the SATs have been quite successful in increasing tax collections (CAD 2004), the models may be difficult to export to smaller municipalities because of the up-front investments required in personnel and equipment (von Haldenwang 2010).

**Low tax autonomy.** While having uniform tax bases is a desirable feature of local taxes, depriving local governments of any discretion in selecting tax rates limits tax autonomy and ultimately the operational efficiency and accountability of local expenditures. In addition, the current assignment of tax sources at the municipal level may be too limited. The question is whether other suitable tax instruments can be identified for assignment at the local level in Peru.

**Reversing the assignments to district and provincial municipalities.** The assignment of property taxes at the district level and vehicle taxes at the provincial level should perhaps be reversed. Many district municipalities lack the administrative capacity to administer and enforce real estate property taxes, including maintaining a cadastre, and for that reason provincial municipalities could do a better job of administering this tax; less than 20 percent of district municipalities report having a local cadastre of properties. Switching assignments at the local level would mean that the vehicle taxes would be reassigned from provincial to district municipalities. Even though this change could make a lot of sense, the reform would imply not insignificant losses to many district municipalities. One way to address this issue would be to introduce revenue sharing for property taxes between provincial and district municipalities.

**Regional issues**

At the regional level, the most significant design flaw has been the complete lack of consideration given at all stages of the decentralization process to providing governments at this level with their own autonomous tax sources. Thus, despite the increase in expenditure responsibilities in recent years, regional governments still lack the means to adjust their financing to the changing requirements of those services. It is not clear what

has kept central authorities from considering the assignments of taxes to regional governments. Administratively, creating new fiscal space for the regional governments does not necessarily require the creation of a new tax administration layer. International experience provides good examples of how regional autonomous taxes (where the regional authorities have autonomy to vary tax rates) can be introduced, with the taxes being collected by the central tax administration.

## 5. Intergovernmental Transfers

The most important transfer at the local and regional levels in Peru is the canon. The canon and other important transfers being used at the local level, including the FONCOMUN, and at the regional level, including the FONCOR, are discussed below.

### *The canon*

Some regional and municipal governments in Peru are entitled to share in the income tax on certain extractive industries, in the form of the canon, sobrecanon, and royalties.<sup>25</sup> These revenues, which are distributed on an origin basis, have increased dramatically in recent years due to the escalation of international prices for Peruvian exports of natural resources. The revenues from the canon represented up to 26.5 percent of total subnational expenditures and 9.7 percent of the general government outlays in 2008.

Law No. 27506, the Law on the Canon of 2001, establishes the total share of subnational governments of the revenues collected through the income tax on extractive industries (which is generally 50 percent), and the procedure for computing the share that corresponds to each subnational government. The distribution procedure is summarized in table 5.24 for the canon from mining, gas, hydroenergy, fishing, and forest resources. The revenues from this type of canon represent 77 percent of total revenues from extractive industries for subnational governments in 2008. The beneficiaries are the district municipalities, provincial municipalities, and regions where the extraction activities are located; no direct transfer from this revenue source is made to jurisdictions outside those geographic areas where the resources are located.

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<sup>25</sup> In the interest of brevity, we refer to all those revenues from natural resources shared with subnational governments (in order of revenue importance, the canon from mineral exploitation, the canon and sobrecanon from oil, royalties from mineral exploitations, the canon from gas, and so forth) as the canon. The central authorities allocate the taxes paid by the mining companies to the territories where the tax revenues are generated.

**Table 5.24 Distribution Procedure for the Revenues from the Mining and Gas Canon**

Share (%)	Beneficiaries	Distribution Criteria <sup>a,b</sup>
10	District municipalities within which the natural resources are exploited	Equal share
25	Municipalities of the province within which the natural resources are exploited	According to population and the index of unmet basic needs
40	Municipalities of the region within which the natural resources are exploited	According to population and the index of unmet basic needs
25	80% to the regional government of the region and 20% to the universities in the region	

*Source:* Law No. 27506 (the Law on the Canon) in Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda 2011.

*Note:* a. These criteria are applicable to the revenues collected from mining, gas, hydroenergy, fishing, and forest resources but do not apply to the oil canon. b. The index of unmet basic needs measures the percentage of the population with at least one basic need that has not been satisfied. The basic needs considered in the index are electricity, water, and sewerage services.

The distribution of oil canon and sobrecanon (which represent 14 percent of subnational revenues from extractive industries) is also based on geographic shares, but they vary in each region (table 5.25). As in the case of the canon for mining and gas, the funds are targeted to be used on infrastructure projects; however, the regions of Loreto, Ucayali, and Huánuco are allowed to use 20 percent of the funds for recurrent expenses.

**Table 5.25 Distribution Criteria for the Canon from Oil**

	Loreto (%)	Ucayali (%)	Piura (%)	Tumbes (%)	Puerto Inca Huánuco (%)
Regional Government	52	20	20	20	0
District Municipalities	0	10	0	0	0
Provincial Municipalities	0	20	20	20	0
Municipalities of the Region	40	40	50	50	0
National Universities	5	5	5	5	0
Advanced Institutes	3	5	5	5	0
Municipal Councils of the District of Puerto Inca					100

*Source:* MEF.

The distribution of mining royalties (which represent 7 percent of regional revenues from extractive industries) is contained in the Law on Royalties from Mineral Exploitations (Ley de Regalías Mineras, No. 28258) of 2004. This law mandates that all mineral enterprises must pay a royalty, independently of its profits, based on the gross value of the mineral resource extracted.<sup>26</sup> The use of funds is also restricted to infrastructure projects. The criteria for distribution are similar to those of the general canon (table 5.26).

<sup>26</sup> The rate applied is 1 percent over the first US\$60 million, 2 percent for the values between US\$60 and US\$120 million, and 3 percent for gross values over US\$120 million.

**Table 5.26 Distribution Criteria for Mineral Royalties**

Share (%)	Beneficiaries	Distribution Criteria for Governments at the Same Level
20	District municipality where the mine is located (of which 50% to the community where the mine is located)	
20	Municipalities in the province	According to population and index of unmet basic needs <sup>a</sup>
40	Municipalities in the region	According to population and index of unmet basic needs
15	Regional government	
5	Universities	

Source: MEF.

Note: a. The index of unmet basic needs measures the percentage of the population with at least one basic need that has not been satisfied. The basic needs considered in the index are electricity, water, and sewerage services.

Table 5.27 presents the evolution of revenues and basic statistics for canon revenues for provincial and district municipalities for 2004 and 2008. The figures convey the explosive increase in revenues from extractive industries and also their variability in the most recent years. Ten departments—in descending order of increase, they are Cajamarca, Cusco, Moquegua, Tacna, Loreto, Piura, Puno, Ucayali, Arequipa, and Ancash—receive over 90 percent of canon revenues.

**Table 5.27 Variability of Provincial and District Revenues from Extractive Industries, 2004 and 2008** (in nuevos soles per capita)

	2004		2008	
	Provinces	Districts	Provinces	Districts
Minimum	0.0	0.0	0.0	0.0
Maximum	1,265.6	2,383.6	24,072.6	29,003.5
(province)	Purús	Lobitos	Lucumba	Ilabaya
Simple average	51.3	57.3	397.6	423.2
Weighted average	8.3	17.4	44.5	134.1
Standard deviation	128.0	129.1	1,762.2	1,257.0
Coefficient of variation <sup>a</sup>	15.3	7.4	39.6	9.4
(max. - min.)/average	151.6	137.0	541.5	216.2

Source: Own computations based on MEF data.

Note: a. The coefficient of variation is defined as the standard deviation divided by the weighted average.

### ***Issues with the canon***

Originally, the canon was conceived of as just another source of financing for subnational governments, without any idea of what much higher international prices could mean for subnational financing and horizontal disparities—the unwanted consequences of the canon.

The sharing of revenues from natural resources among different levels of government is a complex issue. Neither the specialized literature nor international practice provides clear guidelines for the best allocation and sharing of these revenues.<sup>27</sup> Although some issues of economic efficiency are involved (see Cyan 2010), the assignment of property rights over natural resources is generally solved in different ways reflecting the political, cultural, and historical perspectives of each country. Of course, different choices carry different consequences. A generally accepted economic argument for allocating at least some of these resources under a geographic criterion is to compensate local residents for the pollution and environmental damage associated with the extraction of the natural resources. But how much this compensation should be is generally left open. In Peru, the dominant criterion appears to have been one based on the property rights of subnational governments.<sup>28</sup>

The sharing of sizable revenues on an origin (or derivation) basis generally leads to potentially large horizontal fiscal disparities, because the location of natural resources is not necessarily well correlated with the relative expenditure needs or fiscal capacities of the beneficiary governments. Even if the distribution criterion is defined over common determinants of expenditure needs like the population and unmet basic needs, as is partially the case in Peru, the problem of horizontal imbalances remains between beneficiaries and nonbeneficiaries. Also of note is the size of the canon transfers; for example, the maximum per capita transfers received by a province in 2008 from extractive industries (Lucumba) was 25 times greater than the maximum per capita transfers from the FONCOMUN (the province of Lamud). This ratio reaches a value of 17 when comparing maximum transfers to districts, with Ilabaya receiving the greatest amount from extractive industries and San José de Ushua receiving the greatest amount from FONCOMUN (table 5.26). These fiscal disparities have become a large issue in Peru especially because, so far, there are no effective mechanisms to reduce the distortions imposed in the system.<sup>29</sup>

In international practice, it is generally suggested that those subnational governments benefiting from the canon-like transfers generally have lower incentives to develop their own tax administrations or to spend resources efficiently. A 2010 World Bank report finds lower levels of expenditure efficiency in subnational governments benefiting from canon resources.<sup>30</sup> This can also have negative effects on the tax effort of subnational governments excluded from canon revenues, which may look to further central transfers

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<sup>27</sup> See Bahl and Tumennasan (2002) and Searle (2007) for discussions of the issues and international practice.

<sup>28</sup> See, for example, Bahl and Tumennasan (2002).

<sup>29</sup> For example, in March 2007 the Assembly of Regional Presidents petitioned the central government for a share of 10 percent on all canon revenues for those regions currently receiving no funds. See “Asamblea de Presidentes Regionales propone Agenda Descentralista,” Poder Ciudadano, edición 93; [www.poderciudadano.org.pe/?p=658](http://www.poderciudadano.org.pe/?p=658).

<sup>30</sup> The efficiency of public expenditures at the provincial municipality level is derived by dividing a composite of several performance indexes by expenditures. The results show significant differences across regions not only in performance but also in efficiency. Local governments in wealthier regions perform better but are not necessarily more efficient. Larger shares of locally collected revenues are associated with higher performance and efficiency (World Bank 2010).

to alleviate their financing imbalances. Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda (2011), however, do not find that the canon transfers actually lead to lower tax effort by the municipalities receiving them.<sup>31</sup> Beyond the potential lower levels of expenditure efficiency, the canon has also been the likely source of large unspent cash balances at the local level.<sup>32</sup>

Another concern regarding the canon has been the potential loss of macroeconomic control by the central authorities. Since the central authorities are not able by law to alter the amount of these transfers (although they have been able to impose certain conditions on their use), we can infer that, at any time, a fairly volatile 10 percent of the general government budget can follow policy directions that diverge significantly from those designed by the central government

A final controversial issue with the canon is that current law stipulates that these funds be spent on infrastructure (allowing in some cases the use of 20 percent of the funds for maintenance purposes).<sup>33</sup> This has created considerable bottlenecks in spending budgets, which have been followed by pressure from the central authorities and criticism from the national media for faster disbursement of the funds. All this has potentially led to inefficient expenditures (see World Bank 2010).

### *The FONCOMUN and other local transfers*

The Municipal Compensation Fund (FONCOMUN) is a conventional equalization transfer program, established well before the current decentralization process in 1994 by Legislative Decree No. 776 (the Law of Municipal Taxation). The FONCOMUN is financed with the municipal promotion tax (impuesto de promoción municipal), which consists of a surtax rate of up to 2 percent applied over the value-added tax, plus other minor resources. According to the 1994 law, the distribution of the FONCOMUN should be based on “equity” and “compensation” criteria, and the transfer should “ensure the functioning of all municipalities.” More recently, Law 29332 of 2009 and Supreme Decree 060-2010 introduced “managerial performance” as an additional criterion in the distribution formula.

Box 5.5 summarizes the formula currently used to distribute the available FONCOMUN funds among municipalities. In the first stage, the transfer fund is allocated to the provincial municipalities in proportion to their “unmet basic needs” weighted by their

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<sup>31</sup> Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda (2011) also review previous studies with fundamentally the same finding.

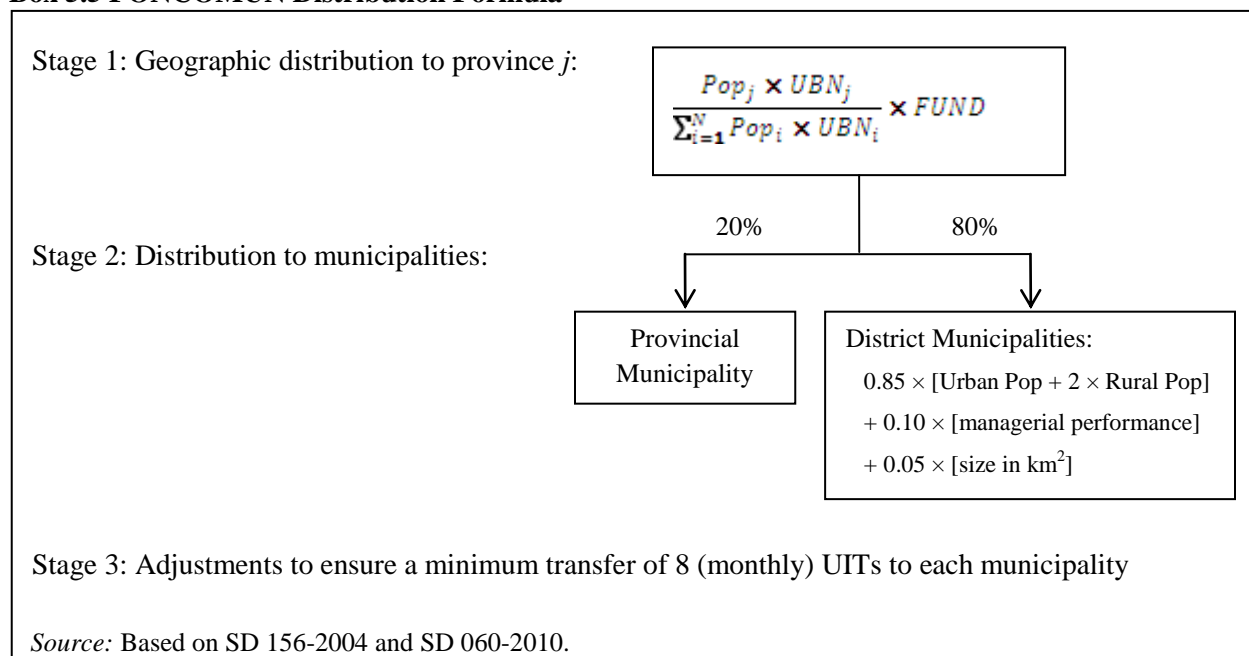
<sup>32</sup> For several years, those local authorities have been the subject of criticism and pressure from the central authorities to disburse those balances. But, clearly, those pressures have been somewhat contradictory to the need to increase the efficiency of local expenditures, which can be expected to take some time and preparation.

<sup>33</sup> The Supreme Audit Institution (Contraloría General de la República) is charged with monitoring the proper use of the canon and other funds.

population.<sup>34</sup> In the second stage, the provincial municipalities get to keep 20 percent of the funds received in the first stage. The remaining 80 percent is distributed among the district municipalities within the province in accordance with three factors: (a) population, (b) managerial performance, and (c) land area. The most important of these factors is population, with a weight of 85 percent, and where rural population is assumed to have twice the expenditure needs of urban population. The next factor in importance is managerial performance, which is defined in terms of the rate of growth of per capita own revenue collections and the share of transfers from FONCOMUN that is spent on capital infrastructure. In the third stage, the amounts of transfers are adjusted so that all municipalities receive at least a minimum transfer equivalent to 8 monthly Tributary Tax Unit (UITs).<sup>35</sup>

The FONCOMUN is the most important component of municipal revenues for many municipalities in Peru, both in terms of its relative magnitude and its compensating function. Table 5.28 presents the variability of FONCOMUN transfers among provincial and district municipalities in 2004 and 2008. As a first approximation to the equalization (lack of) power of the FONCOMUN, note that the FONCOMUN transfers are significantly less variable than transfers from the canon and that the largest per capita transfer from the canon in 2008 was 17 times larger than the largest per capita transfers from the FONCOMUN.

#### Box 5.5 FONCOMUN Distribution Formula



<sup>34</sup> This is an index that includes measures of need of households including poor housing quality, crowding in homes, lack of sewerage disposal, children not attending school, and shortage of food.

<sup>35</sup> The UIT is a legal monetary unit whose value since 2010 has been 3,600 nuevos soles (US\$1,283 as of December 31, 2010).

**Table 5.28 Variability of Province and District Revenues Per Capita from FONCOMUN, 2004 and 2008** (in nuevos soles)

	2004		2008	
	Provinces	Districts	Provinces	Districts
Minimum	22.7	0.0	44.7	7.4
Maximum	1,037.5	1,662.6	954.7	1,691.9
(district)	Iñapari	Curibaya	Lamud	San José de Ushua
Simple average	161.3	165.0	260.1	198.2
Weighted average	25.7	37.3	46.6	66.4
Standard deviation	116.3	167.0	152.9	154.5
Coefficient of variation <sup>a</sup>	4.5	4.5	3.3	2.3
(max. - min.)/average	39.5	44.5	19.5	25.4

Source: Canavire-Bacarreza, Martinez-Vazquez, and Sepúlveda 2011.

Note: a. The coefficient of variation is defined as the standard deviation divided by the weighted average.

More specifically, FONCOMUN transfers do little to compensate for the disparities caused by the canon transfers. In fact, the correlation coefficient between the canon transfers and the FONCOMUN transfers was zero for provincial municipalities and close to zero (0.02) for district municipalities in 2008. A perfect offset between these two types of transfers would have been indicated by a correlation coefficient of -1.0. The actual correlation coefficients imply that the allocation of the canon and other revenues from extractive industries are in practice independent from the expenditure needs at the local level (as approximated by the FONCOMUN formula).

The absolute size of the revenues received by the municipalities from the extractive industries is significantly greater than at the regional level. The total amount of revenues received from extractive industries by municipalities during 2008 was 5.145 billion nuevos soles. This is over three times the 1.669 billion nuevos soles in revenues received by the regional governments from the same source. Accordingly, we can anticipate that the disparities and other distortions imposed by the canon may be larger at the local level. Note, also, that the transfers allocated through the FONCOMUN reached 3.257 billion nuevos soles during 2008, an amount almost five times larger than the funds distributed by the FONCOR (the capital equalization grant) at the regional level.

Besides the FONCOMUN, there are several other central transfers to local governments generally implementing national programs at the local level. One such transfer is the Vaso de Leche program, which pursues nutrition standards for infants and lactating mothers. These transfers tend to be highly correlated with the FONCOMUN transfers.

### ***Issues with the FONCOMUN***

A first issue with the FONCOMUN is that the FONCOMUN is not as equalizing as it could or should be. In particular, its formula considers a number of proxies for expenditure needs, but it does not offer any adjustment for differences in the fiscal capacity of municipal governments. The result is that under the current system all municipalities, even those that already have abundant fiscal resources from the canon, receive a certain amount of transfer. The funds in the FONCOMUN could have a much bigger equalizing effect if they were used to support those municipalities with low fiscal capacity.

The same argument serves to identify a second issue with the current distribution procedure. If some municipalities have their own fiscal capacity to finance their expenditure needs, then the minimum transfer they receive could be used with a greater equalizing effect if they were provided with zero FONCOMUN funds and those funds were allocated to municipalities with lower fiscal capacity.

A third issue is that the allocation in two stages, first to the province and later to the districts, can result in undesirable changes in the final allocations to the districts. For example, two identical districts that belong to different provinces, depending on the provinces' characteristics, could receive quite different per capita transfers even though their expenditure needs and fiscal capacity are the same.

### ***The FONCOR and other regional transfers***

The Regional Equalization Fund (Fondo de Compensación Regional, FONCOR) was introduced in the 2002 Law on the Bases of Decentralization. Its funding was anticipated to come from all the public investment projects at the regional level plus 30 percent of the net proceeds from any privatization and concession projects realized by the central government. The FONCOR was distributed to the regions until 2009 according to an index formula elaborated by the MEF on the basis of the following variables:

- Population
- Poverty
- Unmet basic needs
- Location near borders
- Effectiveness in the execution of investment projects.

In 2009, through Ministerial Resolution No. 322-2009-EF-15, the General Directorate of Economic and Social Affairs introduced a new methodology to compute the FONCOR transfers, which should significantly improve its equalizing power. Under the new methodology, the aforementioned factors are used to compute the capital expenditure needs of each regional government, and then the net capital expenditure needs are obtained by subtracting from this amount the revenues received from canon, sobrecanon, royalties, and custom duties. Finally, the transfer is distributed proportionally among those regional governments with positive net capital expenditure needs. As a result, those

governments for which the revenues from extractive industries exceed their capital expenditure needs receive no transfers from the FONCOR, and the available resources can be concentrated exclusively on the regions where there is not enough funding for capital expenditures.<sup>36</sup>

This reform was designed to be implemented gradually over three years, and provides a suggestive mechanism for reducing the distortions imposed by the revenues from extractive industries and enhancing equity and efficiency in the system of subnational government finances in Peru. Indeed, what this reform has done is simply to introduce in the equalization transfer formula an adjustment for fiscal capacity,<sup>37</sup> a component that the municipal equalization transfer, the FONCOMUN, still lacks.

The Socioeconomic Development Fund of the Camisea Project<sup>38</sup> (Fondo de Desarrollo Socioeconómico del Proyecto Camisea, FOCAM) was created by Law No. 28451 of 2004 with the goal of financing investment projects and socioeconomic infrastructure of the regional and municipal governments in Ayacucho, Huancavelica, Ica, and Lima, and research in the universities of these regions. The funds can also finance the development of biodiversity, renewable energies, and health projects in the area of Camisea. The funding comes from 25 percent of the royalties received by the central government from the exploitation of the related Camisea gas fields and pipelines. The allocation formula is presented in table 5.29.

**Table 5.29 FOCAM Allocation Criteria**

Share (%)	Beneficiaries	Distribution Criteria for Governments the Same Level
30	Regional governments	Based on population, unmet basic needs, and length of pipelines
30	Provincial municipalities	Based on population, unmet basic needs, and length of pipelines
15	District municipalities (with pipeline presence)	Based on population, unmet basic needs, and length of pipelines
15	District municipalities (without pipeline presence)	Based on population and unmet basic needs
10	Public universities	Equal shares

Source: MEF 2006.

<sup>36</sup> The current weights for the distribution factors are 51 percent for population, 43 percent for unmet basic needs, 3 percent for population at international borders, and 3 percent for effectiveness in investment budget execution. Even though the last two factors might not be good determinants of expenditure needs, they account for only 6 percent of the computation, leaving 94 percent to population and unmet basic needs, which are more adequate proxies for needs.

<sup>37</sup> Gómez, Martínez-Vázquez, and Sepúlveda (2009a,b) propose and illustrate this type of adjustment for the FONCOMUN and FONCOR in Peru.

<sup>38</sup> The Camisea Project consists of the construction and operation of two pipelines for natural gas and natural gas liquids from the Camisea fields in the region (Department) of Cuzco and traverses the Ayacucho, Huancavelica, Ica, and Lima departments, reaching Lima 431 kilometers away.

The Fund for the Promotion of Regional and Local Public Investment (Fondo de Promoción a la Inversión Pública Regional y Local, FONIPREL) was introduced by Law No. 28939) of 2007, Ley que establece la implementación y el funcionamiento del Fondo de Promoción a la Inversión Pública Regional y Local. FONIPREL is a competitive fund to provide matching funds for public investment projects at the regional and local levels with the goal of reducing the existing gap in service delivery and infrastructure. The funds are allocated where the impact is the reduction of poverty and extreme poverty. In 2008, the central government funded FONIPREL with 143.9 million nuevos soles, of which only 19.2 million went to regional governments and the rest to local governments.

Table 5.30 shows the evolution of FOCAM, FONCOR, and FONIPREL during 2004–09 and compares it to that of the canon at the regional level. While the FONCOR and the canon represented fairly equivalent levels of funding in 2004, the fast growth of the canon has significantly dwarfed FONCOR and the other capital transfers at the regional level. But while the FONCOR and FONIPREL have a national scope, the canon is concentrated only in those regions with mineral deposits. The same is true for FOCAM.

**Table 5.30 Evolution of Capital Transfers to Regional Governments, 2004–09**  
(millions of nuevos soles)

Source	2004		2005		2006		2007		2008 <sup>a</sup>		2009		% Ings. GRs
		%		%		%		%		%		%	
Mineral canon	106.6	6.5	218.6	9.7	440.9	13.9	1,291.2	22.4	969.6	13.7	933.1	12.4	
Gas canon	18.2	1.1	79.8	3.5	98.6	3.1	1	2.7	2	2.7	2	2.6	
Hydropower canon	25.8	1.6	27.1	1.2	32.3	1.0	37.3	0.6	28.1	0.4	36.1	0.5	
Fishing canon	10.0	0.6	7.3	0.3	12.8	0.4	10.5	0.2	14.6	0.2	16.0	0.2	
Forest canon	0.2	0.0	46.0	2.0	1.6	0.0	1.6	0.0	0.9	0.0	0.0	0.0	
Oil canon	134.7	8.2	173.2	7.7	212.0	6.7	217.3	3.8	279.9	4.0	135.6	1.8	
Oil sobrecanon	54.8	3.3	59.8	2.7	69.4	2.2	57.1	1.0	85.2	1.2	54.8	0.7	
<b>Total Canon and Sobrecanon</b>	<b>350.3</b>	<b>21.2</b>	<b>611.7</b>	<b>27.1</b>	<b>867.4</b>	<b>27.3</b>	<b>1,771.1</b>	<b>30.7</b>	<b>1,566.5</b>	<b>22.1</b>	<b>1,368.7</b>	<b>18.1</b>	
Mineral royalties	0.0	0.0	0.0	0.0	57.3	1.8	72.7	1.3	65.6	0.9	52.6	0.7	
FONCOR	360.3	21.4	428.4	19.4	430.0	13.3	702.5	12.7	673.7	9.5		0.0	
FOCAM	3	8	4	0	0	6	5	2	7	9.5		0.0	
FONIPREL	0.0	0.0	0.0	0.0	31.6	1.0	34.0	0.6	36.4	0.5	58.0	0.8	
Other capital transfers	0.0	0.0	0.0	0.0	116.0	3.7	351.2	6.1	221.4	3.1	789.7	10.5	
<b>Total Capital Transfers</b>	<b>729.7</b>	<b>44.2</b>	<b>1,085.5</b>	<b>48.1</b>	<b>1,502.4</b>	<b>47.3</b>	<b>2,931.6</b>	<b>50.8</b>	<b>2,574.4</b>	<b>36.4</b>	<b>2,338.0</b>	<b>31.0</b>	
Total	1,649.0	100.0	2,255.1	100.0	3,172.9	100.0	5,772.7	100.0	7,076.0	100.0	7,544.0	100.0	

Source: MEF.

Note: Data on FONCOR not available for 2009.

a. Revenues only through September.

To illustrate the variability in regional transfers, table 5.31 presents the basic statistics for the distribution of the regional canon and the FONCOR across regional governments for 2004 and 2008. In 2004, the amounts of revenue distributed from both sources were quite similar; however, the maximum per capita transfers from extractive industries (corresponding to the region of Loreto) almost doubled the maximum amount provided by the FONCOR (to the region of Moquegua). The greater concentration of revenues from extractive industries in fewer regional governments is confirmed by the two measures of variability, the coefficient of variation and the range between minimum and maximum per capita transfers over the (weighted) average, which are much higher for this source of revenue. Similar results are obtained for 2008, but the differences between the maximum per capita revenues and the variability are even more pronounced. Tacna, a region rich in mining resources, received four times more revenue from the canon than Apurimac, the region that most benefited from the FONCOR.

Even though FONCOR transfers are meant to be used only for capital investment purposes and related expenses, the potential fungibility of money within the budgets is, at least in principle, likely to allow for a fairly effective equalizing effect across regions. However, the greater magnitude and variability of revenues from the canon vis-à-vis the FONCOR suggests that the equalizing potential of the latter may be significantly limited. Moreover, assuming that the FONCOR incorporates factors in the distribution formula that are related to expenditure needs, the fact that the correlation between the FONCOR and the regional canon was close to zero in 2004 and quite small in 2008 implies that the revenues from extractive industries are independent from expenditure needs.

**Table 5.31 Variability of Regional Revenues from Extractive Industries and FONCOR, 2004 and 2008** (in nuevos soles per capita)

	2004		2008	
	Extractive Industries	FONCOR	Extractive Industries	FONCOR
Minimum	0.0	0.4	0.0	1.4
Maximum (region)	118.4 Loreto	65.4 Moquegua	647.3 Tacna	134.3 Apurimac
Simple average	21.3	24.5	101.0	43.1
Weighted average	13.3	13.7	60.0	24.2
Standard deviation	32.3	18.0	153.5	39.5
Coefficient of variation <sup>a</sup>	2.4	1.3	2.6	1.6
(max - min)/average	8.9	4.7	10.8	5.5
Correlation:	-0.02		-0.28	

Source: Own computations based on MEF data.

Note: a. The coefficient of variation is defined as the standard deviation divided by the weighted average.

### *Issues with regional transfers*

Issues with regional transfers include the following.

**Presence of sharp fiscal disparities.** There is wide agreement in Peru that the current system of capital transfers, including the canon, generates large disparities in the financing of regional governments.<sup>39</sup> Beyond the obvious issue of equity that this situation raises, these disparities can lead to lower efficiency of public spending and inefficient migration patterns.

Table 5.32 presents the evolution of per capita total revenues for regional governments during 2004–09. Even though per capita revenues have increased in all regions, the data also clearly show significant disparities among the 25 regions. For example, in 2009 the regional government of Huánuco had revenues of 69 nuevos soles per capita, far less than the national average of 471 nuevos soles. By comparison, the same year, the regional government of Moquegua had revenues of 2,107 nuevos soles per capita (or 4.7 times the national average and 30.5 times the per capita revenues in Huánuco). Also note that the disparities have been increasing, with the coefficient of variation almost doubling over the period, which is clearly related to the evolution of canon revenues. Because of the reforms introduced to the FONCOR in 2009, we would expect to see the disparities in table 5.32 to be somewhat smaller. However, more recent data were unavailable.

**Table 5.32 Per Capita Total Revenues at the Regional Level, 2004–09<sup>a</sup>**  
(in nuevos soles)

Region (Department)	2004	2005	2006	2007	2008 <sup>b</sup>	2009
Amazonas	75	91	97	207	333	184
Ancash	64	69	183	1,004	1,282	1,615
Apurímac	86	85	113	129	214	118
Arequipa	82	96	128	201	357	438
Ayacucho	85	126	155	189	183	157
Cajamarca	69	129	200	227	195	305
Callao	194	241	285	314	317	322
Cusco	70	139	223	418	491	472
Huancavelica	121	200	188	340	336	224
Huánuco	60	66	74	108	123	69
Ica	58	66	92	155	104	146
Junín	57	60	78	124	141	129
La Libertad	71	91	108	175	213	228
Lambayeque	46	43	101	139	146	100
Lima	21	39	63	155	232	215
Loreto	188	246	249	320	371	358
Madre de Dios	108	120	157	211	557	629
Moquegua	187	534	1,063	2,100	2,140	2,107
Pasco	101	124	273	604	551	706
Piura	85	100	113	134	176	158
Puno	60	67	84	132	169	196
San Martín	89	90	160	356	405	249
Tacna	133	391	689	1,381	1,730	1,543
Tumbes	168	229	268	307	377	518

<sup>39</sup> See, for example, Herrera (2008); and García and Monge (2008).

Ucayali	215	238	238	219	587	586
Minimum	21	39	63	108	104	69
	Lima	Lima	Lima	Huánuco	Ica	Huánuco
Maximum	215	534	1,063	2,100	2,140	2,107
	Ucayali	Moquegua	Moquegua	Moquegua	Moquegua	Moquegua
Standard deviation	52.3	115.8	216.9	461.9	506.3	521.7
Simple Average	100	147	215	386	469	471
Coefficient of variation (max. - min.)/Reg.	0.52	0.79	1.01	1.20	1.08	0.90
Av.	2.3	4.3	6.2	6.9	5.8	4.3

Source: MEF.

Note: a. Per capita averages correspond to 2007 with population figures from the 2007 Census; for prior years, population is approximated by interpolation between the 1993 Census and the 2007 Census. 2009 population projected based on estimates from the “CIA Factbook” (July 2011). b. Only through September.

***Inability of the FONCOR and other regional transfers to offset the unequalizing impact of the regional canon.*** The FONCOR and the FONIPREL are clearly structured as equalization grants, even though the competitive nature of the FONIPREL could constrain its equalization effects.<sup>40</sup> Even the FOCAM, exclusively allocated to regions where the gas pipelines are located, distributes the funds considering “unmet basic needs,” among other criteria. In contrast, the resources from the canon and other extractive activities are simply allocated by the geographic location of mineral deposits, even though the distribution criteria among the related jurisdictions use variables for relative poverty and unmet basic needs.

Unfortunately, the analysis of the overall impact of capital transfers at the regional level cannot be conducted with data after 2009. The evidence available before the reforms of the FONCOR in 2009 is that regional transfers may not reduce fiscal disparities but actually increase them along several dimensions. From the simple correlation coefficients presented in table 5.33 we can see that capital transfers are highly positively correlated with the canon transfers. We can also see that the measures of per capita revenues (total, capital transfers, and the canon) are negatively correlated with the incidence of poverty and the index of unmet basic needs. Therefore, public resources are less concentrated in regions with higher expenditure needs, at least measured along those two dimensions.<sup>41</sup> Since both poverty and the index of unmet basic needs are part of the allocation formulas for capital transfers, the results partly suggest that the derivation geographic principle used for the canon more than offsets the impact of the poverty and unmet basic needs criteria.

Overall, other transfers reinforce canon transfers in increasing disparities in capital total revenues. Whether transfers are or are not overall equalizing depends on the variables selected as benchmarks. As shown in table 5.33, transfers (including the canon) are not

<sup>40</sup> Basically, poorer jurisdictions may be less able to prepare competitive projects.

<sup>41</sup> The fact that the incidence of poverty and the index of unmet basic needs are highly correlated suggests that those regions with a greater number of needy people are also the regions with greater needs for capital infrastructure.

equalizing in that they tend to go to regions with less poverty and fewer unmet basic needs. However, transfers (including the canon) may be seen as equalizing in that they tend to go to regions with lower regional GDP per capita. This latter result is likely driven by the fact that metropolitan Lima, which has high regional GDP per capita, is not at all a big recipient of transfers (including the canon).

**Table 5.33 Simple Correlation Coefficients between Per Capita Transfers and Measures of Income and Need at the Regional Level in 2007**

	Regional GDP Per Capita	Per Capita Total Revenues	Per Capita Capital Transfers	Per Capita Canon Transfers	Poverty Incidence	Índex of Unmet Basic Needs
Regional GDP Per Capita	1.00					
Per Capita Total Revenues	-0.15	1.00				
Per Capita Capital Transfers	-0.23	0.96	1.00			
Per Capita Canon Transfers	-0.25	0.96	0.98	1.00		
Poverty Incidence	-0.07	-0.30	-0.22	-0.27	1.00	
Index of Unmet Basic Needs	-0.09	-0.31	-0.15	-0.25	0.90	1.00

Source: Gómez, Martínez-Vázquez, and Sepúlveda 2009.

## 6. Borrowing

### *Current legislative framework*

Subnational governments in Peru are allowed to borrow under a fairly conservative set of rules. Subnational government borrowing is regulated by the Fiscal Responsibility and Transparency Law (*Ley de Responsabilidad y Transparencia Fiscal*), Law 27.958 of 2003, and the Fiscal Decentralization Law (Decree No. 955).

Two general rules apply:

- The “golden rule” that borrowed funds can only be used to finance public investments, never current spending
- Prior central government permission is necessary for any foreign borrowing.

The other current rules include the following:

- Limits on debt service: the ratio of servicing the debt without central government guarantee cannot exceed 10 percent of current revenues, the ratio of total debt services to current revenues cannot exceed 25 percent, and short-term debt cannot exceed 8.33 percent of current revenues.
- Limits on total debt levels: the ratio of total debt without central government guarantee to current revenues cannot exceed 40 percent, and that of total debt to current revenues cannot exceed 100 percent.

- Limits on the growth of public spending: the real rate of growth of nonfinancial expenditure cannot exceed 3 percent per year.
- The requirement that the average primary balance for the last three years cannot be negative.
- Borrowing restrictions (with some exceptions) during the year before general elections stated in terms of expenditure limits and budget outcomes.

The MEF is responsible for the supervision of subnational government borrowing and for enforcing the existing rules. Compliance with rules as reported by the MEF is mixed. The rule on short-term borrowing and the rule on limits on nonfinancial spending are broken by most subnational governments. There are also some compliance problems with the rule on “average primary balance” and the rule related to the “limit on total debt without central government guarantee.” In fact, many local governments have a ratio of short-term debt in excess of 8.33 percent of current revenues. There is little information on the size of the so-called “floating debt.” A few local governments are actually in virtual bankruptcy, with total debt over six times their current revenues. The current regulatory framework does not provide for mechanisms to correct debt imbalances or bankruptcy procedures.

Financial administrative capacity is generally quite low among subnational governments, which has limited their access to credit markets. In reality, there are just a handful of subnational governments that have had access to credit markets. The relatively low level of subnational credit likely reflects, at least on the demand side, a combination of a generalized lack of financial administrative capacity and the current conservative regulatory framework. Most municipalities borrow from the central bank (Banco de la Nación). The central bank, in coordination with the Treasury (Dirección Nacional de Tesoro Público), is in charge of channeling all intergovernmental transfers. This has allowed the central bank to introduce an intercept on the transfers to subnational governments to ensure repayment of their debt.

Table 5.34 presents the total debt of regional and local governments aggregated at the regional (department) level at the end of 2009. This total debt of regional and local governments as of December 2009 represented 16.8 percent of total subnational revenues and 1.9 percent of GDP. In table 5.34, total debt is broken down into three categories:

- Internal debt, which includes debt to the central bank, commercial banks, and the Ministry of Housing and Public Works (Ministerio de Vivienda, Construcción y Saneamiento)
- External debt, including with foreign financial and nonfinancial institutions
- “Other obligations,” which includes debt to the Social Security Administration (Oficina Nacional Previsional), the National Tax Administration (Superintendencia Nacional de Administración Tributaria), and the National

Health Insurance (El Seguro Social de Salud del Perú) and Pension Fund Administration (Administradoras de Fondo de Pensiones del Perú) agencies.<sup>42</sup>

The main component by far (over three-fourths) is from “other obligations,” largely representing arrears in payments by subnational governments to central government agencies, including payments for retirement and health insurance of employees, and payments to the central tax administration. International debt represents 17 percent of the total. The totality of international debt is held by Lima.<sup>43</sup> The municipality of Lima is actually the largest debtor, holding around half of the total debt. Note that regional governments represent barely 2 percent of the total debt of subnational governments. The rest of the subnational total debt outstanding corresponds to the municipalities.

**Table 5.34 Total Debt of Regional and Local Governments per Type of Debt as of December 31, 2009** (in nuevos soles, based on information provided by lenders)

Department	Internal Debt	External Debt	Other Obligations	Total
Amazonas	6,343,041	0	6,180,484.37	12,523,526
Ancash	4,172,830	0	98,980,349.26	103,153,179
Apurímac	5,064,993	0	4,595,001.64	9,659,995
Arequipa	3,857,271	0	147,700,844.23	151,558,115
Ayacucho	9,184,861	0	15,503,328.35	24,688,190
Cajamarca	24,673,496	0	25,738,907.00	50,412,403
Prov. Constitucional del Callao	21,183,122	0	329,262,612.64	350,445,734
Cusco	20,119,329	0	9,264,439.13	29,383,768
Huancavelica	15,581,934	0	4,618,884.59	20,200,818
Huánuco	9,442,182	0	22,001,437.45	31,443,619
Ica	1,944,120	0	129,144,814.28	131,088,934
Junín	7,836,115	0	8,420,585.70	16,256,700
La Libertad	3,605,851	0	65,026,499.60	68,632,351
Lambayeque	7,410,056	0	312,317,286.66	319,727,343
Lima	321,636,163	206,958,587	1,042,163,709.63	1,570,758,460
Loreto	34,670,141	0	36,411,930.16	71,082,071
Madre de Dios	717,120	0	6,482,315.50	7,199,436
Moquegua	518,010	0	410,952.10	928,962
Pasco	1,798,556	0	11,278,384.82	13,076,941
Piura	11,062,350	0	91,298,911.25	102,361,262
Puno	14,216,442	0	16,511,595.42	30,728,038
San Martín	9,964,682	0	20,595,857.20	30,560,540
Tacna	1,671,418	0	6,085,655.20	7,757,073
Tumbes	1,871,112	0	40,312,768.86	42,183,881
Ucayali	15,292,083	0	22,776,419.04	38,068,502
<b>Total</b>	<b>553,837,279</b>	<b>206,958,587</b>	<b>2,473,083,974</b>	<b>3,233,879,840</b>

Source: Portal of Transparencia Económica, MEF.

<sup>42</sup> The “floating debt” amounts are not included in the figures in table 34.

<sup>43</sup> A few other subnational governments (for example, Lambayeque) have incurred foreign debt but have done so through the central government.

***Issues related to borrowing***

Issues related to borrowing include the following.

***Despite relatively low levels of debt, there are some troublesome patterns.*** In terms of the nature of the subnational debt, it is notable that much of what is owed by local governments (67.7 percent in 2008) corresponds to “other obligations” including overdue payments for social security of employees, and suspended payments to the National Tax Administration, with the corresponding finance charges. That is all debt to the central government. In contrast, the debt to financial institutions, private or public, appears to be repaid on a timely basis. Thus, the behavior of local governments would seem to reveal an attempt to operate with a soft budget constraint vis-à-vis the central government.

Another source of troublesome issues is the so called “floating” —or provisional— “debt” that local governments hold. This is fundamentally budget arrears with employee wages and benefits. This type of debt is not well monitored at the central level.

***Lack of integration and incongruencies in some of the fiscal rules.*** It is clear that subnational governments in Peru require a regulatory borrowing framework for fiscal responsibility and for helping maintain macroeconomic stability.<sup>44</sup> Beyond the issue of whether the current regulatory borrowing framework may be too conservative, there are possibilities for simplifying and improving the internal consistency of the framework. In particular, there appear to be inconsistencies in how the objective of limiting total debt is pursued by the different rules. An example is in the interaction of the rule concerning the limit on total debt service and the rule limiting short-term debt. Given that debt service is one of the components of short-term debt, the limit imposed on debt service (defined in terms of net current revenues) should be smaller than the short-term debt limit. This is because short-term debt, besides debt service, includes an obligation to the National Treasury, bank drafts, accounts payable, and other obligations. To be adequately complementary, the limit on short-term debt should be higher than the 25 percent of net current revenues now allocated to total debt service; or alternatively, the limit on debt service should be smaller than the 8.33 percent of net current revenues now required for short-term debt. It would appear that the issue is not so much with the limit imposed on total debt service but with the conservative limits imposed on short-term debt.

***The congruence of the limits to subnational public spending growth and other central government policies.*** Even though it is clearly undesirable to have explosive growth in public spending, there appears to be a contradiction between the recent policies of the central government encouraging subnational spending on capital infrastructure, sustained by increased capital transfers, and the 3 percent limit on overall subnational spending growth. The growth in spending would be especially undesirable if it led to budget

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<sup>44</sup> There are different approaches to promoting responsible borrowing in international practice. Approaches that rely on third-party pressure, such as credit ratings or mutual peer pressure, tend to be more effective than approaches that rely on rules and regulations (see Vulovic 2011). However, for the current institutional setup in Peru, with the lack of development of credit markets and vertical dialog and cooperation, a rule-based approach is likely the most attractive option.

imbalance. However, the past growth in subnational spending has been based on subnational revenue increases. Furthermore, there is already a rule requiring nonnegative primary budget balance. Therefore, the need for the rule limiting subnational spending growth can be questioned.

***Is there a need to differentiate between guaranteed and nonguaranteed total debt ceilings?*** The distinction between these two types of debt may not be justified. The vast majority of subnational governments do not have access to foreign borrowing, which by law requires central government prior permission and guarantee. Even though a central government guarantee in the case of domestic borrowing may be required by a lending institution, in practice, this has been a very rare exception. In addition, it is questionable whether nonguaranteed debt is in effect riskier than guaranteed debt. The existing procedures for public investment already seem to have adequate safeguards for capital projects funded with or without debt guarantees. Also consider the following: (a) central government guarantees may add moral hazard issues, since lenders may be less watchful of lending to subnational governments precisely because of the central government guarantee; and (b) guaranteed foreign debt is subject to foreign exchange risk and, therefore, it may be reasonable to argue the need to be more conservative in this case.

Thus, it would seem possible and desirable to simplify the current borrowing regulatory framework by eliminating the separate requirement for guaranteed and nonguaranteed debt (for total debt ceiling and debt service). This would line up Peru's regulatory framework with international practice.

***The special case of the Metropolitan Municipality of Lima.*** The Metropolitan Municipality of Lima is currently the only subnational government in Peru with complete access to domestic and foreign credit markets. For this reason, Lima is subject to ongoing additional monitoring and control of budget finances and debt sustainability by the lenders and credit rating agencies. All this may justify not less central government monitoring, but some degree of asymmetry with less strict borrowing limits for all subnational governments (regions and provincial municipalities) that, like Lima, can develop better access to credit markets and become subject to monitoring and controls by third parties beyond the central authorities.

Overall, even though there are problems with arrears to central government institutions and employee benefits and wages and compliance with some of the debt rules, for the most part subnational governments in Peru operate within a hard budget constraint, and current debt levels are manageable.

## **7. Policy Reform Options**

Policy reform options for the different elements of the decentralization framework in Peru are discussed below. The emphasis is on laying out “sensible” reforms to improve the quality of the decentralization framework, but we have no elements to judge how

feasible, or even desirable, these reforms are within the overall strategy of the new administration of President Ollanta Humala.

***Policy reform options regarding the vertical structure of government***

***Addressing the fragmentation at the municipal level.*** The high level of local government fragmentation remains an important problem in Peru, a problem shared with many other countries around the world. Hence, it is useful to consider how other countries have tried to address this problem. Internationally, the problem of fragmentation has been addressed through two general approaches. One approach has been to implement the forced amalgamation of local governments. Another approach has been to seek either the voluntary amalgamation or the voluntary association of local governments without a loss of their identity. Forced amalgamation has not always delivered cost economies because of political difficulties with firing workers and the administrative need to level salaries typically at the highest existing levels. Furthermore, economies of scale in service delivery, with the exception of a few services requiring large amounts of infrastructure, can be attained at relatively low population sizes (between 10,000 and 20,000 inhabitants).<sup>45</sup> In addition, the forced amalgamation process must also consider the potential cost of lower levels of representation and accountability associated with this approach. The pursuit of voluntary consolidation programs typically has not worked in international experience despite the role played by financial incentives. Typically, these incentives are not large and, therefore, they are not attractive. In addition, the size of the incentives needs to be limited by sustainability. They should not exceed the transaction and administration costs of implementing the amalgamation program.

To consider either forced or voluntary amalgamation, it will be necessary to evaluate the potential for cost savings from economies of scale on a case-by-case basis. To do this well, it will be necessary to have clear assignments of responsibilities and to consider alternative ways to achieve those efficiencies, including the constraints imposed by public employment regulations regarding downsizing personnel and making salary adjustments. This will require information that is not currently available and a scope of work that goes well beyond that of this chapter.

In international practice, there are other alternative strategies that have been used to address local fragmentation including:

- The privatization of public services
- The creation of special districts that can cover the provision of a particular service in several jurisdictions taking advantage of economies of scale
- Local government cooperation through the creation of associations.<sup>46</sup>

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<sup>45</sup> See Gomez and Martinez-Vazquez (2011) for a discussion of the available evidence on the existence of economies of scale in the delivery of different types of public services.

<sup>46</sup> A great advantage of interjurisdictional cooperation is that it allows even the smallest local governments access to capital equipment and technologies that they otherwise could never afford (Martinez-Vazquez and Gómez 2008).

All three approaches can work, but their feasibility and effectiveness depend on the particular country, institutional setting, and history. Local government cooperation through the creation of associations appears to be the chosen formula in Peru. The new Law on Municipal Associations (Ley de Mancomunidades) and its regulations provide an adequate framework to promote those associations except for a few issues. One area where the Law on Municipal Associations can be improved is in extending municipal cooperation beyond public infrastructure projects. Clearly, the provision of current services can also be improved via cooperation. A second area for improvement is that cooperation must not be limited to situations of equal roles and responsibilities for all parties involved. It should also include situations where smaller municipalities may contract with larger neighboring municipalities for the delivery of certain services.<sup>47</sup>

The current law and regulations on municipal cooperation in “mancomunidades” provides a solid basis for solving many of the problems related to municipal fragmentation in Peru, but the law should shift the emphasis from cooperation on infrastructure projects to cooperation on improvements in public service delivery.

***Addressing the impasse of the macroregions.*** The unrealized national aspiration to develop macroregions still threatens to hold hostage many other important aspects of the decentralization process in Peru. In the short and medium term, there is a need to rethink the issue of the macroregions in view of the failed referendums. It would seem that, in practice, the decentralization process at the regional level has gone forward, and that is the right thing to do through the further devolution of expenditure responsibilities as specified in the Organic Law on Regional Governments. Revenue decentralization still has a long way to go, although there have been improvements on the side of transfers. It would seem that fuller devolution to the regional governments on the expenditure and revenue sides is the right thing to do even though the scale of the regional governments may be far from ideal. However, there is more to lose by staying still or waiting for the problematic or the never-arriving approval of the macroregions.

In the longer term, it would help to clarify the objectives of any future territorial reform at the regional level and recognize more explicitly the existing tradeoff between cost efficiencies and better representation. As in the case of municipalities, the consolidation of the current departments into a smaller number of regions has the potential to create efficiencies by reducing average cost and administrative burdens. But relatively smaller jurisdictions also offer the advantage of better matching the needs and preferences of residents and greater accountability. Coming from a long period of centralism, citizens in Peru may more greatly value having better representation and more accountability than taking advantage of potential economies of scale in service delivery. One way to interpret the failed referendum on the macroregions is that Peruvian citizens appear to put more value on having a greater voice in the government system, aided by smaller governments that are closer to the voters, than on the potential increased efficiencies arising from larger regional governments.

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<sup>47</sup> See Herrero, Martinez-Vazquez, and Murillo (2008) for an extensive discussion and set of recommendations on how to increase the potential for interjurisdictional cooperation in Peru.

***Advancing in the boundary demarcation of subnational governments.*** The demarcation of boundaries for regional and local governments needs to advance faster, since clear demarcation is a precondition for a well-functioning system of decentralized finance. Even though geographic demarcation can be hard to implement, especially when there are issues of location of natural resources, the central authorities need to substantially increase the resources available to the National Directorate of Territorial Demarcation to get this task done.

***Policy reform options in expenditure assignments***

***Clarification of expenditure assignments.*** A clear assignment of expenditure responsibilities is a necessary condition for conducting any estimation of expenditure needs of regional and local governments and for debating the proper financing systems for both levels of government. There is, therefore, a need to pursue further clarification of expenditure responsibilities at the three levels of government by amending the current matrix developed by the National Office for Decentralization (Secretaría Nacional de la Descentralización). The lack of clarity and transparency in assignments can lead to inequitable outcomes and threatens the operational efficiency in service delivery due to either the duplication or underprovision of services (with different levels blaming each other for not providing the service), eventually diminishing the overall level of accountability to citizens.

More specifically, the expenditure assignment matrix would need to be updated to include:

- The assignment of responsibilities for financing the different functions
- Further clarification of the assignment of concurrent responsibilities by progressively disaggregating subfunctions to the point that it will be possible to identify what level of government is exclusively responsible for the subfunction in a completely transparent way
- The elimination of overlapping responsibilities between regional and local government
- Providing subnational governments with the authority to design and regulate in some sectoral areas
- Clearly assigning responsibilities for financing the different aspects of concurrent responsibilities.

It is important to realize that the assignment of expenditure responsibilities is a dynamic process that requires periodic assessments.

***Improving the methodologies used to approximate expenditures needs.*** Using historical costs to approximate expenditure needs is only recommendable for the transitional period, since this approach cannot be separated from past inefficiencies or even historically unfair patterns of expenditure. There are a number of alternative workable approaches including a weighted index of variables approximating need drivers or top-

down per-client financial standards adjusted for differences in the cost of provision. A bottom-up approach to costing standard packages of services is also viable but less recommendable because of the time and cost requirements and the fact that it can easily lead to unaffordable financial requirements.<sup>48</sup>

The measurement of expenditure needs should be conducted separately for regional, provincial, municipality, and district municipality governments since they all have different assignments of expenditure responsibilities. The estimation of expenditure needs will facilitate the reform of revenue assignments in the transfer systems at different levels. Some recent estimates of expenditure needs using the methodologies described above strongly suggest that the distribution of expenditure needs is much more uniform than the actual distribution of expenditures, which are led by the availability of financing, in particular from canon revenues (see Gómez, Martínez-Vazquez, and Sepúlveda (2009a,b).

***Increased coordination and collaboration among different levels for concurrent responsibilities.*** The lack of coordination among the different levels of government can lead, in the case of concurrent responsibilities, to the duplication of services or a failure to provide adequate levels of service. Institutional reforms leading to adequate coordination and dialogue among the different levels of government should be a priority.

At the central-regional level, there is a need to clearly delineate the roles of deconcentrated units of the central government and to make them a separate permanent establishment from the “regional directorates.” Further, the regional directorates should be fully integrated into the regional governments, giving regional authorities full power over their budgets. The spending interests of the central government on the different sectoral areas can be protected by using conditional grant instruments to finance the regional governments. Beyond that, there is a need to create permanent coordinating committees by sectoral area between the central line ministries and agencies and the regional governments, which should meet on a periodic basis to discuss issues of coordination and potential conflict between the two levels of government. Bilateral negotiations between the central authorities and regional governments should be avoided unless they are issue specific, because they tend to lack transparency and can give rise to perceptions of favoritism. They are also more expensive for the central authorities to hold.

Similar permanent coordinating committees should be established at the regional level for the dialogue and coordination between regional and local authorities in the main areas where there are concurrent responsibilities.

***Addressing the resolution of conflicts in expenditure assignments.*** Conflict is likely to arise even when mechanisms for coordination and collaboration are in place. As the process of devolution of functions deepens, it can be expected that conflicts in the

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<sup>48</sup> See Gómez, Martínez-Vazquez, and Sepúlveda (2009a,b) and Martínez-Vazquez and Boex (2007) for extended discussions of these approaches.

interpretation of expenditure assignments will continue to rise. The Constitutional Court should work as the last instance for conflict resolution after other avenues have been exhausted. Conflicts among government levels should be first addressed by mixed sectoral committees with representation of the central and regional governments. At a second stage, unsolved issues could be addressed formally (as is now done informally) in the meetings of the national president and regional presidents. If the conflict is among municipalities in the same region, this second stage could consist of the mediation of the regional authorities (for example, the regional president). If the conflict is between regional and municipal governments, the mediation could be entrusted to the prime minister. At a third stage, this issue could be considered by administrative courts or even by the Administrative Bench (Sala de lo Contencioso-Administrativo) of the Supreme Court, and then, finally, it could be considered by the Constitutional Court.

***Fully integrating the regional directorates into the regional governments.*** The de facto double subordination of the regional directorates to the regional government and to the line ministries undermines the autonomy of regional governments and the expected gains from decentralization. Formally, there has been some progress made by having the regional presidents appoint the heads of the regional directorates. Now what is needed is a way to unlock the budgets of the regional directorates such that autonomy to prioritize expenditure is given to the regional governments while protecting the fundamental interests of the central government.<sup>49</sup>

To implement this reform, it will be necessary to clearly differentiate in the now so-called “deconcentrated expenditures” of regional budgets between what are true “delegated” functions from the central government, which should be financed by conditional transfers, and what are truly decentralized functions for which the regional governments should freely decide, and which should be financed by own revenues, unconditional transfers, or both. After the distinction between delegated and own functions is made, attention needs to be given to the design of the conditional transfers, which should allow the financing of minimum standards of service (defined nationally) without micromanagement from the center of how those funds are used.

Regarding the fees and charges currently accruing to the “regional directorates,” even though the concept and practice of a single treasury account at the regional level is desirable for good cash management, its extension to all sources of revenues, in particular fees and charges, is not always desirable or even justified. Retaining those revenues for stimulating increased service quality and accountability among executing units can be well justified. Breaking the link between fees and charges and the executing agency can affect the ability to provide more and better services. Thus, a compromise needs to be

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<sup>49</sup> The lack of administrative capacity of regional governments cannot be used as an argument against providing them with more autonomy in dealing with their budgets. After all, through the long process of certification and transfers of responsibilities to the regional governments, the central authorities have stated that the regional governments already have the material and human means to efficiently manage those public services.

reached at the regional level on what fees and charges can reasonably be kept by the executing agencies to improve service delivery.

Reforming expenditure assignments will also require taking decisions over the next decade involving (a) the overall level of expenditure responsibility for subnational governments, (b) whether local and regional governments should be given more autonomy in particular functions, and (c) whether the balance in expenditure responsibility between regional and local governments should be modified. These are decisions that can only be made by the current and future administrations.

### ***Policy reform options in revenue assignments***

Reforming revenue assignments in Peru will require the implementation of several coordinated initiatives.

At the local level, the general poor revenue performance of provincial and district municipalities suggests the need to address the problem from both policy and administration perspectives. In particular, the property tax on land and buildings and the property transfer tax are currently assigned to the district municipalities. Given the lack of administrative capacity of many of these local governments, it is necessary to consider the reassignment of these taxes at the provincial municipality level. Provincial municipalities may be expected to have technical and financial advantages for the administration, collection, and enforcement of these taxes. Because the tax on the property of vehicles is comparatively easier to administer, this tax now assigned to the provincial municipalities could be reassigned at the district municipality level. However, this logical switch in assignments would not be revenue-neutral by any means. So the reassignment would require some degree of revenue sharing in property taxes between provincial and district municipalities, or finding another tax assignment substitute to at least hold district municipalities harmless, if not with the same degree of (potential) revenue autonomy.

From an administration perspective, the general lack of technical and administrative capacity at the subnational levels calls for a more active role on the part of the central authorities in developing the skills and equipment required to collect taxes. The positive experiences of the semiautonomous Tax Administration Service (SAT) offices in a small number of cities suggest that there is room for improvement on the administration side, and although the SATs' experience is not likely to be replicable in many municipalities, it clearly shows the significant returns that can be obtained from improving tax administration capacity at the local level.

At the regional level, the story is completely different since, until now, regional governments have not been assigned any autonomous revenue sources and depend completely on central government transfers. Here, then, reform can start from zero.

In reforming revenue assignments at the subnational level in Peru, there needs to be the clear objective of significantly increasing revenue autonomy to end up with a fiscal decentralization system that is more accountable and fiscally responsible.

More specifically, the options for reform in revenue assignments include the following.

***Reorganization of municipal revenue assignment.*** Provincial governments are currently assigned the tax on vehicle property, which requires relatively low administrative capacity and spending, while districts are assigned the property tax, which is characterized by complex and expensive procedures. Given that administrative, technical, and financial capacities at the provincial level are, on average, significantly superior to the capacities of district governments, it might be reasonable to consider a switch in the assignment of these tax instruments, provided that the revenue issues discussed above are also addressed.

***Consider an asymmetric decentralization of tax administration at the municipal level.*** Tax administration and tax collections could be assigned only to those local governments that have the means to administer and enforce the collection of their assigned tax instruments. Upper levels of government might temporarily play a subsidiary role by assuming functions that cannot be satisfactorily carried out by certain lower-level governments like, for example, the valuation function for the property tax; but in some cases it might be reasonable to think about a permanent assignment of some of these functions to the higher level. Other asymmetric options in tax assignment reform may be considered. For example, Lima could be given additional tax autonomy vis-à-vis the rest of the regions on the grounds of its level of development and larger expenditure needs and fiscal capacity. However, all asymmetric treatments carry positive and negative discrimination aspects among jurisdictions, and this may make them less politically feasible.

***Invest in capacity building at the municipal level and subsidize initial investments in revenue collection capacity.*** The capacity to administer and collect taxes can be built, but many subnational governments in Peru lack the expertise and resources to reach minimum standards of efficiency. Lower levels of government might need technical and financial assistance from upper levels of government in developing their tax administration and tax collection capacity. Subsidizing initial investments covers many aspects. For example, in the case of the property tax, the central government could assume the responsibility for developing and maintaining the cadastre of properties at the national level for a given period of time. Once the cadastre has been developed, the responsibility of maintaining it can be devolved again to lower levels of government. Other arrangements are possible, including the asymmetric responsibility for the cadastre assigned to provincial municipalities in their territory, but assigned to the regional government in the case of the cadasters for the district municipalites.

***At the regional level, consider the following alternatives for creating revenue autonomy:***

- Implementation of piggyback or “flexible” revenue sharing schedules over *central* government taxes. Regional governments could be given discretion within a range of tax rates on central tax revenues. A good alternative is the labor (wage and professional) income tax, which is paid by those individuals who directly benefit from regional expenditures. The revenues that can potentially be collected may not be substantial in many cases with respect to total regional outlays, but this limitation also allows for a wider range of discretion, which could contribute to fostering revenue autonomy and accountability.
- Implementation of “fixed” revenue sharing schedules over *local* government taxes. A potential alternative to increase revenue autonomy at the regional level is the sharing—with some discretion in rates—the municipal property tax and the property transfer tax. However, in this case, any regional discretion over tax rates might hurt the already limited revenue autonomy of local governments. The participation of regional governments in local tax collection might also promote the involvement of regional authorities in the development of local revenue collection capacity and the control of its performance.
- Introduction of other new taxes at the regional level. There are not many good options here, but two possible candidates include business license taxes (such as Colombia’s Industry and Commerce Tax or Chile’s Patente) and excise taxes on the consumption of electricity and phone services.

The introduction of any new sources of tax revenues is likely to lead to increases in revenue disparities. Therefore, newly increased revenue autonomy may require the strengthening of the system of equalization transfers.

***Policy reform options in the transfer systems***

At the local level, the following policy reform options are offered.

***Modification of the distribution criteria of the canon or transfers from extractive industries.*** Ideally, the distribution of transfers from extractive industries, currently based on a derivation principle, should be changed to other criteria that also consider the expenditure needs, and especially the fiscal capacity, of local governments. In practice, however, such a reform might not be attainable due to the strong political opposition of the current beneficiaries to any tinkering with the system. For this reason, we suggest an indirect approach to reduce the distortionary and inequitable effects of those transfers, based on a possible—we believe more feasible—reform to the FONCOMUN.

***Reforming the FONCOMUN.*** The general goal for this reform should be to strengthen the equalizing power of the FONCOMUN transfer. This can be accomplished by first changing the distribution criteria in the formula in order to internalize the availability of funds from the canon, and second by strengthening its equalization impact by increasing

the overall pool of funds available for distribution. In particular, the reform of the FONCOMUN would involve the following steps:

- *Introduction of a fiscal capacity measure into the FONCOMUN formula.* This reform would allow for partial correction of the inequalities and inefficiencies created by the revenues from extractive industries or canon. Of course, the consideration of canon transfers as part of the fiscal capacity of local governments may be opposed by current beneficiaries of these transfers. But this type of reform may be politically more viable than the direct reform of the canon transfers. Recently, the Peruvian government introduced a similar reform to the FONCOR at the regional level. The new factor, entering negatively in the FONCOR formula, is the amount of transfers from the canon received by the regional governments. This is a good precedent that a similar reform may work at the local level with the reform of the FONCOMUN formula.
- *Elimination of the minimum transfers of 8 monthly UITs.* The reformed measurement of fiscal disparity would consider the ability of a government to finance its expenditure needs. If the fiscal disparities were negative, then the government would require no additional resources to cover its expenditure needs. In this context, the minimum transfer would be unnecessary and those resources could instead be used to support other governments in greater need. This measure would increase the equalizing power of the FONCOMUN.
- *Separation of the FONCOMUN into different provincial and district municipality components.* The procedure by which the transfer fund is first distributed to provinces and then to the districts is unnecessarily complex and leads to undesirable inequalities. For example, two identical district municipalities requiring the same financial support might receive different amounts of transfers only because they belong to different provinces. The system would gain in transparency and fairness by assigning a share of the fund to the provinces, and the rest to all districts in the country in accordance with their relative fiscal disparities. The apportionment of available funds between provincial municipalities and district municipalities could be based on the relative sizes of the aggregate fiscal gaps (the difference between expenditure needs and fiscal capacity) at the two levels.
- *Increasing the size of the pool of funds available for the FONCOMUN.* It is unlikely that offsetting the disparities introduced by the canon would be possible without an increase in the pool of funds available for the FONCOMUN. More actively pursuing the goal of reducing geographic fiscal disparities will require enlarging the pool of funds available for the FONCOMUN. Of course, this increase will depend critically on the chosen criteria for equalization and, therefore, the overall offset of the disparities introduced by the canon transfers.

At the regional level, the following policy reform options are offered.

***Modification of the distribution criteria of the canon or transfers from extractive industries.*** Again, as in the case of local governments, ideally, the distribution of transfers from extractive industries exclusively based on the geographic location of the

natural resources should be changed to include other criteria that also consider the expenditure needs and fiscal capacity of regional governments. It is unlikely, however, that central government authorities would be willing to accept the political costs this reform would bring. Here again, as in the case of local governments, we suggest an indirect approach to offset the impact of the canon on the equity and efficiency of regional public service provision. The good news is that the recent reform of the FONCOR has already moved the system in the right direction.

***Creation of a new unconditional equalization transfer program for recurrent budgets to complement the equalization impact of the FONCOR for capital expenditures.*** The implementation of regional revenue autonomy and revenue sharing schemes would most likely create additional horizontal imbalances that could be counterbalanced by additional equalization transfers. One possible strategy is to increase the funds that are distributed by the FONCOR, but this transfer is currently mainly focused on capital expenditures. The alternative solution is to create a new unconditional equalization transfer program equalizing current expenditure needs and fiscal capacity. No net additional resources would be needed if a share of the funds now transferred as “ordinary resources” (which are distributed in accordance with historical spending) are redirected to fund the new equalization transfer at the regional level.

***Simplify and increase the transparency of the FONCOR.*** The current distribution formula for the FONCOR includes an equalization criterion providing larger transfers to those regional governments that benefit less from the canon and other resources from extractive industries. However, the distribution formula for the FONCOR is excessively complex and practically impossible to replicate by the regional governments themselves. Therefore, there is a need to increase the transparency of the formula, simplifying it and even increasing its equalization power. The latter is important because, at present, the overall distribution of capital transfers to regional governments (including the canon, the FONCOR, and other minor transfers) is still not equalizing.

***Introducing conditional grants.*** As the “regional directorates” get regularized and fully incorporated into the regional governments, part of the funds now allocated through the “ordinary resources” could be assigned to funding new conditional grants to finance the new delegated responsibilities to the regional governments in areas such as education and health.

### ***Policy reform options in borrowing***

The following policy reform options in borrowing are offered.

***Simplify and increase the flexibility and transparency of the fiscal (borrowing) rules.*** Even though there is no ideal blueprint to regulate subnational borrowing, borrowing regulations in Peru need to be less constraining, less complex, and more transparent.

Simplification can be achieved by eliminating the rules limiting the growth in real nonfinancial spending, the rule limiting the total debt without central government

guarantee, and the rule limiting the service of the debt without central government guarantee. Imposing limits on total debt and on debt service (applied equally to centrally guaranteed and not guaranteed debt) is all that should be required. Flexibility and transparency can be gained by increasing the limit on short-term debt at least above the limit applied to debt service. It will also be desirable to consider laxer rules in terms of total debt and debt service for a top group of subnational governments with larger borrowing and administrative capacity, such as the Metropolitan Municipality of Lima. But in this case, it would be necessary to have explicit rules for how to qualify for the “preference” group.

***Improve reporting and data gathering.*** Although there have been significant improvements in data reporting by lender institutions, the data reporting by many local jurisdictions is still incomplete and unsatisfactory. For example, there is currently little information on the debt held by local jurisdictions through their corporations and public enterprises. There also continues to be spotty reporting on the budget arrears (the “floating debt”).

***Consider updating current sanctions for lack of compliance with borrowing rules.*** The Law on Fiscal Prudence and Transparency states that, in cases of lack of compliance with borrowing rules, subnational governments can be sanctioned with restrictions to their access to particular transfers by the MEF. It may be desirable to update these provisions taking into account the following factors:

- It may be desirable to differentiate among cases of sustained lack of compliance from single incidents created by external causes. Thus, it would be desirable to introduce protocols giving subnational governments the chance to straighten out their finances.
- It is desirable to try to avoid punishing the residents of any jurisdiction for the behavior of public officials they are supposed to represent. In this sense, it may be desirable to adopt the French and Spanish approach of fining public officials personally after the opportunity is given to them to rectify the situation.
- In cases of persistent lack of compliance, it might be desirable to have an appointed receivership (preferably by a court of justice) in charge of managing the subnational jurisdiction finances until the compliance issues are fully addressed.

## **8. Conclusions**

Even though fiscal decentralization is a relatively new phenomenon in Peru, the country has made significant progress. Over the last decade, Peru has developed a comprehensive legal framework involving the four pillars of fiscal decentralization (expenditure assignments, revenue assignments, transfers, and borrowing).

Despite that progress, significant challenges remain. These challenges can be grouped into two main categories according to their degree of difficulty.

There will be significant political constraints to reforming certain aspects of the intergovernmental fiscal system. In the “hard to deal with” category, we clearly find two main issues:

- How, at the regional level, to move beyond the formation of macroregions by the amalgamation of the existing regions or departments
- How to undo the important negative consequences of the canon system.

Having been soundly rejected in public referendums, the constitution of the macroregions should not continue to hold hostage the evolution of the decentralization process at the regional level. Even though the scale of current regions and departments may be less than ideal, the reform process and updating of the four fiscal decentralization legs should proceed at full speed for the regional governments.

The most desirable way to address the unwanted consequences of the canon, which has created significant horizontal and vertical fiscal disparities in the system, would be to reform the canon laws. However, this direct approach is likely to be politically infeasible even for the new administration, given the political and social turmoil that has surrounded canon issues in the past. The approach recommended here is to address this issue indirectly but still effectively by reforming the existing transfer system in order to offset the effects of the canon. In particular, at the local level, this can be done by reforming the FONCOMUN equalization transfers to include in its formula an explicit measure of fiscal capacity. This would virtually deprive local governments now relatively much richer because of canon funds from receiving FONCOMUN funds. Including better measures of expenditure needs in the formula for the FONCOMUN should also help alleviate existing disparities. How effective these reforms will be will depend on the pool of resources left for the equalization fund; therefore, the issue of funding should also be considered as part of the reform.

One remaining question concerns the political feasibility of this reform, or how local governments that may be excluded from the FONCOMUN in the future will react. The recent reform of the regional capital equalization fund, FONCOR, along the same lines suggested here for the FONCOMUN, sets a hopeful precedent. However, the unlikely event of a significant decline in commodity prices could make it less urgent to address the “unwanted consequences” of the canon.

In the “easier to deal with” category, this chapter has identified a rather long list of issues and has offered potential options for their reform.

Much remains to be done in addressing the fragmentation and lack of administrative capacity of local governments, especially of district municipalities. Here, the central government has started on the good path of supporting and encouraging the formation of local government associations, the “mancomunidades.” However, there will be a need to reorient this effort toward general service provision and not only infrastructure, and to allow service contracts among larger and smaller municipalities. In addition, much more effort will be needed in capacity building.

There is still a considerable lack of clarity on expenditure assignments at the different levels of government. Building on the work already done, this is an area where fast progress can be made. Other aspects of expenditure assignments that need attention include the final push to convert the currently deconcentrated functions at the regional level into truly decentralized functions. This will require bringing the budgets of the regional directorates fully under the authority of the regional governments and partially converting the “ordinary funds” into conditional grants to finance the newly delegated functions. Other aspects of expenditure assignment reform include the building of a transparent methodology to estimate expenditure needs of regional and local governments derived from their expenditure responsibilities. Improvement in the coordination and dialogue among the different levels of governments will significantly help solve interpretation and practical issues in concurrent responsibilities.

Revenue assignments are in relatively good shape at the local level, but they need to be done from scratch at the regional level. The longer-term health of the decentralization system in Peru, in terms of expenditure efficiency, accountability, and fiscal responsibility, will depend largely on the effective degree of tax autonomy among local and regional governments. The taxes assigned at the local level, the property tax and the tax on vehicles, are good choices to provide revenue autonomy. But perhaps that list could be enlarged and those two taxes reassigned so that the property tax is collected by the provincial municipalities, since generally they have better administrative capacity than the district municipalities. However, several revenue issues would need to be addressed and revenue effort considerably increased. At the regional level, this chapter has suggested several possibilities for new tax assignments including using a piggyback flat personal income tax on the national personal income tax.

The hardest reforms in the current transfer system involve better integration of the canon and the equalization transfers. This chapter has offered specific steps for how this can be accomplished. A final set of issues concerns the simplification and greater transparency of borrowing regulations. Although this is an area that poses no immediate concrete threat, there is considerable room for simplification and improvement of reporting and information gathering. A second-generation concern will be how to improve access to private credit markets for those subnational governments that have sufficient administrative and fiscal capacities.

Peru has arrived at a stage where the question is no longer whether to decentralize, but rather what form of decentralization to adopt. This chapter provides a blueprint for achieving a more efficient and equitable decentralization system in the country.

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