OUTLOOK OF FISCAL RELATIONS AMONG GOVERNMENT LEVELS IN LATIN AMERICA AND THE CARIBBEAN

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Introduction

Outlook of Fiscal Relations among Government Levels in Latin America and the Caribbean is a joint publication prepared by the Inter-American Development Bank (IDB) and the Economic Commission for Latin America and the Caribbean (ECLAC) with the aim of providing a regional and national analysis of the subnational public finances of the countries of the region. These pages present detailed and internationally comparable statistics on the subnational public finances of 26 Latin American and Caribbean IDB borrower countries, including unpublished information on some Caribbean countries. Also included are analyses of themes from the IDB's Vision 2025: Reinvest in the Americas, such as the contribution of subnational finance to gender equality and climate change.

Chapter 1 presents major regional trends and identifies progress and challenges in fiscal relations between levels of government. Chapter 2 is devoted to the development of a special theme, which in this first edition is the impact of the crisis caused by the coronavirus (COVID-19) pandemic on subnational public finances. This crisis, which has exacerbated historical problems and creates new challenges, is one of the reasons for renewing the work agenda in the sector.

In view of the importance of historical developments in defining fiscal relations between levels of government in each country, Chapter 3[1] presents a compilation of unpublished country files, which provide a complete and didactic overview of the main aspects of the fiscal relations among the levels of government in the 26 countries of the region. The topics describe the main characteristics of fiscal relations among government levels in six areas, namely:

i) Organization of the subnational public sector: The basic characteristics of this sector in each country are described, including the main aspects of the election of subnational authorities.

ii) Key issues of subnational finance in each country: A summary of the historical evolution of the decentralization process, the current situation, and recent trends is presented.

iii) Public expenditure of subnational governments: The levels and composition of subnational government spending, investment, and functional expenditure are analyzed.

iv) Public revenues of subnational governments: Their main own-source revenues, the most prominent features of collection, and transfers received by subnational governments are examined.

1 Chapter 3 is presented in the Spanish version of this publication.

v) Public debt of subnational governments: The characteristics of subnational indebtedness are analyzed, including the legal framework and, if applicable, the rules of subnational fiscal responsibility.

vi) Entities responsible for managing the relationship between central government and subnational governments: The governing bodies, coordination forums between levels of government, associations of subnational entities, and sources and main characteristics of tax information are presented.

This publication is analytical in nature, and its conclusions and recommendations arise from the bibliographic review and the information presented. *Outlook of Fiscal Relations among Government Levels in Latin America and the Caribbean* seeks to be a reference for the analysis of the main characteristics and trends regarding subnational public finances of 26 countries in the region and to contribute to the design and implementation of public policies that strengthen the sector.

Chapter 01

Fiscal Relations among Government Levels in Latin America and the Caribbean: Regional Trends

Fiscal Relations among Government Levels in Latin America and the Caribbean: Regional Trends

Strategic Messages

Over the past 40 years, subnational governments' share of aggregate public spending of Latin American and Caribbean countries has increased.[1] After rapid growth of 13 to 25 percent between 1985 and 2010, it stabilized at 26 percent in 2019. As a reference, the subnational governments' share of public spending in Organisation for Economic Co-operation and Development (OECD) member countries averaged 32 percent in 2019 (OECD, n.d.). However, the size of the subnational public sector in Latin America and the Caribbean varies greatly from country to country due to their respective historical trajectories, land mass, and population size. In the political realm, almost all countries in the region elect their mayors in popular elections for terms of more than 20 years, compared to only six countries that did so in 1980.[2] In the case of intermediate governments, the number of countries with popularly elected authorities increased from 1 in 1980 to 11 in 2021. It should be noted that in Chile the first elections of authorities for regional governments took place in 2021. In terms of gender, the proportion of female mayors in Latin America and the Caribbean increased from 6.2 percent to 12.4 percent of mayors between 1998 and 2018, a figure that, although it has doubled in 20 years, continues to be low.

Latin America and the Caribbean is an increasingly urban region, with 8 out of 10 inhabitants living in cities. The populations of many of the region's countries concentrate around large cities (more than 500,000 inhabitants). Some countries have atomization at the municipal level, as measured by the average number of inhabitants per municipality, which can result in higher costs of providing services for subnational governments with few inhabitants. The region is also characterized by great economic inequality at the territorial level. This leads to disparities in the generation of subnational revenue, which transfer systems cannot sufficiently cover.

At the fiscal level, the financing structure that is highly dependent on transfers is a traditional challenge for the subnational sector in the region, standing out from other regions and reducing the incentives for subnational governments to manage efficiently and be accountable and fiscally responsible. On the other hand, the region made progress in terms of subnational fiscal sustainability thanks to the implementation of subnational fiscal responsibility frameworks. Recent subnational reforms include those carried out in Panama, which in 2015 began devolving the resources collected from real estate tax to the municipalities, and Chile, which began implementing a gradual decentralization of spending functions toward regional governments in 2018.

As noted in Chapter 2, while the coronavirus (COVID-19) pandemic is having a profound impact on the region's subnational finances, it also provides an opportunity to improve

1 The series covers 12 countries in the region and refers to the weight of subnational governments with respect to the general government or the nonfinancial public sector, as the case may be. This arises from Fretes et al. (2018) and from the country sheets in this publication for 2019.
2 The exception at the municipal level is Barbados.

mechanisms of coordination between levels of government and strengthen the capacities of subnational governments.

In terms of expenditure, the region's subnational governments provide services that affect the daily well-being of the population and include, at the municipal level, improvements of public spaces, garbage collection, sweeping and cleaning, local transportation, public lighting, and issuance of construction and operating licenses. The subnational governments of Argentina, Brazil, Colombia, Mexico, and Peru have the primary responsibility for education and health functions at the intermediate government level and, in the case of Brazil and Colombia, also at the local level. The weight of personnel expenditure in these functions explains the relatively high share of subnational government spending in general government spending in these countries. The security and public order function is also important at the subnational level in many countries. On the other hand, subnational governments in the region invest in essential services, such as transportation and water and sanitation, which can help boost local economies. On average, subnational governments spend about 1.5 percent of gross domestic product (GDP) on public investment. In Argentina, Colombia, Ecuador, and Peru, subnational public investment accounts for more than half of all aggregate public investment. In the case of the Andean countries, this is largely due to the growth of transfers linked to natural resources conditional on capital expenditure. Although this publication does not elaborate on this aspect in detail, the administrative capacity of subnational governments, including their personnel services, procurement, and public investment, among others, is a fundamental point on the agenda for improving the management of subnational expenditure.

With respect to revenues, the taxation authority of subnational governments is generally limited, and its use is insufficient. At the intermediate level, the provinces of Argentina and the states of Brazil levy taxes on consumption with high collection potential, although in both cases there are some design problems. At the local level, almost a third of tax revenue comes from property tax, whose collection performance is still far from its potential. In five countries of the region, this tax is collected at the central level, and in Argentina mainly at the provincial level.

The design of transfer systems presents opportunities for improvement. Transfers account for 56 percent of subnational revenues. Most countries have tax-sharing systems that incorporate redistributive criteria, such as population, poverty, and territory. However, unlike many OECD countries, no country in the region has matching transfers, which are used to close the estimated gap between spending needs and fiscal capacity. In several countries, resources are transferred conditional on certain functions, including coverage of infrastructure gaps. In this regard, it is worth highlighting the case of Colombia, where almost all transfers are conditional. In recent decades, transfers linked to natural resources have increased, especially in the Andean countries. The transfer systems of several countries contain a highly discretionary component, which means transfers are less transparent and often used for political purposes.

Regarding financing, the region has taken important steps to promote subnational fiscal sustainability. Fiscal responsibility frameworks have contributed to this objective. The average indebtedness of subnational governments in Latin American and Caribbean countries is 3 percent of GDP, compared to 12 percent in OECD countries

(OECD, 2020a). Fiscal pressures caused by the COVID-19 crisis are likely to lead to a rethinking of existing regulatory frameworks, with a view to promoting more comprehensive and timely monitoring of subnational liabilities, not only for effective control but also to better exploit the potential of responsible indebtedness as a tool for development by subnational governments.

Fiscal transparency is still a challenge for the countries of the region. While some of them, such as Brazil and Peru, have created integrated subnational financial management systems and disseminate the information from these systems about all subnational governments, some problems remain related to the timeliness, quality, and completeness of the information presented. This includes the way in which investment expenditure is classified, the lack of detailed expenditure data by functional classification, and the inadequacy of information on the stock and debt situation of subnational governments of the region. Strengthening government oversight bodies and increasing the involvement of civil society can lead to greater transparency of public finances and thus improve accountability.

High Subnational Heterogeneity in Latin America and the Caribbean

In the 26 countries of Latin America and the Caribbean analyzed, there are more than 17,000 subnational governments, which provide public goods and services essential for the well-being of the population and offer a wide variety of management experiences. Of these, 270 (2 percent) are intermediate governments and 17,233 (98 percent) are local governments (see Table 1.1). Among many other experiences are the island decentralization of the Bahamas and Trinidad and Tobago (in the latter country through the asymmetric allocation of functions and resources between the two islands), different types of municipalities in Belize and Guyana, the creation of a municipal government level in Uruguay in 2009, and the recent constitutional reform that, for the first time in 2021, established the popular election of regional governments in Chile.

TABLE 1.1 - Latin America and the Caribbean (26 countries): Number of Subnational Governments by Country

	NUMBER OF INTERMEDIATE GOVERNMENTS	NUMBER OF LOCAL GOVERNMENTS	TOTAL SUBNATIONAL GOVERNMENTS	IMMEDIATE REELECTION OF THE EXECUTIVE BRANCH	
				Intermediate level	Local level
Argentina	24	2,327	2,351	Yes	Yes
Bahamas	n.a.	32	32	n.a.	No
Barbados	n.a.	41	41	n.a.	n.a.
Belize	n.a.	202	202	n.a.	No
Bolivia (Plurinational State of)	9	339	348	Yes	Yes
Brazil	27	5,570	5,597	Yes	Yes
Chile	16	346	362	Yes	Yes
Colombia	33	1,101	1,134	No	No

(Continued on the next page)

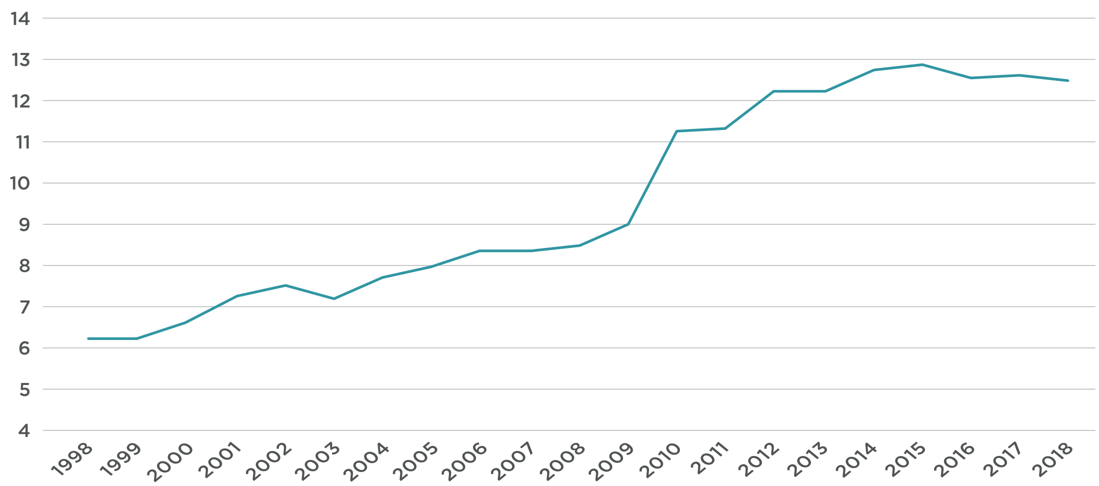
TABLE 1.1 (continued)

Costa Rica	n.a.	82	82	n.a.	Yes
Dominican Republic	n.a.	391	423	n.a.	Yes
Ecuador	23	221	244	Yes	Yes
El Salvador	n.a.	262	262	n.a.	Yes
Guatemala	n.a.	340	340	n.a.	Yes
Guyana	10	178	188	No	No
Haiti	10	186	196	No	Yes
Honduras	n.a.	298	298	n.a.	Yes
Jamaica	n.a.	14	14	n.a.	No
Mexico	32	2,470	2,502	Yes	Yes
Nicaragua	n.a.	153	153	n.a.	No
Panama	n.a.	78	78	n.a.	No
Paraguay	18	254	272	No	No
Peru	26	1,874	1,900	No	No
Suriname	n.a.	10	10	n.a.	Yes
Trinidad and Tobago	n.a.	15	15	n.a.	No
Uruguay	19	112	131	Yes	Yes
Venezuela (Bolivarian Republic of)	23	337	360	Yes	Yes
Total	**270**	**17,233**	**17,535**		

Source: Authors' elaboration based on official country information.
Note: n.a.: not applicable.

The population elects its rulers or representatives at the local level in all countries analyzed except Barbados, where the central government still appoints them. Fifteen of the 25 countries permit reelection at the municipal level. In 11 of the 13 countries with intermediate governments, authorities are also elected through popular elections, and 8 allow reelection at the intermediate level. While progress has been made in electing women to head subnational entities, there is still a long way to go in terms of gender equity in executive positions: between 1998 and 2018, women mayors (or equivalents) in Latin America and the Caribbean increased from 6.2 percent to 12.4 percent of local governments, a percentage similar to that recorded in 2012 (see Figure 1.1).

FIGURE 1.1 - Latin America and the Caribbean (22 countries): Regional Average of Women Mayors, 1998–2018 (as a percentage of the total)

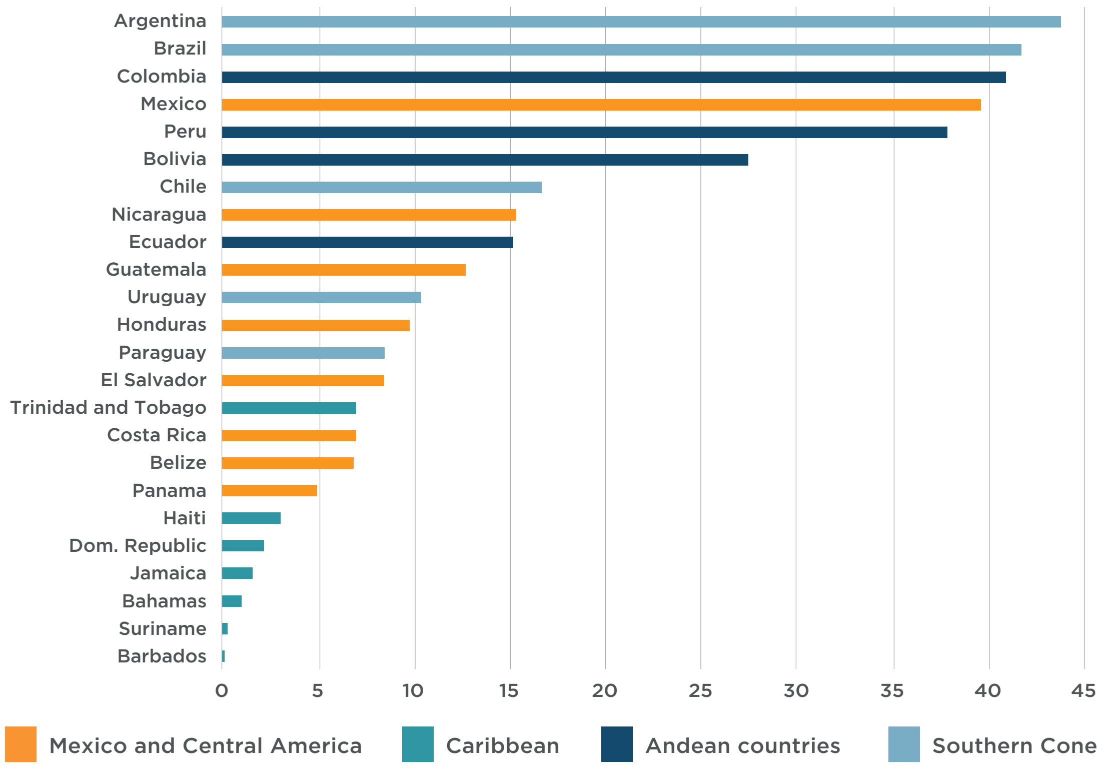


Source: ECLAC (2018).
Note: Uruguay's departments are considered within local governments because their spending functions are typical of that level of government. This figure refers to the following countries: Argentina, Belize, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, Uruguay, and Venezuela (Bolivarian Republic of).

Depending on the degree of autonomy of subnational governments, countries are classified into federal—where the Constitution guarantees the permanence and independence of subnational governments, which have their own division of powers—and unitary, where subnational governments do not usually have constitutional sovereignty and the central government determines the spending functions it returns to them. The region can be divided into four groups: (i) large federations (Argentina, Brazil, and Mexico), (ii) unitary countries with greater decentralization (Bolivia, Colombia, Ecuador, and Peru), (iii) unitary countries with less decentralization (Chile, Paraguay, Uruguay, and several Central American countries), and (iv) unitary countries with incipient decentralization, a group that includes the Caribbean countries (Fretes et al., 2018).

The size of the subnational public sector, measured as the percentage of expenditure executed by subnational governments relative to aggregate government expenditure, also shows great heterogeneity, linked to the historical evolution of the country and its geographical and population size (see Figure 1.2).

FIGURE 1.2 - Latin America and the Caribbean (24 countries): Public Expenditure of Subnational Governments, 2019 or Most Recent Year (as a percentage of aggregate government expenditure)



Sources: Authors' elaboration based on official country information and Fretes et al. (2018).

As for the distribution of the population in the territory, as already mentioned, Latin America and the Caribbean is an increasingly urban region, with 8 out of 10 inhabitants living in cities. Urban municipalities, which account for 10% of the total, concentrate two-thirds of the population of the region, while about half of the local authorities have less than 10,000 inhabitants each. In many countries in the region, much of the population is concentrated around the capital: this is the case of Argentina, Chile, Paraguay, Peru, Venezuela, and the Dominican Republic, among others, where more than a third of the population is concentrated in metropolitan cities or capital cities. In Costa Rica, Panama, Suriname, and Uruguay the share of the population living in the capital city area exceeds 50 percent. Brazil, Mexico, and Colombia (in that order) stand out for having a relatively high number of large cities (more than 500,000 inhabitants) distributed throughout the territory: 50, 42, and 12, respectively (see Table 1.2).

TABLE 1.2 - Latin America and the Caribbean (26 countries): Number of Cities with More Than 500,000 Inhabitants and Percentage of Urban Population

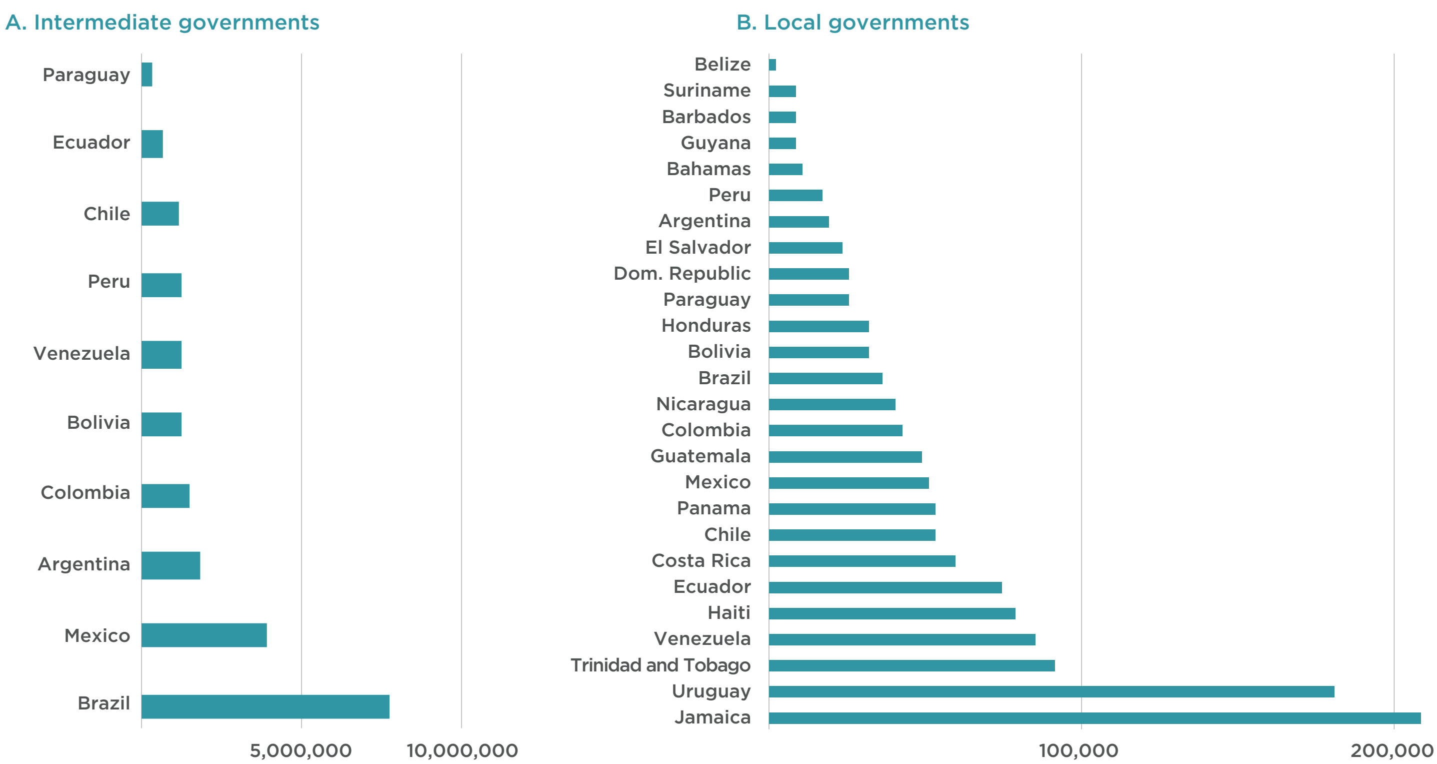
	CITIES WITH MORE THAN 500,000 INHABITANTS	PERCENTAGE OF URBAN POPULATION
Southern Cone	**65**	**84.6**
Argentina	10	91.9
Brazil	50	86.6
Chile	3	87.6
Paraguay	1	61.6
Uruguay	1	95.3
Andean countries	**33**	**76.0**
Bolivia (Plurinational State of)	3	69.4
Colombia	12	80.8
Ecuador	2	63.8
Peru	7	77.9
Venezuela (Bolivarian Republic of)	9	88.2
Mexico and Central America	**51**	**68.4**
Costa Rica	1	79.3
Dominican Republic	2	81.1
El Salvador	1	72.0
Guatemala	1	51.1
Honduras	2	57.1
Mexico	42	80.2
Nicaragua	1	58.5
Panama	1	67.7
The Caribbean	**3**	**52.1**
Bahamas	n.a.	83.0
Barbados	n.a.	31.1
Belize	n.a.	45.7
Guyana	n.a.	26.6
Haiti	1	55.3
Jamaica	1	55.7
Suriname	n.a.	66.1
Trinidad and Tobago	1	53.2

Sources: Authors' elaboration based on official country information and United Nations (2019).
Note: Cities conceptually considered as urban agglomerations by the United Nations. n.a.: not applicable.

"Atomization," measured by the average number of inhabitants per entity, helps to calibrate efficiency in the provision of services. In intermediate entities, the average population ranges between 1 million and 3 million inhabitants per territorial demarcation. The extreme values correspond, respectively, to Paraguay and Brazil. At the local level, the dispersion is much greater: the average population per municipality varies between 30,000 and 70,000 inhabitants in most of the region.

In cases such as Peru, which is the most atomized among large countries, there are about 17,000 inhabitants per municipality on average and more than 70 percent of municipalities have less than 10,000 inhabitants (see Figure 1.3). In general, the cost of providing subnational services per capita is higher in small municipalities with low population density. The creation of new municipalities has increased atomization in several countries; this was the case in Brazil until 1996 and the Dominican Republic until 2010, and it was still the case in Paraguay in 2021. This proliferation responds in some cases to the incentives of transfer systems, which in certain countries include the distribution of a portion of resources in equal parts among all municipalities. This can stimulate the creation of entities to receive the minimum guaranteed amount. In general, Latin American legislation allows the creation of consortia, associations, or other mechanisms of intermunicipal cooperation for the purpose of generating economies of scale in the provision of services. However, these mechanisms remain unused for a number of reasons. Some of them have to do with a lack of incentives, as the creation of consortia implies a transfer of functions from subnational governments, as well as a limitation of municipalities' duties (Carrión, 2016).

FIGURE 1.3 - Latin America and the Caribbean (26 countries): Average Population by Level of Government, around 2019 (in number of inhabitants)



Sources: Authors' elaboration based on official country information and World Bank (2021).
Note: Uruguay's departments are considered within local governments, as their spending functions are typical of that level of government.

Finally, Latin America and the Caribbean is also characterized by great economic inequality at the territorial level: the ratio of per capita income of the richest regions to the poorest is, on average, double that of OECD countries. This greater economic inequality is also reflected in the ability to generate tax revenues. On average, the difference between the 10 percent of intermediate governments in Latin America and the Caribbean with the highest per capita tax collection and the 10 percent with the lowest is four times higher than that observed in OECD countries, a difference that, as explained below, is only partially compensated by intergovernmental transfers (Jiménez, Muñoz, and Radics, 2021).

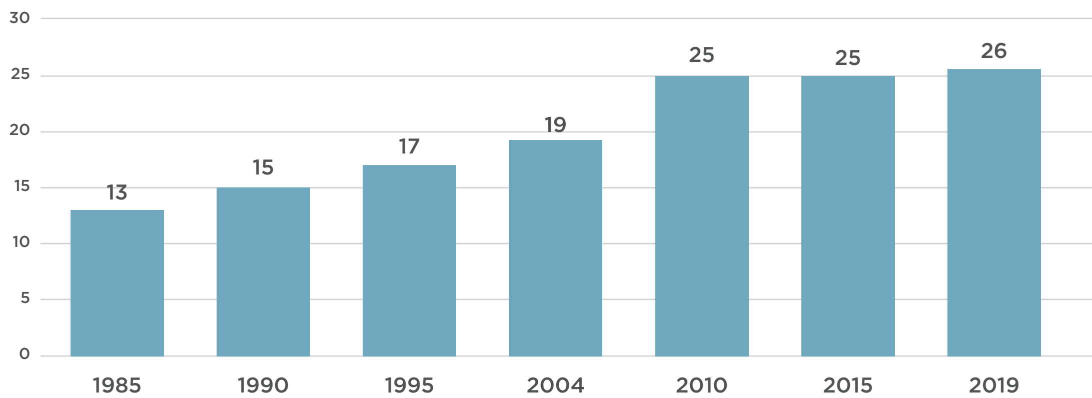
Key Issues in Fiscal Relations among Government Levels in Latin America

RECENT MAJOR HISTORICAL CHANGES

Since the 1980s, almost all countries in the region have undertaken decentralization processes and assigned subnational governments increasing responsibility for the provision of public goods and services. This led to subnational governments' share in aggregate public spending almost doubling between 1985 and 2010, from an average of 13 percent to 25 percent, stabilizing to 26 percent in 2019 (see Figure 1.4). For reference, in OECD countries, this share averaged 32 percent (OECD, n.d.). The reasons for decentralization include democratic openness, which generated demands for greater political and fiscal autonomy at the subnational level (Arzaghi and Henderson, cited in Fretes et al., 2018); economic crises, which led some countries to transfer spending functions to subnational governments in a context of structural adjustment (Rezende and Veloso, cited in Fretes et al., 2018); and the institutional reforms of the late 1990s, for which responsibilities were transferred to subnational governments to increase the efficiency of the public sector (Lora, cited in Fretes et al., 2018). A major factor contributing to the growth of subnational spending in the 2000s was the boom in extractive industries, mainly mining and hydrocarbons, which increased transfers to subnational governments related to tax revenues from these industries, especially in the Andean countries (ECLAC, cited in Fretes et al., 2018). It was characterized by a high level of volatility, directly associated with changes in international prices of natural resources (Fretes et al., 2018).

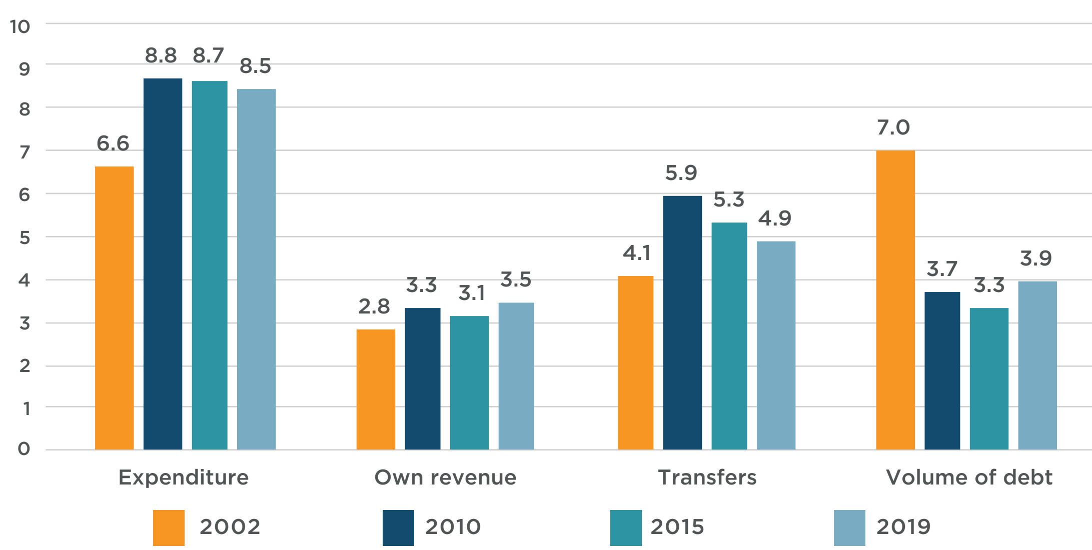
The region has made progress on improving the fiscal sustainability of subnational governments, largely thanks to the implementation of legal frameworks for fiscal responsibility. This is especially true in Argentina, Brazil, and Colombia, where in the late 1990s and early 2000s, subnational indebtedness contributed to episodes of macro-fiscal instability that led to financial rescue by national administrations (see Figure 1.5). The creation of such legal frameworks seeks to mitigate the risk of subnational debt overhang, so that subnational governments are fiscally sustainable and do not represent a contingency for their respective national governments. Colombia is noteworthy because of the thorough and timely monitoring carried out by the Subdirectorate of Fiscal Analysis of the Ministry of Finance and Public Credit (MINHACIENDA), which includes an early warning system that allows corrective measures to be taken against risks. In Peru, legislation on subnational fiscal discipline was implemented proactively from the beginning of the decentralization, with successive modifications that have perfected the fiscal rules. In Ecuador, limits were established on the volume and service of the public debt. If they are exceeded, it is mandatory to adopt plans for fiscal strengthening and sustainability, which must be approved by the Ministry of Economy and Finance. In 2016, after some specific episodes of over-indebtedness, Mexico approved the Financial Discipline Law of the Federative Entities and Municipalities, which includes requirements to strengthen the accounting and budgetary transparency of subnational governments.

FIGURE 1.4 - Latin America (12 countries): Public Expenditure of Subnational Governments, 1985–2019 (as a percentage of aggregate government expenditures)



Sources: Authors' elaboration based on official country information, Fretes et al. (2018), Talvi et al. (1997), and Daughters and Harper (2007).
Note: The sample for this figure comprises the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, El Salvador, Guatemala, Mexico, Paraguay, Peru, and Uruguay.

FIGURE 1.5 - Latin America (12 countries): Size and Financing of Subnational Expenditure, 2000–2019 (simple averages as a percentage of GDP)



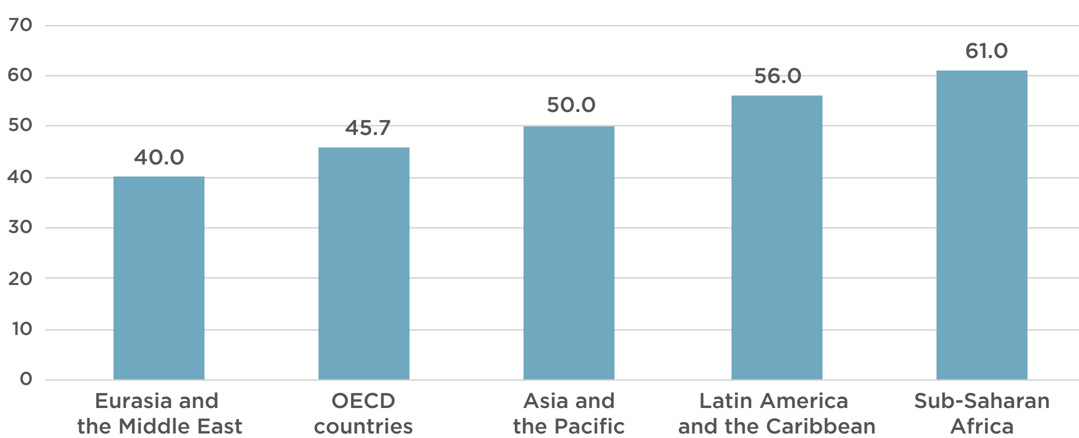
Source: Authors' elaboration based on official country information.
Note: The sample for this figure comprises the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, El Salvador, Guatemala, Mexico, Paraguay, Peru, and Uruguay.

CURRENT SITUATION[3]

A traditional challenge for the sector is that the financing structure of subnational governments creates a high dependency on transfers (see Figure 1.5). Between 2002 and 2019, the average subnational government expenditure as a percentage of GDP increased by more than 2 percentage points, due mainly to higher transfers and to a lesser extent to subnational governments' own revenues. Transfers grew sharply in the 2000s, especially in the Andean countries, linked to the exploitation of natural resources, with specific allocation to capital expenditure. This high reliance on transfers led subnational governments to finance a significant portion of their spending without incurring a fiscal effort of their own, reducing their incentives to manage efficiently, be accountable, and be fiscally responsible (Ardanaz and Tolsá, 2016; Stein, 1998; Weingast, 2009).

Subnational government dependence on transfers in the region (56 percent) is higher than that recorded in OECD countries (46 percent) and other regions in development, except for Africa. While at least 10 of the 16 Latin American and Caribbean countries analyzed show imbalances above 50 percent, this only occurs in 4 of the 38 OECD countries (see Figure 1.6).

FIGURE 1.6 - Transfers to Subnational Governments, by Region of the World (as a percentage of financing of subnational expenditure)



Sources: Authors' elaboration based on official country information, OECD (n.d.), and OECD/UCLG (2019).
Note: The data for Latin America and the Caribbean and the OECD correspond to 2019; for other regions data is from 2016. In some countries, OECD data may underestimate fiscal dependence, as they consider some co-participation revenues to be those of subnational governments.

3 The sample of subnational governments includes the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Peru, and Uruguay. The averages of the graphic elements may not match due to differences between the samples.

RECENT TRENDS

After the decentralizing impulse of the countries with the largest population and territory of the region, which lasted until 2010, the share of subnational governments' spending as a percentage of general government spending has stabilized. At the institutional level, however, several countries undertook reforms linked to relations between levels of government. In this regard, Uruguay is noteworthy for having created the municipal government level, with spending functions still incipient (2009); Ecuador and Paraguay reformed their transfer systems (2010). In Panama, resources from property tax collected at the central level (2015) were allocated to the municipalities, and Chile is in the process of decentralizing spending functions to the regions (intermediate level). In the Caribbean, Jamaica implemented laws aimed at improving the institutional framework that regulates the revenue and expenditure functions of municipal governments.

The biggest recent challenge for subnational finance has been how to address the impact of the COVID-19 crisis, as will be discussed in Chapter 2. Although the information is preliminary, the crisis has worsened subnational fiscal performance by requiring higher current expenditures by subnational governments, at a time when their own revenues have fallen substantially, often more than for the central government. While in the larger countries transfers were maintained and even increased to sustain subnational spending linked to the emergency, in others they were cut or significantly delayed, putting the financing of essential services provided by subnational governments at risk. At the same time, the postponement of investments by subnational governments to redirect these resources to address the pandemic implies a cost in terms of economic reactivation and reduction of development gaps.

Expenditure by Subnational Governments

AGGREGATE EXPENDITURE

Subnational governments in the region provide goods and services that contribute to the daily well-being of the population. At the municipal level, these include improvement of public spaces, waste collection, sweeping and cleaning, local transportation, street lighting, and issuance of building and operating permits. At the intermediate level, they include education, health, and citizen security services, among others. Public spending by subnational governments in Latin America and the Caribbean is highly heterogeneous across countries, ranging from less than 1 percent of GDP in some Caribbean countries to more than 20 percent of GDP in Argentina and Brazil.

In countries with an intermediate level of government that has political autonomy and spending functions, the largest proportion of spending as a percentage of GDP corresponds to Argentina and the lowest to Uruguay, although in the latter the intermediate level is more like a municipal level, due to the functions assigned. At the local level there is great variety, with countries such as Panama and the Dominican Republic (whose local administrations execute less than 1 percentage point of GDP), while, at the other extreme, Brazil (which has the largest local public sector in the region), Bolivia, and Colombia account for more than 6 percent of GDP (see Table 1.3).

TABLE 1.3 - Latin America (16 countries): Composition of Subnational Public Expenditure, 2015–2019 Average (as a percentage of GDP)

A. Intermediate governments

COUNTRY	TOTAL EXPENSES	WAGES AND SALARIES	OTHER CURRENT EXPENDITURE	CAPITAL EXPENDITURE	INTERESTS
Argentina	17.3	8.1	6.6	2.1	0.5
Bolivia	2.5	0.3	0.4	1.7	0.0
Brazil	12.4	5.9	5.2	0.7	0.6
Colombia	5.0	0.3	3.4	1.3	0.0
Mexico	9.5	2.1	6.8	0.5	0.2
Peru	4.2	2.2	1.1	0.9	0.0
Uruguay	3.8	1.5	1.7	0.6	0.0
Average	**7.8**	**2.9**	**3.6**	**1.1**	**0.2**
Maximum	**17.3**	**8.1**	**6.8**	**2.1**	**0.6**
Median	**5.0**	**2.1**	**3.4**	**0.9**	**0.0**
Minimum	**2.5**	**0.3**	**0.4**	**0.5**	**0.0**

B. Local governments

COUNTRY	TOTAL EXPENSES	WAGES AND SALARIES	OTHER CURRENT EXPENDITURE	CAPITAL EXPENDITURE	INTERESTS
Argentina	3.5	1.8	1.1	0.6	0.0
Bolivia	7.3	1.2	3.2	2.8	0.0
Brazil	8.5	4.3	3.6	0.5	0.1
Chile	3.7	2.0	1.4	0.3	0.0
Colombia	6.5	0.5	4.4	1.5	0.1
Costa Rica	1.6	0.5	0.5	0.6	0.0
Dominican Republic	0.4	0.2	0.1	0.1	0.0
El Salvador	3.1	1.0	0.9	1.0	0.2
Guatemala	2.3	0.5	0.4	1.4	0.0
Honduras	2.8	...	1.1	1.8	0.0
Mexico	1.9	0.7	0.7	0.5	0.0
Nicaragua	3.2	0.7	0.8	1.7	0.0
Panama	0.5	0.2	0.2	0.1	0.0
Paraguay	1.5	0.5	0.5	0.4	0.1
Peru	3.6	0.4	1.3	1.9	0.0
Average	**3.4**	**1.0**	**1.3**	**1.0**	**0.0**

(Continued on the next page)

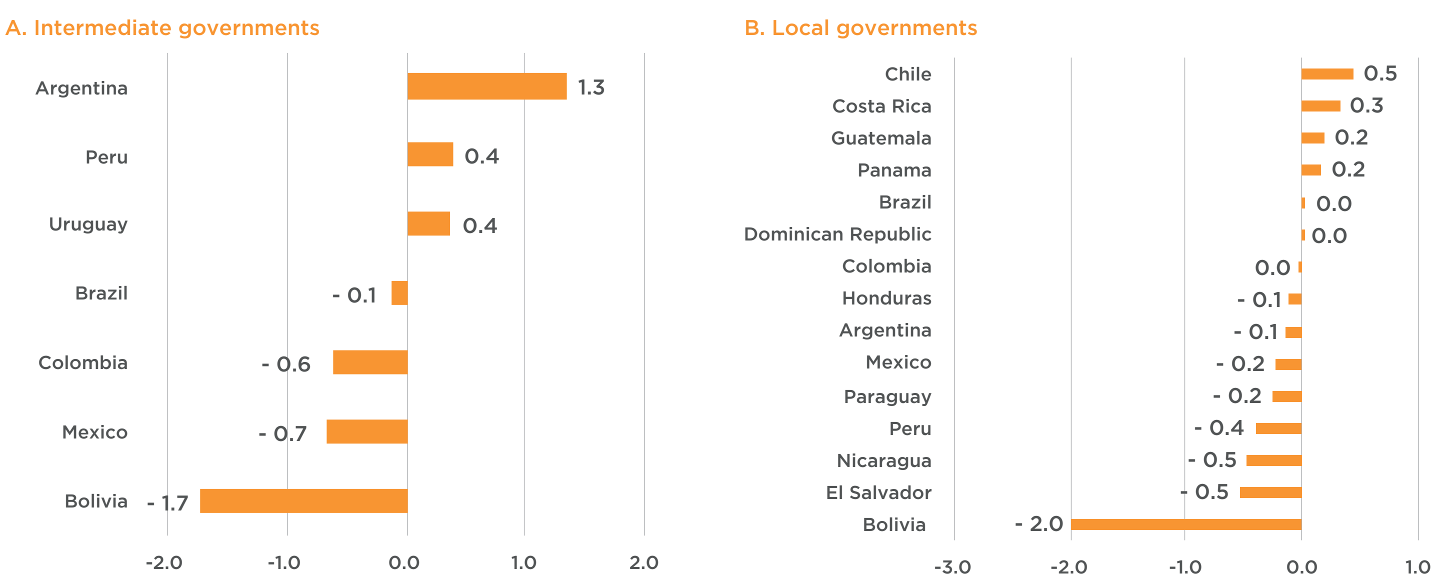
TABLE 1.3 (continued)

Maximum	8.5	4.3	4.4	2.8	0.2
Median	3.1	0.6	0.9	0.6	0.0
Minimum	0.4	0.2	0.1	0.1	0.0

Source: Authors' elaboration based on official country information.
Note: The average, maximum, median, and minimum levels were calculated without including Honduras, due to lack of information. Detailed data for each of Ecuador's subnational levels of government are not shown, as discrimination by level of government is not publicly available.

The largest increase in spending at the intermediate level of government was recorded in Argentina, while the largest decrease in relative terms was in Bolivia. In local governments, the largest positive variation was registered in the municipalities of Chile, with an increase of 0.5 points of GDP between 2015 and 2019, while the largest decrease was again found in Bolivia, which was affected by the reduction of transfers for natural resources (see Figure 1.7).

FIGURE 1.7 - Latin America (16 countries): Change in Public Expenditure, 2015–2019 (in percentage points of GDP)



Source: Authors' elaboration based on official country information.

COMPOSITION OF EXPENDITURE BY ECONOMIC CLASSIFICATION

The composition of expenditure by economic classification largely reflects the functions assigned to the different levels of government in each country. Thus, in Argentina, Mexico, and Peru (intermediate level), and in Brazil and Colombia (intermediate and local level), expenditure on personnel is particularly important, since in these countries subnational governments are primarily responsible for education and health functions. On average, subnational public investment amounts to 1.5 percent of GDP, equivalent to 31 percent of total expenditure by subnational governments, or one-third of aggregate public investment. In contrast, public investment by subnational governments in OECD countries amounts to 3 percent of GDP, equivalent to 53 percent of aggregate public investment (Allain-Dupré, Hulbert, and Vincent, 2017; OECD, 2018). As a percentage of GDP, the share of public investment is higher in Argentina and the Andean countries. In the Andean countries, this is due to transfers for natural resources, which are usually conditional on capital expenditures (see Table 1.4). Likewise, the weight of capital expenditure as a percentage of total subnational expenditure is highly relevant in Central American countries such as Guatemala, Honduras, and Nicaragua, where the distribution of intergovernmental transfers is conditional on this type of expense. Finally, as a percentage of aggregate capital expenditure, in the largest countries in the region (Argentina, Brazil, Colombia, Mexico, and Peru), as well as Bolivia and Ecuador, subnational public investment exceeds 40 percent of total investment expenditure.

TABLE 1.4 - Latin America (17 countries): Agregate Expenditure Breakdown: Current and Capital, 2015–2019 (in percentages)

	PERCENTAGE OF GDP			PERCENTAGE OF TOTAL SUBNATIONAL EXPENDITURE			CAPITAL EXPENDITURE
Country	**Current**	**Capital**	**Total**	**Current**	**Capital**	**Total**	**As a percentage of aggregate capital expenditure**
Argentina	18.1	2.7	20.8	87.0	13.0	100.0	67.5
Bolivia (Plurinational State of)	5.2	4.6	9.7	52.9	47.1	100.0	46.2
Brazil	19.7	1.2	20.9	94.3	5.7	100.0	42.9
Chile	3.4	0.3	3.7	91.9	8.1	100.0	7.1
Colombia	8.7	2.8	11.5	75.7	24.3	100.0	60.9
Costa Rica	1.0	0.6	1.6	62.5	37.5	100.0	31.6
Dominican Republic	0.3	0.1	0.4	75.0	25.0	100.0	3.1
Ecuador	2.6	2.6	5.3	50.2	49.8	100.0	50.5
El Salvador	2.1	1.0	3.1	67.7	32.3	100.0	25.0
Guatemala	0.9	1.4	2.3	39.1	60.9	100.0	29.8
Honduras	1.1	1.8	2.8	37.2	62.8	100.0	28.1
Mexico	10.5	1.0	11.4	91.5	8.5	100.0	24.4
Nicaragua	1.5	1.7	3.2	46.9	53.1	100.0	37.8
Panama	0.4	0.1	0.5	80.0	20.0	100.0	1.9
Paraguay	1.1	0.4	1.5	73.3	26.7	100.0	21.0
Peru	5.0	2.8	7.8	64.1	35.9	100.0	60.9
Uruguay	3.2	0.6	3.8	84.2	15.8	100.0	27.3
Average	**5.0**	**1.5**	**6.5**	**69.0**	**31.0**	**100.0**	**33.3**
Maximum	**19.7**	**4.6**	**20.9**	**94.3**	**62.8**	**100.0**	**67.5**
Median	**2.6**	**1.2**	**3.7**	**73.3**	**26.7**	**100.0**	**29.8**
Minimum	**0.3**	**0.1**	**0.4**	**37.2**	**5.7**	**100.0**	**1.9**

Source: Authors' elaboration based on official country information.
Note: For comparative purposes, the capital expenditure of the Plurinational State of Bolivia does not include social investment. In the accounting of this country, social investment is part of capital expenditure.

SUBNATIONAL PUBLIC EXPENDITURE FROM A FUNCTIONAL PERSPECTIVE

Unlike the economic classification of expenditure, countries in the region publish less information on subnational spending from a functional perspective. However, subnational governments in the larger countries have more responsibility for social spending.[4] Specifically, a significant part of the expenditure is allocated to education and health. For example, Argentina's provincial governments allocate more than 40 percent of spending to these functions; Brazil's local governments about 50 percent; Colombia's subnational governments more than 50 percent; Mexico's state governments more than 70 percent; and the regional governments of Peru more than 76 percent of total expenditure (see Table 1.5). Within social expenditure, Guatemala's municipal governments allocate more than 30 percent to environmental protection functions. In addition to the five largest countries in the region, Bolivia and Guatemala have concurrent functions in health and education at the subnational level, while Chile executes the basic education function at the municipal level. Several countries in the region have made progress in mainstreaming a gender perspective into subnational public finances (see Box 1.1). Other expenditures at subnational levels include public order and security in the intermediate governments of Brazil (17.5 percent), the provinces of Argentina (10.9 percent), and the states and municipalities of Mexico (8.9 percent and 19.7 percent of total expenditure, respectively), followed by expenditure on urban development at the local level, which includes environmental protection (see Box 1.2) and social security (social protection), especially in Brazil.

TABLE 1.5 - Latin America (5 countries): Composition of Subnational Functional Expenditure (social and other, in percentages)

	ARGENTINA (IG)	ARGENTINA (LG)	BRAZIL (IG)	BRAZIL (LG)	PERU (IG)	PERU (LG)	MEXICO (IG)	MEXICO (LG)	COLOMBIA
Education	28.4	5.6	14.0	26.0	49.4	6.1	53.4	1.0	29.0
Health	17.3	12.4	12.3	24.5	27.2	1.2	16.7	1.0	22.0
Urban Development	5.9	37.9	1.0	12.5	1.2	15.1	0.0	31.8	4.0
Social Protection	15.4	10.5	22.5	11.6	5.7	4.9	0.0	0.0	7.0
Safety	10.9	1.1	17.5	1.4	0.8	5.3	8.9	19.7	2.0
General Public Services	9.7	23.8	27.3	17.2	5.0	29.3	0.0	19.5	13.0
Other Expenditure	12.5	8.7	5.4	6.6	10.8	38.0	21.0	27.0	23.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Authors' elaboration based on official country information.
Note: IG: intermediate government; LG: local government.

4 Based on international standards, it is possible to obtain social spending by combining the following six functions: environmental protection, housing, health, recreation and culture, education, and social protection (European Commission et al., 2009; IMF, 2014).

BOX 1.1 - Latin America: Progress on Mainstreaming Gender in the Public Finances of Subnational Governments

In recent years, it has been widely recognized that fiscal policy is not gender neutral. This awareness has resulted in the adoption of international commitments in favor of women's rights and the construction of public policy frameworks to promote gender equality. These include the actions derived from the 2030 Agenda for Sustainable Development and the Regional Conference on Women in Latin America and the Caribbean.

Initiatives to adopt gender-responsive budgetary measures are often national, although some subnational governments have also made progress in this regard. Specifically, progress is being made on gender-responsive budgeting, an instrument that takes into account differences in the needs, rights, and obligations of women and men, considers the differentiated impact of spending, and seeks solutions to reduce inequalities. The main objectives of gender-responsive budgets are to increase transparency and monitor spending allocations to implement gender-sensitive policies, improve the quality of spending to promote gender equality, and analyze the impact of budgets on gender gaps.

Gender-responsive budgeting has been institutionalized in eight countries in the region (Bolivia, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Peru), incorporating legal mandates that regulate budgetary processes. One noteworthy country in this regard is Bolivia, where changes operate directly at the subnational level and whose Framework Law on Autonomy and Decentralization "Andrés Ibáñez" urges entities to achieve gender equality, incorporate gender categories in the budgetary process, and consider policies, programs, and investment projects in social and gender equity. Specifically, this law establishes that up to 5 percent of intergovernmental transfers may be allocated to nonrecurrent programs to support gender equity.

With respect to the transfer system, the Dominican Republic's conditional transfer system establishes a specific percentage (4 percent of the total) to be used in government programs with a gender perspective.

Regarding subnational government budgeting, it is worth highlighting the government of the state of Guanajuato (Mexico), which has incorporated concepts of gender in public reports and the programmatic structure of the budget and has developed a guide to define budget programs with a gender focus at the municipal and state levels. It requires that units and entities have programs in the field of women and equal opportunities and must administer lists of beneficiaries, submit quarterly reports on the results achieved, and comply with follow-up, monitoring, and performance evaluations. Mexico City is noteworthy for its guidelines for evaluation and accountability with a gender-sensitive approach.

In relation to public procurement, there is a set of subnational policies aimed at the inclusion and economic autonomy of women. In the Autonomous City of Buenos

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Aires, there are planning processes aimed at women, such as the Women's Business Seal and the implementation of networking workshops for women. Likewise, in Cali (Colombia), there are social clauses for the inclusion of women in the planning, bidding, awarding, and execution of public procurement contracts.

Due to the need to accelerate progress on gender equality in intergovernmental fiscal relations, it is important to consider the following recommendations based on the diverse experiences in the region:

- Increase the number of gender-sensitive studies and analyses at the subnational government level.
- Promote incidence analyses of subnational fiscal policy, to gather evidence on the differentiated effects of tax systems and public spending policies on men and women.
- Generate gender-disaggregated tax statistics at the regional and local levels.
- Incorporate a gender perspective at all stages of the budget: formulation, implementation, monitoring and evaluation, and liquidation.
- Generate information on public spending with a gender perspective.
- Include a gender perspective in public procurement processes.
- Strengthen the capacity of control entities to analyze the budget with a gender focus.
- Promote the use of innovative sources of public financing related to closing gender gaps at the regional and local levels.
- Promote the reduction and eventual elimination of gender bias in public revenues, in both the design and implementation of the collection policy.

Sources: Authors' elaboration based on ECLAC (2021a) and Fretes, Pessino, and Rossignol (2021).
Note: On gender biases in Latin American and Caribbean tax systems in general, see Fretes, Pessino, and Rossignol (2021).

BOX 1.2 - Climate Change and Fiscal Decentralization: The Experience of Latin American and Caribbean Countries

The countries of Latin America and the Caribbean have made several commitments to reduce greenhouse gas emissions (Nationally Determined Contributions [NDCs], Agenda 2030, and Sustainable Development Goals [SDG]). To comply with them effectively, coordinated actions between levels of government are required. For this reason, it is necessary to deepen the analysis of the relationship between climate change and fiscal decentralization.

Subnational governments have responsibilities that impact climate change mitigation and adaptation, as well as the management of adverse climate effects. The main responsibilities related to mitigation are planning and territorial planning, the provision of drinking water, solid waste management, and transit and transportation. The spending responsibilities associated with adaptation are land use (building and land

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use codes), resilient public investments, and adaptive recovery. Responsibilities for managing adverse effects is generally shared with other levels of government.

Despite these authorities, subnational governments can levy only a few environmental taxes. The main environmental taxes they charge, both at the intermediate and local levels, relate to the ownership and use of vehicles. Some subnational governments levy taxes on energy, such as the tax on petroleum-based fuels in Argentina and the tax on the environmental impact of motor vehicles in Bolivia. Most subnational governments charge fees for the provision of public services that impact climate (such as for drinking water and solid waste management). Finally, Brazil's states charge a fee for environmental control, and Colombia's local governments can set surcharges on real estate liens, a percentage of which goes to environmental conservation and renewable natural resources.

Regarding intergovernmental transfers, in Nicaragua, municipalities must allocate at least 5 percent of the resources received to the environment. Transfers from nonrenewable natural resources do not have to be used for environmental purposes, although their economic rationale is to compensate subnational governments for negative environmental and social externalities caused by the extraction of natural resources in their territories.

With respect to access to climate finance by subnational governments, the provinces of Jujuy and La Rioja in Argentina[a] and Mexico City have issued subnational green bonds. In 2017, the province of Jujuy raised $210 million to partially finance the Cauchi Solar Park. That same year, the province of La Rioja placed US$200 million to finance the expansion of the Arauco Wind Farm. The government of Mexico City issued two issues of this type of bond, for US$49.3 million (2016) and US$112.6 million (2017), which included categories related to water (flood mitigation), energy efficiency, and clean transportation, among others.[b]

Against this backdrop, there are significant challenges for fiscal relations between different levels of government to contribute to the transition to a low-carbon, climate-resilient economy. The main ones include:

- Strengthening intergovernmental coordination of policies and responsibilities related to climate change and the commitments established in the NDCs.
- Increase the quality of spending through resilient subnational public investments.
- Implement an expanded functional classifier to determine subnational public spending with climate impact; monitor and make its contribution visible.
- Incorporate climate criteria into development and land use plans.
- Improve subnational regulations on building and land use codes.
- Encourage subnational governments to ensure that their own resource collection systems serve the dual purpose of generating their own revenues and encouraging changes to promote sustainable and low-carbon consumption and production patterns.

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BOX 1.2 (continued)

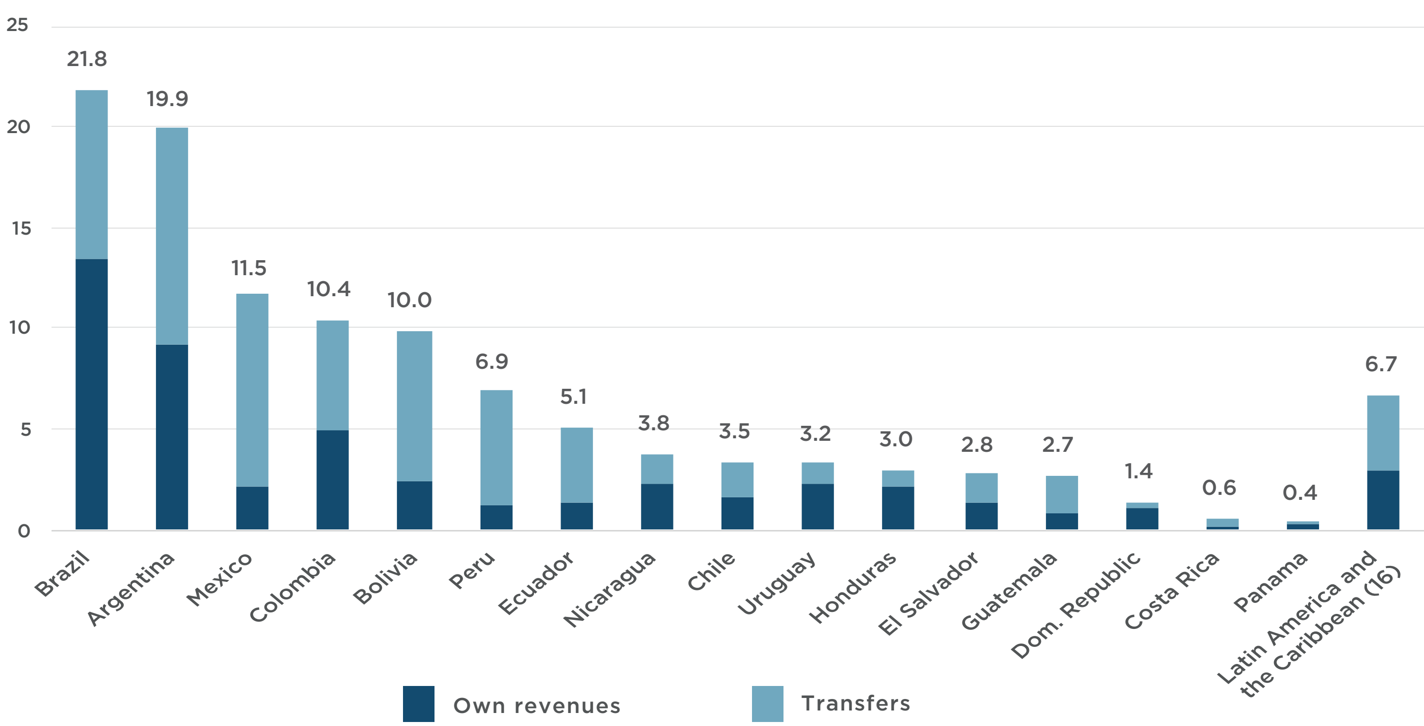
- Adapt local financing frameworks so that subnational governments have responsible access to capital markets through mechanisms such as sustainable bonds, green bonds, or public–private partnerships with environmentally sustainable criteria.

Sources: Authors' elaboration based on Rioja Virtual (2018) and IDB (2021a).
[a] See Rioja Virtual (2018).
[b] See IDB (2021a).

Subnational Income

In aggregate form, the subnational incomes of the countries studied amounted to 6.7 percent of GDP on average between 2015 and 2019. With respect to its structure, 56 percent of this income corresponds to transfers and the remaining 44 percent to own revenues (tax and non-tax) (see Figure 1.8). Own revenues have remained around 2.9 percent of GDP, which is less than that registered in OECD countries, where subnational governments collect more than 5 percent of GDP (ECLAC, 2021a; Gómez Sabaini and Jiménez, 2017). At the regional level, the highest income levels are observed in Brazil's subnational governments, accounting for 21.8 percent of GDP (Figure 1.8).

FIGURE 1.8 - Latin America (16 countries): Subnational Income, 2015–2019 Average (as a percentage of GDP)



Source: Authors' elaboration based on official country information.

The revenue structure of the region's intermediate governments is heterogeneous. In the regional governments of Peru and the autonomous departmental governments of Bolivia, almost all revenues (97.4 percent and 94.5 percent, respectively) come from transfers. Mexico's state governments and Ecuador's decentralized autonomous governments also receive 83.9 percent and 70.1 percent of their revenues in the form of transfers, respectively. In terms of tax revenues, the state governments of Brazil and the departmental governments of Uruguay are noteworthy; respectively, tax revenues represent 62.6 percent and 48.9 percent of total revenues (in the latter case, it increases to 68 percent if non-tax revenues are included). Likewise, in the provincial governments of Argentina and the departmental governments of Colombia, more than a third of their revenue comes from tax collection (to finance broader spending functions in the case of Argentina). The state governments of Brazil collect the highest proportion of tax revenues, at 8 percent of GDP, followed by the provinces of Argentina, whose collection was 5.2 percent of GDP in the period analyzed.

Between 2015 and 2019, local governments reached an average income level of 3.4 percent of GDP. Transfers constituted 1.9 percent of GDP, representing 57 percent of total revenues. On average, tax revenues reached 0.8 percent of GDP, equivalent to 24.1 percent of revenues. The rest of the non-tax and capital revenues accounted for 0.7 percent of GDP, equivalent to 19.2 percent of revenues. Local governments in Brazil have the highest levels of income, at 9 percent of GDP. Brazil also has the highest proportion of transfers at the local level, representing 5.5 percent of GDP. With respect to collection of tax revenues, the municipal governments of Colombia stand out, collecting 2.4 percent of GDP. The weight of transfers is more than 60 percent of total revenues in the municipal governments of Argentina, the municipal autonomous governments of Bolivia, the municipal governments of Brazil, the decentralized municipal autonomous governments of Ecuador, the municipalities of Guatemala, the municipalities of Mexico, the local governments of Peru, and the municipalities of the Dominican Republic. Tax revenues represent more than one-third of total revenues in the municipalities of Chile and Colombia, the local governments of Costa Rica, the municipalities of Nicaragua, and the municipalities of Panama (see Table 1.6).

TABLE 1.6 - Latin America (15 countries): Composition of Subnational Income, 2015–2019 Average (as a percentage of GDP)

A. Intermediate governments

COUNTRY	TOTAL REVENUE	OWN-SOURCE REVENUES		TRANSFERS
		Tax	Non-tax	
Argentina	16.5	5.2	2.7	8.6
Bolivia	2.6	0.0	0.1	2.5
Brazil	12.8	8.0	2.0	2.8
Colombia	4.7	0.8	1.8	2.1
Mexico	9.6	0.7	0.9	8.1
Peru	4.0	0.0	0.1	3.9

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TABLE 1.6 (continued)

Uruguay	3.2	1.6	0.7	1.0
Average	**7.6**	**2.3**	**1.2**	**4.1**
Maximum	**16.5**	**8.0**	**2.7**	**8.6**
Median	**4.7**	**0.8**	**0.9**	**2.8**
Minimum	**2.6**	**0.0**	**0.1**	**1.0**

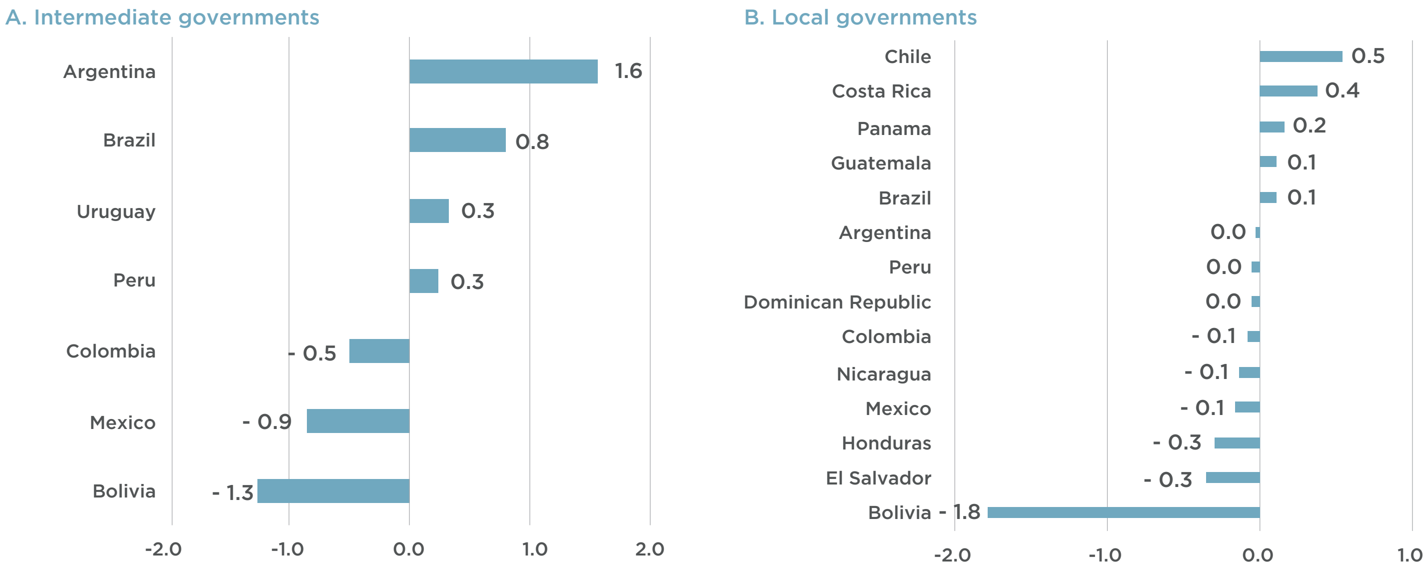
B. Local governments

COUNTRY	TOTAL REVENUE	OWN-SOURCE REVENUES		TRANSFERS
		Tax	Non-tax	
Argentina	3.4	0.1	1.2	2.1
Bolivia (Plurinational State of)	7.4	1.3	1.0	5.0
Brazil	9.0	1.9	1.6	5.5
Chile	3.8	1.6	0.7	1.5
Colombia	5.7	2.4	0.0	3.3
Costa Rica	1.5	0.7	0.4	0.3
Dominican Republic	0.5	0.1	0.1	0.4
El Salvador	2.7	0.4	1.0	1.4
Guatemala	2.4	0.3	0.5	1.6
Honduras	3.0	0.6	1.5	0.9
Mexico	1.9	0.3	0.2	1.5
Nicaragua	3.5	1.3	0.3	1.8
Panama	0.5	0.2	0.1	0.1
Peru	2.9	0.5	0.6	1.8
Average	**3.4**	**0.8**	**0.7**	**1.9**
Maximum	**9.0**	**2.4**	**1.6**	**5.5**
Median	**2.9**	**0.6**	**0.6**	**1.6**
Minimum	**0.5**	**0.1**	**0.0**	**0.1**

Source: Authors' elaboration based on official country information.

Argentina had the largest increase in revenues of intermediate governments, with a positive variation of 1.6 points of GDP between 2015 and 2019. The increase corresponds to non-tax revenues, the magnitude of which offset the reduction in tax revenues and transfers in the period under review. The most marked decreases were registered in the autonomous departmental governments of Bolivia and in the states of Mexico, at -1.3 and -0.9 points of GDP, respectively. At the local level, the municipalities of Chile led the increase in revenues, with an increase of 0.5 points of GDP, followed by the municipalities of Costa Rica, with an increase of 0.4 points of GDP in the period analyzed. The steepest decline was observed in the autonomous municipal governments of Bolivia, with -1.8 points of GDP (see Figure 1.9). This is explained by the reduction in revenues from co-participation, direct tax on hydrocarbons, and royalties.

FIGURE 1.9 - Latin America (15 countries): Change in the Income of Subnational Governments, 2015–2019 (in percentage points of GDP)



Source: Authors' elaboration based on official country information.

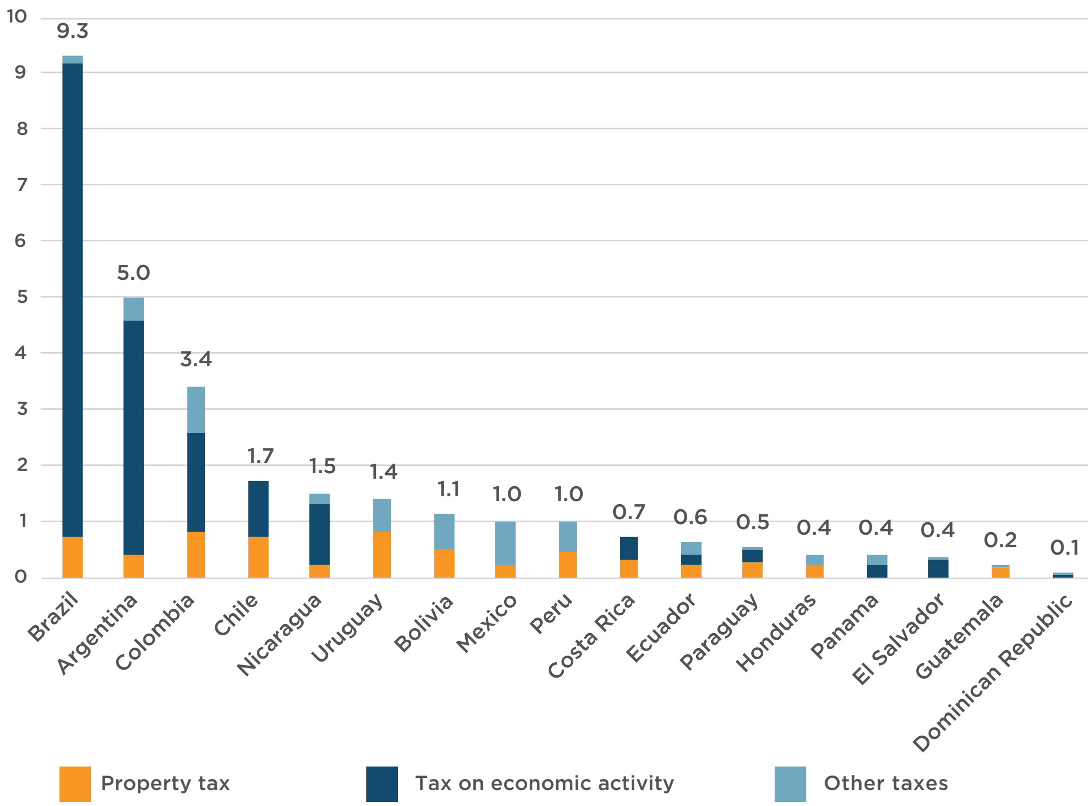
SUBNATIONAL GOVERNMENT REVENUES

In the countries of the region, subnational governments' authority to levy taxes at the intermediate level is generally limited, except in Argentina and Brazil, where intermediate governments tax consumption. Local governments usually have the authority to tax economic activity and assets (land and vehicles). In Argentina, Brazil, Colombia, Mexico, and Peru, the national capital city combines the collection authority of the intermediate and local levels. In the case of Argentina, due to its population size, wealth, and the types of taxes it collects, the Autonomous City of Buenos Aires is unique among Latin American and Caribbean capitals for its collection capacity.

In Brazil, about 92 percent of tax revenues at the state level come from the tax on the circulation of goods and services (ICMS). The ICMS is a tax like the value-added tax (VAT), with different rates depending on the origin and destination of the transaction. In Argentina, more than 80 percent of the tax structure of provincial governments comes from the collection of the gross receipts tax, a distorting tax levied on economic activity at each stage of production. In Mexico, state government tax revenues come mostly from the collection of the payroll tax, which taxes payments for formal work. Finally, in Colombia, the departments charge selective taxes on the consumption of beer, spirits, cigarettes, and tobacco, in addition to motor vehicles and stamps: these taxes are considered "earmarked income" and, unlike what happens in other countries, must be allocated to specific functions, such as health, sports, municipalities, and social assistance, among others.

At the aggregate level, nearly a third of local government tax revenue comes from real estate taxes. In the municipalities of Guatemala, this tax represents more than 80 percent of local tax revenues. They are followed in order of importance by the local governments of Peru, where this type of tax represents more than 55 percent of taxes. With respect to taxes levied on economic activity, in Nicaragua and Panama, all municipal tax revenues come from this type of tax. In Chile (commercial patents) and Costa Rica (taxes on goods and services), these taxes account for nearly two-thirds of tax revenues, and in Colombia, the tax on industry and commerce accounts for 8 percent of municipal revenues and amounts to 22 percent in the Capital District of Bogota. In Panama, taxes on commercial activities and services predominate, as do taxes on industrial activities (see Figure 1.10).

FIGURE 1.10 - Latin America (17 countries): Composition of Tax Revenues, 2015–2019 Average (as a percentage of total)



Source: Authors' elaboration based on official country information.

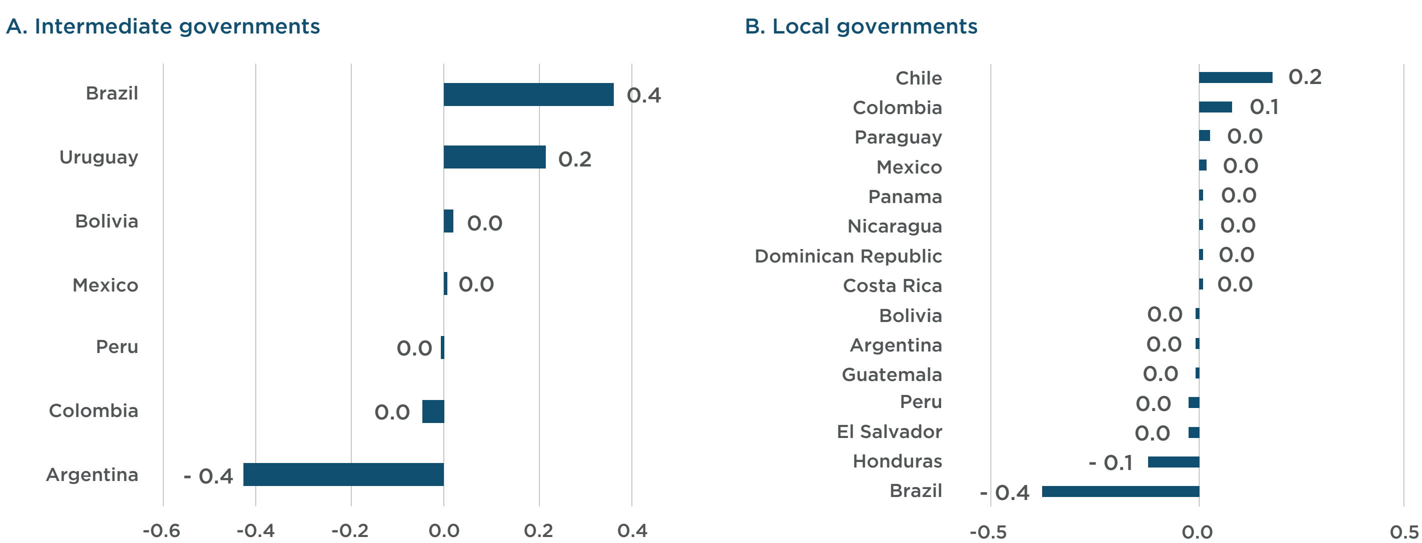
Although in most countries of the region the management of property tax or equivalent is delegated to local governments, the collection of this tax remains centralized in Chile, the Dominican Republic, Guyana, Haiti, and Panama. In Chile and Panama, there are mechanisms for distributing this tax among the municipalities. In the case of Argentina, property tax is collected at the provincial level in almost the entire country, as well as the automobile tax (the so-called patrimonial taxes).

Some innovative mechanisms of subnational tax administration are worth mentioning, such as the dual system of property tax collection implemented in Guatemala.

Municipalities can choose between collecting this tax themselves or adhering to a mechanism offered by the central government so that it collects the tax in their name and subsequently delivers the resources collected minus a service fee. Smaller municipalities with less institutional capacity are most likely to benefit from this mechanism. To solve the problem of erosion of the tax base of the automobile tax due to competition between departments to attract taxpayers, Uruguay created a Single System for the Collection of Vehicle Income (SUCIVE), through which the definition of the tax base and its collection were centralized in a trust, substantially improving its collection. In 1997, 10 Tax Administration Services (SAT) were created in Peru, which has semi-autonomous tax collection entities at the municipal level. Initial results indicate better collection compared to municipalities without SAT. Horizontal intermunicipal redistribution mechanisms in Chile, Panama, and Paraguay are also worth mentioning. In these, a portion of the income obtained through property tax is divided among local governments (and in Paraguay, also among intermediate governments).

With respect to the evolution of tax collection by intermediate governments in recent years, the highest growth was registered in the state governments of Brazil, where tax revenues increased almost 0.4 percentage points of GDP between 2015 and 2019, an increase attributable to improvements in tax administration. Provincial governments of Argentina experienced the steepest decrease, of 0.4 points of GDP. In the state governments of Mexico and the departmental governments of Colombia there were no considerable variations during this period. In local governments, the average variation between countries increased slightly amounting to just 0.01 points of GDP between 2015 and 2019. The increase in the local governments of Chile was noteworthy, amounting to 0.2 points of GDP. On the other hand, the largest decline occurred in Brazil's municipal governments, falling by 0.4 points of GDP (see Figure 1.11).

FIGURE 1.11 - Latin America (16 countries): Change in Tax Revenues, 2015–2019 (in percentage points of GDP)



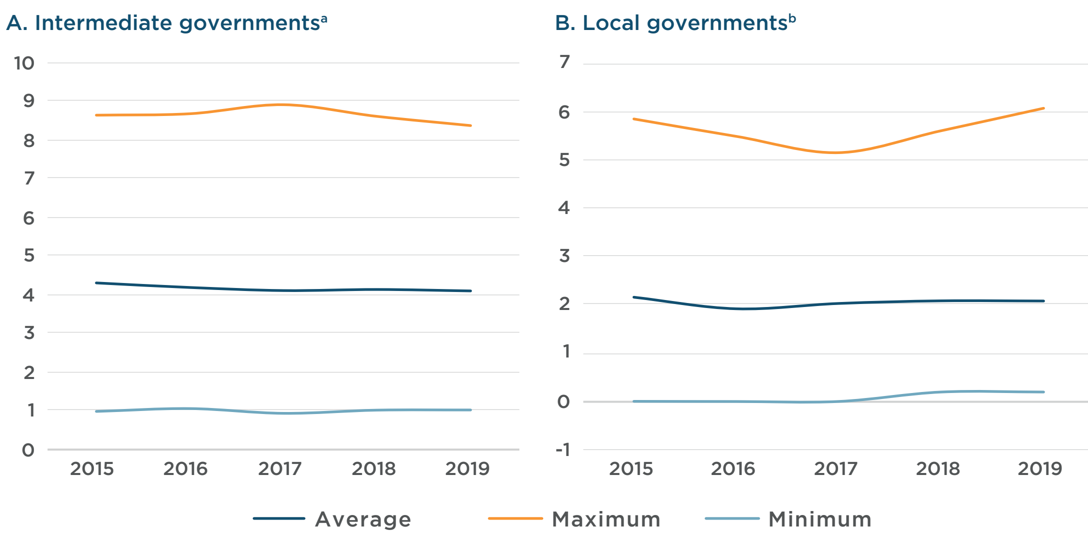
Sources: Authors' elaboration based on OECD et al. (2018, 2020).

TRANSFERS TO LATIN AMERICAN SUBNATIONAL GOVERNMENTS

Transfers to the subnational governments of the countries studied amount to 3.7 percent of GDP, equivalent to 56 percent of their total revenues. In intermediate governments, transfers averaged 4 percent of GDP. This value remained constant during the period under review. The maximum levels were recorded in the provinces of Argentina, where transfers amounted, on average, to 8.6 percent of GDP in the period 2015–2019. In local governments, transfers averaged 2.1 percent of GDP, a figure that remained constant in the analysis period. The highest level of transfers, 5.5 percent of GDP, was recorded in the municipal governments of Brazil. In the autonomous municipal governments of Bolivia, income from transfers amounted to around 5 percent of GDP. These revenues include royalty systems and tax sharing (see Figure 1.12).

Good practice assumes the principle that financing follows function—that is, that transfers cover the estimation of the so-called fiscal gap, defined as the difference between the cost of providing services (expenditure needs) and the collection potential of subnational governments (fiscal capacity), compensating subnational governments based on this gap. Likewise, some transfers are conditional on subnational governments implementing national objectives and complying with standards of service and sectoral infrastructure and compensatory transfers to cover, for example, the costs of extractive activities (social, environmental, and necessary costs to facilitate such activity).

FIGURE 1.12 - Latin America (15 countries): Evolution of Transfers to Subnational Governments, 2015–2019 (as a percentage of GDP)



Source: Authors' elaboration based on official country information.
[a] At the intermediate level, the countries are Argentina, Bolivia, Brazil, Colombia, Mexico, Peru, and Uruguay.
[b] At the local level, the countries are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, and Peru.

In practice, transfer systems in Latin America and the Caribbean are rarely based on an estimate of the fiscal gap, or on the cost-of-service coverage, and they often lack regular estimation and updating mechanisms, which reduces their effectiveness.

Most countries have tax sharing systems based on a percentage of the revenue collected at the central level. This is true of almost all Central American countries (10 percent of revenues), Ecuador (territorial equity model provides for co-participation with respect to 21 percent of permanent revenues and 10 percent of nonpermanent revenues), Uruguay (3.33 percent of the five-year budget), Argentina (co-participation of the provinces is based on percentages of the main national taxes), Brazil (for the definition of the Participation Fund of the States and the Federal District [FPE] and the Participation Fund of the Municipalities [FPM]), Peru (the Municipal Compensation Fund [FONCOMUN] is based on two collection points of the General Sales Tax [IGV]), and Mexico (the General Fund of Participations receives a percentage of the collection of different federal taxes), among others. For many years, Colombia separated its main transfer (General System of Participations of Departments, Districts, and Municipalities) from current revenues through a formula of growth of this mass of resources. Chile, Panama, and Paraguay have a solidarity system, whereby a fraction of the property tax is divided among all municipalities. In the case of Paraguay, where the collection of this tax is decentralized (in Chile and Panama it is collected at the central level), a fraction of the municipalities is also transferred to the departments (co-participation "upwards"). Paraguay is also the only country where the main co-participation systems are based on the tax revenues of hydroelectric companies (a natural resource).

No country in the region distributes transfers in a way that compensates for subnational fiscal inequalities, based on the explicit estimation of the fiscal gap, which is the difference between spending needs and subnational fiscal capacity. In other words, in Latin America and the Caribbean there are no explicit systems of matching transfers, which are prevalent in OECD countries. Ecuador is the only country where this type of system is available for the transfer of new responsibilities.[5] Thus, in countries such as Argentina (provinces) and Uruguay (departments), the distribution of transfers is based on fixed coefficients for each subnational government, negotiated politically. Although these coefficients, which began in 1988 in Argentina and in 2005 in Uruguay, are related to historical indicators based on objective and redistributive criteria, they have become obsolete. In most countries of the region, the formulas for the territorial distribution of the co-participation systems include sociodemographic indicators, such as population, poverty, and land area, which make it possible to compensate, at least partially, for existing fiscal disparities. However, one of the criteria applied in several countries (the Dominican Republic, Guatemala, Guyana, Honduras, and Paraguay) provides for the distribution of resources equally among all municipalities. This is not a good practice, because it does not take into account the heterogeneity between subnational governments and encourages the creation of new municipalities to receive the guaranteed minimum income.

In many countries, the use of co-participation systems is conditional on specific expenditure functions. In Colombia, almost all transfers are conditional. In Peru, "regular resources" are conditional on certain functions and projects and mainly finance health and education expenditures of regional governments. In Mexico, federal contributions, which are the second-largest item of transfers to subnational governments, should be used primarily for education, security, and infrastructure. Even in Brazil, at the state level, there are conditional transfers for education (Fund for the Maintenance and

5 Article 206 of the Organic Code of Territorial Organization, Autonomy and Decentralization (Ecuador, 2010).

Development of Basic Education and the Valorization of Education Professionals, or FUNDEB) and health. In Ecuador, a maximum of 30 percent of the transfers of the territorial equity model can be allocated to permanent expenses, and a minimum of 70 percent must be allocated to investment expenses. Some transfers are conditional on public investment for the purpose of convergence or territorial compensation and in many cases are the main source of subnational resources for infrastructure. These include Chile's National Regional Development Fund (FNDR), Uruguay's Interior Development Fund (FDI), Peru's Regional Compensation Fund (FONCOR), and Mexico's Social Infrastructure Contribution Fund (FAIS). Not all of these transfers contribute to reducing interregional inequalities (Muñoz, Pineda, and Radics, 2017).

In the last two decades, transfers linked to natural resources, mainly minerals and hydrocarbons, have gained importance in several countries of the region because of the boom in raw materials. In 2019, these represented 22 percent of the total subnational income of Bolivia and reached 57 percent in the departments. That same year, in Peru, they constituted 17 percent of subnational revenues and reached a third of the total for municipalities. In Paraguay, transfers linked to tax revenues from hydroelectric companies account for 65 percent of total transfers. Ecuador gives 10 percent of transfers for nonrenewable resources to subnational governments. In general, these resources are devolutive in nature (they are allocated to the subnational governments in the places where the resource is extracted) and their use is usually conditional on the realization of public investments. The high volatility of commodity prices, their geographical concentration, and the fact that they exacerbate inequality in terms of resources per capita pose challenges to the management of these resources.

Finally, many countries in the region allocate transfers on a discretionary basis, both for current and investment spending. This is not a good practice, as it detracts from transparency and predictability, can be used politically, and can discourage the government's own fiscal efforts. Other examples of these transfers include discretionary transfers in Mexico, which account for 18 percent of total transfers (trending downward); nonautomatic transfers from Argentina (19 percent of total transfers); and regular resources for regional and local governments in Peru (beyond transfers to finance social spending). In some Caribbean countries there is also a prevalence of discretionary transfers from the central level.

Like other aspects of intergovernmental finance, reforming transfer systems is politically difficult due to the existence of winners and losers, both among government levels and among subnational governments themselves. However, it is worth mentioning the case of Ecuador, where in 2010 the entire transfer system was reformed, by eliminating about 19 laws that established co-participation with respect to central government revenues and establishing a system with three types of transfers: a territorial equity model for current competences, a system for new competences, and transfers for the exploitation of nonrenewable resources (Almeida and Burgos, 2016).

In some cases, decentralization has been confused with increasing transfers, without respecting the principle that resources follow function. In many countries, this helps explain the high dependence on transfers from subnational governments, which becomes very difficult to reverse (Fretes et al., 2018). This dependence generates problems of efficiency of expenditure (Ardanaz and Tolsá, 2016; Gadenne, 2017), accountability

(Martinez, 2019; Brollo, et al., 2013), and fiscal sustainability (Stein, 1998; Rodden, 2002, 2003), since the main source of subnational resources does not come from the local fiscal effort but from that of the rest of the country through national taxes.

Regarding the redistributive performance of transfers in Latin America and the Caribbean, co-participation systems generally tend to reduce fiscal disparities in own revenues among subnational governments. They do so incompletely, since they distribute resources in equal proportion to entities with high and low fiscal capacity, without considering measures of fiscal capacity. On the contrary, other systems, such as those for the transfer of capital and natural resources, tend to widen these disparities, as they do not consider the fiscal capacity of the entities receiving the transfers. Equalization transfers are prevalent in OECD countries and contribute to reduce subnational fiscal disparities, as opposed to transfer systems in Latin America. This suggests the desirability of promoting reforms and increasing the technical capacities of the countries of the region to estimate and improve transfer systems, to increase their distribution capacity among subnational governments (Muñoz, Pineda, and Radics, 2017), and to create spaces for political dialogue with decision makers, including the legislative branch, which is where legal reforms are developed.

Subnational Government Debt in Latin America

In most countries, indebtedness is allowed at the subnational level, with varying degrees of autonomy from the national government. As a result of the adoption of fiscal responsibility laws in the region, surveillance and supervision by central authorities has increased in recent years. Legally, indebtedness to multilateral development organizations is allowed, with the endorsement of the national government, in practically all countries of Latin America and the Caribbean, except for Mexico, where all external financing is prohibited. In the recent period, average subnational government debt was around 3 percent of GDP. For reference, subnational debt in OECD countries amounts on average to 12 percent of GDP (OECD, 2020a).

Brazil's state governments have the highest levels of debt (11.1 percent of GDP), a figure nine times higher than that recorded in the country's local governments (1.2 percent of GDP). They are followed, in order of importance, by Argentina, with a provincial debt burden of 6.3 percent of GDP, and Colombia, where aggregate subnational government debt was 3.7 percent of GDP in 2019 (see Table 1.7).

TABLE 1.7 - Latin America and the Caribbean (12 countries): Subnational Government Debt, 2015–2019 (as a percentage of GDP)

COUNTRY	2015	2016	2017	2018	2019
Argentina	4.5	5.5	6.3	7.6	7.4
Bolivia (Plurinational State of)	3.2	3.5	3.7	4.2	4.6
Brazil	12.9	11.9	12.0	12.4	12.3
Chile	0.02	0.02	0.03	0.03	0.03
Colombia	3.4	3.1	3.1	3.3	3.7

(Continued on the next page)

TABLE 1.7 (continued)

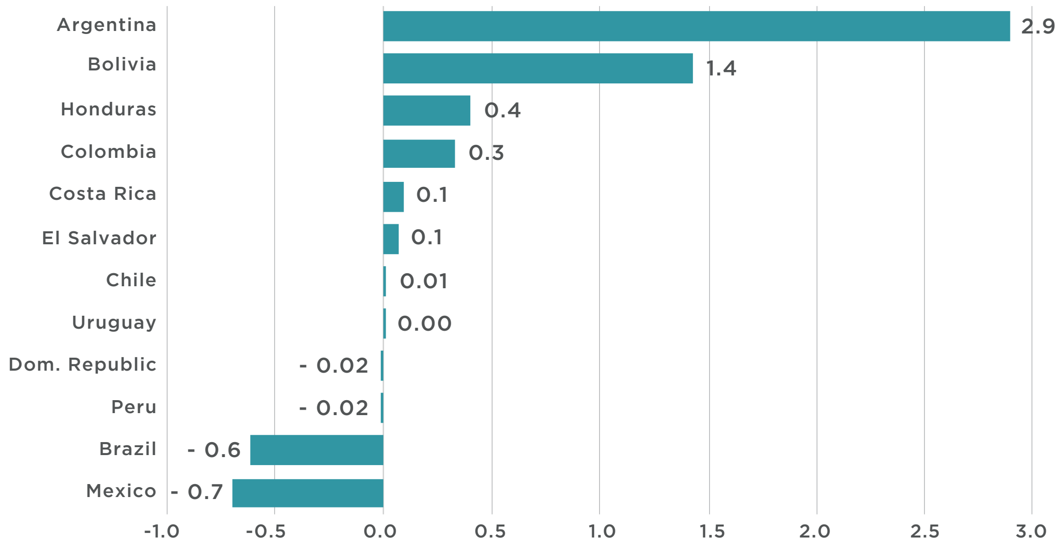
Costa Rica	0.2	0.2	0.2	0.2	0.2
Dominican Republic	0.04	0.03	0.02	0.02	0.02
El Salvador	2.1	2.1	2.1	2.0	2.2
Honduras	2.0	1.8	2.2	2.4	2.9
Mexico	3.1	2.8	2.6	2.5	2.4
Peru	0.5	0.6	0.3	0.5	0.5
Uruguay	0.2	0.2	0.2	0.2	0.2
Average	**2.7**	**2.6**	**2.7**	**3.0**	**3.0**
Median	**2.1**	**2.0**	**2.1**	**2.2**	**2.3**
Maximum	**12.9**	**11.9**	**12.0**	**12.4**	**12.3**
Minimum	**0.02**	**0.02**	**0.02**	**0.02**	**0.0**

Source: Authors' elaboration based on official country information.

Latin American countries exhibit heterogeneity regarding the funding sources of subnational governments. In the case of Colombia, Mexico, Peru, and the countries of Central America, the largest source of financing is the banking sector. In the case of Mexico, the national development bank plays a large role, providing approximately 30 percent of credit to the subnational sector. In Argentina, the main source of financing is the national and international bond market. Multilateral development banks have an important presence in Brazil, where they are the largest active lender, given the restrictions on subnational financing resulting from the 1997–2003 bailouts.

Between 2015 and 2019, the largest increase in the volume of debt was recorded in the Argentine provinces (almost 3 percent of GDP). This evolution is due to the opening of national and international markets to Argentine debt during that period. At the other extreme are Mexico and Brazil, with reductions of 0.7 and 0.6 percentage points, respectively. In Mexico, the decrease is due to the implementation of the Financial Discipline Law of the Federative Entities and Municipalities approved in 2016, which resulted in administrative controls and monitoring of credit metrics. In Brazil, the decrease is due to the gradual payment of liabilities to the central government (see Figure 1.13).

FIGURE 1.13 - Latin America (12 countries): Change in Subnational Debt, 2015–2019 (in percentage points of GDP)



Source: Authors' elaboration based on official country information.

In the five most decentralized countries in the region—Argentina, Brazil, Colombia, Mexico, and Peru—fiscal responsibility laws have been implemented for subnational governments. All of these laws seek to limit indebtedness as a proportion of income, although they also monitor idiosyncratic metrics of each country. For example, in Brazil, the fiscal responsibility law limits personnel spending and the level of debt, while in Mexico, unsecured credit is monitored in the short term, as this is the market segment that defaulted in the 2010s. In Brazil, Colombia, Mexico, and Peru, legislation includes timely monitoring through alert systems. A trend to be observed in the region is the pledge or guarantee of transfers from the national government as a source of debt repayment. In the case of Mexico, the subnational debt market operates mainly through this federal transfer pledge: approximately 90 percent of the credits of subnational governments in Mexico are backed by that flow. Other countries where credit markets have evolved in this direction are Uruguay, where the market operates through the pledge of SUCIVE (vehicle ownership tax); Guatemala, although on a very small scale given that the debt market continues to be very short term and through credits without a specific source of payment; and El Salvador, where recently municipal indebtedness grew against resources of the Fund for the Economic and Social Development of the Municipalities (FODES), which is the main transfer entity in that country. However, there is no detailed information on the status of the sources of payment of financing from these countries.

Entities Managing Fiscal Relations among National and Subnational Governments

The Latin American and Caribbean region has many experiences in the management of the fiscal relationship with subnational governments. While ministries of finance play an important role in almost all countries, there are often other entities with relevant responsibilities in defining subnational policies and technical assistance to subnational governments. These include the Ministry of the Interior of Argentina, the Undersecretariat for Regional and Administrative Development (SUBDERE) of the Ministry of the Interior and Public Security of Chile, the National Planning Department (DNP) of Colombia, the Ministry of National Planning and Economic Policy (MIDEPLAN) of Costa Rica, the Ministry of Local Development (MINDEL) of El Salvador, the National Decentralization Authority (AND) of the Ministry of the Presidency of Panama, and the Office of Planning and Budget (OPP) of Uruguay.

Almost all Central American countries have entities responsible for subnational training and technical assistance, including the Instituto de Fomento y Asesoría Municipal (IFAM) of Costa Rica; the Salvadoran Institute of Municipal Development (ISDEM), which also administers the main transfer in that country; the Institute of Municipal Development (INFOM) of Guatemala; the Institute of Municipal Development (IDEM) of Honduras; the Nicaraguan Institute of Municipal Development (INIFOM); the Dominican Municipal League (LMD); and the Institute for the Technical Development of Public Finances (INDETEC) of Mexico. In addition to ministries of finance, most Caribbean countries have a ministry of local governments that manages the provision of public services jointly with local governments. Brazil deserves a separate mention since there are different entities at the central government level with a sectoral logic and collaborative networks between all levels of government.

All Latin American countries and most of the Caribbean countries have groups of subnational governments that manage the interests of the sector before the respective national governments and carry out other functions, such as technical assistance. Some noteworthy examples are the Congress of Mayors of Uruguay, which has constitutional status and articulates the dialogue between the national government and the departmental governments; the National Conference of Governors (CONAGO) and the National Federation of Municipalities of Mexico (FENAMM); the Federal Investment Council (CFI) at the provincial level in Argentina; the Association of Ecuadorian Municipalities (AME); and the Consortium of Provincial Autonomous Governments of Ecuador (CONGOPE). Brazil has active subnational networks that bring together states and municipalities, including at the thematic level in terms of financial and tax administration, among others.

TAX INFORMATION AND TRANSPARENCY OF SUBNATIONAL GOVERNMENTS

In Latin America and the Caribbean, progress has been made in the presentation of public accounting data of subnational governments, a process in which the implementation of integrated financial management systems has been essential. In this regard, Brazil and Peru have complete and timely information from their subnational governments. In Chile, Colombia, El Salvador, and Guatemala, information is also disseminated at the budget line level for subnational governments, at both the intermediate and local government levels. However, significant challenges remain regarding the quality of information: in most countries data remain incomplete and, moreover, are presented at the wrong time, sometimes with opacity and delays of up to more than a year in the publication of information. Similarly, few nations report on budget performance according to a functional or purpose classification. There is a wide range of criteria with respect to the accounting classification of investment expenditure, and few countries provide complete and timely information on the assets and liabilities of their subnational governments.

Chapter 02

The Impact of COVID-19 on Subnational Public Finances in Latin America and the Caribbean

The Impact of COVID-19 on Subnational Public Finances in Latin America and the Caribbean

Strategic Messages

The coronavirus (COVID-19) pandemic has had significant impacts on Latin America and the Caribbean in terms of loss of life, economic contraction and increased poverty, and deterioration of public finances, both nationally and subnationally. Subnational governments were forced to increase their current spending, especially to provide emergency services linked to the pandemic, and to reallocate their capital expenditure in a context of reduced own income due, in part, to tax relief programs for families and businesses.

Many countries in the region, particularly the larger countries where some critical social functions have been decentralized, have maintained and even increased the flow of transfers to subnational governments. This shifted some of the fiscal cost of the crisis to the central government and increased the already high dependence on transfers on the part of subnational governments. Where possible, subnational governments increased their debt levels. In addition, subnational fiscal rules were relaxed in several countries to give subnational governments more opportunities to respond to spending needs caused by the pandemic.

Many subnational governments in the region implemented measures to support the most vulnerable sectors. On their own, or as agents of the central government, they created and expanded programs of transfers, economic support, food assistance, and distribution of basic inputs to the most vulnerable households. To a lesser extent, measures were also taken to provide facilities for the payment of basic services and to grant credit to small and medium-sized enterprises.

The COVID-19 crisis has exacerbated the sector's traditional problems and revealed new ones, including weaknesses in intergovernmental coordination of the pandemic response, which show the need for a new agenda of reform of intergovernmental fiscal relations. For subnational governments, the pandemic resulted in deteriorating public finances, increasing dependence on transfers, and reduced fiscal space for borrowing, in a context of growing territorial inequalities. In addition, it highlighted the need to strengthen intergovernmental coordination mechanisms to respond to future emergencies with greater efficiency and clarity of functions. This requires strengthening subnational public finances in the post-pandemic period and increasing the fiscal equalization capacity of transfer systems. Governing bodies, both in central government and in subnational government associations, should also be strengthened to prepare response plans for future crises and to design and implement an agenda of intergovernmental fiscal relations reforms, including measures to enhance the capacities of subnational governments.

Highlights

The health emergency caused by COVID-19 had an unprecedented immediate impact on the economies of Latin America and the Caribbean. According to various reports (ECLAC, 2021b; IDB, 2021b), the region was the hardest hit in the world in terms of deaths and social and economic setbacks. The region's economic growth was already low before the pandemic, with an annual average of 2 percent in real terms between 2014 and 2019. The arrival of COVID-19 led to measures such as lockdowns, social distancing, and the closure of many economic activities, to which were added the external and internal shocks of supply and demand. All this led to an economic contraction of around 6.8 percent, on average, for the region in 2020 (ECLAC, 2021b) and the loss of around 26 million jobs (IDB, 2021b).

The complex economic scenario increased pressure on public finances. In most countries in the region, national governments implemented important packages of fiscal measures to contain the effects of the pandemic, mainly on the public spending side (ECLAC, 2020; IDB, 2021b). Recent figures from the central governments of 16 Latin American countries show that, on average, spending amounted to 24.7 percent of gross domestic product (GDP) in 2020, following an increase of 3.2 percentage points over 2019. The Caribbean also saw a general increase in expenditures (ECLAC, 2021b).[1]

These increases in spending were not accompanied by an increase in revenue. On the contrary, the tax revenues of Latin American and Caribbean countries fell due to the decline in productive activity and tax relief measures. According to recent figures for Latin America, the average reduction in total income was 0.7 points of GDP, declining from 18.5 percent of GDP in 2019 to 17.8 percent of GDP in 2020. Indeed, tax revenues decreased from 15.3 percent of GDP in 2019 to 14.7 percent of GDP in 2020. As a result, the debt of Latin American countries increased, on average, from 58 percent of GDP at the end of 2019 to 72 percent of GDP a year later (IDB, 2021b). In most Caribbean countries there was a reduction in revenues, which is explained by the decline in tourism and the effect on revenues of the contraction in the price of oil (ECLAC, 2021a).

The pandemic has had a direct impact on subnational governments in the region. Due to the high level of dependence on intergovernmental transfers, the limited capacity to generate own revenues, and the limited additional margin of indebtedness, subnational governments faced difficulties in confronting the demands for social and economic recovery derived from the pandemic. Subnational governments had to meet urgent demands in the context of reduced own income, in part due to tax relief programs for families and businesses. At the same time, the reorientation of the budget to meet the urgent needs created by the pandemic led to the neglect of other budgetary aspects. On the one hand, this led to an increase or maintenance of intergovernmental transfers in several countries in the region, partially shifting the fiscal cost of the pandemic response from subnational governments to the central government. On the other hand, it exacerbated the sector's traditional challenges by increasing dependence on central government transfers and in some cases the debt levels of subnational governments, as well as the relaxation of subnational fiscal rules to increase public spending or indebtedness. Additional pressure on health and social assistance systems from the pandemic limited the provision of local public services. Faced with this complex scenario, existing territorial inequalities have worsened (Jiménez, Muñoz, and Radics, 2021; Bello-Gómez and Sanabria-Pulido, 2021).

1 Suriname, for which data were not available at the time of this writing, is excluded.

The current situation requires greater coordination between national and subnational governments in the region in all phases of the pandemic: immediate response to the emergency, resolution (based on vaccination activities), and, in the future, the necessary adjustment of intergovernmental fiscal measures to address the traditional challenges exacerbated by the crisis and new challenges. Various responses to the pandemic such as the implementation of quarantines, placing limits on regional mobility, the provision of health supplies, the adoption of measures to support the income of households and companies, and even the planning of the post-pandemic economic and fiscal recovery suggest that intergovernmental coordination is crucial in an unprecedented crisis such as COVID-19, which requires action from different levels of government. International evidence indicates that the quality of the response to the crisis does not necessarily depend on the degree of decentralization, as there are good practices in centralized and decentralized countries. What does seem to make a difference is the previous existence of intergovernmental coordination mechanisms that allow agile, but also consensual, decision-making processes between the various levels of government (OECD, 2022).

Beyond intergovernmental coordination mechanisms, subnational governments are at the forefront of containment of the pandemic (ECLAC, 2020; Radics and Rodríguez Ramírez, 2020). They are making innovative decisions, establishing permanent dialogues with national authorities, and adapting methods of providing public services.

Impact of the Pandemic on Subnational Public Finances in Latin America[2]

INTERGOVERNMENTAL COORDINATION TO MITIGATE THE EFFECTS OF THE PANDEMIC

The pandemic tested intergovernmental coordination and demonstrated that such coordination must be improved to meet the needs of the population in a comprehensive manner (ECLAC, 2020).

Recently documented experiences in the countries of the Organisation for Economic Co-operation and Development (OECD) indicate that intergovernmental coordination during the emergency was instrumental in (i) increasing available resources to deal with the crisis, which had asymmetrical effects in different regions of each country; (ii) creating economies of scale in the procurement of health supplies and equipment; (iii) communicating in a coherent manner with the public; (iv) efficiently promoting the dissemination of policies and procedures; and (v) strengthening the capacity to respond, especially in large cities (OECD, 2020b) (see summary of coordination measures in OECD countries in Box 2.1).

In Latin America and the Caribbean, incipient evidence suggests that coordination was conducted through two parallel channels: fiscal policy and sectoral policy. On the fiscal policy side, the pandemic forced all levels of government to undertake coordination activities to provide adequate resources to confront the pandemic. Two noteworthy cases are Argentina, where coordination was aimed at ensuring the provision of

2 This section focuses on the analysis of the public finances of subnational governments in the region in four dimensions: (i) intergovernmental coordination, (ii) expenditure, (iii) revenues (own and by transfers from the national government), and (iv) debt levels.

basic goods in the provinces and municipalities, and Mexico, where the distribution of non-earmarked transfers (*participaciones*), which fluctuate with economic activity, was ensured through the Fund for the Stabilization of Income of the Federal Entities (FEIEF), a contingency fund that is unique in the region in that it ensures compensation to subnational governments in case of unexpected intrayear budget drops. In Chile, municipalities created policy dialogue spaces (*mesas*) to coordinate health measures implemented at the central level (for example, the COVID-19 Social Table). Since May 2020, the decentralized autonomous municipal governments of Ecuador have been responsible for adopting lockdown measures according to a traffic light system, reporting to the National Emergency Operations Committee (COE-N). In Peru and the Dominican Republic, central governments created ad hoc committees to coordinate with subnational governments. In Uruguay, coordination forums between the central government and subnational governments that were established before the crisis, such as the Congress of Mayors, were used to discuss and implement actions regarding the pandemic.

BOX 2.1 - Intergovernmental Coordination to Address COVID-19 in OECD Countries

In most OECD countries, existing institutions were used to strengthen intergovernmental coordination, while others created new institutions for this purpose. The success of these entities varied depending on their degree of institutionalization, political weight, and capacity to coordinate the response. In Australia, a country whose territory is divided into relatively few states and which has a long history of intergovernmental cooperation mechanisms, a national cabinet composed of government representatives was created, consisting of central and subnational governments. Austria implemented National Crisis and Disaster Management, an instrument that involves the main authorities of the federal government and the provinces to coordinate responses. In Canada, a committee of deputy ministers of health at the federal, provincial, and territorial levels held regular meetings to address the challenges of the pandemic and share good practices. The exchange of information on COVID-19 cases between levels of government was also systematized in order to increase efficiency of social communication on the state of public health and guide decision making on response actions. In Spain, there are two committees that facilitated coordination of the response to the pandemic: the Conference of Presidents, composed of the President of the Government and the Presidents of the Autonomous Communities, and the Interterritorial Council of the National Health System, consisting of the Minister of Health and Consumption and the competent councilors in matters of health of the Autonomous Communities and Cities with Statute of Autonomy. Finally, it should be noted that, in general, the main activities to address the pandemic were carried out in a coordinated manner between the central government and subnational governments, namely: the management of inputs from health, COVID-19 testing, and lockdown measures (OECD, 2020a, 2022).

(Continued on the next page)

BOX 2.1 (continued)

In urban areas, recent reports underline the importance of intergovernmental coordination as an instrument for coherence and consistency of actions to address the emergency and urbanization process facing each country (OECD/UN-Habitat/UNOPS, 2021). They indicate that dialogue between levels of government is essential for managing capacity in urban hospitals, understanding their needs, and, consequently, designing appropriate legal and financial instruments. In the United Kingdom, the most visible outcome of coordination is the set of funding schemes to help small businesses, channeling the flow of resources through local authorities. In Spain, the role of the Spanish Federation of Municipalities and Provinces (FEMP) in managing the crisis and the agreements reached for post-pandemic recovery actions were noteworthy. Turkey established bodies in each city to monitor the measures taken and, if necessary, to take additional measures to ensure the continuity of local public services (OECD, 2020b).

Sources: OECD (2022, 2020a, 2020b) and OECD/UN-Habitat/UNOPS (2021).

At the sectoral policy level, the pandemic highlighted important challenges facing the countries of the region in the coordination of actions and policy measures, especially in the areas of public health and economic development. In Mexico, the measures taken at the central level (through the General Health Council) were adopted at different times and with different degrees of intensity by the state governments. Likewise, contradictions were revealed in the flow of information for decision making and the granting of social benefits to counteract the economic effects of the pandemic (Trujillo, Bravo, and Romo, 2020; Cejudo et al., 2020). In Colombia, the arrival of COVID-19 caused tensions related to the responsibilities of subnational governments (especially municipalities) and, in some cases, the lack of congruence between the actions of subnational governments and the national government resulted in ineffective responses to alleviate the deepening of territorial inequalities (Bello-Gómez and Sanabria-Pulido, 2021). On the other hand, the situation required different levels of government to coordinate actions to meet the demands in the health sector and the treatment of temporary and permanent refugees (LaForge, 2021). In Brazil, the Crisis Committee for the Supervision and Monitoring of the Impacts of COVID-19 was established without the presence of representatives of state or municipal governments.

Effects of the Pandemic on Public Expenditures

To respond to the crisis according to their financial capabilities, most subnational governments in the region took measures on the expenditure side, which implied a reduction in spending in other areas, specifically public investment. This is explained, especially in the region's largest countries, by measures to maintain spending on social roles and responsibilities, including health emergency response and recurrent expenditures on education, health, and safety. In Argentina, provincial spending decreased by 7.4 percent in real terms compared to 2019, a figure that, disaggregated by type of expenditure, declined further on the public investment side. In Brazil, state and municipal governments together recorded an increase of 3.1 percent over 2019. The total expenditure of the states decreased by 2.2 percent, while that of the municipalities increased by 11.3 percent, driven by capital expenditures for the execution of previously programmed projects (Frente Nacional de Prefeitos, 2021), as well as for the country's electoral cycle, specifically the municipal elections held in November 2020. This difference in performance is explained by the complex fiscal situation of the states, whose own revenues were reduced, while additional spending on health determined the reallocation and reduction of expenses in other areas and municipalities increased their total spending. Both levels of government have concurrent functions for the provision of health services, which led to an increase in their expenses in this area, particularly with regard to the payment of personnel and the purchase of health care supplies. According to data from the Accounting and Fiscal Information System (SICONFI), the fiscal data system of the National Treasury, states increased spending on health by 16 percent, while municipalities increased spending by 8.6 percent.

Ecuador and Chile also recorded reductions in spending of 14.3 percent and 5.2 percent, respectively, which fell more heavily on the capital expenditure side. In the aggregate, Peru's subnational governments recorded an increase in spending of 8.5 percent in real terms, mainly due to the increase in current expenditure over capital expenditure. In Colombia, expenditures decreased by 9.3 percent, mainly influenced by the capital expenditures of the two levels of subnational government.

In Central America, total spending in Guatemalan municipalities fell by 12.7 percent compared to the end of 2019. The reduction occurred to a greater extent in capital expenditure, which fell by 19.5 percent, while current expenditure contracted by 1.4 percent. However, municipalities in that country recorded a significant increase in expenditure aimed at containing the impact of the pandemic through social protection programs (see Table 2.1). Similarly, Costa Rica's subnational governments reduced their expenditures by about 7.7 percent, and those of the Dominican Republic increased them by 4.6 percent, both by adjusting their capital expenditures.

TABLE 2.1 - Latin America (12 countries): Real Change in Subnational Government Expenditures, 2019–2020 (in percentages)

COUNTRY	ACTUAL CHANGE IN TOTAL EXPENDITURE	REAL CHANGE IN CURRENT EXPENDITURE	REAL CHANGE IN CAPITAL EXPENDITURE
Argentina (provinces)	-7.4	-5.6	-23.3
Bolivia	-21.9	n.a.	n.a.
Departmental autonomous governments	-21.9	n.a.	n.a.
Municipal self-governments	21.9	n.a.	n.a.
Brazil	3.1	1.8	25.8
States	-2.2	-2.9	1.7
Municipalities	11.3	9.2	38.1
Chile	-5.2	-4.9	-10.7
Colombia	-9.3	0.4	-32.1

(Continued on the next page)

TABLE 2.1 (continued)

Departments	-8.7	-1.3	-29.6
Municipalities	-9.8	4.2	-38.3
Costa Rica	-7.7	-3.9	-14.4
Dominican Republic	4.6	27.5	-31.4
Ecuador	-14.3	-3.6	-26.2
El Salvador	1.5	-4.1	12.1
Guatemala	-12.7	1.4	-19.5
Paraguay	-19.5	-12.2	-33.6
Peru	8.5	16.1	-7.3
Local governments	8.8	27.1	-9.3
Regional governments	8.3	11.2	-3.6
Average	**-6.7**	**0.9**	**-16.4**
Maximum	**8.5**	**27.5**	**25.8**
Median	**-7.6**	**-2.9**	**-21.4**
Minimum	**-21.9**	**-12.2**	**-36.3**

Sources: Authors' elaboration based on official country information and IMF (2021).
Note: Inflation data for calculating real changes come from IMF (2021). If there are two levels of government, measures of central dispersion (average, maximum, median, minimum) are calculated using national consolidated levels. In the case of Bolivia, no official disaggregated information was found by type of expenditure at the time of the consultation. n.a.: not applicable.

RESPONSES OF INTERMEDIATE AND LOCAL GOVERNMENTS TO THE PANDEMIC ON THE PUBLIC SPENDING SIDE

The main measures taken by intermediate and local governments in the region to deal with the effects of the pandemic are related to the responsibilities of caring for the most vulnerable groups. Detailed information on the actions taken shows that subnational governments created transfer or economic support programs for the poorest households or expanded existing ones. These consisted largely of food assistance and the distribution of basic inputs. To a lesser extent, they took action aimed at postponing or temporarily forgiving payments for the provision of basic services (water, electricity, housing) and granting loans to small and medium-sized enterprises to reactivate local economies.

The subnational governments of Argentina, Brazil, and Chile provided food assistance and support for the care of the elderly, disabled, and children. Governments took massive actions to distribute basic inputs and food. In Chile, municipalities also offered support through the distribution of medical supplies, the provision of lodging services and funeral services, and the payment of basic services. Mexico's subnational governments took similar measures and, in addition to providing direct monetary support and food to vulnerable populations, pregnant women, and nursing mothers, provided credit and microcredit to small and medium-sized enterprises along with support for the procurement of equipment and training scholarships.

In Colombia, to provide support to households, the government decreed that territorial entities should assume partial or full payment of the public cleaning service, taking into account the availability of resources for that purpose and the need to prioritize allocations for people with lower incomes (Colombia, 2020). In Peru, local governments were authorized to procure and distribute necessities from the basic basket to the population in vulnerable situations (MEF, 2020). Health spending was increased through allocations to regional governments, and the expenditure was reallocated to emergency medical care.

In the area of public procurement, Brazil's states intensified the use of online transactions to contribute to the efficiency and transparency of spending and implemented actions that facilitated the comparison of the prices of essential products.

Finally, in the Caribbean, the Caribbean Development Bank (CARIBANK) agreed to provide support to improve the capacity of local governments to manage resources to address the pandemic.[3]

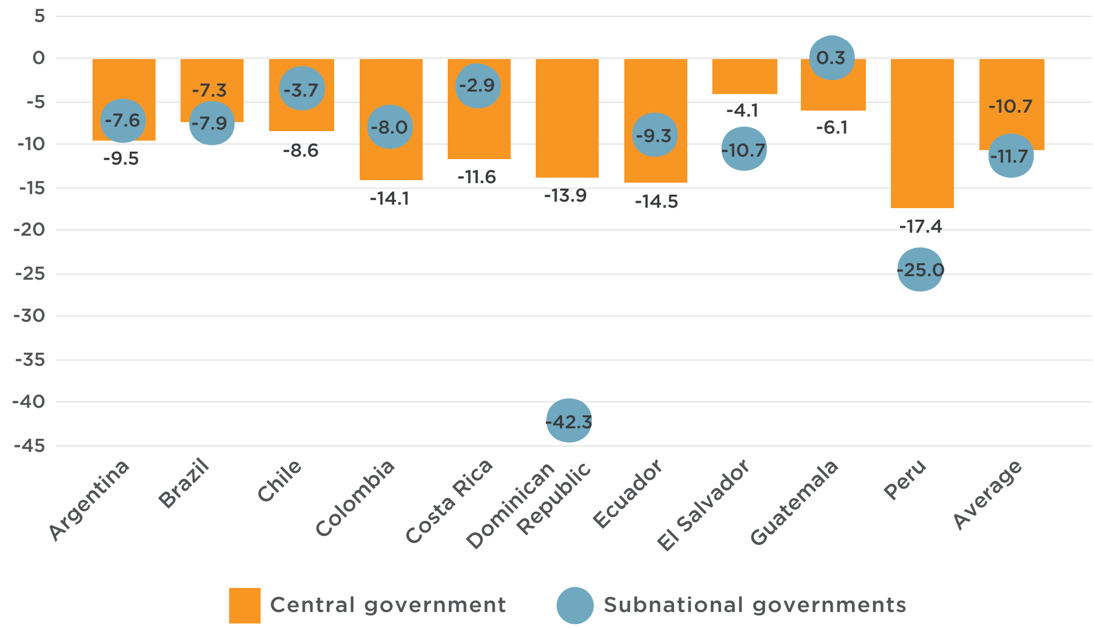
Effects of the Pandemic on Subnational Incomes

Another major effect of the pandemic has been the widespread reduction in tax revenues, both from central and subnational governments. Overall, tax revenues of central governments decreased slightly less than those of subnational governments (10.7 percent vs. 11.7 percent), although with large differences between countries and different levels of government depending on their tax bases and collection capacity, among other factors (see Figure 2.1).

In Central America, the municipalities of El Salvador (which mainly collect fees for services) recorded a reduction in tax revenues of around 10.7 percent compared to 2019. By contrast, the municipalities of Guatemala presented a slight increase of 0.3 percent in real terms. With respect to the Andean countries, tax revenues in the decentralized autonomous governments of Ecuador decreased by 9.3 percent, while the tax revenues of the local governments in Peru fell by 25 percent, both due to the forgiveness of taxes by the authorities and lower compliance by taxpayers.

3 See Commonwealth Local Government Forum (2020).

FIGURE 2.1 - Latin America (10 countries): Real Change in Tax Revenues of National and Subnational Governments, 2019–2020 (in percentages)



Sources: Authors' elaboration based on official country information and IMF (2021).
Note: Inflation data for calculating real changes come from IMF (2021).

In the Southern Cone countries, subnational government income of the provinces of Argentina decreased by more than 7 percent compared to 2019. In Brazil, subnational governments recorded a decrease of 8 percent. Brazil's tax on the circulation of goods and services (ICMS) fell by 5.4 percent, while other state and municipal tax revenues fell further. The relatively moderate reduction in the ICMS is due to the proliferation of digital commerce resulting from the pandemic. Tax revenues collected by Chile's municipalities decreased by 3.7 percent. With respect to property tax, preliminary evidence suggests that, in several countries, municipalities were less affected than the central government due to early tax payment mechanisms. These allowed municipalities to collect the planned amounts during the first two months of the year, before quarantine and lockdown measures were decreed in March 2020. In general, differentiated effects were observed between tax and non-tax revenues, with a greater reduction in the latter.

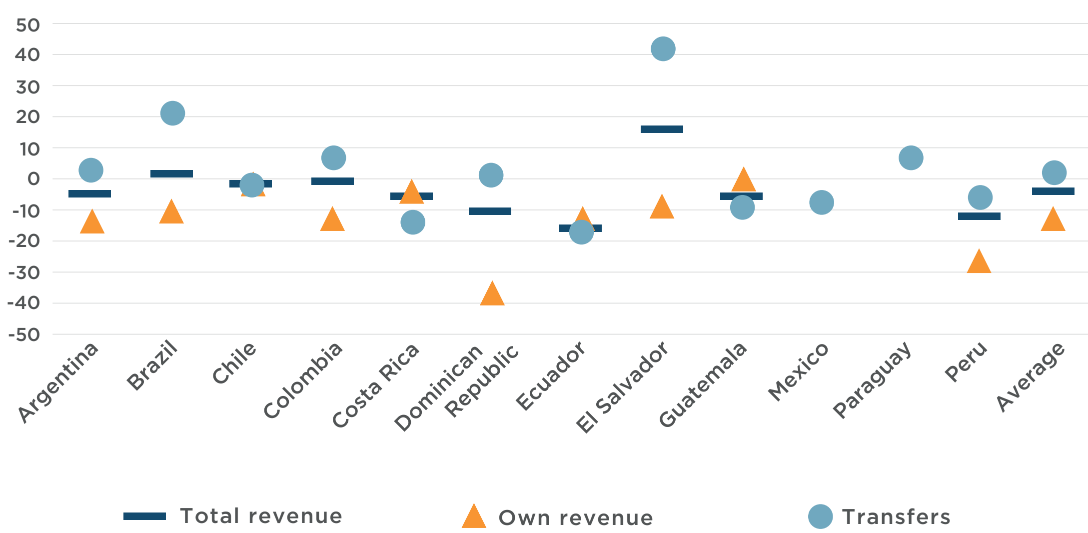
THE ROLE OF TRANSFERS FROM CENTRAL GOVERNMENTS

In this complex scenario, transfers from the central government in many countries contributed to maintaining the level of income needed to contain the socioeconomic effects of the pandemic and reactivate local economies. Actions by central governments to maintain scheduled volumes of transfers to subnational governments include reallocating spending from the central government in Brazil, Chile, and Honduras; the relaxation of the criteria for the use of royalties in investment to address the emergency in Colombia; and the use of income stabilization instruments to maintain the flow of transfers to subnational governments, as was done in Mexico through the Fund for the Stabilization of Income of the Federal Entities (FEIEF) (OECD, 2020a; Radics and Rodríguez Ramírez, 2020).

In general, national governments took steps to preserve the flow of transfers to subnational governments based on their fiscal capacities. However, transfers decreased in some countries in the region compared to 2019. In Ecuador and Costa Rica, transfers to subnational governments fell by 17.2 percent and 13.7 percent, respectively. In Guatemala, Mexico, and Chile, they contracted less, by 8.9 percent, 7.7 percent, and 1.7 percent, respectively.

By contrast, due to the recovery of tax revenues during the second half of 2020, Uruguay and the Dominican Republic were able to maintain the flow of transfers in real terms. This also occurred in Argentina, where transfers from the central government increased by 2.6 percent in actual terms. The largest variations were observed in Colombia, Paraguay, Brazil, and El Salvador, where central government transfers registered real increases of 6.5 percent, 6.8 percent, 21.2 percent, and 42.3 percent, respectively. In the case of Paraguay, the increase was due in part to the passage of Law No. 6.641, which authorized special transfers to the departments (intermediate level) (Paraguay, 2020). In the case of Brazil, the increase was due to subnational governments' need to finance health expenditures. In Colombia, the increase was mainly due to capital transfers to municipal governments (see Figure 2.2).

FIGURE 2.2 - Latin America (12 countries): Real Change in Subnational Governments' Total Revenues, Own Revenues, and Transfers from National Governments, 2019–2020 (in percentages)



Source: Authors' elaboration based on IMF (2021).
Note: Inflation data for calculating real changes come from IMF (2021).

RESPONSES OF INTERMEDIATE AND LOCAL GOVERNMENTS TO THE PANDEMIC ON THE PUBLIC REVENUE SIDE

The measures adopted most frequently by subnational governments are based on the need to facilitate compliance with the payment of taxes, fees, and public services through installment payments, extension of deadlines, and moratoriums, among others. With regard to benefits aimed at households, Chile extended deadlines for the renewal of circulation permits. In Brazil, state and municipal governments granted various extensions and exemptions from payment of some taxes and public services to vulnerable groups, such as the exemption from the ICMS charge on the electric bill and the suspension—and even prohibition—of cutting off the supply of treated water and electrical energy. In Ecuador, drinking water and electric power companies suspended cutoffs for nonpayment for the duration of the state of emergency. In most Mexican states, measures were implemented to forgive and postpone the payment of the vehicle control tax and, and in the municipalities, facilities were suspended or granted for the payment of property tax or public services such as drinking water.

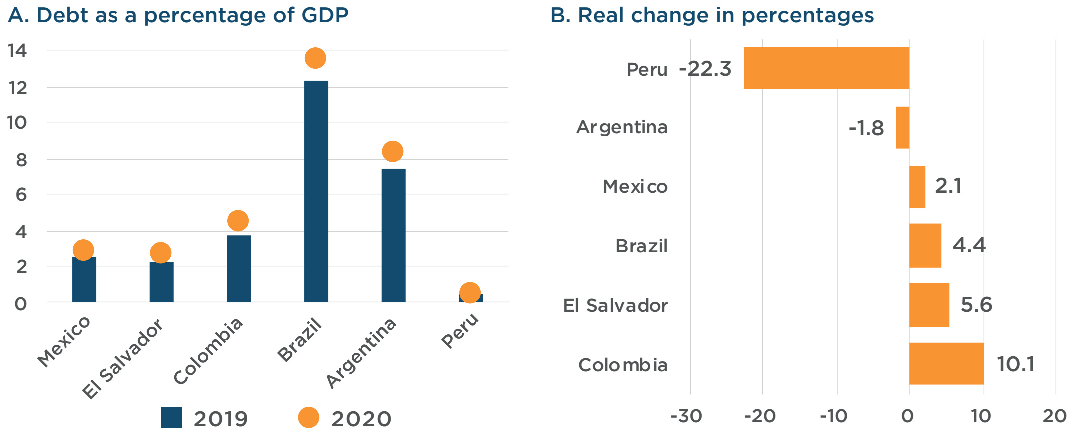
With respect to companies, most Brazilian states applied financial support measures, such as the extension, forgiveness, and reduction of the payment of the ICMS. In Mexico, state governments offered exemptions and extensions to micro, small, and medium-sized enterprises for the payment of subnational taxes, mainly the payroll tax. Low-cost credits were also provided for productive reactivation.

Subnational Debt to Confront the Emergency and Relaxation of Fiscal Rules

According to the available information, debt levels of subnational governments in the region increased overall compared to 2019. This is partly explained by the relaxation of subnational fiscal rules (Peru, Brazil), the need to expand hospital capacity (Mexico), or the electoral cycle (Brazil).

The largest variations were registered in Brazil and Colombia, where debt in 2020 increased by 1.1 and 0.7 percentage points of GDP, representing an increase of 4.4 percent and 10.1 percent, respectively, in real terms compared to 2019. In El Salvador, municipal debt rose by 0.4 points of GDP, equivalent to an increase of 5.6 percent in real terms. This increase was largely due to the consolidation and restructuring of liabilities (refinancing debt with suppliers and obtaining grace periods accompanied by increases in debt levels) and, to a lesser extent, to infrastructure projects (Ministry of Finance of El Salvador, 2021). In Argentina, provincial debt increased by 0.8 points of GDP compared to 2019, which in real terms corresponds to a decrease of 1.8 percent (considering the sharp contraction of GDP in 2020). In Mexico, subnational debt (states and municipalities) increased by 0.3 points of GDP, with a real variation of 2.1 percent compared to 2019. Finally, Peru's regional and local government debt decreased considerably by 22.3 percent in real terms, which is mainly explained by a reduction in the volume of debt of the Municipality of Lima (see Figure 2.3).

FIGURE 2.3 - Latin America (6 countries): Debt and Real Change, 2019–2020 (as a percentage of GDP and in percentages)



Sources: Authors' elaboration based on official country information and IMF (2021).
Note: GDP values are at current prices.

Various actions have also been observed in relaxation of the fiscal rules in force at the subnational level. In Peru, Emergency Decree No. 024-2021 suspends the provisions contained in the Framework of Fiscal Accountability and Transparency of Regional and Local Governments with respect to corrective measures for noncompliance with fiscal rules, as well as the complementary provision that establishes compliance with tax rules as a requirement for entering into public-private partnership contracts or an agreement of works for taxes (*convenio de obras por impuestos*). At the same time, an exception to the maximum limit determined for the incorporation of higher public revenues from sources of financing other than regular resources, such as mining royalties, was established to devote these resources to the prevention, control, diagnosis, and treatment of COVID-19 (Peru, 2021). Article 21 of Law No. 27.591 of the 2021 budget of Argentina suspends the limits established in the Federal Regime of Fiscal Responsibility with respect to the use of the proceeds of the sale of fixed assets in current expenditure and indebtedness (Argentina, 2020). Brazil took measures to suspend the debt service payments of subnational governments to the central government and to analyze the possibility of these governments renegotiating debt payment with banks. In Ecuador, the Organic Law on Humanitarian Support to Combat the Health Crisis Derived from COVID-19 establishes the possibility of increasing the debt limits of subnational governments for drinking water, sewerage and integrated solid waste management, and rural development projects within three years after the end of the state of emergency due to COVID-19 (Ecuador, 2020).

Transparency of Measures to Support the Population

This section considers several experiences of compiling and disseminating actions undertaken by subnational governments in the region throughout 2020. The cases of Brazil, Peru, Guatemala, and Mexico are noteworthy.

In Brazil, the National Treasury compiles the spending measures that subnational governments have implemented to mitigate the effects of the pandemic on the population. In addition, the public finance team of the Getulio Vargas Foundation and the Brazilian Institute of Economics (IBRE) conducted surveys among the population to examine the actions of the state and federal governments with respect to the health emergency within the framework of the Fiscal Policy Observatory project. The actions implemented range from lockdowns and financial assistance to companies to the distribution of basic food baskets, extending the payment of public services, purchasing medical materials, and hiring health personnel, among other relevant measures.[4]

In Peru, the Ministry of Economy and Finance presents budget information related to COVID-19 in the Friendly Consultation module of the Economic Transparency Portal, in which, for 15 years, the Peruvian government has presented real-time information on budget execution at the budget line level. The site dedicated to COVID-19 includes a budget tracking dashboard that links all emergency decrees, supreme decrees, and the reoriented budget to institutions, with their corresponding budgetary impact. Among other classifications, it is possible to analyze the budget by executing institution, regional government, municipality, execution district, program, economic classification, and functional classification.

In the Guatemalan Budget Transparency Portal, the Directorate of Assistance to the Municipal Financial Administration (DAAFIM) presents real-time information on municipal expenditure by department, object of expenditure, functional classification, project, program, and activity. In the current context, this makes it possible to analyze the changes with respect to the budget and the new measures that local governments have adopted to contain the effects of the pandemic.[5]

Finally, in Mexico, the National Laboratory of Public Policies (LNPP), an initiative of the Center for Economic Research and Teaching (CIDE) and the National Council of Science and Technology (CONACYT), developed the Federalism in COVID project, which collects, analyzes, and facilitates the understanding of information on health, fiscal, labor, economic, and social measures implemented by state governments to cope with the pandemic. This project consists of an interactive platform on state policies, including an analysis of social, economic, and regulatory measures. A series of working papers was also published that discusses the set of economic and social policy measures announced by the 32 states of Mexico since the beginning of the pandemic. Federalism in COVID also produced interactive maps to assist in the location of programs by state.

Preliminary Results for 2021

At the close of this publication (March 2022), two countries—Chile and Peru—had information on the fiscal flows of subnational governments for all of fiscal year 2021. Chile's total expenditures grew by 2.2 percent in real terms, driven mainly by capital expenditures (7.1 percent), and revenues increased 3.9 percent, mainly due to an increase of 6.5 percent in own income, which represents a return to pre-pandemic levels. In Peru, expenditures increased by 7.9 percent in real terms, driven mainly by higher capital expenditures (27.4 percent), while revenues were 7.6 percent, induced by the recovery of own income (27.4 percent). The growth rates of these variables observed in 2021

4 See https://observatorio-politica-fiscal.ibre.fgv.br/.

5 See https://transparenciapresupuestaria.minfin.gob.gt/gobiernos-locales/.

are proportional to the declines observed in fiscal year 2020, suggesting that flows are returning to their pre-pandemic levels.

In addition to Chile and Peru, information was gathered on transfers from national governments to their subnational governments for five other countries (Table 2.2). In these countries, transfers to subnational governments in 2021 returned to their pre-pandemic levels. In countries such as Chile, Costa Rica, Mexico, and Peru, where transfers were reduced in 2020, these resources were recovered in 2021. On the other hand, in Brazil, where transfers increased markedly in 2020, a slight decrease in transfers was observed in 2021. Finally, in Argentina, transfers grew in real terms in 2020 and, to a greater extent, in 2021, and in Ecuador, they decreased significantly in real terms in 2020 and less so in 2021.

TABLE 2.2 - Rates of Real Change in Transfers to Subnational Governments, 2019–2020 and 2020–2021 (in percentages)

COUNTRY	2019-20	2020-21
Argentina	2.6	12.0
Brazil	21.2	-2.0
Chile	-1.7	1.0
Costa Rica	-13.7	8.0
Ecuador	-17.2	-1.9
Mexico	-7.7	0.1
Peru	-5.6	5.0

Source: Authors' elaboration based on official country information.

In the cases of Argentina and Ecuador, consolidated information on subnational fiscal flows through the third quarter of 2021 was identified. Compared to the same period in 2020, Argentina's expenses and revenues increased by 5.8 percent and 10.3 percent, respectively, while Ecuador's expenses and revenues increased 9.3 percent and 2.1 percent, respectively.

The Future of Subnational Public Finances in the Post-Pandemic: Lines of Action

The pandemic is having a strong impact on subnational finances in Latin America and the Caribbean. As a result, subnational governments in the region will emerge from this crisis with increased spending needs and dependence on transfers (which was already high before the pandemic), a low allocation of resources for public investment (in the face of growing infrastructure needs), and a greater need to improve the efficiency of spending and to redouble efforts to mobilize own revenues, especially as central governments withdraw their temporary stimulus. In that sense, they will have less fiscal space to borrow, which will make it necessary to strengthen some fiscal responsibility frameworks, depending on the country. As an additional effect of the pandemic, economic and fiscal disparities among subnational governments are widening in some countries. Thus, there is scope to create or strengthen intergovernmental coordination mechanisms and strengthen the redistributive nature of transfer systems with a fiscal equalization objective. In addition, the traditional challenges of the region's subnational sector, linked to low levels of capacity, transparency, and accountability, will remain. All of these are reasons to undertake a strategic reform of intergovernmental fiscal relations, which includes the following lines of action:

i) Prioritization of spending. Deteriorating fiscal performance at the national and subnational levels across the region will require better prioritization of spending in two dimensions. First, the announced gradual reduction of transfers received by many subnational governments in the context of emergency response, as well as the stimulus measures of the subnational governments themselves, points to the need to improve efficiency of expenditure (better use of available resources). Second, given the general reduction in subnational public investment, the efficiency of expenditure allocation becomes relevant. This refers to preserving allocations to expenditure items such as environmentally sustainable infrastructure that contribute to economic growth and reduction of socioeconomic development gaps.

ii) Strengthening the mobilization of own resources of subnational governments. Subnational fiscal consolidation will require greater mobilization of subnational governments' resources. Subnational governments in Latin America and the Caribbean collect little, especially in typically subnational taxes such as property tax, whose regional average is just over a third relative to OECD countries (0.4 percent vs. 1.1 percent of GDP) (Fretes et al., 2018). In addition, tax stimulus measures adopted by many subnational governments also affected collection and will have to be gradually withdrawn. In addition to traditional initiatives linked to improving the capacities of the subnational tax administration, there are opportunities linked to increased incentives for subnational authorities to mobilize their own revenues, reduce distorting taxation and expenditures, and consider new sources of subnational income, such as taxes on urban congestion, considering their impact on economic reactivation.

iii) Reform of transfer systems to subnational governments with a view to reducing territorial inequalities. The pandemic is widening territorial inequality in the region and highlighting the redistributive potential of transfers which, as noted in Chapter 1, is limited. The agenda on the reform of transfer systems includes the progressive introduction of equalization transfers, improvement of conditional transfers, the use of transfers linked to natural resources to offset the costs of extractive activity, and the gradual reduction of discretionary transfers. This should be accompanied by the development of technical capacity at the central government level for the design and implementation of better transfer systems, as well as at subnational government level to use these resources efficiently and transparently. At the same time, spaces for dialogue and communication strategies must be created with the different actors involved in these types of reforms, which are politically complex.

iv) Responsible access to financing markets. While the average total indebtedness of subnational governments in the region is generally relatively low in international comparison, the pandemic will reduce the fiscal space for borrowing and several subnational governments with chronic debt problems will need to restructure their liabilities. However, the recovery offers an opportunity to improve based on good practices in the regulation and monitoring of subnational indebtedness. First, there will be room to reform subnational fiscal responsibility frameworks, with a view to protecting public investment, incorporating subnational stabilization funds, and recalibrating limits linked to current expenditure, debt volume, and debt service. Second, the central government can create or reform, as appropriate, the relevant regulatory framework so that subnational governments have responsible access to financing markets. To this end, it is essential to continue improving subnational financial transparency so as to allow for complete, reliable, and timely monitoring. Regulatory frameworks should incentivize subnational governments to access competitive financing based on their own credit risk, with effective early warning systems that safeguard subnational fiscal responsibility. The inclusion of automatic escape clauses in the face of unpredictable external shocks can also be considered to reduce discretionality in subnational fiscal responsibility frameworks.

v) Strengthening intergovernmental coordination mechanisms and institutional capacities at the central and subnational levels. The pandemic highlighted the need to strengthen intergovernmental coordination mechanisms and, in turn, to clearly define the division of responsibilities among levels of government. This will be necessary to develop articulated action plans to respond to future pandemics, similar to the coordination mechanisms that already exist in many countries for natural disasters. It also offers the opportunity to strengthen both the governing bodies at the central level and the subnational governments themselves and the entities that comprise them, to improve their capacity to propose, analyze, and implement, in a coordinated manner, measures in areas relevant to the reform agenda of intergovernmental fiscal relations. In addition to the previous lines of action, this agenda includes strengthening the capacities of subnational governments to manage their services, administrative systems, revenues, and indebtedness, as well as their transparency and ability to perform.

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