

Subnational government revenues: The role of taxes and transfers

● Structure of subnational government revenues in Latin America and the Caribbean.

● Characteristics of subnational tax revenues and action areas.

● Status of transfer systems and action areas.

5

Key messages

1 On average, 58% of subnational government revenues in Latin America and the Caribbean (LAC) come from transfers, while 42% originate from own-source revenues, though these figures vary significantly both between and within countries.

2 There is a positive relationship between the quality of public spending and its financing through own-source revenues, as tax payments increase citizens' interest in influencing spending decisions and ensuring they are effectively implemented.

3 Disparities in own-source revenues among subnational governments are substantial, particularly at the local level, and exceed those in developed countries. These inequalities are driven by differences in economic development and fiscal effort across jurisdictions.

4

A reform agenda for subnational tax revenues that includes reducing dependence on gross revenue taxes, increasing real estate tax collection, strengthening the role of new taxes, and improving fiscal coordination and cooperation across levels of government.

5

Transfers help reduce disparities in own-source revenues among subnational jurisdictions in LAC. However, inequality in total revenues remains much higher than in OECD countries due to broader initial gaps.

6

Reforming transfer systems in LAC requires strengthening their redistributive components, increasing incentives and capacities for own-source revenue collection, and improving government performance. Additionally, developing savings funds to mitigate the procyclical bias of transfers is necessary.

7

The rules for distributing royalties and the governance of natural resources should incentivize the extraction and production of critical minerals and hydrocarbons for the energy transition—such as copper, lithium, and natural gas in the areas where these deposits are located.

Subnational government revenues: The role of taxes and transfers¹

Introduction

Subnational governments can finance themselves through their own revenue collection or with transfers from the national government. Each source has its advantages and disadvantages. A key advantage of financing with own-source revenues (OSR) is its positive impact on spending quality. For example, in Brazil, Gadenne (2017) shows that an increase in municipal tax collection is reflected in improvements in educational infrastructure, while increases in transfers have no similar impact. Martínez (2023) finds similar results in Colombia, examining a wider range of spending allocations and comparing the effectiveness of local tax revenues to that of revenues from natural resource extraction royalties.

The positive relationship between the quality of spending and its financing through own-source revenues is largely explained by the link

between tax payment and political engagement—understood as citizens' interest in influencing spending decisions and ensuring they are effectively implemented. Many authors² agree that this results in greater accountability.

Decentralizing tax collection, which increases subnational governments' own-source revenues, can improve spending quality but requires careful design, coordination with national policies, and careful consideration of potential drawbacks. One such drawback is that regions with stronger economic bases tend to generate more tax revenue than poorer regions, leading to disparities in public service provision. Additionally, in some contexts, decentralizing tax collection can lead to administrative inefficiencies or trigger “races to the bottom,” where jurisdictions lower taxes to attract

1 This chapter was written by Carolina Camacho and Ricardo Estrada, with assistance from Rodrigo Fernández and Daniela Goyheix.

2 Weigel (2020), Bates and Lien (1985), Hoffman and Rosenthal (1997), Moore (2004), Prichard (2015) and Bräutigam et al. (2008).

businesses or high-income individuals, reducing overall tax revenues.³



The payment of taxes contributes to increasing government accountability to citizens, thereby improving the quality of public spending

Fiscal transfers from national to subnational governments can mitigate inequality in terms of their capacity to provide public goods and services. Moreover, they are essential for addressing fiscal imbalances caused by the decentralization of responsibilities that require expenditures exceeding revenues generated by tax autonomy.

However, transfers can also produce undesirable effects, particularly by discouraging local revenue collection. Evidence indicates that this effect can be especially significant in contexts with weaker institutional development (Lago et al., 2024). For instance, Ferraz et al. (2024) find that a reduction in the transfers received by municipalities in Brazil leads to increased investment in fiscal capacity and local revenue collection, particularly in jurisdictions with greater political competition and mayors with higher levels of education. Another potential unintended effect is that transfers can contribute to the excessive growth of subnational governments and debt accumulation (Lago et al., 2024).

This chapter addresses two central objectives related to the challenges of tax collection and transfers. First, it analyzes how to improve subnational government revenue collection in Latin America and the Caribbean. This improvement involves strengthening tax administration in most cases and advancing the design of tax regimes to enhance efficiency, simplicity, and equity.

Currently, the tax systems of many subnational governments in the region are characterized by unnecessary complexity, taxes that significantly distort economic activity, and high levels of tax delinquency and evasion. The revenue agenda focuses on three key questions: What are the best taxes to collect at the subnational level? How can their design be harmonized to ensure that incentives and penalties generate the desired outcomes? And what interventions can improve coordination and cooperation across jurisdictions?

The second objective of the chapter is to analyze the challenges of intergovernmental transfer systems in Latin America and the Caribbean. Creating transfer systems that are more efficient, equitable, and transparent requires a careful analysis of instruments and local realities, addressing multiple tensions. The importance of transfers in subnational public finances and the opportunities for improvement within these systems in the region make this task essential.

Subnational government revenues

In Latin America and the Caribbean, subnational government revenues average 6.5% of national GDP. Across countries, transfers account for 58% of total revenues on average, exceeding own-source

revenues, which represent 42%. However, both the magnitude of total revenues and the significance of transfers vary widely between countries (Graph 5.1).

³ The concept of a "race to the bottom" refers to the idea that the more lax the regulations in a competitive context for attracting investment, the lower the costs for investors, thereby increasing the location's appeal.

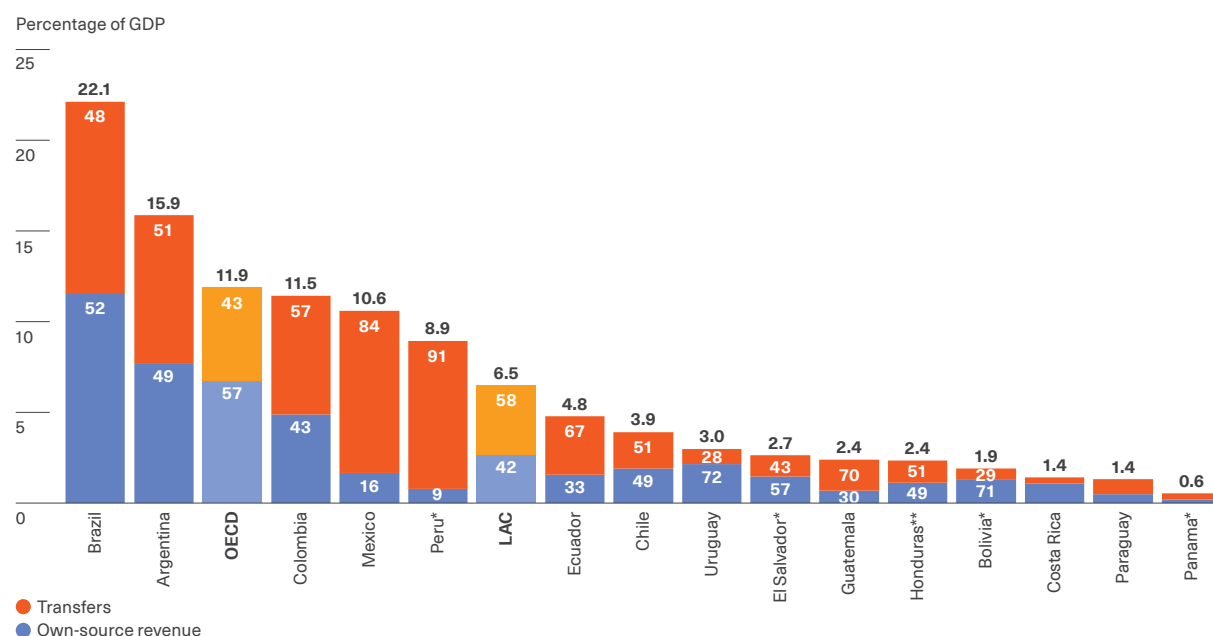
By comparison, subnational government revenues in OECD countries average 11.9% of national GDP. Of this, 43% comes from transfers, 15 percentage points less than the LAC average.

There is a clear association between the level of subnational government revenues and the degree of decentralization in a country. Among the five

countries where subnational governments have the highest revenues, three are federal systems (Argentina, Brazil, and Mexico), and two are the most decentralized unitary states (Colombia and Peru).⁴ In the other ten countries shown in Graph 5.1—all with smaller populations and unitary systems—subnational government revenues average only 2.4% of GDP.

Graph 5.1

Fiscal revenues of subnational governments in LAC countries, 2022



Note: The graph reports the total revenues of subnational public sectors as a percentage of national GDP. Following the IMF manual (2014), "own-source revenues" include tax revenue and non-tax revenue, such as property income; sales of goods and services; fines, penalties, and forfeits; and premiums, fees, and claims related to nonlife insurance and standardized guarantee schemes. "Transfers" include grants and transfers not elsewhere classified. Social security contributions and other social contributions are excluded. Data for Argentina, Brazil, Colombia, Mexico, Paraguay, and Peru pertains to subnational governments (regional and local). Data for Bolivia, Ecuador, and Uruguay covers regional governments. For Chile, Costa Rica, El Salvador, Guatemala, Honduras, and Panama, data pertains to local governments. * Indicates the latest available data is from 2021. ** Indicates the latest available data is from 2020.

Source: Authors based on national sources for Argentina (MECON, 2023b), Bolivia (MEFP, 2023a), and Uruguay (OTU, 2023b) and IMF (2024e) for other countries.

4 More information about the degree of decentralization in the countries of the region can be found in chapter 2 of this report.



Inequality in own-source revenues is due to differences in economic development and the fiscal effort of jurisdictions

Total revenue is roughly evenly split between own-source revenue and transfers in most countries. However, Ecuador, Guatemala, Mexico, and Peru stand out for their heavy reliance on transfers, which account for at least two-thirds of total revenue. In Peru, the high prevalence of transfers aligns with a low score on the fiscal dimension of the composite indices of autonomy analyzed in chapter 2 (Hooghe et al., 2016; Ladner et al., 2023).⁵ This suggests that fiscal decentralization in Peru is more limited than the decentralization of responsibilities. The opposite is true in Bolivia, Costa Rica, and

Uruguay, where the devolution of responsibilities is more limited than in Peru, but own-source revenue accounts for more than 70% of total revenue.

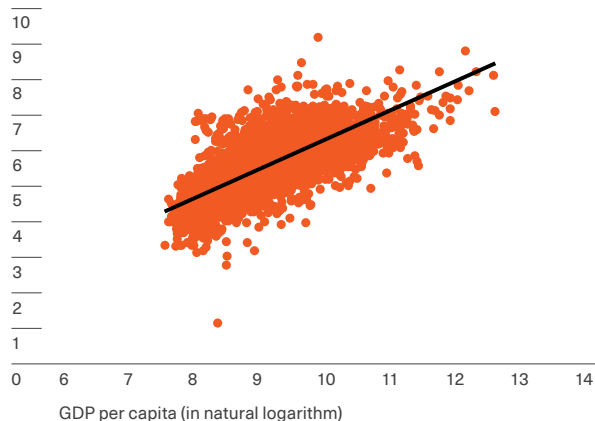
Subnational government revenues not only differ significantly between countries but also within them. These disparities in total revenues originate in inequalities in own-source revenues, which are closely linked to the per capita GDP of jurisdictions. For example, in Brazil, a 1% increase in a local jurisdiction's per capita GDP is associated with a 0.82% rise in its per capita tax revenues, while in Colombia, the increase is 0.54% (Graph 5.2). Additionally, there is considerable variation in own-source revenues among jurisdictions with similar GDP levels, indicating that revenue collection not only depends on economic development. This suggests that there are significant differences in fiscal effort across jurisdictions.

Graph 5.2

Own-source revenues and per capita GDP in local jurisdictions in Brazil and Colombia, 2022

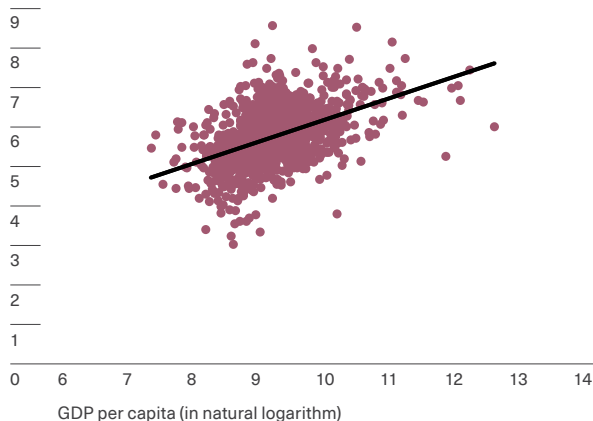
Panel A. Brazil

Own-source revenue per capita
(in natural logarithm)



Panel B. Colombia

Own-source revenue per capita
(in natural logarithm)



Note: Transfers, credit disbursements, available cash balances, and social security contributions are excluded. For Brazil, the latest available GDP data is from 2021. Own-source revenue and GDP amounts are adjusted to purchasing power parity (PPP).

Source: Authors based on data from IBGE (2023b) and STN (2023d) for Brazil, and DANE (2023d) and DNP (2023c) for Colombia and IMF (2024d).

⁵ The fiscal autonomy dimension is very low at the regional level in Peru, according to the Regional Authority Index (RAI), with a score of 0 out of a maximum of 4.

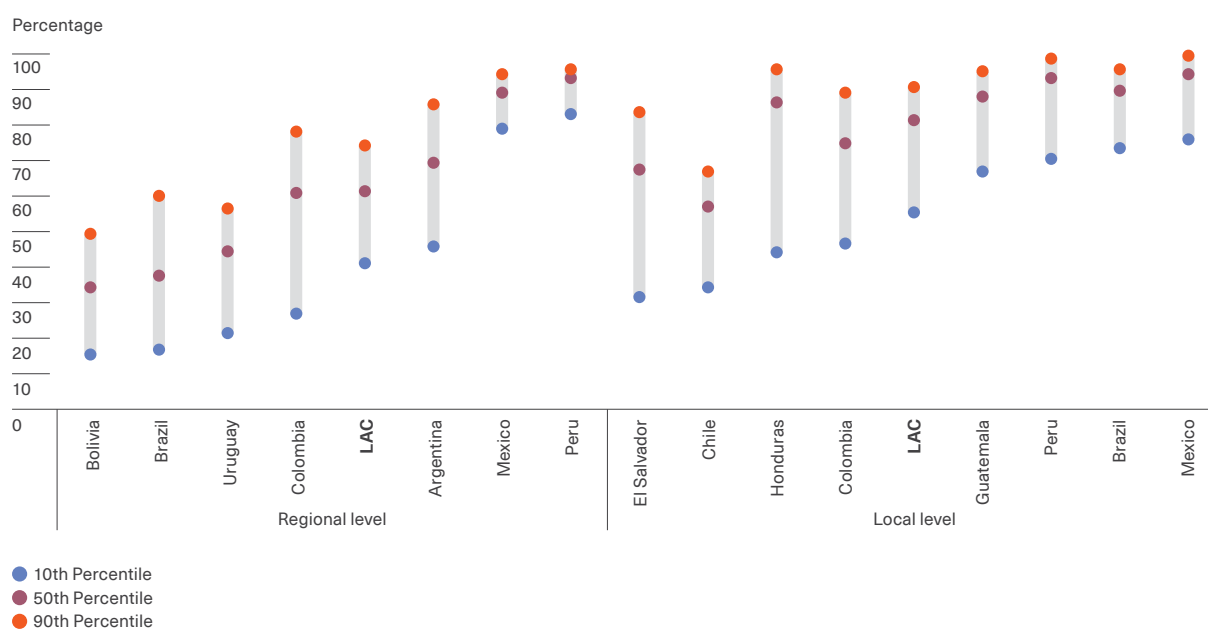
Disparities in own-source revenues among subnational governments are substantial, especially at the local level, and greater than those observed in developed countries. On average, the Gini coefficient for inequality in per capita own-source revenues is 0.33 for regional governments and 0.46 for local governments. By comparison, the Gini coefficient for regional governments in OECD countries averages 0.18.

As detailed in subsequent sections on transfer systems, transfers partially reduce disparities in

total revenues across jurisdictions. In line with this, the importance of transfers within the revenue structures of subnational governments also varies significantly within countries. On average, in Latin America and the Caribbean, the bottom 10% of regional governments in terms of transfer reliance derive at most 41% of their revenues from transfers, while the top 10% derive at least 74% (Graph 5.3). Transfers have even greater weight in the revenues of local jurisdictions, which receive, on average, 14.4 percentage points more of their revenues from transfers than regional jurisdictions.

Graph 5.3

Transfers as a percentage of total revenues of subnational governments in LAC, 2022



Note: Data for Bolivia corresponds to 2021.

Source: Authors based on national sources (details provided in Table A.5.1 in the appendix, available in the online edition of RED).

Structure of own-source revenues

Tax collection constitutes the majority of own-source revenues for subnational governments in Latin America and the Caribbean, accounting for 66% of these revenues.⁶ On average, tax revenues represent 1.8% of GDP, significantly below the 5.3% average for OECD countries.⁷

The importance and composition of non-tax revenues for subnational governments vary across countries and levels of government. Generally, the largest share comes from administrative fees charged for services and the sale of goods and services, with much smaller contributions from fines and rents derived from government-owned properties (see Graph A.5.1 in the appendix available in the online edition of RED). In contrast, non-tax revenues in OECD countries are concentrated in the sale of goods and services and rents from government-owned properties. Except in Brazil and Colombia, non-tax revenues are more significant in countries with lower levels of own-source revenue generation.

Consistent with the observed patterns in total revenues, tax collection is highest in Brazil (9.9% of GDP), Argentina (5.1% of GDP), and Colombia (3.3% of GDP), followed by Chile, Nicaragua, and Uruguay. In ten other countries for which data is available, subnational government tax revenues are minimal, not exceeding 1.1% of national GDP.⁸

The composition of tax revenues by type of tax differs greatly between local and regional levels, both in LAC and OECD countries. At the local level, real estate tax is the main category in both regions, accounting for approximately 40% of total revenues in each (Graph 5.4). However, the higher overall revenues in OECD countries imply that real estate taxes represent 0.9% of GDP, compared to just 0.3% in LAC.

The second most significant category of local taxes shows greater variation, both between OECD countries and LAC as well as within the latter region. In the OECD, this category comprises taxes on income, profits, and capital gains of individuals and corporations, whereas, in LAC, these taxes are virtually nonexistent at the local level—except in Ecuador—and are similarly absent at the regional level.

Local governments in the region rely more heavily on other types of taxes. For example, in Brazil, Colombia, and Nicaragua, nearly half of local tax revenues come from taxes on the production, sale, transfer, leasing, and delivery of goods and rendering of services. This category includes a wide range of taxes, but business taxes levied on gross revenues (which do not deduct costs) account for the bulk of collections.⁹ In Colombia, the most important tax is the industry and commerce tax (ICA), representing 36% of tax revenues; in Brazil, it is the tax on services of any nature (ISS), accounting for 47%; and in Nicaragua, it is the municipal license tax, making up about 15% of tax revenues. Meanwhile, in Chile, Costa Rica, and Paraguay, taxes on the use of goods, or on permission to use goods or perform activities play a prominent role. The largest source of revenue in this tax category in these countries comes from taxes on the use of goods other than vehicles.

The contrast between the OECD and LAC is even more pronounced at the regional level of government. In the OECD, taxes on income, profits, and capital gains of individuals and corporations constitute the main category, accounting for 37% of revenues, whereas these taxes are irrelevant in all LAC countries.

6 2022 data for 15 countries in the region, based on official sources.

7 Excluding Latin American countries.

8 2022 figures for 15 countries in the region: Argentina, Belize, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Jamaica, Mexico, Nicaragua, Paraguay, Peru, and Uruguay.

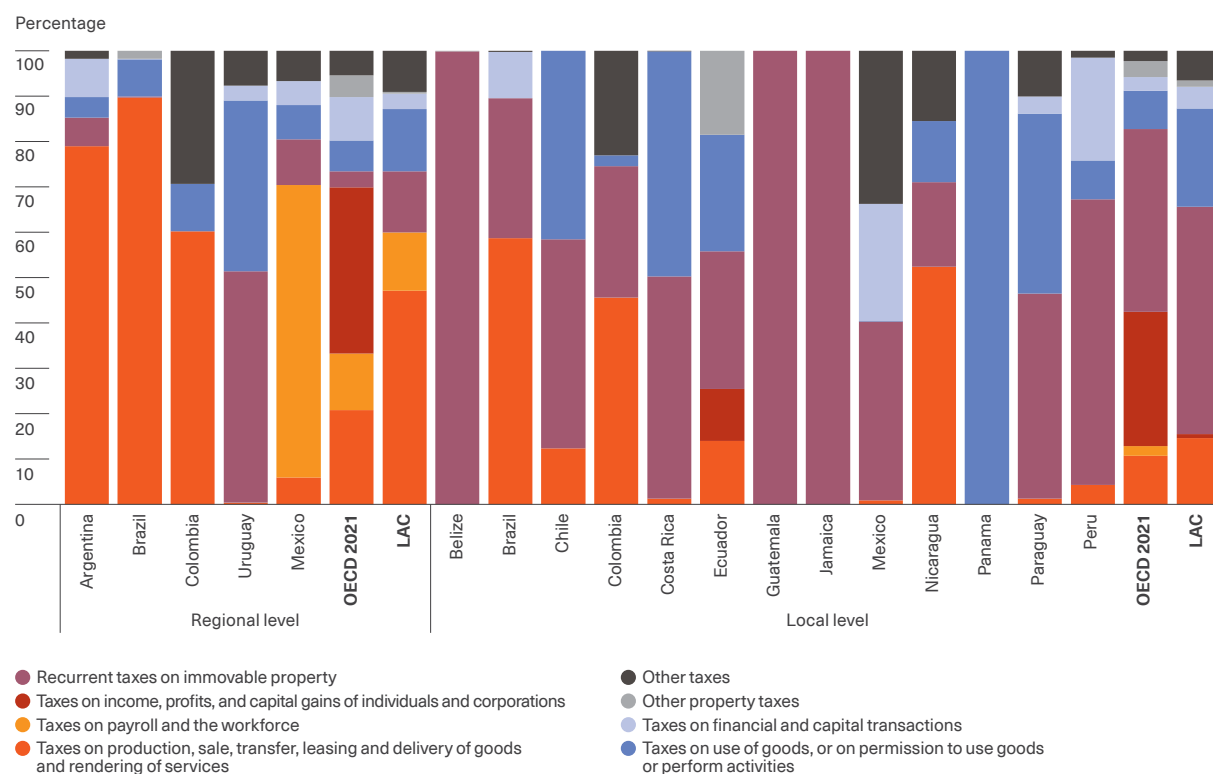
9 Taxes in this category include value-added tax (VAT), sales taxes, excise taxes, and gross revenue taxes.

There are substantial differences among LAC countries regarding the primary regional tax. Taxes on goods and services dominate in Argentina, Brazil, and Colombia. In Argentina, 79.1% of revenues are concentrated in the gross revenue tax; in Brazil, 81.1% comes from the tax on the circulation of goods and transportation services (ICMS); and in Colombia, 46.1% comes from taxes on the

consumption of alcoholic beverages, wine, and beer. Conversely, in Mexico and Uruguay, taxes on the production and sale of goods account for less than 6% of revenues. In Mexico, more than 60% of tax revenues come from payroll taxes, while in Uruguay, collections focus on real estate and vehicle taxes (Graph 5.4).

Graph 5.4

Composition of main tax revenue categories in total tax revenue, 2022



Note: The average in Latin America and the Caribbean is calculated as the simple average of percentages across countries. The OECD average represents the simple average of member countries. In the local government panel, Bolivia, El Salvador, and Honduras are excluded because the "other taxes" category accounts for over 50% of their revenues.

Source: Authors based on OECD (2023).

Opportunities for improving the tax structure of subnational governments

Reducing the weight of gross revenue taxes

The primary issue with the tax structures of subnational governments in many countries is the significant reliance on inefficient taxes, such as those levied on gross revenues. Gross revenue taxes have several flaws. Since they are applied to total sales rather than profits, they penalize businesses that would otherwise be profitable, creating inefficiencies. Additionally, because they do not allow deductions for intermediate goods, they encourage vertical integration of enterprises, putting small and medium-sized enterprises (SMEs) at a disadvantage.

Gross revenue taxes persist despite their general limitations due to political economy factors and their ease of collection. On one hand, they are relatively well-accepted by the public, as their impact on prices is not always obvious. On the other hand, they offer administrative and monitoring advantages over other taxes, such as real estate taxes. Their ease of collection stems from the direct valuation of the taxable base, which simplifies filing for taxpayers and oversight for authorities. They are also easy to verify through third parties and, by definition, have a broad tax base.



Gross revenue taxes persist despite their general limitations due to political economy factors and their ease of collection

In addition to the inherent flaws of gross revenue taxes, their application by autonomous subnational jurisdictions without coordination or harmonization mechanisms creates further distortions. Variability in rates and exemptions across jurisdictions leads to two key issues: (1) higher transaction costs for

businesses operating nationally, as they must navigate different regulations across jurisdictions, and (2) a shift in investment toward sectors or locations with lower tax burdens. Argentina's gross revenue tax exemplifies this lack of coordination. Similarly, Brazil has long faced challenges with the ICMS, though it is currently undergoing reform.

In Brazil, the ICMS on transportation is levied on interstate sales of goods and accounts for 81% of subnational tax revenues.¹⁰ ICMS collection occurs in the state of origin of the transaction, incentivizing states to reduce rates or introduce exemptions to attract more businesses. The tax rates vary widely, from 0% to 35%, depending on the jurisdiction and product. This variability can distort business location decisions, reducing overall efficiency and tax revenues across the system. Additionally, the ICMS is part of a more complex system involving five taxes on goods and services applied by three levels of government. In this context, overlapping tax bases and the inability to fully deduct intermediate input costs lead to cascading tax effects, distorting productive resource allocation.

In December 2023, Brazil enacted a comprehensive tax reform aimed at gradually addressing these issues by replacing the existing taxes, including the ICMS, with a dual Value Added Tax (VAT) system. The reform introduces two value-added taxes. The first is the subnational tax on goods and services (IBS), which, between 2026 and 2033, will replace the ICMS levied by states and the tax on services (ISS) levied by municipalities. The second is a federal tax: the contribution on goods and services (CBS), which will replace other federal taxes, such as the Social Integration Program (PIS), the tax on industrialized products (IPI), and the contribution for financing

¹⁰ Figures sourced from STN (2023d) for the year 2022.

social security (COFINS), between 2024 and 2027. Notably, the reform eliminates tax exemptions, such as those previously established under the ICMS by some states to attract investments. This

change is expected to equalize tax conditions across Brazilian states, reducing distortions in investment decisions.

Increasing real estate tax collection

Real estate tax collection is not only low in several countries but it is particularly low in many jurisdictions within those countries. This is the case, for example, in Colombia, one of the region's leaders in real estate tax collection, where revenues are highly concentrated in major cities. In 2022, five cities accounted for 60% of real estate tax revenues.¹¹ Additionally, per capita revenue in rural areas was only half that observed in urban areas.

The limited collection of real estate taxes in the region is largely explained by the higher political costs associated with this tax compared to others. This is due to several factors. First, the tax is highly visible to taxpayers because of direct billing and significant payment amounts. Second, payment methods are often limited to a single annual installment, without adequately aligning with taxpayers' cash flow. Third, there can be a mismatch between presumed and actual payment capacity. For instance, when a homeowner occupies their property, the asset does not generate direct monetary income, potentially leaving the owner without the means to pay the tax. Fourth, cadastral valuations are often difficult for taxpayers to understand, and the widespread lag in updating taxable values can lead to sudden increases in obligations.

In this context, it is more politically costly for local governments to implement measures to increase real estate tax revenues than to raise other, less transparent taxes. Chacón and Sánchez (2020) show that mayors in Colombia have more incentives to increase industry and commerce taxes than real estate taxes, as the former carry lower political costs.



The collection of real estate taxes is low in several LAC countries and tends to be concentrated in a minority of jurisdictions within each country

In addition to political costs, real estate tax collection is challenging because valuing the tax base entails significant expenses. As a result, administrations face substantial delays in updating valuations, even though most countries require property values to be updated every five years.¹² These delays are also partially explained by a lack of administrative capacity or technological resources. A noteworthy example is the introduction of self-assessment for real estate valuation in Bogotá in 1993, which doubled tax collection as property owners declared values closer to market value (De Cesare et al., 2016).¹³

11 Bogotá collected 33.9% of real estate taxes, while Medellín, Cali, Barranquilla, and Cartagena collectively accounted for 23.3% (DNP, 2023c).

12 In 2019, only 5.7% of properties in Colombia had updated cadastral information, 66% had outdated information (with an average lag of 12.2 years), and 28.3% had no cadastral information at all (IGAC, 2019).

13 In 1994, Colombia's Constitutional Court declared the use of the self-assessment mechanism unconstitutional without a benchmark or point of comparison provided by the cadastral authority. Following the ruling, the self-assessment mechanism was maintained, but the benchmark was shifted to the value established by the cadastral authority, which constitutes the minimum valuation base. In practice, this has placed the full burden of property valuation back on the cadastre.

Box 5.1

Revenues from urban land value capture

Subnational governments have potential revenue opportunities through the capture of urban land value generated by actions such as infrastructure construction. In addition to real estate taxes, the following instruments can be used for this purpose: betterment levies, value added by regulations the sale of development rights, and charges for land readjustment or partial plans, which are fees in exchange for benefits or increased land use allowances.

According to Borrero Ochoa and Rojas Ruiz (2020), betterment levies are among the most traditional instruments in the region and have significant revenue potential. These are levies imposed on property owners who benefit from the construction of public works. The authors note that between 2007 and 2013, betterment levies accounted for only 0.16% of tax revenues in eight Latin American countries, with Colombia having the highest share (0.64%).

An example of charges or fees in exchange for benefits or increased land use allowances can be found in the municipality of Tres de Febrero (Argentina), which in 2020 introduced the Urban Development and Sustainable Habitat Fee. This fee is imposed on property owners benefiting from increases in land value due to enhanced development rights and changes in land use. According to Pino (2024), this is a noteworthy case, as revenues grew over the four years following its implementation, with funds allocated to improving urban infrastructure.



Updating the taxable base value for real estate taxes is often delayed due to high costs and a lack of administrative and technological capacities

While the political and economic costs of broadening the tax base are critical determinants of valuation delays and, consequently, low collection rates, other factors also play a role. According to Chacón and Sánchez (2020), transfers reduce real estate tax collection in Colombian municipalities. Higher transfers decrease the incentives to incur the costs of updating cadastral records, limiting the increase in the tax base value. Additionally, owners of high-value properties can influence local governments, curbing the tax's progressivity, delaying cadastral updates, and hindering effective collection. Villaveces (2016)

notes that one reason for the gap in real estate tax collection between urban and rural areas in Colombia is the delay in updating cadastral records in areas with high political concentration, where private landowners' interests can exert greater influence on public policy decisions.

In general, countries in the region have room to expand the collection of real estate taxes.¹⁴ This tax can be strengthened through adjustments to make it more taxpayer-friendly and easier to collect. These adjustments include: 1) simplifying tax rates (reducing differentiation by activity) to facilitate monitoring (Sjoquist, 2004); 2) limiting exemptions and periodically reviewing exempt properties (Kelly, 2013); 3) aligning payment schedules with taxpayers' cash flow, introducing gradual payment methods, and using complementary information to address mismatches between presumed and actual payment capacity; and 4) Improving transparency by using valuations based

14 For details on real estate tax regulations, see Table A.5.2 in the appendix, available in the online edition of RED.

on observable parameters and drawing on lessons from cases such as Bogotá's self-assessment system, described above. Governments can also innovate by utilizing taxes and fees that capture extraordinary increases in urban land values, as detailed in Box 5.1.

The low and uneven collection of real estate taxes contrasts sharply with their advantages as a fiscal instrument for local governments. First, the tax base is immovable, simplifying the identification of the jurisdiction responsible for collection and limiting the tax's impact on economic activity. Second, taxpayers directly benefit from local public goods and services, as these often lead to

increased property values. Third, real estate taxes function as an urban planning tool, enhancing the efficiency of land use and serving as a mechanism to encourage voter scrutiny of local authorities. In addition, when properly designed, the tax can be both progressive and transparent. It is progressive because property values tend to correlate with the wealth of their owners, having the potential to ensure that those with greater economic capacity contribute more. It is transparent because the combination of a clear and verifiable tax base with a simple structure makes it easy to understand, especially when technical methodologies are employed to define the taxable base (Ahmad et al., 2019).

A greater role for new taxes

As previously noted, the primary difference between the tax revenues of subnational governments in LAC and those of their OECD counterparts lies in the significant role of income taxes on individuals and corporations in the latter. This presents an opportunity for the region to increase subnational revenue from these taxes, though it is not without challenges. Since these are relatively complex taxes that require measures such as filing declarations, subnational collection must be coordinated with national systems. The difficulty in expanding subnational collection lies in the fact that the national collection of income tax on individuals in LAC has notable deficiencies compared to OECD countries (OECD et al., 2018).

Another category of taxes that requires strengthening includes those levied on consumption and activities that generate social costs. This includes the consumption of alcoholic beverages and sugary drinks, which impose burdens on healthcare systems. Taxes

on alcohol consumption, for example, are widely applied by regional governments in Colombia. The implementation or expansion of taxes on sugary drinks has generally been considered at the national level. However, they also represent a viable alternative at the subnational level, as evidence suggests they do not result in significant tax evasion through cross-jurisdictional shopping (see, for instance, Powell and Leider (2020), in the case of Seattle in the United States).

An area with the potential to strengthen taxes that penalize behaviors with social costs is urban mobility. These taxes target the use of private motorized transport due to its environmental, congestion, and accident-related impacts. Such penalties include urban tolls, congestion charges, mileage-based fees, and parking fees. Revenue from these sources can be allocated to financing mass public transportation systems, which reduce pollution and congestion. The challenges of these systems are explored in chapter 6.

Using new tools to promote voluntary tax compliance

The political costs of imposing penalties for noncompliance with tax obligations often limit their use by authorities. Dunning et al. (2015) show that in Montevideo (Uruguay), tax delinquency rates are high, and debtors are repeatedly granted amnesties despite the government having sufficient information and monitoring capacity to identify and penalize nonpayment of local taxes. Similarly, Holland (2015) demonstrates how, in Bogotá, Lima, and Santiago, the enforcement of sanctions against unlicensed street vendors follows an electoral logic: sanctions tend to be weaker in districts where informal vendors hold greater electoral significance.

In this context, deploying incentives to encourage voluntary tax payment emerges as a cost-effective alternative to strengthen compliance with fiscal obligations.



The use of incentives to encourage voluntary tax payment can be a cost-effective alternative to strengthen compliance with fiscal obligations

Among the strategies tested to promote voluntary tax compliance, one approach involves sending communications aimed at influencing tax morale—defined as motivations that are not necessarily tied to the expected costs of detection and punishment. Specifically, taxpayers appear motivated to conform to social norms¹⁵ or to reciprocate the provision of public goods. For example, expanding the availability of public goods and making their funding through tax payments more visible can increase taxpayers' willingness to pay. Carrillo et al. (2017) find that building or renovating sidewalks in Santa Fe (Argentina) has broad and lasting positive effects on real estate tax collection.

A second set of interventions to encourage voluntary compliance involves offering monetary or social rewards (Dalton et al., 2021; Sjöberg et al., 2019). Existing evidence provides mixed results on their effectiveness (Bahl and Bird, 2008). Dunning et al. (2015) document the widespread use of rewards or lotteries in Argentina, Brazil, Colombia, Mexico, Peru, and Uruguay to incentivize timely payment of subnational taxes. However, they find that in Uruguay, a lottery for punctual taxpayers that exempts winners from paying taxes in the following fiscal year does not positively affect compliance. These findings lead the authors to question the general effectiveness of rewards and highlight their potential negative impact on taxpayers' intrinsic motivations,¹⁶ particularly in contexts of persistent tax evasion.

In general, evaluations of various interventions aimed at inducing voluntary tax payment yield mixed results. This may be due to differences in intervention design or contextual factors, such as prevailing fiscal policies and the economic or political environment. Hence, it is crucial to accompany implementation with evaluations that take into account the specific context of the intervention. Broad and accurate information about taxpayers, along with effective communication technologies between citizens and tax authorities, is essential. These requirements involve costs, which can present a challenge for implementation. Nevertheless, the cost-benefit analysis of fostering a cooperative relationship with taxpayers proves more advantageous than relying on enforcement measures (Alm and Martínez-Vázquez, 2003).

15 Del Carpio (2014) finds evidence from Peru of an increase in tax collection when individuals who underestimated the tax compliance rate were informed about the actual rate.

16 Intrinsic motivation is defined as engaging in an activity for its inherent satisfaction rather than for any external consequence.



The Barbuda Council is one of the local jurisdictions with the highest proportion of Afro-descendant peoples in the region.

Coordination and cooperation with national authorities in tax policy

Failures in coordination and cooperation between national and subnational governments in the design and implementation of revenue instruments can create a burdensome environment for taxpayers. The multiplicity of tax levels, with differing rules and procedures, increases compliance costs and may lead to higher tax delinquency and evasion. Bahl and Bird (2008) emphasize that these complexities are especially pressing in developing countries, where tax administration capacity varies significantly between levels of government.



Fiscal coordination can allow for a degree of autonomy in setting tax rates without creating significant disparities between jurisdictions

To address inefficiencies, compliance challenges, and the risks of double taxation arising from a lack of coordination between national and subnational fiscal policies, recommended initiatives include tax harmonization, strengthening administrative capacity, and establishing institutional frameworks to enhance governance.

Tax harmonization involves aligning the definitions of taxable bases across government levels. It is also advisable to develop a coordinated framework to prevent significant disparities that could lead to tax competition or arbitrage, while still allowing a degree of autonomy in setting tax rates. For example, in the European Union, the design of the VAT is harmonized across member states, reducing compliance costs for businesses operating in multiple countries. Similarly, in Canada, the federal government and provinces coordinate the Goods and Services Tax (GST) and the Harmonized Sales Tax (HST) to maintain consistency nationwide, while still granting provinces some flexibility.

Strengthening intergovernmental fiscal bodies or councils can facilitate regular dialogue and coordination between government levels. These entities can help resolve conflicts, coordinate fiscal policies, and ensure the consistent application of tax laws.

Collaboration between central or federal governments and regional and local governments, as well as partnerships among jurisdictions, can promote the convergence of institutional capacities. For instance, regional or local governments could collect income taxes more effectively if the national government provided support with the necessary data infrastructure. Similarly, gathering cadastral information for collecting real estate tax at the local level could be made less costly with collaboration among jurisdictions, even when they are at the same government level. A concrete example is the Metropolitan Area of the Aburrá Valley, a public administrative entity that brings together ten municipalities in the department of Antioquia (Colombia). This organization acts as a coordinating body for territorial planning and has become a cadastral manager. Through this association, the member municipalities work together to manage and update cadastral records more efficiently, leveraging shared resources and joint technical expertise.



Collaboration between different levels of government and jurisdictions—through shared infrastructure and activities that leverage economies of scale—can reduce tax collection costs

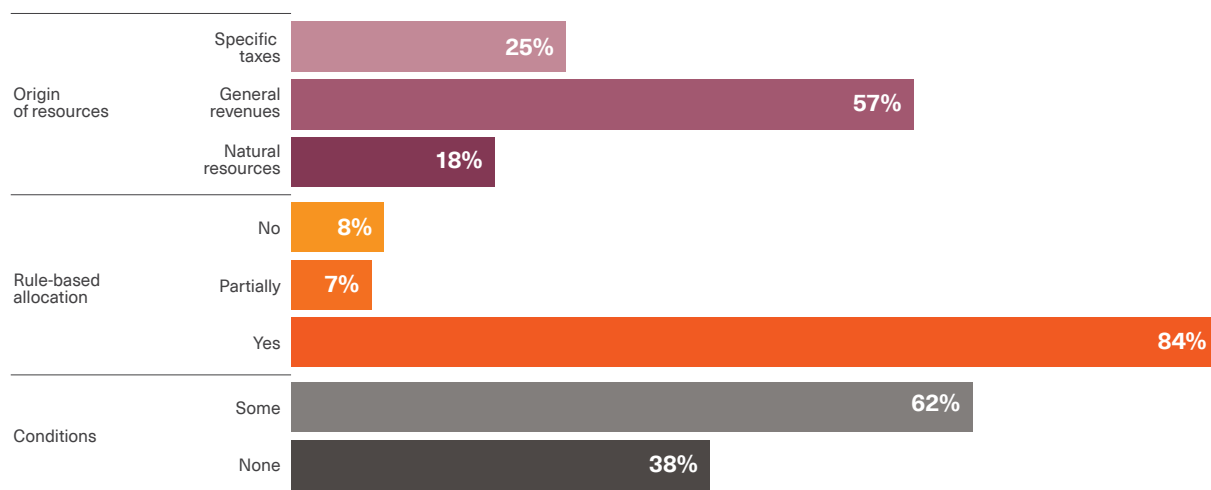
How are transfer systems structured?

Fiscal transfer systems in Latin America and the Caribbean consist of multiple programs with varying objectives, allocation rules, and spending conditions. For this report, 38 transfer programs from national to subnational governments in 15 countries of the region were analyzed.¹⁷ Each program represents at least 5% of the total amount of transfers to subnational governments in its respective country, based on the most recent available data, and together account for an average of 91% of total transfers in the countries studied. On average, in the nine countries with two levels of government, 58% of transfer funds go to the

regional level and 42% to the local level, while in the six countries with only local governments, all transfers are allocated to the local level. In some countries, there are also transfers between subnational governments, of which there are two types (see Box 5.2).

Regarding the source of funds, on average, 57% of transfer amounts come from the national government's general revenues, 25% from the revenue sharing of specific taxes, and 18% from the exploitation and consumption of natural resources.

Graph 5.5
Characteristics of the main transfer programs to subnational governments



Note: The graph reports simple averages across countries for the distribution of total transfer amounts by the variables analyzed. Calculations are based on the programs listed in Table A.5.3 in the appendix available in the online edition of RED (excluding Trinidad and Tobago).

Source: Authors based on Radics et al. (2022), Miranda et al. (2017), ECLAC (2024), and national laws and official government data (details in Table A.5.1 in the appendix available in the online edition of RED).

17 See Table A.5.3. in the appendix, available in the online edition of RED.

Box 5.2

Transfers between subnational governments

Although less prominent, there are also transfer programs between subnational governments in the region. Table 1 lists the existing programs in five countries. These mechanisms can be classified as either vertical or horizontal transfers.

Vertical transfers exist in Argentina, Brazil, and Mexico, which are federal countries where local governments share in revenues from specific taxes collected by regional governments. In Argentina and Mexico, the criteria for allocating funds are determined at the regional government level, while in Brazil, national-level common indicators are also used. In all three cases, there are no spending conditions attached to revenues from shared specific taxes. In Mexico, regional governments also transfer resources from their general revenues to local governments, which are earmarked for spending on health, education, security, and infrastructure.

On the other hand, Chile and Paraguay, both unitary countries, have horizontal transfer programs between local governments. In Chile, the Municipal Common Fund seeks to reduce fiscal disparities among local governments. The fund's resources come from automatic contributions by municipalities, which include a portion of their revenues from real estate taxes, business licenses, vehicle registration fees, vehicle circulation taxes, and fines. Transfers are allocated through a rule-based procedure and are intended to finance service operations and infrastructure investment.

In Paraguay, the Special Fund for Paving and Complementary Works aims to finance local infrastructure through special contributions, primarily from property and vehicle owners. Spending is determined by the Five-Year Paving Plan, which is prepared by each municipality and approved by the fund.

Table 1
Main transfer programs between subnational governments

Country	Concept	Rules	Allocation criteria	Origin of resources	Type	Conditions on spending
Argentina	Provincial tax revenue sharing system	Partially	Each regional government establishes its own revenue-sharing regime based on agreements and regulations	Taxes	Vertical	None
Brazil	Municipal participation in state taxes	Yes	Vehicles registered in their territories, value added in operations, and local legislation	Taxes	Vertical	None
Chile	Municipal Common Fund	Yes	Equal shares, poverty, number of properties exempt from property tax, and own revenues	General revenues	Horizontal	Operating costs for services and infrastructure
Mexico	State participations	Yes	According to the State Fiscal Coordination Law of each jurisdiction	Taxes	Vertical	None
	State contributions	Yes	According to the State Fiscal Coordination Law of each jurisdiction	General revenues	Vertical	Health, education, infrastructure, and security
Paraguay	Special Fund for paving, stormwater drainage, sewerage, and complementary works, and special account	Partially	Five-year paving plan of each municipality	General revenues	Horizontal	Infrastructure

Source: Authors based on national laws, Radics et al. (2022), Miranda et al. (2017), and ECLAC (2024).

Intergovernmental transfer programs vary widely in design. Two key dimensions for understanding how they operate are: first, whether conditions are imposed on how recipient jurisdictions can use the resources; and second, the rules that determine how funds are distributed among recipient jurisdictions. The following subsections examine the advantages of different arrangements

and the characteristics of the programs used in the region for each of these two dimensions. Finally, the extent to which transfers in the region equalize fiscal revenues across jurisdictions is explored, as the degree of equalization is one of the most significant outcomes of the rules governing transfer allocation.

Conditional and unconditional transfers

A primary way to classify transfers is by distinguishing between unconditional transfers, which grant subnational governments the autonomy to decide how to use the funds, and earmarked transfers, which restrict this autonomy by conditioning the use of allocated funds on specific purposes. Each program has its advantages. Unrestricted transfers allow subnational governments to better leverage their informational advantages about local territories. In contrast, earmarked transfers enable national governments to guide subnational spending toward national priorities and enhance the provision of local public goods with positive regional and national externalities (e.g., environmental policies).

On average, 38% of the resources allocated through the analyzed transfer programs are unconditional, while 62% are earmarked for specific expenditures. However, there are significant differences between government levels and countries. Regional governments generally have greater autonomy in deciding how to allocate expenditures compared to local governments. On average, 51% of the resources received by regional governments are unconditional, compared to just 27% for local governments (Graph 5.6). As might be expected, subnational governments in federal countries tend to have greater spending autonomy. Among unitary countries, there is substantial heterogeneity in the level of autonomy, which is not necessarily linked to the degree of decentralization. For example, among the two most decentralized unitary countries, Peru's subnational governments receive one of the highest proportions of unconditional transfers, while in Colombia, all transfers are conditional.

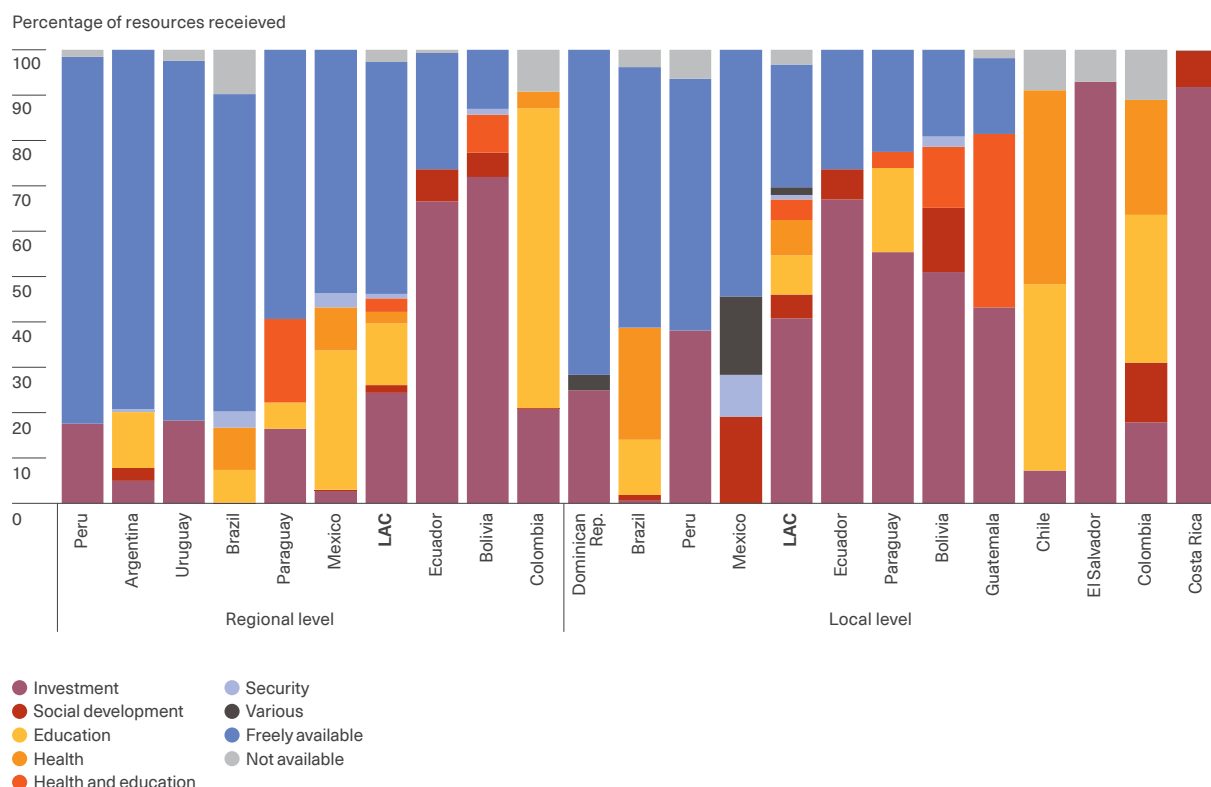
●●
On average, 38% of the resources allocated through the analyzed transfer programs are unrestricted, while 62% are earmarked for specific purposes

Due to concerns that transfers might be used to excessively expand subnational public employment, countries often impose significant restrictions directing funds toward investment expenditures. On average, 24% of the transfers received by regional governments and 41% of those received by local governments must be used for investment expenditures (without specifying a primary sector). Conditional transfers are closely associated with financing education and healthcare sectors in countries where these services have been decentralized (Argentina, Brazil, Chile, Colombia, and Mexico).

In general, there is a correlation between the source of funds and whether spending is conditional or unconditional. Programs funded by general revenues or natural resource revenues tend to impose conditions on how funds can be used, whereas those funded by the sharing of specific taxes are typically unconditional.

Graph 5.6

Transfers to subnational governments by key spending conditions in Latin American and Caribbean countries



Note: Percentages are based on an analysis of transfer programs in the region, using the most recent available fiscal data for each country. Most data correspond to 2022. The “investment” category includes programs that condition spending on infrastructure works and capital goods, without specifying a particular sector for the funds. Resources linked to specific sectors include programs that can be used for either current or investment expenditures. The graph does not specify amounts that must be allocated to investment within a specific sector.

Source: Authors based on Radics et al. (2022), Miranda et al. (2017), ECLAC (2024), and national laws and official government data (details in Table A.5.1 in the appendix available in the online edition of RED).

Rule-based and discretionary transfers

Transfers can be classified based on the mechanisms used for their allocation, distinguishing between rule-based transfers, which rely on predetermined indicators or formulas, and discretionary transfers.

Rule-based transfers are generally more transparent about the criteria used for allocation, offer greater predictability, and are less subject to

political discretion. However, their use is limited by the availability and updating of relevant data. For example, a rule that prioritizes poorer jurisdictions requires up-to-date poverty data, which is often unavailable. In general, the effectiveness of these mechanisms depends on the relevance of the indicators used, the program’s objectives, and the need to avoid creating undesirable incentives. For instance, programs that compensate jurisdictions

with low revenue levels may disincentivize fiscal effort, as transfers decrease when local revenues increase.



Rule-based transfers are generally more transparent about the criteria used for allocation, offer greater predictability, and are less subject to political discretion

Discretionary transfers, on the other hand, face the typical challenges associated with discretion. On the one hand, they provide greater flexibility in national fiscal management. For example, in the context of fiscal adjustment, discretion allows for raising taxes without automatically increasing transfers and facilitates reallocating expenditures to new priorities (Bahl, 2000). On the other hand, discretion increases the risk of favoritism in the allocation of transfers and the inefficient use of resources. Several studies show that increased transfers tied to political alignment benefit subnational governments electorally by increasing their reelection chances, without significantly improving the quality of public services or the

population's well-being (Bonilla-Mejía and Higuera-Mendieta, 2017; Brollo and Nannicini, 2012).

On average, in the region, 84% of transferred resources are allocated using rule-based criteria, 7% partially using rule-based criteria, and 8% through discretionary means. Notable examples of discretionary allocation programs include Peru's ordinary resources (which account for around 60% of total transfers), Treasury-funded transfers in Paraguay (24% of total transfers), Argentina's current and capital transfers, and Mexico's decentralization and coordination agreements (around 10% of the total in both cases).

Transfer systems with some degree of discretionary allocation are often linked to financing specific projects or programs. In almost all cases, the allocation authority rests with the national government. An exception is Chile's neighborhood improvement and urban improvement programs, where the Subsecretariat for Regional and Administrative Development distributes the amounts defined in the budget regionally, and regional governments decide on the allocation of national transfers to local jurisdictions (Decree 946, 1993; Decree 829, 1998).

Are transfers equalizing?

The allocation criteria determine whether transfers tend to equalize revenues across subnational jurisdictions. This goal can be pursued directly by incorporating criteria into distribution rules that explicitly aim to reduce per capita fiscal revenue disparities. However, there are many other allocation criteria that, while not explicit, indirectly result in greater equalization of fiscal resources. For example, simple population-based distribution can achieve some level of equalization, although it is not the most progressive criterion.

Of the 33 rule-based transfer programs analyzed in this chapter, 11 (representing 35% of total transfer amounts) do not include explicit criteria for reducing inequality in fiscal revenues between jurisdictions.¹⁸ In Bolivia, Paraguay, and the Dominican Republic, none of the studied programs include such criteria.

18 Most of the programs use multiple criteria for resource allocation, not just one.

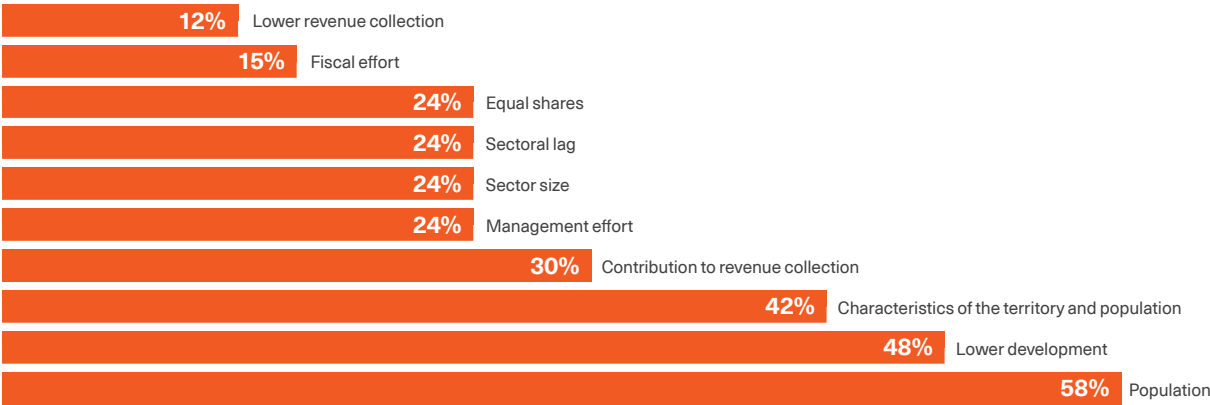
On the other hand, half of the programs use criteria that allocate more resources to less developed areas (based on an inverse proportion to GDP per capita, poverty rates, unmet basic needs indices, etc.); one-quarter follow sectoral gap criteria, and 12% address lower levels of own-source revenue (Graph 5.7). All these criteria are progressive in the sense that they allocate more resources to jurisdictions with lower own-source revenues.

Beyond the criteria used in specific transfer systems, a broader question is whether the total transfers in a country reduce fiscal resource inequality between jurisdictions. In answering this question, it is important to note that disparities in own-source revenues among subnational governments in the region are substantial, especially among local governments, and much greater than those in developed countries. On average, in LAC, the Gini coefficient for per capita

own-source revenue inequality is 0.33 for regional governments and 0.46 for local governments (Graph 5.8). By comparison, the average Gini coefficient for regional governments in OECD countries is 0.18.

Transfers reduce income inequality among jurisdictions in almost all analyzed countries in the region. On average, the Gini coefficient decreases from 0.33 to 0.22 for regional governments and from 0.46 to 0.30 for local governments, representing a reduction of about one-third in both cases. In OECD countries, transfers also reduce the Gini coefficient by approximately one-third, from 0.18 to 0.12. This indicates that relative to initial inequalities, transfer systems in Latin America and the Caribbean have an equalizing effect similar to that of OECD countries. However, final inequalities among jurisdictions are much greater in the region due to the wider initial gaps.

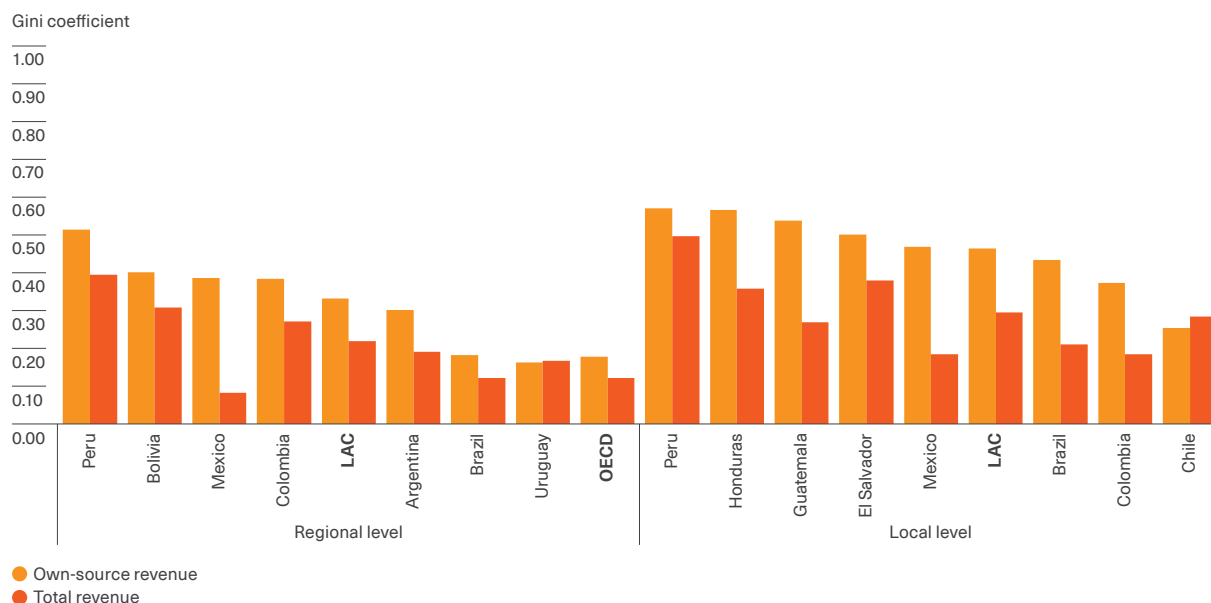
Graph 5.7
Rule-based transfer programs by allocation criteria



Note: The graph shows the percentage of transfer programs that consider each criterion. Calculations are based on the programs listed in Table A.5.3 in the appendix, available in the online edition of RED (excluding Trinidad and Tobago).
Source: Authors based on Radics et al. (2022), Miranda et al. (2017), ECLAC (2024), and national laws.

Graph 5.8

Gini coefficient of per capita fiscal revenues for subnational governments in Latin America and the Caribbean, 2022



Note: Data for Bolivia correspond to 2021. The averages for LAC and OECD are simple averages of the countries with available data for the most recent year. Mexico and Colombia are excluded from the OECD average calculation. Gini coefficients were calculated by weighting each jurisdiction's population.

Source: Authors based on OECD (2024a) and national sources (details in Table A.5.1 in the appendix available in the online edition of RED).

There are significant differences among countries in the region in terms of final income inequality and the redistributive role of transfers. Brazil and Mexico stand out for the significant role of transfers in reducing income inequality at both the regional and local levels, as do Honduras, Guatemala, and Colombia at the local level. As a result of these efforts, the level of inequality among regional jurisdictions in Brazil and Mexico is similar to or lower than that in the OECD. Conversely, regional inequality in Uruguay and local inequality in Chile are slightly higher for total revenues than for own-source revenues, indicating that transfers tend to exacerbate disparities. Finally, a combination of high inequality in own-source revenues and moderate redistribution creates very high levels of inequality in total revenues among regional and local governments in Peru and local governments in El Salvador, posing challenges to equity in public service provision in these countries.

The data indicate that transfer programs in the region have the capacity to equalize resources among jurisdictions. This is positive, provided that equalization is one of the system's objectives. However, a concern is whether this uniformity is achieved through allocation criteria that create undesirable incentives, such as reducing the fiscal effort of subnational governments. While this is difficult to determine precisely, some findings suggest that such negative effects occur (Ferraz et al., 2024; Lago et al., 2024). Therefore, it is important that mechanisms strike a balance between equalization objectives and ensuring efficiency and incentives for subnational governments to strengthen their own revenue collection efforts. The following section explores this idea further.

Royalties and transfers to subnational governments from non-renewable natural resource exploitation

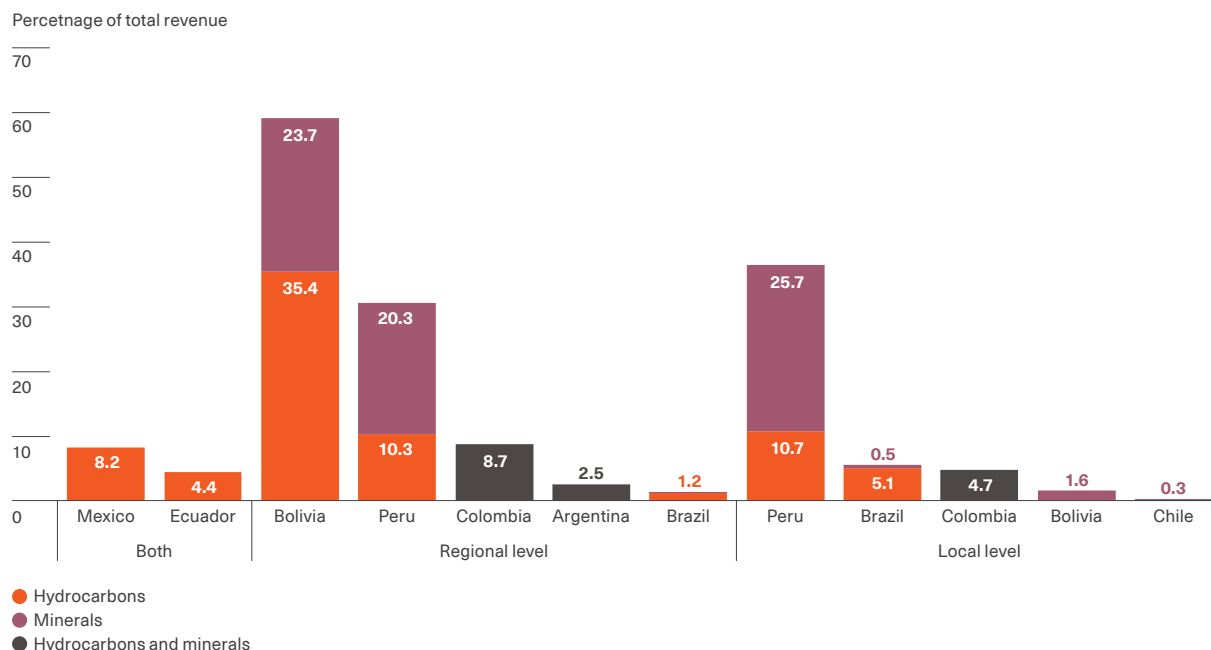
Revenue from royalties, rights, or canon linked to the exploitation of non-renewable natural resources (NNR) is significant for subnational governments in some Latin American and Caribbean countries, particularly in the Andean nations, as well as Argentina, Brazil, and Mexico. Royalties from NNR represent about 60% of the total revenues for regional governments in Bolivia; 35% for local governments and 9% for regional governments in Peru; and 9% for regional governments in Colombia. In the remaining analyzed countries, they account for less than 6% of the total revenues of corresponding subnational jurisdictions (Graph 5.9). After a significant increase

starting in 2000, due to the commodity price boom, revenue from this source has experienced a period of relative stagnation and volatility over the past decade (Radics et al., 2022).

● ●
Revenues linked to the exploitation of non-renewable natural resources are significant for subnational governments in the Andean countries, as well as Argentina, Brazil, and Mexico

Graph 5.9

Revenue from non-renewable natural resource exploitation as a percentage of total revenues for subnational governments in Latin America and the Caribbean, 2022



Note: Data for Bolivia correspond to 2021. In Argentina, Bolivia, and Colombia, royalties are included; in Chile, mining patents; in Peru, royalties, canon, and its additional component (surcanon); and in Ecuador, oil revenues allocated to the Amazonian decentralized autonomous governments. In Argentina, local governments do not receive royalties, and no regional-level data were available for Chile.

Source: Authors based on national data sources (details in Table A.5.1 in the appendix available in the online edition of RED).

In most cases, the national government holds the authority to collect royalties and transfer a portion to subnational jurisdictions. The exception is Argentina, where these revenues are not transfers from the central government, as regional jurisdictions have the authority to grant permits and collect royalties from NNR exploitation.

The distribution of royalties among jurisdictions poses equity and efficiency challenges due to the high geographic concentration of NNR. On one hand, there are arguments for prioritizing producer jurisdictions. These jurisdictions face costs associated with facilitating sector activities, such as providing and maintaining infrastructure for companies and workers. Additionally, NNR exploitation can generate negative environmental externalities in local communities, which need to be addressed. On the other hand, concentrating royalties in producer jurisdictions creates income gaps between these areas and non-producer jurisdictions. These gaps can widen further if producer jurisdictions use the resources to lower taxes on businesses and individuals, leading to geographic relocation decisions that might not otherwise occur (Ahmad and Brosio, 2018).

Balancing these tensions is challenging, but it is crucial that the rules for distributing royalties and the governance of NNR incentivize exploitation in areas with deposits of critical minerals for electrification, such as copper and lithium, as well as natural gas, which, as a transition fuel, helps reduce greenhouse gas emissions compared to oil and coal. Promoting the exploitation of these resources is essential to seize the opportunities the energy transition presents for some countries in the region (Álvarez et al., 2024; Brassiolo et al., 2023). To achieve this, sector governance must prevent subnational governments from becoming obstructive actors.

In the region, distribution models vary between countries and have even evolved over time. In Colombia, the General Royalties System, created in 2011, initially prioritized resource allocation to producer jurisdictions. However, reforms introduced toward the end of that decade shifted the focus to distributive criteria. This change aligns with a regional trend toward prioritizing the redistributive component of royalties (Radics et al., 2022).

Some characteristics of royalty revenues pose additional governance challenges. First, they constitute income generated without the need to tax the population, potentially reducing fiscal effort and government accountability to citizens. Similar concerns arise with the high dependence on intergovernmental transfers for subnational government revenues. Studies of local jurisdictions in Brazil and Colombia indicate that royalty revenues have a limited impact on the quality of public services and population well-being (Ferraz and Monteiro, 2012; Martínez, 2023), while in Brazil, jurisdictions increase fiscal effort when transfer amounts are reduced (Ferraz et al., 2024).



The volatility of prices and the non-renewable nature of hydrocarbons and minerals have led to royalties-based transfers being conditioned on investment spending

Another key feature of these revenues is the high volatility of international prices for hydrocarbons and minerals, which creates challenges for the stability of subnational public finances. Price volatility—coupled with the non-renewable nature of hydrocarbons and minerals—has sparked discussions about how royalty revenues should be spent. A common concern is their use to finance current expenditures, especially when this leads to unsustainable spending levels in the face of declining international prices or resource availability. To address this issue, royalty transfers are often earmarked for investment spending.

While this approach has a clear rationale, it is not without flaws. First, when jurisdictions receive royalties earmarked for investment, they may reallocate resources originally intended for capital expenditures to current spending, causing current spending to increase regardless. Second, investment spending itself can become more volatile. Therefore, any royalty distribution system should ideally be complemented by the establishment of stabilization funds to prevent major fluctuations in resource availability.



The Nevis Island Assembly is the sole local government in Saint Kitts and Nevis.

How can transfer systems be improved?

Transfer systems in the region face a triple challenge in the way resources are distributed: ensuring the financing of decentralized services and tasks, reducing income inequality among jurisdictions, and simultaneously not disincentivizing fiscal effort or the development of administrative and revenue-collection capacities of regional and local governments.

One common criticism is the lack of programs with explicit fiscal equalization objectives (Miranda et al., 2017). In their most complete form, equalization transfers aim to close the fiscal gap between revenue-raising capacity and spending needs in jurisdictions. Since the allocation criteria depend not on actual revenue collection but on revenue-raising capacities, a well-designed system preserves incentives for administrations to generate their own revenues while contributing to more equitable access to public services. Promising examples of such programs exist in several OECD countries. However, their implementation is very challenging. They require quantitative estimates of revenue capacity and spending needs for each jurisdiction. This task demands extensive data and the development of capabilities that most budgetary institutions in the region currently lack. Another challenge of these mechanisms is the complexity of the resulting allocation formulas, which necessitates a high level of stakeholder acceptance to avoid controversies in their application (Dougherty et al., 2024; Lago et al., 2024).

Another arrangement that can improve incentives for recipient jurisdictions involves performance-based programs, in which transfers reward subnational administrations for progress on predefined indicators. Policy objectives worthy of such rewards can vary and do not necessarily focus on own-source revenue collection; the value of these mechanisms lies in their potential to encourage subnational governments to use

resources efficiently. As with the fiscal equalization programs described earlier, implementation is challenging due to significant data requirements and vulnerability to manipulation in measurements (Dougherty et al., 2024).



Performance-based programs reward subnational administrations for progress on predefined indicators

In the region, there are no transfer programs explicitly designed to reward jurisdictional performance. However, one-quarter of the programs analyzed include at least one indicator related to management efforts. Notable among these are Ecuador's transfers for territorial equity, which account for 87% of the country's total transfers. Among the eight allocation criteria included in this program, four are linked to the performance of regional governments: reduction in the unmet basic needs (UBN) poverty index, tax collection relative to fiscal potential, current spending as a proportion of total revenues, and achievement of targets in development and territorial planning. Other programs in Guatemala, Mexico, and Colombia include criteria that reward the fiscal effort of jurisdictions to generate their own revenues. However, quantitative studies of the results achieved by these arrangements are lacking, which could provide valuable insights for understanding their potential.

An additional challenge for subnational public finances lies in cyclical fluctuations and the unpredictability of revenues. Tax collection is procyclical at both the national and subnational levels, as tax bases expand with economic activity. Therefore, while transfer programs are not the sole cause of the procyclical bias in subnational finances, they can exacerbate it (Sánchez, 2013; Bousquet et al., 2015; Ter-Minassian and Jiménez, 2016).



The creation of funds that accumulate resources during periods of growth to be used during downturns can mitigate the procyclical bias of transfers

Revenues from natural resource exploitation also introduce significant volatility in regions where they play an important role. Unlike general tax revenues, these fluctuations are more closely tied to international prices than to local economic activity or tax collection.

One way to reduce the procyclical bias of transfers is to establish funds that accumulate resources during periods of economic growth for use during economic downturns. However, such instruments are rare. An exception is Mexico's Stabilization Fund for Federal Entities, which aims to compensate for declines in the revenue-sharing allocations that regional governments receive from national government revenues, caused by reductions in economic activity or oil revenues. This fund is primarily financed through surpluses in national government revenues—particularly oil revenues—that exceed budgeted amounts, and it is activated when revenue-sharing transfers fall below the levels stipulated in the national budget (CIEP, 2023).

A similar case is that of national funds that transfer resources to subnational governments to address damages caused by natural disasters. In this regard, Mexico's Natural Disaster Fund (FONDEN), which operated between 1999 and 2018, provides a useful example. FONDEN's design was characterized first by its use of rules for resource allocation (primarily based on extreme weather indices), damage assessment, and expenditure control. Second, the fund was financed through the accumulation of resources from the federal budget, the purchase of reinsurance for excess losses, and the issuance of catastrophe bonds. Evidence shows that, compared to discretionary funds, FONDEN was more effective in supporting reconstruction efforts and reducing mortality in affected areas, due in part to its rapid response capabilities and its ability to prevent spending leakage (Del Valle et al., 2020; Del Valle, 2024).

The creation and strengthening of counter-cyclical transfer funds is an important policy area. In countries with limited fiscal space to increase national revenues or allocate additional resources to transfer systems, setting up these funds will require balancing guaranteed minimum transfer amounts with the allocation of a portion of current resources to reserve accumulation, likely necessitating an initial additional investment from national governments.



Reforming transfer systems involves addressing both technical and political challenges

As the above paragraphs illustrate, any reform of transfer systems involves significant technical challenges, including data systematization, capacity development, and monitoring objectives of these programs.

Beyond these, the political challenges may be even greater, as changing transfer system conditions creates tensions among stakeholders. For example, any reform that seeks to modify the criteria or parameters for transfer allocation while maintaining overall amounts will create “losing” jurisdictions relative to the status quo, which are likely to resist change. Similarly, reforms altering overall amounts or the discretion of distribution tend to provoke tensions between national and subnational governments. Consequently, such reforms typically require intense, high-level technical and political work to achieve broad enough consensus to ensure that the resulting frameworks are both effective and enduring.



Mexico City's seat of government.