Minor Field Study:

Evaluating Fiscal Decentralization in Peru


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Abstract

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Purpose: This thesis aims to evaluate how the 2002 reform of decentralization has changed Peru. The evaluation will be focused on the fiscal decentralization, especially the tax collection of subnational governments. By identifying the obstacles of the Peruvian process we hope to be able prescribe how to minimize demerits; and optimize merits of decentralization.

Theory: The thesis contains relevant theories regarding decentralization and fiscal decentralization. A great deal of the empirical data has been gathered from on site interviews in Peru with local experts. Our goal has also been to use Peruvian secondary sources, to the extent that has been possible.

Methodology: The analysis is made on the basis of selected merits and demerits of decentralized governance. The authors have used available statistics and the results of interviews to evaluate the most relevant merits and demerits for the case of Peru. The thesis is a result of combining quantitative information (statistics) and qualitative information (interviews).

Conclusions: The current decentralization process has stable support both from the ruling parties and residents of Peru. The setbacks in the process are mainly due to Peru’s heterogeneous nature and the large inequalities among regions and individuals in the country. There are also large incapacities on the subnational level to handle greater responsibilities. To optimize the merits of decentralization, the Peruvian government needs to make great efforts to reduce these incapacities and to ensure a more equal distribution of the country’s wealth. They must also carefully tend to the challenge of increasing the subnational independence while keeping the national unity intact.
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Abbreviations and Acronyms

CIES - El Consorcio de Investigación Económica y Social (Economic and Social Research Consortium)
FONCOMUN – Fondo de Compensación Muncipal (The Compensation Fund for Municipalities)
GDP – Gross Domestic Product
IMF – International Monetary Fund
MEF – (Peruvian) Ministry of Economy and Finance
NGO – Non-Governmental Organization
PIT – Personal Income Tax
PRODES – PERU ProDecentralization
SAT – Servicio Administración Tributaria (Tax Administration Services)
Sida - Swedish International Development Cooperation Agency
SUNAT – Superintendencia National de Administration Tributaria (National tax administration agency)
UNESCO – United Nations Educational, Scientific and Cultural Organization
VAT – Value Added Tax
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1. Introduction

After a decade, 1990-2001, of highly centralized governance different movements in Peru were demanding decentralization. The massive public pressure rushed forward a national reform of decentralization that was accepted by congress in 2002. The decentralization was meant to proceed gradually and shift a growing number of functions from a central to a subnational level. In other words, decentralization is a concept that refers to the general dispersion of responsibilities from central government to subnational administrative units. In this thesis we are especially interested in the economic aspect of the dispersion, i.e. the fiscal decentralization (Bardhan 2002:186). When reading the thesis we wish the reader to be attentive to when we are referring to the decentralization in general and when referring to the fiscal decentralization especially.

The initial purpose of this thesis was to evaluate the welfare effects of the fiscal decentralization. To do this we listed the most relevant, for the Peruvian case, merits and demerits of decentralization. These were accompanied by theories of fiscal decentralization as an analytical tool. To better grasp the decentralization we travelled to Peru to collect empirical data and consulted experts on the topic of decentralization. The situation in Peru was very different from the one we had anticipated; an image based on the 2002 decentralization laws and previous research. The decentralization had not proceeded as far as specified in the 2002 reform and instead the thesis came to revolve around the obstacles standing in the way for further decentralization. This mapping of obstacles felt more relevant than our initial purpose.

Our findings can be concluded by answering the following three research questions:

1. What are the main factors behind the experienced setbacks in the Peruvian decentralization process?
2. How can the process change to maximize the merits of decentralization and minimize the demerits?

3. How will the decentralization process proceed in the future?

Chapter two provides the reader with theoretical aspects behind decentralization in general and highlights selected merits and demerits especially related to decentralization in Peru. In chapter three and four the Peruvian decentralization and the fiscal decentralization especially are presented in a purely descriptive form. In chapter five we evaluate the decentralization process by using the analytical tools previously presented. Lastly chapter six contains conclusions and a summary of selected aspects of the Peruvian decentralization.
2. Fiscal Decentralization – theoretical aspects

In this chapter general theories of decentralization will be presented, starting with a general definition of the concept. This is followed by merits and demerits of decentralization which are also for a general decentralization. We then narrow this down to fiscal decentralization and tax decentralization. The chapter is finished off with a section on Fiscal Federalism.

2.1 Defining decentralization

Decentralization is the dispersion of responsibilities from a central government to regional or locally managed units. These regional and local units act as agents for the central government and executes certain functions on its behalf. If the decentralization is deeper there may also be power devolution which means that the regional or local units are not only allowed to execute certain functions but also have the authority to make decisions on these functions (Bird-Vaillancourt 1998:3-5).

It is not surprising that the literature on decentralization reports of many failures as decentralization is dependent on the capability of institutional, political and managerial factors. Many decentralization attempts occur after political and economic crisis and others happen due to pressure from external forces and donor programs. When decentralization is not built on a stable foundation, it is not likely to succeed (Smoke 2002:49). For decentralization to be implemented successfully, fiscal, political and administrative aspects need to be integrated. Decentralization often suffers from being implemented in a fragmented way without the complementarities between all these aspects. When implementing decentralization, including fiscal decentralization, one can expect it to be a complicated and slow process, due to its complexity. It should be designed so that it is gradual, tailored and strategically outlined (Smoke 2002:53-4).
Developing economies, like Peru, usually have a relatively young institutional environment. The short term way to administer such a construction appears to be to concentrate power to a central government, creating a lucid organization that utilizes the limited competence accessible (Ahmad - Garcia-Escribano 2008:2) (Bird - Vaillancourt 1998:1). In the longer term this type of power exercise eventually appears to become insufficient. The construction distances politics from voters and as an economy grows the central government becomes inadequate to distribute positive welfare effects. By transferring responsibilities, the central government aims to accomplish one or more of the following: improve economic efficiency, cost efficiency, accountability and increased resource mobilization (Bird-Vaillancourt 1998:1).

One of the risks of decentralization is that it will have a destabilizing impact on the institutional environment. In order to avoid this, authors Vaillancourt and Bird (1998) stress the importance of implementing decentralization in a way which increases political accountability rather than decreases it, meaning that politicians can be held responsible for their actions. As the central government continuously remains responsible for maintaining macro stability it is important that all the instruments of policy needed to regulate this, stay on a national level. It is not appropriate that all functions are decentralized. It is also important that the central government can enforce all necessary restrictions against raising expenditures above the point of revenues when subnational governments are given greater autonomy. This is especially important during the early stages of decentralization since the responsibility of collecting revenues, i.e. taxes, often transfers as one of the last fiscal instruments (Bird-Vaillancourt 1998:6-8).

The process of transferring fiscal responsibilities tends to take place gradually as the structuring of the subnational government develops. The first step for Peru and other developing countries has been to let subnational authorities handle local investment decisions. By allowing some control over selected expenditures, while not transferring any of the responsibilities for collecting revenue, subnational government become highly dependent on intra national transfers. This could cause less responsible money management and is often mentioned as the
risk of moral hazard (Bird - Vaillancourt 1998:191). To optimize the effects of decentralization many stress the importance of transferring not only the expenditure responsibility but also revenue collecting (Ahmad – Garcia-Escribano 2008:11) (Bird-Vaillancourt 1998:191).

2.2 Merits and demerits of decentralization

The literature on the effects of decentralization is ambiguous, with some research showing that the cost of decentralization is outweighed by the benefits from it, while others show that costs are higher than benefits (Enkolopow - Zhuravskaya 2007:2263). This section will highlight selected aspects related to the Peruvian process. The merits and demerits presented below constitute the tools with which the evaluation analysis in chapter five will be conducted.

2.2.1 Merits

For an economist the most important argument for decentralization is the creation of a higher level of efficiency, so that welfare gains can be achieved. Oates’s decentralization theorem states that unless residents across a country are fully homogeneous in their preferences and needs of public services – an adjusted decentralized provision of public services will be more efficient than a centralized provision (Hong Vo 2009:662-663). A decentralized system can better respond to the local needs and therefore reduce over or under consumption of public goods. The more heterogeneous a country is, the greater are the welfare costs from uniformity. Some further argue that fiscal decentralization will not only mean direct welfare improvements but also indirectly stimulate economic development, revenue mobilization, innovation in public service delivery, raise the accountability of elected officials and increase local participation in governance (Bahl – Bird 2008:2-3). This is due to subnational governments’ responsiveness to the demands of local citizens compared to the central government. The responsiveness will be stimulated by increased dependence on own source tax revenues in relation to alternative sources e.g. intergovernmental transfers. The subnational government becomes more attentive
towards local financial movements. This works both ways as citizens who pay taxes will be more inclined to demand that their local government be more transparent and accountable for their decisions (Mahon 2005).

Concentrating on a more economic perspective, a decentralized system is thought to be better at mobilizing revenue and reaching a greater share of the taxable operations. Central governments of developing economies, in general, heavily rely on business and personal income tax (PIT), value added tax (VAT) and customs duties for revenues. In developing countries smaller firms, workers and owners of property are underrepresented in the tax base as tax evasion is common (Bahl – Bird 2008:2). It is argued that a decentralized tax system and subnational governments, due to their closeness, have the potential to better reach and control the collection of taxes in ways that a central government cannot. The tax base can be broadened by numerous tax instruments, e.g. operative licenses for firms, betterment charges, property taxes etc. The key is to identify what kinds of businesses exist within the community and to understand their assets and operations. When relying on own source revenue, subnational governments will have greater incentives to be inventive in ways to broaden the tax base since the revenues collected will have a more noticeable effect. Subnational governments’ closeness to the businesses and the residents gives them a better chance of detecting taxable operations (Bahl – Bird 2008:2-3).

When local services are financed through their own revenues they become more careful in their spending. This can partly be explained by the transparency effect which improves along with the closeness to residents, but also partly because of the sense of responsibility that comes with an increased independence of the central government. As decentralization brings local politicians a larger degree of responsibilities this should include the ability to adjust their taxation structure. A full independence is not recommended but rather a partial one, e.g. deciding tax rates within a span given by the central government (Bahl – Bird 2008:10). Since the tax base, by tax collection at the subnational level, can be broadened an increase in
subnational revenue does not necessarily have to cause a decrease of central level revenue (ibid.) (Ahmad – Garcia-Escribano 2008:4).

When allowed to adjust the tax structure locally, competitions between subnational areas may arise. Assuming residents to be mobile, they will choose to live in the region providing the perfect mix between local public goods and taxes. This competition effect was primarily presented by Charles Tiebout in 1956. He developed the ‘Tiebout model’, where citizens are able to choose in what municipality or region to settle. The model assumes that each municipality or region is given the autonomy to themselves adjust public services and taxes. National residents, being rational beings, will move to the municipality or region that best matches their preferences. Subnational governments will then be forced to create an optimal level of supplied public goods and taxes or they will fail in attracting residents (Tiebout 1956:418).

A similar idea was presented by Salomon in 1987 where he argued the positive effects of decentralization with help of something called ‘Yardstick Competition’. The idea of Yard Stick Competition is based on the fact that decentralization ends up giving residents a wider set of options; options which make them directly more influential over a political agenda. A national monopoly lacks competition but a regional or local one does not, thus creating a competitive situation and just as with the Tiebout model residents have the possibility move to the region which they believe to have the best regional government. The residents’ threat to move will become a powerful instrument in order to gain greater influences over the political decisions (Oguzhan et.al. 2010:170).

A decentralized economy represents independent taxation and expenditure decisions. The system will create difference in policies between regions and the policies will vary in their effectiveness. Besley and Case (1995) found in their study on American state governance that if a particular policy was adopted by one governor and deemed to be successful, it was quickly copied by its neighbors. By allowing the subnational governments to be creative, efficient
institutional examples can be spread to other regions. In developing countries this characteristic might prove to be even more important as numerous independent jurisdictions provide a bigger potential of trying upcoming ideas. Instead of just having one large administration functioning as a test sample, tests can be carried out on a smaller scale, making mistakes less costly. In the long run this might speed up the process of the development of establishing functional and efficient subnational governments (Oguzhan et. al. 2010:270-71).

2.2.2 Demerits

Authors Calabrese, Epple and Romano state that: “the inefficiencies arising from decentralization are of comparable magnitude to the preference-matching benefits of decentralization. Thus, rather than produced gains, decentralization may well result in aggregate welfare losses.” The core of the argument is that a well implemented decentralization generates substantial welfare gains but a non-functional one will have a direct opposite effect (Calabrese et.al. 2009: 2-3).

Destabilization can be one of the downsides of decentralization, from an economic and political perspective. Many developing countries are ‘young countries’ and may need uniting policies instead of increasing the autonomy of regions within the country. There is a risk that decentralization may be reduced to ‘regionalization’, i.e. making regions independent to the extent where they function as a little country of their own, creating internal friction and instability. A less united country will delay the process of decentralization, the establishment of future efficient macro-regions and disturb the intergovernmental relationships both horizontally (central government and local government) and vertically (other regional governments) (UNESCO 2005:46).

Fiscal decentralization demands a higher level of administrative skills from subnational governments and the right competence is often a commodity short in supply in developing countries. These countries often suffer from a limited access of competence which is one of the
The main reasons why power is centrally concentrated. This low competence at local level refers to politicians, officials and residents. If the competence is low among residents they will not be able to put, or be aware of, the pressure they can exert on the local politicians, and this will reduce the efficiency of bringing decisions down to the local level (Bahl – Bird 2008:4).

Another issue is the importance of good transparency towards the public as well as internally between all levels of government, i.e. this call for greater institutional collaboration. Decentralization involves a higher degree of bureaucracy and a clear delineation of responsibilities is vital to provide the best possible conditions to make the process work (Bird 1992:147). The framework will also have to incorporate how to minimize the damage of ‘the tax revenue gap’. The tax revenue gap refers to the different economic conditions facing each unique region. The large inequities that often exist in developing countries result in a significant variation in the tax base at disposal. To create a functional internal transfer system is therefore often a complicated but important part of the framework (Bahl – Bird 2008:44).

The competition effects mentioned as merits also have a potential downside. When subnational governments are given a partial right to decide their own tax policy it will not only affect the residents within the region but also adjacent areas. Regions will behave non-cooperatively and compete for the same mobile tax base and capital. A common outcome is to levy a tax lower than what would be considered optimal due to the competitive situation. The low level will not only effect the own region. When subnational governments are competing for the mobile tax base they do not account for the total national aggregated tax revenue. The subnational tax level will not only affect its own region but will also have external effects. An example of this could be that corporations in the adjacent regions decide to move to the region with the lower tax rate. The indirect cost will not be taken into consideration when one region decides its own tax policy. A decentralized system makes it hard to internalize these indirect costs and levy taxes sub-optimally low in a national perspective (Gaigne – Riou 2004:17-18).
During the process of establishing functional subnational administrations countries heavily rely on intergovernmental transfers. When subnational governments only spend and do not collect taxes themselves the risk of ‘moral hazard’ is increased, meaning that since regions and municipalities are not directly linked to the income source they might behave differently and be less responsible when spending the funds received from intergovernmental transfers. For this risk to be reduced the central government is recommended to keep some controlling ability so that subnational governments will not engage in excessive spending (Sato 2002:1).

Figure 1 below concludes the merits and demerits:

<table>
<thead>
<tr>
<th>Merits</th>
<th>Demerits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oates’s decentralization theorem - Better matching regional needs, no over or under consumption of public goods.</td>
<td>Destabilization of national unity, instead reinforcing regionalisation.</td>
</tr>
<tr>
<td>Local governments are more responsive to local needs. The greater closeness to the residents also creates a transparency effect.</td>
<td>Tax revenue gaps within the country.</td>
</tr>
<tr>
<td>Local governments are better at raising tax revenues as they better can understand the operations of their citizens; tax evasion can be reduced.</td>
<td>A sub-optimal tax level due to competition and externalities arising from tax competitions.</td>
</tr>
<tr>
<td>Tiebout model - Rational citizens will move to the municipality or region that best matches their preferences.</td>
<td>Competition creates distortions of the different markets, e.g. different property taxes affect the housing market.</td>
</tr>
<tr>
<td>Yard Stick competition – Giving residents a wider set of options increases their influence over the political agenda.</td>
<td>Highly dependent on local competence.</td>
</tr>
<tr>
<td></td>
<td>A more complicated system demanding greater bureaucracy.</td>
</tr>
<tr>
<td></td>
<td>Moral Hazard - intergovernmental transfers insulate subnational governments from risk.</td>
</tr>
</tbody>
</table>
2.3 Fiscal decentralization

Within the area of fiscal decentralization there are four main interrelationships among levels of government: expenditure decisions, taxing and revenue-raising powers, subnational borrowing and intergovernmental fiscal transfers (Hong Vu 2009:657). As the principle of Wagner’s law say: the more developed a country is the larger is the public expenditure, i.e. that government plays a gradually more dominant role the more developed (richer) a country becomes. When the size of the central government is enlarged, decentralization may be appropriate as there now are better scale effects of a local public goods provision than before. Developed economies are therefore characterized by higher levels of decentralization than developing countries (Arzaghi – Henderson 2005:1161). To optimize the benefits it is required that subnational areas are accustomed to handling increased responsibilities and developing countries often struggle with adjusting the internal division. Beside economic conditions, factors correlating positively with deeper fiscal decentralization are the level of democratization, population and land area size (Arzaghi – Henderson 2005:1184).

Almost all countries, except for the really small ones, have some degree of decentralization which demands a functional intergovernmental fiscal system. When designing this system it is good to answer the following five questions of who does what:

1. Which level should provide the public service and therefore bear that expenditure?
2. Which level is the tax levied to, i.e. who will receive the revenues?
3. What will the inevitable imbalance, i.e. the vertical imbalance, be from the two questions above?
4. How should the question of horizontal imbalance be tackled?
5. To what extent should adjustments be made to balance the difference in capacities and needs among government units?

(Bird-Vaillancourt 1998:15)
The concept of vertical imbalance refers to the imbalance that occurs when it is not the same level of government, which collects the revenues that are paid to supply that public service. If there was no vertical imbalance, intergovernmental transfers between government levels would not be necessary. Horizontal imbalance refers to the difference between subnational units at the same level of government, i.e. that there is a difference in expenditures and revenue capability between regions and municipalities.

There is no universal solution to fiscal decentralization and these questions should be answered uniquely for each country’s situation. Furthermore the answers should be adjusted so that the fiscal system is a tool to achieve the policy objectives of a country. Among those objectives we find the common economic trio – efficiency (allocation), equity (distribution) and stabilization (Bird-Vaillancourt 1998:15). Other important goals may also be economic growth, poverty alleviation and increased income equality. When implementing fiscal decentralization both political and economic constraints need to be tackled. Developing countries face larger constraints as they are usually less politically stable and rely on a lower technical capacity. There is an enormous variety of solutions to intergovernmental fiscal problems and each country is unique. Still, lessons can be learned from looking at other countries, to see what has worked and what has not, especially since experiences from abroad in fact are the only guide book available (Bird - Vaillancourt 1998:16).

2.3.1 A difference in economic strength across regions

A more decentralized system means that local governments are responsible for the financing of public goods. The accessible tax revenues differ greatly from region to region, ‘tax revenue gap’, which will result in a large difference in supply of public services across regions. Poorer regions are not likely to be able to collect large sums of tax revenues and will therefore not be able to provide a high level of social services. In poorer communities the need for public services might even be greater as they cannot afford private options of education and health
care. The income inequality between poor and rich regions will now be more evident than with a central system (Rao et.al. 1998:359-60).

An intergovernmental transfer system from richer regions to poorer regions is therefore recommended to offset the unwanted situation arising when the local revenue capacity is far below the need of social services; this to offset the so called ‘need revenue gap’. The structure of the decentralized system needs to be designed so that a minimum and preferable fairly similar level of social services is provided across all regions counterbalancing fiscal disabilities (Rao 1998:359-60). Transfers are also important to offset fiscally induced migration as equalization reduces the incentives for people to move to richer regions supplying a higher level of public services. Such a migration would further deepen the gap. Broadway and Shah (1994), state that the reduction of net fiscal benefit differentials is one of the rare cases in economics when equity and efficiency considerations coincide. The contra argument of this theory is that interregional transfers induce inefficiency as labor otherwise would have migrated to high-income regions where they will be more productive (Shah 1996:100).

2.4 Tax decentralization

There are two ways for sub-national governments fund the provision of public services; they can either rely on transfers from the central government or be given the ability to raise revenues, e.g. collect taxes, to finance the expenditures. Many developing countries are far behind when it comes to utilizing their potential tax base; this is especially true for Latin American Countries who have a history of low tax pressure (von Haldenwang 2010:2-3). To reach this potential the countries must have a more active approach to tax revenue mobilization. Governments need to counteract tax evasion and fiscal fraud. The pressure to improve the financial governance from international finance organizations and donors has increased. A decentralized tax system should fulfill the requirements of raising fiscal
accountability and legitimacy through increased effectiveness, transparency and rule-obedience so that a higher credibility of the tax system can be achieved (von Haldenwang 2010:2-3).

The level of decentralization in general coincides with the ratio of subnational tax revenues of total tax revenue. In developed counties around 20 percent of all taxes are collected by subnational governments, compared to 10 percent for developing countries (Bahl – Bird 2008:5-6). There are only a few cases in the world, exclusively wealthy countries, where local governments have a significant access to large and elastic tax bases which are often attained by levying a surcharge on the national income tax. Worldwide there are almost no cases where a local government’s revenues are as large as their spending. Intergovernmental transfers enable excess spending relative to possible tax revenue collection (Bird-Vaillancourt 1998:17). The transfers also often aim to fight inequity between regions. Regional conditions, within each country, cause great differences in ability to raise tax revenues. The transfers, in a way, even out and ensure that poorer regions also can access a higher level of public services and counteract the tax revenue gap (Bird - Vaillancourt 1998:18).

In developing countries national governments have been reluctant to decentralize tax collection, instead local spending is mostly financed through an intra governmental transfer system. This is often due to administrative incapacities which make tax decentralization costly to implement and sustain. As shown later there are usually many obstacles to overcome before the central government transfers the authority to collect taxes to subnational governments (Bahl – Bird 2008:5-6).

2.5 Subnational taxes

There is no right answer to which level taxes should be assigned, neither in theory and even less so in practice. A widely known argument in favor of tax decentralization is the principle of fiscal equivalence which is known as fiscal correspondence. This equivalence is achieved when there
is a match between those who benefit from a collective good and also those who pay for it (Olson 1969:482). Subnational governments work optimally when tax revenues, expenditures and benefits of public spending are equal; meaning that people residing in the region constantly receive what they are paying for. At which level of government the taxes should be collected to best attain this will be determined by political and administrative factors. If taxes are handled at the right level, the fiscal equivalence is attained and the need for intergovernmental transfers between regions is abolished. This kind of optimal situation is extremely hard to attain and to implement in developing countries as they need to undergo a substantial transformation in becoming more equalized countries (Bird-Vaillancourt 1998:13).

One of the things most important to accomplish is accountability. Economic accountability means that local governments are responsible for providing the services which the local residents pay for. This is preferably made at the margin so that citizens can feel the difference in services supplied when the tax rate is reduced or increased. This will add to the accountability of the local government but also increase the perceived power of the local government (Bird - Vaillancourt 1998:14). There are really only two alternatives which are large enough to achieve this: a surcharge on PIT and/or a surcharge on the VAT. If local governments are given the responsibility of providing important social services which require large expenditures, then it is only fair that they also get access to the taxes where the larger revenues can be extracted. Subnational governments of developing economies usually, as a first step, handle the responsibility of smaller sources of income of which property taxation is the most important one (ibid.).

2.5.1 Property taxation

A few decades ago it was generally considered that the only appropriate tax for subnational level was property taxation which resulted in property tax being the most important local tax in developing countries. Even if the tax is the most important subnational tax it still only adds up to around 4 percent of GPD in developed countries and 2 percent in developing countries. The
property tax is poorly developed in Latin American countries. Peru’s 0.2 percent of total GDP is extremely low in a global perspective; implying that there is much room for improvement here. The property tax is a relatively stable and ‘easy’ tax source compared to other taxes. It is levied on a large share of the population, even on parts of population that operate in the informal sector (Rühling 2005:4-6). When subnational governments are given increased responsibilities the property tax revenues are not nearly enough to cover the expenses. There is a large resistance from local citizens towards increasing the property tax rate. This due to it being a relatively visible tax; it is hard to hide real property. The fact that it is collected in a lump sum annually also makes it seem larger. The property tax does have an important role to play in local tax structures but it needs to be accompanied by a few more elastic and broad based sources of revenue (Bahl – Bird 2008:14-18).

2.5.2 Value added tax

Marginal income tax rates and brackets across the developing world have been significantly reduced, while taxes on consumption, particularly the VAT, have become of significant importance in newly reformed tax systems (Arce 2006:37). In developing countries VAT is usually the single most important income for a central government, which explains the large resistance to losing control of it. For a long time it has been generally believed that a subnational VAT was technically unfeasible but lately a subnational VAT tax has proven not only to be feasible, but even desirable in some cases. For the VAT to be effective as a subnational tax the regions and revenues must be large enough to outweigh the increased cost of administration. The VAT tax is therefore most effectively handled at a central level but an appealing possibility would be to add a subnational supplement to the central VAT. This combination enables the perks of an effective central collection while still having a better chance of catching tax evaders. (Bahl – Bird 2008:23).
2.5.3 Personal income tax

Local personal income taxes are not commonly administered at a subnational level in developing countries. Like the VAT this is mainly due to the reluctance of central governments to give up these sources of income. Governments in developing countries often struggle with difficulties collecting potential PIT since they usually lack the resources to fight tax evasion (Bahl-Bird 2008:19). To shift the exploration of the PIT to a subnational government is therefore only a possibility for advanced developing countries, in particular for large urbanized areas. In order to avoid administrative and economic distortion effects a single flat rate is recommended. Subnational payroll tax is not very common in developing countries, with a few exceptions. Although payroll taxes are easy to administrate, i.e. productive at a low rate, it has the disadvantage of being a barrier to employment and encourages employers to substitute capital for labor. Therefore the recommendation is to use the PIT rather than payroll taxes at the subnational level (Bahl-Bird 2008:20-21).

2.5.4 Other alternatives

In many developing countries it has been difficult and unpopular to introduce residential property taxes and as central transfers have been unreliable, business taxes have sometimes been the only way for subnational governments to expand revenues. These taxes are popular both with local officials and citizens since it is not very clear on whom the incidence falls. Tax exporting may sound like an attractive option but to prevent problems of tax exporting and tax competition between regions a centrally decided ceiling and floor should be given to prevent distortions (Bahl-Bird 2008:23-26).

2.6 Fiscal Federalism

Fiscal federalism does not discuss the classic centralization versus decentralization. It is more concerned with securing a beneficial interaction and coexistence of national and subnational
levels of government. The theory aims to make continuous adjustments and explore the respective roles of the different levels of government to optimize the governance and institutional efficiency (Sharma 2003:178)

Fiscal federalism is a subfield of public finance and it lays out a general normative framework for the assignment of fiscal functions and instruments to different levels of government. In a very general perspective the theory states that the central level should be responsible for the macroeconomic stabilization functions and the income redistribution when it comes to assisting the poor. In addition to this the central government should also provide ‘national’ public goods, e.g. the national defense, as these services supply the entire population of the country. Subnational levels of government should provide the goods and services that are limited to their own jurisdiction, this due to the argument previously presented, that they can tailor the goods and services to the particular preferences and circumstances within that region. The preferred level of services and goods is likely to vary across jurisdictions and as the optimal level of a local public good is when a resident’s marginal benefit equals the marginal cost, to maximize the overall social welfare will then require that the local output varies according to local preferences (Oates 1999:1121-1122).

The prescription above is a very general one and there are some areas where the delineation of specific goods and services is not so clear. Two areas which are often up for discussion are education and health where it is not easy to draw a clear line of who benefits from the goods and services. At a quick glance one might say that it is local but externalities from education may benefit a wider area and maybe even the whole country. In the case of health care there are special units at certain hospitals that may treat patients with rare diseases coming from all regions of the country (Oates 1999:1122).
3. Decentralization in Peru

The major reform of 2002 was a serious effort by Peru to disperse governing elements. This chapter will firstly give a general description of the recent Peruvian economic development. The reform of 2002 is further presented and followed by a section of a description of the decentralization process as of today. We have chosen to focus on the issues of inequity and insufficient local capacities.

3.1 Peru’s recent political and economic development

Since the mid-1980s, Latin American countries have increasingly turned from a state planned economy to be more influenced by markets in the aim to achieve greater economic growth. Peru has experienced, like many countries in the region, a breakdown of institutions and authorities but has gradually started to recover (Arce 2006:28). During the 1980s the current president, Alan Garcia, reigned and started to decentralize Peru. Unfortunately during the same period Peru experienced one of the deepest economic crises in the region, coupled with far-reaching social disorder resulting from prolonged guerrilla warfare. In the beginning of the 1990s, Peruvians rejected the entire traditional political party system and elected President Alberto Fujimori – a political outsider. Fujimori initially proposed a gradual program of economic adjustment but later had to change as external pressures mounted. A new program, very much in line with the so called ‘Washington Consensus’, was adopted (Williamson 2004:3). By the late 1990s the dissatisfaction with Fujimori’s politics and his abuse of central power was overwhelming (Barreix et.al. 2007:108). The hyper centralism during the Fujimori era was harmful to the local institutional development and he managed to eliminate the little decentralization that Garcia had started during the 1980s.

The economic development of Peru during the last decade is impressive and Peru is ranked as a top-performer among the Latin American countries. The annual GDP growth between the years
2002-2008 has been within the span of 5 to 10 percent and the growth of 2010 is expected to be 8 percent (Worldbank 2011). Peru even managed to achieve economic growth during the worldwide financial crisis. Figure 1 below displays the GDP growth since 1998.

Along with the favorable economic development Peru has experienced greater political stability. Today’s elected government is focused on reducing poverty, income inequalities and aims to distribute welfare gains equally among the population. The purpose is to guarantee access to basic public services across the country and achieve a more equal country from both an economic and social perspective (IMF Country Report 2009:31). The poverty rate between 2005 and 2009 fell from 48.7 percent to 34.8 percent. The extreme poverty, which includes the population living under $ 1.25 a day, declined from 17.4 percent to 11.5 percent during the same time period. The poverty rate varies greatly within Peru with some regions showing rates above 60 percent. Peru is often divided into three areas (see Figure 3 for visual): the Cost (la Costa), the Mountain (la Sierra) and the Jungle (la Selva). It is estimated that in 2009 the Mountain area had a population of 53.4 percent living in poverty, the Jungle 46 percent while the Cost has a relatively much lower share of residents living in...
poverty, only 19.1 percent (Worldbank 110104). The income inequality across the population is growing and one way to measure this is the Gini coefficient. A Gini coefficient value of 1 represents total inequity while a value of 0 represents total equity. Peru’s Gini coefficient was 0.46 in 1996 and 0.52 in 2008, thus the inequality within the country is rising. This number puts the country on the list for the 20 most unequally measurable countries in the world (CIA World Fact Book 101207).

3.1.1 The reform of 2002

Peru committed itself to a decentralization reform in 2002 as a result of massive public pressure to increase the power of subnational governments. The reform changed the constitution and a legal structure was built for how to institute the decentralization. The amendment of the constitution meant that Peru now would have three levels of government national, regional and municipal. Peru was divided into 25 regions and about 1800 municipalities. After the reform it began to intensify its gradual decentralization process which shifted a growing number of functions and funds to the local and regional level (Friz - Huanqui 101018).

Three organic laws of decentralization formed a framework for the process of fiscal and political decentralization: There are three main laws: the Framework Decentralization Law of 2002, the Organic Law of Regional Governments of 2002 and the Organic Law of Municipalities of 2003. The first of the three mandates a clear fiscal neutral devolution of expenditures and revenues at the different stages in the devolution process. The other two define the areas of responsibilities for all of the levels of governance. The decentralization process was planned to start with the relocation of social and infrastructural programs followed by other sectored functions and lastly the health and education functions will be transferred (Ahmad - Garcia 2008:8). The national government is not supposed to weaken or reduce its role during the process, but rather to coordinate its actions with the actions of the regional and local governments. The regional governments have set up their departments and tried to strengthen
these new institutions. In the longer run the regional institutions are intended to merge with other regions and form macro-regions (UNESCO 2005:45).

The intention is to gradually move spending and investment decisions closer to the ones affected by it. When increasing the responsibilities for subnational governments the central government hopes to rebuild the trust for the public sector. To maintain macroeconomic stability this shift takes place gradually (Ahmad – Garcia-Ecribano 2008:2). In time the subnational governments will not only have increased spending responsibilities but also be able to collect essential revenue components; making it possible for the subnational governments to rely more on own-source income, i.e. tax revenues (ibid.). According to the regulatory framework the newly established regional level should handle its own tax base. The Fiscal Decentralization Law states that: once regions are merged into macro regions, regional governments will receive 50 percent of the revenues collected in each region (Bernardi 2008:77). However this process has not proceeded as expected, which will be further explained in the next section.

3.2 Current status of the Peruvian decentralization

The decentralization laws of 2002 stated that Peru’s 24 regions were to merge into 12 macro regions, to make the regions reap the benefits of scale effects and become more economically independent. Primarily the regions will receive intergovernmental transfers from the central government. In line with ‘The Framework Decentralization Law’ of 2002, these transfers will be marked for specific social and infrastructural programs. When the regional governments start to merge into macro regions they will qualify for a second phase. This phase means that regional governments are entitled to collect 50 percent of selected taxes within the region, especially indirect taxes such as the VAT. Merging also entitles them to increased intergovernmental transfers and, in total the regions are given a larger degree of independence. If the regions manage to increase tax collection and decrease tax evasion they
are also entitled to a ‘bonus’ meant to be spent on specifically selected projects. During the entire process, regional governments are required to present results and economic forecasts to the central government (Ahmad - Garcia 2008:9).

The ambition was to start the establishment of macro regions in 2006 but in a national referendum a large majority of the Peruvian population voted no to the merging, in spite of the incentives given by central government. The unwillingness to merge can be explained by the fact that a majority of residents strongly identify themselves with the region they belong to. The people sitting in the regional governments are also in general unwilling to share their powers with another regional government making them counteract the will of the central government (Rühling 101015). The scheme of the regions merging has been described both as unrealistic and hasty since the regions themselves are newly established from the reform of 2002 (Carranza Ugarte 101018). Something that further worsens the matter is that the regional rulers are called ‘presidents’, which has constructed the feeling that regional presidents are at the same level of authority as the national president and rulers of their own little country (Gordillo Carrillo 101020).

Not only is the number of regions currently considered to be too high. If the municipalities in Peru had the right to fully collect their own source revenue, less than 25 percent (300-400 of the 1800 municipalities) would be able to bring in large enough tax revenues to cover the costs of collecting taxes. A simple cost-benefit analysis shows that the other municipalities do not have enough collection potential to justify constructing that kind of tax policy (Reilly 101022). There is a need for municipalities to merge as not even half of them fulfill the minimum requirements of a population over 5000 residents. In spite of this, the trend goes in the opposite direction as sub-municipalities called ‘populated centers’ are increasing their importance and also are receiving direct funds (Reilly 101022).
3.2.1 Aspects of inequality

There are large economic disparities between different areas in Peru. Poverty rates in rural areas are much higher than in urban areas and the difference between the rich coastal areas and the inland areas is significant (Ahmad - Garcia 2008:3). Peru can be described as three countries in one. The rich coastal region, including Lima, the poor regions of the Andes with majority of residents engaged in agriculture and lastly the jungle, alienated from the rest of the country with a population living under very diverse conditions (Pesantes Villa 101021). During the last 60 years there has been urbanization and migration towards the coastal areas. The capital population makes up about 30 percent of the total Peruvian population and Lima is now the home for almost 10 million people (ibid.).

<table>
<thead>
<tr>
<th>Year</th>
<th>Total population (million)</th>
<th>Coastal region</th>
<th>Mountain region</th>
<th>Jungle region</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>6.3</td>
<td>28%</td>
<td>64%</td>
<td>7%</td>
</tr>
<tr>
<td>1972</td>
<td>13.5</td>
<td>46%</td>
<td>48%</td>
<td>11%</td>
</tr>
<tr>
<td>2005</td>
<td>26.1</td>
<td>54%</td>
<td>32%</td>
<td>14%</td>
</tr>
</tbody>
</table>

(bcrp.gob.pe 110104)
Figure 5 on the following page shows the varied poverty rate in each of the 24 Peruvian regions, mountain areas such as Ayacucho and Huancavelica experiences poverty rates significantly above 50 percent while coastal areas like Lima and Arequipa are significantly below.

An agglomeration effect linked to the urbanization and unequal opportunities is ‘brain drain’; the higher educated population tends to live in Lima or other larger coastal cities as the qualities of services better match their demand. Both the generation in schools today and their parents do not see it as an alternative to leave Lima because of the services they have gotten accustomed to in the urban areas. Good schools, hospitals and life quality for their families keep them in the capital area (Gordillo Carrillo 101020). The consequence is a lower level of competence in regions outside of Lima (ibid.) (Pesantes Villa 101021).

The heterogenic situation in Peru makes ideas and initiatives coming from Lima hard to implement in a rural context. The technical competence coming from other regions is often thwarted by the local municipalities, due to regional patriotism. Both NGOs and the Central Government face the challenge to adjust their projects and ideas to fit a local context; this also
applies to something as highly technical as tax collection (Reilly 101022). Janet Palomino, General Director of Taxation in the mountain area of Cusco describes the situation: “It is like bringing a model of another country and expecting us to make it work in our reality.”

3.2.2 Increased subnational influence

Over the last decade subnational governments have received largely increased funds. Regional governments, whose budgets are almost made up entirely of transfers, received $ 1700 million in 2002 which increased to $ 3365 million in 2006 (Vega 2007:33). Within the same period the transfers to municipalities increased from $ 700 million to $ 1400 million (Vega 2007:66). Most subnational public administrations have become more professional but lack efficient strategies to convert funds in an optimal way. Regional and local governments are criticized for making shortsighted investment plans to see fast and clearly visible results, which will increase their prospect of reelection. Due to incapacity there are also examples of governments not even able to spend all the money they have been distributed (Reilly 101022) (Rühling 101015).

Peruvian studies show that residents support increasing funds to the municipal level rather than other levels; indicating that the residents trust the level of government closest to them (Reilly 101022). Peruvians value a high degree of citizen participation and some municipalities apply something called participatory investments, a kind of local consultation, which allow citizens to have a direct influence on where resources should be allocated. To secure an unbiased development between regions there is a tool called the ‘barometer’ which allows municipalities to compare themselves with others. The ‘barometer’ measures important aspects such as local quality of infrastructure, education and health (Reilly 101022). Local government officials criticize the central level for taking too long in approving investments and desire clear rules in order complete the projects decided by participatory budgeting (Palomino 101114).
3.3 Lack of subnational competence

After 500 years of central ruling, dependence on authorities coming out of Lima has grown to be a part of the Peruvian culture. Eight years of decentralization is not enough to change habits and mental structures (Pesantes Villa 101021). In order to make decentralization function, and subnational governments able to handle the increased responsibility, municipal institutions need to be strengthened and regional institutions established. The transfer of functions to subnational level have proceeded faster than the actual development of the subnational institutions which means that there today is a lack of capacity and competence (Carranza Ugante 101018). Subnational governments have so far received increased responsibility from the central government but not guidelines, or guidance on how to handle these functions (Palomino 101114).

Something which complicates the strengthening of local competence is the great rotation of people holding important, political positions in Peru. Peru does not have strong political parties which mean that rotation of politicians and officials becomes extensive. Political candidates are elected more because of their personal charisma or because they stand in a specific election issue rather than their political ideology. Without a base of political ideology or broad agenda the elected politician will be judged solely on his achievements. This system encourages short term investment plans. Elected politicians have to show results at the end of their term to be more attractive for reelection. Long run investment, e.g. in education and health, becomes less prioritized (Pesantes Villa 101021).
4. Fiscal Decentralization of Peru

This chapter will cover the different aspects of the Peruvian financial state with a focus on tax policy. As mentioned previously in the decentralization theory, it is vital that subnational governments partly rely on own-source revenue to achieve greater efficiency; therefore the content of this chapter will revolve around the input aspect. This entails the structure of tax rates and bases for taxation, both at local and national level. The information used in this chapter is gathered partly from interviews and partly from relevant secondary sources.

4.1 Peruvian tax revenues

The economic growth in the start of the twenty-first century made the Peruvian nonfinancial public sector deficit decrease from three percent to almost zero. This favorable situation can partly be explained by the new tax structure but also by factors like lower world interest rates, higher commodity prices and an appreciation of the national currency (Garcia 2007:105). Figure 6 on the next page displays the total increase of collected taxes in the last decade. Figure 7 demonstrates the different sources of income, divided into four categories, as well as the amount returned to the tax payers. All numbers are expressed in real terms. Besides ‘Trade and Tariffs’ the remaining three categories show a stable growth and especially the revenues from the VAT and income tax. Especially the growth in VAT revenues can be explained by the increased prices of the national export commodities, as well as the boost both to the company income tax and provisional taxes on financial transactions and corporate assets (Vega 2007:73-74).
The numbers used in the figures in this paper are in Peru’s currency, Peruvian Nuevo Soles (PEN). Exchange rate for US Dollar (USD) is: 1 USD = 2.8 PEN
The main consumption tax is the Peruvian VAT with a standard rate of 18 percent. 2 percent of the VAT is distributed to the local level as a municipal promotion tax. Luxury goods are subject to excise taxes ranging from 2% to 118%. The VAT is the single most important source of income and in the last ten years the already heavy reliance on the VAT tax has further increased. At the end of 2007, VAT related taxes amounted to 41.3 percent, while the PIT accounted for 37.4 percent of total tax revenue. In terms of tax burden, total tax revenue accounted for 15.4 percent of GDP in 2007 (Vega 2007:73).

PIT is the second largest revenue source in Peru. A large degree of people living in poverty and a big informal sector make it hard to collect the PIT in Peru. The central government hopes to achieve a more efficient collection of the PIT as the distortion of responsibilities is continuous. Subnational governments are predicted to be better at discovering and dealing with the informal sector and help target poverty relief programs better (Ahmad – Garcia-Escribano 2008:8-9).

4.1.1 Tax decentralization in Peru

Although the reform in 2002 has made Peru one of the most decentralized South American countries it is still centralized compared to developed countries, especially when it comes to subnational tax revenues (Vega 2007:20). The 1,834 municipalities still collect less than 5 percent of total tax revenues (INDE Consultores 2007:7). 500 of the municipalities have less than 5,000 inhabitants and many of them are totally dependent on intergovernmental-transfers as they themselves cannot collect any revenues (von Haldenwang 2010:14). The lack of own-source revenues does not seem to restrain the expenditures. Municipal expenditures have risen from 9.2 percent in 2004 to 14.0 percent in 2007 of total public spending. Regional governments still do not collect any taxes at all, but receive a growing amount of intergovernmental transfers. In 2007 regional governments’ share of total spending was 16.8 percent which leaves a share of 69.2 percent to the central government (Rühling 2005:6).
The growth of the Peruvian economy has meant a significant increase in the revenues of local governments; this increase especially comes from intergovernmental transfers. The enactment of the Canon Law in 2001 and the Law on Bases of Decentralization in July 2002 rapidly changed the conditions for subnational governments. The subsequent expansion of funds for subnational governments has resulted in a significant rise in relocation of resources from central to regional and local governments. (Vega 2007:20). This is shown in Figures 9 and 10 on the following page. The enlarged budgets are mainly due to transfers. The municipal level has to some extent developed its own-source incomes.
Figure 9: Evolution of the regional budget

Figure 10: Evolution of the municipal budget

(Vega 2007:33)

(Vega 2007:66)
4.2 Tax Administration in Peru

When looking at total taxes collected, Peru falls into the category of middle income country (Barreix et.al. 2007:108). Almost all great sources of income are collected by the national tax agency – SUNAT. On a subnational level all taxes are collected by the municipal governments and as previously stated: regions do not yet collect any taxes. Figure 11 below shows at which level the Peruvian taxes are being collected.

*Figure 11: The national tax system*

The income, production, consumption and import goods are the main taxable sources in Peru and are collected by SUNAT. In 1998 SUNAT was given its semi-autonomous status, i.e.
separated from the general public administration (von Haldenwang 2010:8) (Rühling 2005:20). It is independent in the way that it can operate without political interference as long as it follows the law and fulfills the required amount of tax revenues. The autonomous part also means that the organization financially relies on own-source revenue. To a large extent, SUNAT's budget base is the organization's collection outcome. Consequently, SUNAT has the authority to set its own salary structure and to appoint and remove its employees without the need to consult with any other public sector entity. The SUNAT of Peru has perhaps the most independent personnel system among all semi-autonomous tax agencies in the world (von Haldenwang 2010:9)

Municipal government’s most important tax is the property tax. The tax was reintroduced in 2002 and the administration of the tax is shared between the central and the local government. The rate and valuation of the tax is set on the central level and the local government is able to set the parameters and perform the actual collection of the tax. The property tax makes up to 0.2 percent of total GDP which, compared to other countries, is very low. The average rate for developed countries is around 4 percent and for developing countries around 2 percent (Rühling 2005:6). Local taxes that bring in smaller amounts are a sales tax, a tax included in transfer payment of property and a vehicle tax (Bernadi 2008:78). As previously stated, Peru's population is very heterogeneous and it is a country with large differences between richer and poorer regions. The importance of the property tax and vehicle tax in the municipalities depends on the degree of density and income level of the local population. In heavily populated areas such as Lima and other metropolitan cities the revenues from these taxes are significant but not in rural areas (Bernadi 2008:68). Property tax exemptions are also fixed by law. The underlying motive behind the exemptions is often tax negotiations, i.e. governing parties use taxes as a bargaining good in order to keep local citizens content and to attract new residents (SAT 101021).

4.2.1 Intergovernmental transfers
Since the central government handles all great sources of income the budgets of subnational governments is made up of intergovernmental transfers. The two largest transfers are FONCOMUN and the Canon. FONCOMUN, Fondo de Compansación Municipal or Municipal Compensation Fund, is based on a two percent surcharge on the VAT. It aims to promote investment in different municipalities across the country with a redistributive approach for rural and marginal urban areas (Vega 2007:24). The Canon is the tax on corporate income engaged in exploitation of natural resources. Incomes from the canons are divided in two parts: 50 percent belongs to the central government and the other 50 percent is transferred to the subnational governments. This second half is distributed among regional and municipal governments in varying proportions as provided by law (Vega 2007:22). The distribution of the Canon is designed around historic patterns, transferring back money to the area where the resource originally was extracted and does not take regional or local needs into consideration (Reilly 101022). Only five of Peru’s regions are considered to have a significant mineral industry and about 75 percent of the revenues linked to the exploitation of natural resources eventually end up in these regions. When designing the allocation rules for the canon in 2003, the transfers amounted to 451 millions of nuevo soles. The subsequent rise in mineral prices had already increased these funds twelve fold to 5400 millions of soles in 2007 (Yanguas 2008:2).

The Canon started to become a real problem around 2005 when mineral prices boomed. Revenues for regions connected to the cannon amplified and the distribution effects became very noticeable. What makes the design so hard to change is the history of always having distributed the funds in this specific way. The regions receiving the funds strongly protect their continuing right to do so (Friz - Huanqui 101018). There have been attempts to redesign the Canon, for example by the former Minister of Finance, Luis Carranza Ugarte, but the resistance to change was overwhelming. There are however many suggestions under development of how to reform the law to ensure a more equal distribution in the future (Carranza Ugarte 101018). The Canon has grown to account for 34.3 percent of local revenue in 2006, making it the single largest source of income for local governments. Other intergovernmental-transfers that do consider the socioeconomic situation, such as the FONCOMUN, nearly become neglected due
to the size of the Canon. The overall result of the transfer system is that it is increasing inequality instead of decreasing it (Ahmad – Garcia – Esbribano 2006:7).

4.2.2 The informal sector

The base for the PIT is narrow in Peru much due to the size of the informal sector. The informal sector in Peru is defined statistically as employers, self-employed, employees and unpaid family workers who work in unregistered enterprises with fewer than ten employees. By this definition, 53 percent of the working population is estimated to be employed in the informal sector (Budlender 2008:1). Informal employment can also be measured by the proportion of working people without access to social protection and in Peru a total of 65 percent of the population is estimated to be excluded from the system (ibid). Peru has by international standards rather high tax rates but due to the informal sector the revenues collected are rather low. When trying to increase tax revenues it is not recommended to raise the tax level as this may only enhance the existing distortions. The large informal sector, which also complicates the taxation on consumption, is one of the factors restricting the tax policy design of developing countries (Marking 2009:11).

4.3 The positive example of Lima

Servicio de Administracion Tributaria de Lima (SAT) is a successful example of locally administrated tax collection. The SAT in Lima managed to increase taxes collected from 177 million soles to 503 million soles between 1998 and 2009, an increase of 184 percent. In the same time period the central government increased their collected taxes by 133 percent (SAT 101021) (Huanqui 2010). Figure 12 illustrates the development and the numbers presented are in nominal terms.
The organization was primarily established to have a tax agency independent of political influence. Instead of being part of the ‘big public machinery’ SAT was given the right to work in a semi autonomous way alongside with the local government of Lima. The local government in Lima each year gives SAT a budget to fulfill and to motivate an efficient performance SAT gets to keep a percentage of the tax money collected (SAT 101021).

SAT is responsible for collecting the property tax, vehicle tax and a transaction tax when selling a house. It is also responsible for enforcing some of the fines handed out, e.g. traffic tickets. When evaluating the success of SAT it should be noted that the institution handles rather ‘easy’ taxes to collect as it is hard to hide real property and vehicles. The organization has however been clever in introducing tax forms that have to be filled out by the real estate agent, in case of property transaction, and by the car dealer, in the case of vehicles. The organization has proven so efficient in collecting tax money that the institutional vision has changed from: “to be a leading local administration in tax collecting with a model suitable for the entire country and Latin America” to: “…the entire country and the world”. In order to be successful the
organization works with the following objectives: to make it easier to pay tax, i.e. simplifying the administrative burden for residents; optimize accessibility and increase awareness involving taxes among local residents; and to require feedback of how to develop and to reward the continuous taxpaying citizens (SAT 101021).

SAT Lima was the first local SAT in Peru when it was established in 1997, and since then the semi-autonomous model has spread to eight more cities. Research indicates that the SAT agencies collect taxes more efficiently than conventional tax administrations. The SATs have been successful at broadening the tax base, improving tax justice and equity and strengthening the relationship between tax administrations and tax payers. The biggest obstacle to why the concept of SAT is not spread nationwide is due to political and heterogeneous conditions. The SAT model works well for larger municipalities, but not in the poorer and less populated municipalities (von Haldenwang 2010:16-17). These will not be able to fund themselves as the costs from tax collection will exceed the taxes collected; there is also the issue of sufficient capacity and competence to apply the structure (Reilly 101022). The model of SAT is not very popular among politicians as it means that everyone has to pay taxes, which excludes the possibility of tax bargaining. The pressure of being reelected and the culture of negotiating have made tax bargaining a common tool for politicians to keep their residents content. The SAT model is not liked by residents as they do not feel motivated enough to pay taxes, due to the low quality of public services (SAT 101021).
5. Evaluation – Peru and a decentralized tax policy

In this chapter we will evaluate the Peruvian decentralization process by using the merits and demerits of decentralization presented earlier, as our tools. In what aspects has Peru shown to be able to reap of the merits of decentralization and what demerits appears to be the most important to try to reduce. Our evaluation identifies two specific reasons why the decentralization of Peru is stalling, the lack of local competence and the heterogeneous national foundation.

5.1 Improved efficiency of public services?

Oates’s decentralization theorem prescribes that a local provision of public goods will be able to be more efficient than a central one. Since the reform of 2002, municipal- and regional governments have been distributed growing funds. Besides needing the approval of the central government for larger investments the subnational governments are, to a large degree, free to invest the transferred funds as they wish. Important public services, like education and health, are still operated by the central government and are the last functions to be decentralized. Both positive and negative critique has risen since the subnational governments have been given enlarged responsibility. The Peruvian people prefer public money to be spent at the level closest to them (Reilly 101022) and this can be seen as a sign that Peruvians have a higher trust for local and regional level. It is also an indication that residents think that the local level is doing a good job supplying public services. The merit of a subnational government’s possibility to be more responsive of local needs therefore has already shown to be a positive outcome, and important in the struggle to gain public trust for authorities. Another important aspect is the increase of participatory governance, i.e. that local citizens in some areas can have a say in what they like the public funds to be invested in (Reilly 101022). This is also an indication of the supply being better matched with the demand. In the case of Peru a decentralized system can not only better respond to the local needs, it will also inspire political awareness and
accountability; something well needed in a country where the confidence for government is low.

The negative critique is however strong from many angles and suggests that local politicians are not suited to make investments decisions. As previously stated, one of the reasons for this is the high turnover of politicians and officials, since Peru lacks strong political parties. During the five year term, the politicians feel pressures to accomplish enough results to get reelected. Therefore when choosing investment projects there is a tendency to “show off” and choose the most impressive project; investments projects are not chosen on the base of what is most needed (Carranza Ugarte 101018). The inconstant political system makes it more difficult to strengthen capacity and it increases the risk of money being inefficiently spent. Adding to the misplacement of resources is that the central government handles the operations of public services within health and education. So even if the local politician decides to invest in a hospital or a school he or she cannot guarantee a proper operation of it as all the staff in public education and health care is hired by the central government.

The widespread opinion of lack of local competence is often highlighted as a key issue in the process of decentralization. If local competence is not established a decentralization may lead to a more inefficient solution, which is clearly a demerit of decentralization. It has only been eight years since the reform but from the aspects discussed above, it seems that so far the inefficiencies of the decentralization are larger than the efficiency gains. The building of competence is complicated due to the political instability and the frequent turnover in political administration officers. A larger continuity in technical administrative officials is needed. Not only among officials is competence of importance, but also among local citizens since an increased awareness will raise the efficiency of the governments (Bird 1992:147). The lack of competence appears to be one of two important reasons why the decentralization in Peru is stalling and will continue to do so in the near future.
5.2 Increasing tax revenues?

The theory states that a decentralized system will be able to increase tax revenues as the closeness of the subnational government makes it better to understand the taxable operations than a central government (Bahl – Bird 2008:2). The gains for Peru may be particularly large due to the great differences within the country. The operations in the mountain area differ greatly from the operations in the jungle and in coastal areas. A local design would be better at knowing how to detect the taxable operations.

The merit of a deeper local knowledge can hopefully reduce tax evasion and due to the estimated size of the Peruvian informal sector the potential gains are large. The plan is for the regional level to build the necessary administrative capacity to be able to collect both ‘smaller’ and ‘larger’ taxes (Friz-Huanqui 101018). The income tax is suitable for the regional level as it will be too costly to collect at the local level and appears to be less accessible for the central government. The competitive disadvantage for businesses and individuals to pay tax must be counteracted. SUNAT, the national tax agency, is gradually working on improving their knowledge about business operations and will therefore hopefully, step by step, be able to reduce the great tax evasion.

The positive example of SAT Lima is proof of how local tax collection can become more efficient. The SAT Lima has significantly raised the amount of tax revenue collected from property and vehicle taxes by being creative in ways to collect taxes (SAT 101021). With a decentralized system small upcoming ideas can be tested locally. They can be tested simultaneously and this might speed up the institutional development process (Oguzhan 2010:270-71). The fact that SATs are spreading around the country complies with the competition merit of successful examples being adopted by other regions. The challenge is to make the SAT model fit into the different local conditions around Peru and to fight the political resistance, i.e. those who want to keep a more flexible tax collection system and the culture of tax bargaining. In the Peruvian case, the competition demerit of creating distortions in the
different markets will be of less importance. Different taxes at local levels would normally affect the market forces and create distortions due to unequal conditions. These distortions already exist because of the culture of tax bargaining so the situation will not worsen with decentralization.

5.3 Differences, a motivating or reactionary force?

The cultural differences within Peru keep stalling the decentralization process. As Peru rests on a highly differenced cultural ground the welfare gains of a successful decentralization is substantial and should therefore be encouraged. According to Oates’s Theorem the more heterogeneous a country is, the greater is the welfare costs from uniformity. In line with Oates’s theorem, Peruvian subnational governments who are given further tax collection responsibilities will be more successful at matching supply with demand. As the local governments of Peru have yet to receive the possibility of collecting larger taxes it is not possible to evaluate this. Before the transferring of tax collection function can begin the demerit of tax revenue gap must be reduced. The large variation in tax revenue ability across regions needs to be evened out.

Oates argues that a heterogenic country like Peru has the most to benefit from a successful decentralization. However, this great heterogeneity is also one of the two most important causes to why the decentralization process has been stalled. Almost all highlighted demerits regarding Peruvian decentralization are connected with some kind of inequity. The inequity between different areas increases both the vertical and horizontal imbalance. Peru’s heterogenic foundation has delayed the establishment of macro-regions and continuously disturbs the intra governmental relations. As Peru is not a politically stable country the government needs to balance giving the regions greater autonomy while still holding the country together; something that is further complicated by the heterogeneity. Today Peru is experiencing an agglomeration to coastal areas as people who have gotten used to a certain
standard of public services have a hard time to move to other regions in the country. In order to overcome possible hazardous regionalization there is a need to establish common goals and a unity around the structure of the decentralization. The heterogeneity can be reduced partly by reducing the inequalities of the resource distribution and in the level of public services. A national standardization of opportunities will gain the unity of the country and is likely to improve the intergovernmental relationships.

5.3.1 Corruption

Whether corruption will increase or decrease with the Peruvian decentralization is hard to predict, but the political distrust is a large problem in Peru. This distrust gives further incentives for people not to pay taxes and to partake in the informal sector (Gordillo Carrillo 101020). There is widespread perception in Peru that corruption does exist on all levels of society. If the risk of corruption is larger on a central or local level is debatable. People working in central government seem to think that corruption exists to a wider extent on local level and local governments think that corruption is more frequent on the central level (Rühling 101015) (Friz-Huanqui 101018). This indicates that corruption exists on all levels, and that there is little trust between different levels of government. The lack of trust contributes to the central government being less willing to disperse responsibilities to subnational levels. Corruption is therefore harmful to the decentralization and needs to be dealt with. Reducing corruption is a complex task and needs to involve all levels of government in a united effort.

5.4 Intergovernmental transfers inducing moral hazard behavior

The current system of increasing the subnational public spending functions without the collection authority induces moral hazard behavior (Carranza Ugarte 101018). The subnational governments continue to ask for increased funds and are critical towards the Peruvian Ministry of Economy and Finance (MEF) for not authorizing local investment plans. It can be difficult for
subnational governments to see the bigger picture and understand the task of the MEF to maintain the overall macroeconomic stability (Friz-Huanqui 101018). The Moral Hazard issue is a consequence of the large dependence of the intergovernmental transfers and until the central governments distribute further tax collection responsibilities the problem will remain.

5.4.1 The Canon – increasing inequality

The revenues from natural resources extraction in Peru has boomed and this made the distribution of the Canon the largest cause of the growing inequities within the country. The difference in budgets between regional and local governments receiving Canon transfers and those who do not, is constantly growing. Not only does this create growing differences between rich and poor regions but the growing budgets also create distinctly administrative problems as the local governments have not been use to handle these large budgets and do not always hold the capacity to spend the increased funds wisely (Vega 2007:36).

The Canon has rapidly made Peru a more unequal country and it will continue to do so unless the mineral prices restore their old price level or the distributions pattern is redesigned. Changing this pattern is a very sensitive matter and it has caused a great deal of political turbulence within Peru. The Canon is none the less a pressing matter as it causes Peru to develop in an unbeneificial way. Peru has managed to hold a stable macroeconomic situation during the last decade but growing income gaps within the country have a destabilizing effect. The emergence of new political movements, especially in the highlands, is constant. These movements are a reaction to the fact that, despite the country’s huge economic growth, large parts of the rural population have been excluded from the improved welfare. Although the national poverty rate has greatly decreased, the poverty rate in the most economically weak regions of the Andes remains between 70-80 percent (Rural Poverty Portal 110104). A change in the Canon has to be approved by the congress and a great challenge lies in convincing enough delegates of the congress to prioritize the national objective above what is best for their own region. For the decentralization to be able to advance it is vital for Peru to turn
around the development of becoming increasingly unequal and secure a more equal
distribution.

5.5 The Framework of the 2002 reform

The decentralization reform of 2002 did not include the much needed modernization of
subnational institutions - necessary for an efficient implementation. The decentralization law
from 2002 was formed after Lima and other more developed cities and was not adjusted to the
rest of the country which made it hard to implement nationwide (Palomino 101114). There is a
big challenge in forming a framework that suits a country as differentiated as Peru.

The 2002 reform did include a decentralization of certain functions but it did not include a
guide book for subnational governments of how to execute these functions. Parts of why the
subnational governments are having difficulties with executing some of the functions are due to
an unclear delineation of who is going to do what. The theory of fiscal federalism underlines the
importance of a clear delineation of responsibilities between different levels of government.
Government services are unlikely to be efficiently provided unless lines of responsibility are
clearly established. In order to reduce the demerit of decentralization demanding increased
bureaucracy it needs to be clear on whom the responsibility falls otherwise the public service
may not be provided at all. The transfer of functions was supposed to happen in gradual
manner but was carried out prematurely as president Garcia, being a strong promoter of
decentralization, one day in 2007 ordered that all the functions should be transferred before
the year ended. Johnny Zas Friz and Silvana Huanqui, both working in an expert group in the
MEF, feel that the transferring of functions was hastened and in many aspects done without a
clear delineation or instructions. Today, three years after the final transfer of functions, the
MEF are still working on the specific details around the already decentralized functions (Friz-
Huanqui 101018).
The attempt to merge Peru’s 25 regions into 12 macro regions ended up in total failure, in spite of the lucrative incentives given to the regions. The design of the 2002 reform is questionable; the reform first established 25 regions, to only a few years later wanting to create a new structure. According to the Peruvian experts we have consulted none seem to believe that the regions will ever be willing to merge voluntarily. Therefore, until the framework is changed – the decentralization process will be stalled.

5.5.1 No deadline, no pressure

In the first years after decentralization reform the World Bank gave Peru loans to secure a careful and gradual decentralization process. The reason for this was for the Peruvian decentralization not to end up in disorder, as it has in the case of some other developing countries (Rühling 101015). This slower approach is not favored among everyone e.g. Tom Reilly, the project manager of PRODES in Peru, is afraid that if the decentralization proceeds as slowly as it has so far it might never be fully realized. The problem is that there is no deadline on the decentralization project (Reilly 101022). The political unity in favor of decentralization may not always be there and therefore the process should be treated with a careful urgency and clear objectives while support still exists. Peru’s next presidential election is coming up in the spring of 2011 and the future of the decentralization process will heavily depend on the interest of the new president to carry out the process. There are mixed opinions, between the experts we have consulted, whether the process should be carried out at a slower or faster pace. Some say that the subnational institutional growth needs time to develop and that they are far from ready to accept more responsibilities while others agree with Reilly above and fear that the process will eventually run into the sand.
6. Conclusions and Policy Implications

In this section we will answer the research questions that we specified in the introduction of the thesis. We believe that these can conclude the most important empirical findings presented in this thesis. Firstly the most important obstacles for the decentralization to be able to deepen are identified. We conclude how Peru can proceed to minimize the demerits and maximize the merits of decentralization to ensure a more successful outcome of the process. Lastly we try to predict how the decentralization process will proceed in the future.

What are the main factors behind the experienced setbacks in the Peruvian decentralization process?

This thesis originally aimed to analyze and evaluate the decentralized tax structures in Peru but due to the setbacks of the decentralization, the process has not progressed as expected. Instead, this thesis came to revolve around the issues standing in the way for Peru to deepen its decentralization. In order to maintain a macroeconomic stability the central government is still reluctant to share the responsibility of collecting tax revenues with subnational levels. Since neither the capability nor the capacity, in general, exists on subnational level the risks involved with tax decentralization are believed to be too large. Until Peru’s subnational governments have developed the appropriate institutional capacity, the larger tax collection responsibilities will remain in the hands of the central government. The focus in the decentralization process has so far been to decentralize the functions without giving guidelines or assistance for an efficient implementation of the functions. This was only prioritized recently which means that we will hopefully see more competent subnational governments in five to ten years time.

Together with the lack of subnational competence, the horizontal imbalance in Peru is the largest issue for a deeper fiscal decentralization. Peru’s wealth is rapidly growing but the
increased flows of funds are unevenly distributed. This mainly due to the unforeseen growing size of the tax revenues distributed through the Canon. It is essential that the distribution pattern of the Canon is reformed to ensure a more equal distribution. The horizontal imbalance also creates big differences in the level of public services supplied across regions, causing the higher educated people stay in the richer urban areas. This ‘brain drain’ from the rural areas further increases the gap between regions and makes it harder to raise competence outside of Lima.

The failed attempt to create macro regions has stalled the decentralization process. The Peruvians identify themselves strongly with their local and regional identity and will not voluntarily agree to a change something that will diminish this identity. Experts in Peru believe that the whole idea of merging is peculiar and that it will be hard to realize. It is therefore important to reform the decentralization laws and create other ways for the regional government to be given increased responsibilities so that the decentralization can proceed.

**How can the process change to maximize the merits of decentralization and minimize the demerits?**

To reap the benefits of a potentially more efficient administration of public goods, the local competence among politicians, officials and residents needs to be raised. A higher degree of competence will make officials run the institutions more efficiently. It will also provide residents with increased awareness to put more pressure on the politicians to make appropriate decisions. Increased competence will hopefully result in funds being invested in a way more in line with the social optimum. Enlarged competence is also important to make subnational governments ready for the next step of the decentralization, which also entails being responsible for the input side, i.e. tax collection. To reduce the risk of Moral Hazard and foster responsible spending, extended own source reliance is of great importance. SAT Lima has been brought up as a positive example of how a local government can efficiently collect taxes. In time SAT Lima should also be ready to deal with the collection of more complicated taxes of
larger scale. The central government should try their best at spreading the ideas of successful examples to the rest of the country and adjust the successful ideas to fit into different local contexts.

The strongest demerit of decentralization is perhaps the increased demand of local competence and more bureaucracy. These demerits can be reduced by building strong institutions at all levels of government and through upholding good intergovernmental communications. A clearer delineation of functions has been requested and along with an ambition to create a more equal intrastate foundation, Peru has a greater chance at achieving institutional efficiency at all levels. Many of the merits described in chapter two have yet to be reaped due to their characteristics of being long-term, e.g. local governments’ ability to match both tax rates and public services with the resident’s preferences as well as the citizen’s possibility to move to the area best matching their preferences. The demerits are however noticeable from the start and often larger in the beginning of the process, e.g. the demand of increased local competence and bureaucracy. Therefore the benefits from decentralization are likelier to be seen later on in the process and the demerits will hopefully gradually be faded out.

**How will the decentralization process proceed in the future?**

In the spring of 2011 Peru will fall under a new leadership as President Garcia cannot be reelected. The future of the decentralization process will heavily depend on the outcome of the election. There is a strong consensus among experts that the decentralization process cannot be reversed no matter what the outcome of the election but there is a great insecurity of how the process will advance, especially concerning at which speed the process will evolve.

The lack of subnational competence is being emphasized by many people consulted and actions to improve this have been taken. This however takes time and even if it is not appropriate to shift further tax collection responsibilities to subnational level today, it may hopefully be so in five to ten years. In long term perspective a sustainable solution should rely on own-source
revenue so that the risk of moral hazard can be avoided and the benefits of local tax collection reaped.

The Peruvian experts of decentralization that we have consulted are pessimistic and do not believe that any larger taxes like the PIT and the VAT will be collected on a subnational level in a foreseeable future. The onsite experts consulted from developed countries are much more positive to the Peruvian situation and believe that it will happen, in its right time. It is vital for the decentralization process that Peruvians build confidence in themselves, in each other and in all levels of the government and establish a strong national identity.
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