

IN DEBT WITH THE CONSTITUTION: THE COPARTICIPATION REGIME, ITS PROBLEMS AND SOLUTIONS

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Executive summary

The coparticipation regime is one of the best known (and most criticized) resource transfer channels between the Federal Government and the provinces. This system has serious problems relating to its original design and, moreover, it has also suffered growing transformations caused mainly by fiscal emergencies rather than by profound discussion about responsibilities accrued to the different government levels.

The provincial governments have suffered a reduction in their share of resources, which has impacted negatively on the quality of services these governments provide; among them, Education, Health, Security and Justice. These services are essential to guarantee equal opportunities in the Argentine territory and, therefore, the reduction in the quality has caused uneven development. This can be seen both when measuring the provincial State capacities and when observing individual income distribution. The federal fiscal system, particularly through the coparticipation regime, has only worsened the existing inequalities, by maintaining a distribution mechanism that responds to past political strengths rather than national development objectives.

The need to reform the system was admitted in the 1994 constitutional reform, which mandated sanction of a new law before the end of 1996. Twelve years later, we have yet to comply with this mandate. This default only delays the possibility of enjoying sustainable and equitable development. The farmers' crisis generated by the proposal to implement an adjustable system of export taxes slightly awoke some debate on fiscal federalism. Additionally, the proposal to unify the Social Security System in the hands of the State revives discussion to a point. Few, however, are looking at the problem in the face. Necessary consensus still has to be built. This paper provides a diagnosis on the state of resource distribution between the national and provincial governments and presents possible reforms to the dilemmas posed by the current coparticipation regime.

The Constitutional mandate

In its Article 75, subsection 2, the Argentine Constitution clearly states that the “distribution of resources between the Federal Government and the provinces, including the City of Buenos Aires, and among the latter will respect the responsibilities, services and duties assigned to each, contemplating objective distributive and solidarity criteria; it will be equitable and will prioritize an equivalent degree of development, quality of life and equal opportunities in the entire national territory.” Additionally, the sixth transitory clause states that the new coparticipation law should have been established prior to the end of 1996.

Despite this, Argentina continues to live with a federal coparticipation regime implemented 20 years ago. The “transitory regime imposed by Law 23.548 originally meant to provide a provisional answer to the challenges which hyperinflation and a serious fiscal crisis created for fiscal relationships between the Federal government and the provinces.

Even though the 1988 law still applies, the coparticipation regime has suffered indirect modifications. On the one hand, several deductions were made to the coparticipated taxes, diverted to finance the social security system. On the other hand, specific funds were created and distributed automatically but with different coefficients to those of the coparticipation regime. Thus, something known as the “coparticipation labyrinth” has been generated, a system whose complexity is not its worst defect.

Coparticipation regime: its problems

a) Primary distribution

One of the more controversial aspects of the coparticipation regime is known as primary distribution, a formula

through which tax collection is apportioned between the Federal government and the Provinces (and the third partner, the Social Security System). Regarding this primary distribution, the Provinces make three justified claims.

In the first place, these automatic transfers partially and indirectly sustain services essential to us: Education, Health, Security and Justice, all public services provided by the provincial States. In some cases, these services were jointly provided by the national and provincial government. But since the 1970s to the 1990s, a process of gradual decentralization culminated with the delegation in the provinces of the complete responsibility for providing those services; however, this process was not accompanied by the corresponding fund transfers (Cetrángolo and Gatto, 2002). In 1992, for example, the transfer of schools to the provincial government finalized and, in return, the Federal government committed to transfer a fixed amount (Law 24.049). Some time later, the number of students increased and teacher salaries changed but the amount remained constant. This problem recently increased in intensity due to obligations assumed through the Law on Education Financing (Law 26.075) and the Law on National Education (Law 26.206), which demand greater resources for education.

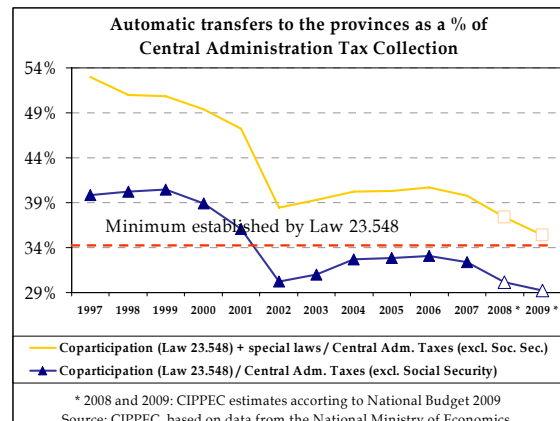
Secondly, several detractions to primary coparticipation in during the 1990s were directed to cover the deficit of the social security system, worsened by the 1993-1994 reform that implemented a capitalization system. Such is the case of the 15% detraction of gross coparticipation, 11% from the amount collected through the Value Added Tax (IVA), 20% from the Income Tax collection, 70% from independent workers' contributions (Monotributo), most of taxes on vehicles and certain fuel taxes, all of which go directly to the social security system. Since 2006, the national social security system has had a surplus,

to the point of reaching a positive result of nearly \$600 million in 2007. Furthermore, the recent proposal to eliminate the private retirement and pension fund administrators (AFJP) and the unification of payments in the hands of the national government would further increase this positive result in the short and medium-term. Thus, several provinces are claiming a reversal of the detractions made in the past to cover the historical deficits of the social security system.

In the third place, the provinces claim that since the latest recession began in the third trimester of 1998, they lost participation in the primary distribution, with a larger contraction after the 2002 crisis, which left them with an amount that does not even suffice to cover the minimum guaranteed by the Coparticipation Law. Its Article 7 establishes a minimum of 34% to be automatically transferred to the provinces. Considering coparticipation transfers, CIPPEC's calculations indicate that after the 2001-2002 crisis, the proportion fell sharply after export taxes and the Tax on Banking Debits and Credits or "cheque tax" were imposed by the national government. Exports taxes are not shared with the provinces since the Constitution and the Coparticipation Law give the right to the national state to keep them, whereas in the case of the cheque tax only 30% is coparticipated. In 2007, coparticipation transfers reached 32.4% of taxes collected by the Central Administration. Projections for 2008 and 2009 show they will continue to fall. Admittedly, other funds have been created to complement coparticipation, so total automatic transfers now round up to 37.8%.

In short, one of the central points to look at is how much goes to the Federal government and how much to the Provinces. Clearly, primary distribution does not respect the constitutional mandate to take into account the

distribution of responsibilities between the different levels of government.



In fact, the creation of new, non-shared national taxes without the corresponding obligation of increasing services provided by the Federal government goes against this mandate. The multiple reforms to the system have responded to fiscal emergencies rather than to the objective of laying out a rational distribution subject to responsibilities, services and duties of each government level, as the Constitution dictates. It should be stated that the fate of millions of Argentines stands behind this complex system, in particular, the opportunity of having a desk in a school, a bed in a hospital or a secure place to live in. That is to say, the coparticipation system determines the possibility that the State may - or may not - be able to guarantee an equitable provision of basic social rights.

Of course, to propose that the provinces increase their share in the primary distribution of taxes would entail a deterioration of the national fiscal situation. One of the pillars of the current economic model, which no one dares to question, is fiscal prudence in national fiscal accounts. Taking away resources from the Federal government could push public accounts into deficit, a story that nobody wants to witness again, especially in the current adverse international context. It is also true that if things remain as they are, the provinces will face a deteriorating fiscal situation,

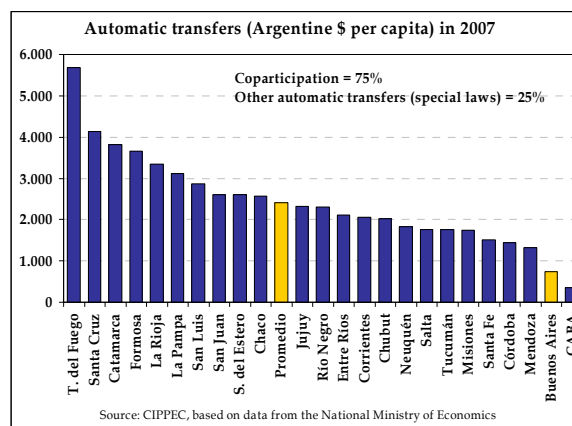
as well as in the quality of the services they provide.

Such being the case, the solution could come, in part, from an increase in tax pressure, a phenomenon currently under way, in particular through the reduction of tax evasion. But this should not impair the discussion on spending responsibilities and consequent resource distribution between different levels of government.

b) Secondary distribution

The second step in the coparticipation regime consists of distributing tax collection among the different Provinces: this is called secondary distribution. Again, reality differs from the constitutional mandate, which establishes that: "It will be equitable, committed to solidarity and will prioritize the achievement of an equivalent degree of development, quality of life and equal opportunities." The secondary distribution coefficients were determined by Law 23548, based on the averages negotiated bilaterally between the Provincial governments and the Federal government during the period 1985-1988. This formula originated as a commitment to guarantee the Provinces the same amount they had received up to that moment. That is to say, neither equity criteria were contemplated, nor the possibility of achieving an equivalent degree of development in the different Provinces, nor equality of opportunities. Instead, provincial authorities' negotiating capacities and political weight determined the result of the negotiations with the Federal government. In a country characterized by strong regional inequalities, this system has clearly not contributed to a more equitable development. Even worse, it seems provinces are growing apart with the existing distributive mechanisms.

At a recent event in the province of Buenos Aires, former President Néstor Kirchner stated: "A new Federal Coparticipation Law is needed because in the eighties, regrettably, 6 points were taken from Buenos Aires province."

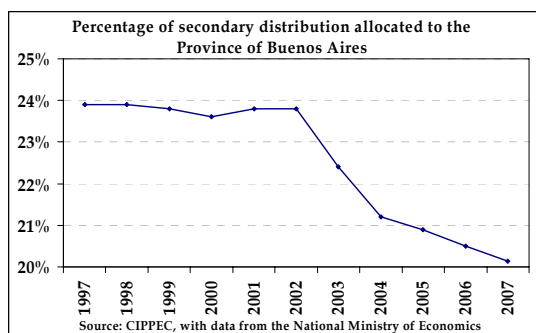


The province of Buenos Aires is the least benefitted under the current coparticipation regime. They lost in the eighties and lost again after the 2002 crisis, when the Buenos Aires Suburbs Fund was frozen to a nominally fixed amount. This Fund complements the automatic transfer of resources distributed according to the current Coparticipation Law.

This is how, in 2007, the province Buenos Aires (PBA) received only \$745 per capita from the automatic transfers of the coparticipation system and other complementary regimes. This amount represents less than one-third of the average received by all jurisdictions. In fact, in per capita terms it is the jurisdiction which received the least resources after the Autonomous City of Buenos Aires which should not be compared with other districts since it receives other direct transfers, such as Justice and Security provisions, from the Federal government.

As the figure shows, the most serious issue for the PBA is that it receives a smaller portion of the cake every year. In 2007, its participation in the secondary distribution was just over 20% (despite housing 38% of the

population) when it was just under 24% in 1997.



In any case, the PBA is not the only loser. Other provinces seem to be receiving an unfair share: Mendoza, Córdoba, Santa Fe and provinces of the northeast and northwest such as Misiones, Tucumán, Salta and Corrientes, the last ones, seriously hit by poverty.

c) Complexity

The coparticipation regime has transformed into a highly complex labyrinth, plagued by deductions, exemptions and specific ear-marked expenditures. As mentioned before, this complexity appeared in part as a result of the large deficit generated by the 1994 privatization of the social security system which has become one of the major drains from the coparticipation resources to the point of becoming the “third partner” in the coparticipation regime.

Additionally, the creation of funds multiplied to ensure that a certain portion of resources reached specific destinations. Such is the case of the energy and housing funds, with distribution criteria barely different from those that rule the coparticipation transfers.

It would be advisable to revise this complex automatic transfer structure, and update and correct criteria through which funds are transferred. This labyrinth is usually illustrated by the graph attached in the Annex.

d) Procyclicality

A fourth problem inherent to the coparticipation regime is its procyclical character. Since the coparticipation mass is a percentage of tax collection, closely correlated to the economic cycle, transfers to the provinces increase in times of growth and falls during recessions, similar to what happens with resources collected by the Provinces in their territories (through Gross Income Tax, Real Estate Tax, Vehicles’ Tax, Stamp Tax and other revenues). The absence of an anticyclical mechanism or, at least, some system that rewards prudent fiscal conduct pushes the Provinces to spend more during times of abundance, having to adjust spending during times of scarcity. This pattern not only aggravates the economic cycle, it is also particularly negative for social spending, which suffers cuts in recessionary times just when it is more urgent to attend the growing needs of the poor.

For now, Argentina is in an upward cycle, but the need to apply adjustments in the provinces would increase dangerously if the international crisis worsens the terms of trade, if Brazil devalues its currency, if China stalled or Argentina slowed down. For this reason, it is urgent to take advantage of the growth phase to generate savings (or anticyclical funds) that would prevent these contingencies in the medium-term.

The implementation of anticyclical fiscal is a valid way to confront procyclicality. In low inflation contexts, another solution would consist of making coparticipation transfers equal to a moving average of the tax collection of the past three years instead of percentage of the current tax collection – as it is today. This would soften fluctuations. However, within the current inflationary context, this recommendation would not be advantageous to the provinces.

Alternatively, the transfer of a fixed amount defined in real terms might be suggested, for example, an amount that

covers the provision of certain basic services. Nevertheless, this modification would imply a structural change in the way the Federal government sets its budgets and would, therefore, demand knowledge and information processing for which Argentina is perhaps not fully prepared.

e) Contradictory incentives

Another problem facing the fiscal federal system is the existence of multiple negative incentives. On the one hand, provincial governments have few incentives to collect provincial taxes since a good portion of their revenue stems from the Federal government. Nor do they have incentives to collaborate with federal tax collection in their jurisdictions since these amounts do not remain in their territories. On the other hand, the Federal government lacks incentives to reduce tax evasion, since it benefits from creating new, non-coparticipated taxes.

It would be essential to line up incentives for the different government levels and to promote cooperation between them, for example, by creating shared use of the different sources of information to reduce tax evasion and solidify a more efficient, just and stable tax system. A revision of the tax system and a clearer division of responsibilities for the different taxes would contribute to correct these problems.

The federal government has bailed out several provinces under financial stress. These bailouts were criticized for generating a moral hazard, that is to say, provinces have an incentive to take fiscal risks knowing they will eventually be saved by the financial support from the Federal government. Although it is true that repeated bailouts loosens fiscal discipline, the theory of federalism justifies the fundamental role of stabilization carried out by the Federal government in order to prevent that a contagion to other regions stemming

from a crisis in another one. Additionally, the refinancing of provincial debt through the Plan of Orderly Financing (Planes de Financiamiento Ordenado or PFO, reconverted later to the current Financial Assistance Plan or Planes de Asistencia Financiera, PAF) was an inevitable result of the 2001-2002 crisis. At that time, the rules of fiscal responsibility were weak, and timely detection of imbalances was difficult. It is important to build the institutions that may strengthen fiscal responsibility and enable the detection of imbalances in order to “trigger” decision-making and correct the disequilibria before circumstances force Central government intervention.

f) Realities and preconceptions

A last problem worth mentioning is that the implications and complications of the Argentine fiscal federal regime (in particular of its complex coparticipation system) continue to be understood exclusively by a small academic and political elite.

Liderbarómetro, a poll taken since 2005 by CIPPEC and Equipos MORI, periodically consults political leaders regarding their perceptions on the main problems affecting Argentina. In that respect, 143 federal, provincial and municipal leaders from the Legislative and Executive Powers were queried about which provinces benefit and which are harmed by the current coparticipation regime. The answers were varied and contradictory.

Although feelings about its injustice are widely shared, curiously, perceptions are uneven about which provinces are winners or losers. Sixteen percent say that the PBA benefits the most from the current regime, while 48% declares that this province is the biggest loser, showing a significant level of ignorance on the part of the sources consulted.

Transfers excluded from the Coparticipation regime

Coparticipation and automatic transfers are not the only way by which the provinces receive funds. The Federal government budget is spent across the entire national territory. Although there are many pre-determined expenditures whose geographic distribution cannot be affected by those who administer them, as is the case of retirement funds, the allocation of certain types of expenditure is highly dependent on discretionary decisions of the Federal Executive Power. CIPPEC estimates that out of \$12.3 billion spent by the Federal government in 2007, approximately \$3.5 billion (28%) may be classified as discretionary expenditures. This amount is equivalent to 77% of coparticipation resources, which reached \$4.5 billion in 2007. It is not exactly like dealing cards and giving again, but almost. For provinces like Catamarca, Córdoba or San Luis, national discretionary spending represented close to an additional 20% of coparticipation resources. At the other end of the spectrum, for Santa Cruz, the discretionary expenditure items incurred by the Federal Government was almost triple to that which it receives through the coparticipation system¹.

The chart below shows the absence of explicit criteria for the allocation of certain expenditure items. The uneven participation by the provinces in "Treasury Obligations" (Obligaciones a cargo del Tesoro) stands out, as does the disproportionate participation of Santa Cruz in roadwork investment. Improving the geographic allocation of these funds could indirectly moderate existing

inequities and improve our fiscal federalism. This decision is solely in the hands of the Federal Executive Power and is therefore politically viable.

¹ For a complementary analysis, see Abuelafia, Emmanuel; Braun, Miguel and Díaz Frers, Luciana: "Coparticipación Federal: Una mirada más allá del debate de corto plazo" *Documento de Análisis de Políticas Públicas*, N°7,, CIPPEC, Buenos Aires, December, 2004 available in http://www.cippec.org/nuevo/files/bv_124.pdf.

Coparticipation: discretionary and automatic transfers

2007	Automatic transfers			Non-automatic transfers	
	Million AR \$			Million AR \$	%
Province	Coparticipation (Law 23.548)	Special laws	Total autom. transf.	Discretionary Expenditures	Discretionary expenditures/ coparticipation
CABA (*)	1.043,1	21,2	1.064,2	13003,7	1246,7
Buenos Aires	9.320,8	1.798,4	11.119,2	4895,4	52,5
Catamarca	1.215,3	238,7	1.454,1	268,0	22,1
Chaco	2.190,9	483,5	2.674,4	790,7	36,1
Chubut	689,3	234,1	923,5	419,3	60,8
Córdoba	3.877,2	879,5	4.756,6	966,8	24,9
Corrientes	1.621,0	439,4	2.060,4	564,4	34,8
Entre Ríos	2.148,3	484,4	2.632,6	665,7	31,0
Formosa	1.608,6	336,2	1.944,8	593,9	36,9
Jujuy	1.243,7	314,7	1.558,4	548,5	44,1
La Pampa	829,6	193,8	1.023,5	398,6	48,0
La Rioja	911,2	205,9	1.117,1	600,1	65,9
Mendoza	1.802,5	462,9	2.265,4	533,8	29,6
Misiones	1.419,2	438,5	1.857,7	613,7	43,2
Neuquén	753,0	236,1	989,0	231,5	30,7
Río Negro	1.106,3	264,0	1.370,3	360,1	32,6
Salta	1.661,3	464,6	2.125,8	722,8	43,5
San Juan	1.493,2	297,0	1.790,2	591,3	39,6
San Luis	1.010,4	217,6	1.228,0	234,4	23,2
Santa Cruz	705,2	214,2	919,4	1358,1	192,6
Santa Fe	3.917,8	938,4	4.856,3	1280,0	32,7
Santiago del Estero	1.807,8	416,5	2.224,4	656,6	36,3
Tierra del Fuego	556,3	140,0	696,3	144,4	26,0
Tucumán	2.076,0	498,0	2.573,9	988,5	47,6
TOTAL	45.008,0	10.217,4	55.225,4	34.637,6	77,0

* The City of Buenos Aires (CABA) must be analyzed separately because a big portion of the expenditures of the Central Administration are registered as corresponding to the City, as is the case with several purchases or subsidies to private enterprises that have a legal address in the city (like transportation and energy)

Source: elaborated by CIPPEC, with data from the Federal Economics Ministry. For further details on what is included in discretionary expenditures, see chart below.

Detail of discretionary programs and their geographic allocation

Province	Obligaciones a Cargo del Tesoro	Ministerio del Interior	Ministerio de Planificación Federal	Dirección Nacional de Vialidad (Min. Planif. Fed.)	Ministerio de Educación	Ministerio de Trabajo	Ministerio de Salud	Ministerio de Desarrollo Social	TOTAL	Discretionary spending per capita
	Treasury	Domestic Affairs Ministry	Ministry of Federal Planning	Highway Direction (of the Ministry of Federal Planning)	Ministry of Education	Ministry of Work	Ministry of Health	Ministry of Social Development		
CABA	1.063.332	275.255	9.266.438	88.388	161.664	264.334	858.048	1.026.280	13.003.739	4.286
Buenos Aires	621	57.040	1.321.152	232.608	1.124.755	841.540	244.046	1.073.683	4.895.445	328
Catamarca	0	1.765	82.110	51.889	18.293	43.785	5.038	65.148	268.028	705
Chaco	0	5.605	221.131	77.212	100.591	125.932	22.845	237.423	790.739	758
Chubut	5.300	3.358	171.717	144.800	23.147	9.447	3.859	57.706	419.334	920
Córdoba	0	13.900	155.110	163.276	123.181	118.381	28.499	364.490	966.837	292
Corrientes	14.000	1.770	122.829	90.765	84.694	97.058	22.974	130.359	564.449	563
Entre Ríos	49.537	8.444	133.883	120.784	120.754	54.739	8.122	169.428	665.691	536
Formosa	0	13.680	132.201	189.425	55.058	93.199	10.003	100.332	593.898	1.116
Jujuy	0	10.021	160.792	43.536	79.377	118.190	12.850	123.691	548.457	818
La Pampa	101.094	4.303	90.666	60.768	17.742	13.262	6.433	104.339	398.607	1.210
La Rioja	189.000	9.480	142.678	111.056	38.569	35.836	4.664	68.789	600.072	1.795
Mendoza	0	11.850	140.568	65.194	77.682	46.359	11.737	180.439	533.829	312
Misiones	575	4.591	154.634	80.715	90.074	46.667	16.029	220.411	613.696	578
Neuquén	14.431	1.761	59.771	37.090	36.528	24.987	2.782	54.193	231.543	430
Río Negro	9.725	7.448	82.166	116.809	33.869	22.746	5.020	82.349	360.132	606
Salta	0	11.328	163.212	149.068	92.115	88.996	19.605	198.473	722.797	601
San Juan	0	4.290	288.469	36.661	58.139	43.399	14.175	146.149	591.282	862
San Luis	48.376	595	26.774	52.155	17.612	22.285	4.529	62.111	234.437	548
Santa Cruz	254.612	2.604	272.383	781.010	17.447	4.154	815	25.065	1.358.090	6.121
Santa Fe	179.941	12.619	247.126	216.123	125.931	196.554	12.137	289.542	1.279.973	397
Santiago del Estero	81.540	3.153	91.553	131.366	73.437	80.057	22.214	173.307	656.627	766
Tierra del Fuego	1.168	2.970	108.204	8.393	9.848	2.930	696	10.185	144.394	1.178
Tucumán	0	17.467	305.325	130.179	107.957	116.204	34.050	277.345	988.527	678
Total	3.322.234	523.058	14.366.523	4.599.189	2.688.464	2.523.403	1.373.529	5.241.237	34.637.637	880

Source: CIPPEC, from Federal Economics Ministry database, National Budget 2007.

Reform proposals

The National Constitution reform of 1994 evidenced an existing agreement between specialists and politicians about the need to reform the federal coparticipation system. At the time, it was established in the sixth transitory clause that, before the end of 1996 (12 years ago) a new Coparticipation Law should be sanctioned with the agreement of all the provinces. The difficulty in achieving a consensus about a new resource distribution system has delayed the compliance of the Constitutional mandate. With the aim of finding some consensus, below we put forward some proposals stemming from the diagnosis presented in this paper.

In the first place, the primary distribution formula should be revised, taking into account the responsibilities of each level of government and the available resources to finance them. The loss of relative participation in total resources by the provinces observed in the long-term trend is incompatible with the objective of improving services such as Education, Health, Security and Justice. Thus, a solution would require:

- A deep revision of the coparticipation labyrinth, in particular, of those laws which detracted resources from the provinces, channelling them into the Social Security System, then in deficit, currently in surplus.

- The distribution between the National government and the provinces of the most recently created taxes (such as the tax on banking Debits and Credits) should also be revised, as they are appropriated in larger proportion by the Federal government without the corresponding increase in its responsibilities.

- Additionally, any achievement in the fight against tax evasion would increase the cake to be shared, thus allowing for a bigger

portion to be transferred from the Federal government to the Provinces. Obviously, the Provinces should support this effort, sharing sources of information and increasing efforts to reduce provincial tax evasion.

In the second place, secondary distribution coefficients should be revised, following the Constitutional guidelines. The objective should be to guarantee equal access to basic social rights through the provision of, at least, a minimum of public goods per inhabitant across the entire territory. More specifically, the recommendation would be to calculate potential tax collection in each province and then transfer to each one the adequate amount to cover the costs of providing some basic public services.

One challenge of this proposed scheme is that it implies moving from a fixed coefficient system to one which is periodically revised (possibly every 3 to 5 years) to respond to the changing reality of the nation. This highlights the importance of a trustworthy public statistics system.

Once a minimum provision of public goods is guaranteed in all the territory, any additional transfer could be made using devolutionary or equity criteria, rewarding efficiency, solvency, compliance with the rules or compensating for existing conditions of disadvantage (such as low population density or natural resource scarcity). It is important that these criteria become explicit, widely debated, and that proper discussion conditions are generated to arrive at a consensual proposal that stems from a diagnosis on priorities that need to be attended in order to achieve medium and long-term sustainable development.

Thirdly, the labyrinth should be simplified to increase transparency and decrease complexity. In addition to eliminating all the subtractions to the

primary coparticipation resources, multiple existing funds should be revised, regrouped and simplified to be replaced by simpler formulas and focused objectives.

In the fourth place, incentives need to be aligned. One of the main themes to be scrutinized is which taxes should be collected by each level of government. An integral tax reform that redefines tax collection responsibilities would be useful in complementing any coparticipation reform. For instance, there is some overlapping on the tax base of the Wealth Tax (Impuesto a los Bienes Personales) collected by the federal government, with the Real Estate and Vehicle Tax (Rentas & Automotor) collected by the provincial governments. The need to update the values of those goods, as well as property rights is widely acknowledged. This is an example where collaboration and coordination of efforts could result in important benefits and better information to tax administrations of different levels of government.

Although there are many proposals which include tax decentralization on a provincial level to decrease vertical fiscal imbalance, this approach should be cautiously considered since most of the provinces apparently have less administration capacity than the Federal government. Also, tax decentralization on its own could increase inequities instead of reducing them.

Finally, there is much to do to improve the national budgeting process. Of course, the reform of the fiscal coparticipation regime cannot be dealt with independently from other relevant variables. In this sense, a lot can be improved even outside the coparticipation system.

- In the first place, just as true as the fact that new secondary distribution criteria should be

imposed to coparticipation transfers, so is the fact that it is crucial to discuss criteria with which allocations of Federal government expenditure are made. This opens the opportunity to improve resource allocation without requiring great consensus; simply the will and commitment of the Executive and Legislative Powers to improve allocation criteria.

- Secondly, regarding institutions regulating the budget process, a big improvement would be that regulations are complied with. For example, to avoid excessive indebtedness, the Federal government and the Provinces should start ensuring the compliance with the Law on Fiscal Responsibility by obeying its limits. Also, the anticyclical fiscal fund committed in the same law should be implemented at the national and subnational level. At the same time, the capacity of the federal government for arbitrary bailouts to the provinces should be constrained. Government officers who do not comply, and fall into excessive debt within their jurisdictions, should be effectively sanctioned. Today, the Federal Fiscal Responsibility Council monitors compliance with this law. It would be valuable that this institution developed other capacities and responsibilities, such as promoting the discussion of federal conflicts, providing the necessary information, producing proposals, all intrinsic responsibilities of a federal fiscal organism mandated by the National Constitution (and still inexistent).

Below is a synthesis of the problems described above as well as the proposals for reform discussed in this section.

Fiscal Federalism – Problems and solutions

Problems in the design	Negative consequences	Proposal for reform
Primary distribution: tax centralization with decentralization of expenditure (vertical fiscal imbalance). Trend of relative loss by the Provinces.	Problems to cover the expenditures of Education, Health, Security and Justice System	Increase provincial portion. Revision of tax structure. Very specific decentralization of taxes.
Historical criteria in secondary distribution: horizontal imbalance.	Do not contribute to resolving territorial inequities.	Update secondary distribution criteria. Redistributive method guaranteeing a minimum of public goods per inhabitant.
Labyrinth complexity: incremental reforms to coparticipation system to attend to various needs (Social Security, for example). Numerous automatic complementary funds.	Complexity and lack of transparency in primary coparticipation, absence of consensual criteria.	Simplify coparticipation labyrinth. Unify automatic transfers to the Provinces. Rethink the subtractions made to the coparticipation mass.
Transfer procyclicality	Accentuates economic cycle. Punishes social policy => Poverty with increasing secular trend.	Anticyclical mechanisms (such as the anticyclical fiscal fund)
Incentives problems: a) Nation and Provinces do not collaborate; b) Bailout history	Generalized tax evasion and low collection in the provinces. Moral risk: promotes indebtedness and fiscal insolvency.	Fiscal Responsibility Law with stricter limits to fiscal discipline. Federal Fiscal Organism with effective control mechanisms regarding Fiscal Responsibility Law in each province.
Budget process with high concentration of powers within the Executive Power, scarce debate and parliamentary control.	Discretionary management of public funds which does not contribute to equity and hinders debate on coparticipation.	Limits to Executive Power discretionality via explicit criteria regarding national public spending.

Political challenges for achieving reform

Admittedly, it is not simple to put these reforms into practice. In the first place, the coparticipation reform requires that it is approved through a “Consensus” Law (Ley Convenio) which means that it should first be passed by the Senate, then by the House of Representatives, and finally by each Provincial Legislature. At the same time, there is the belief – valid for the short-term – that this reform implicates a zero-sum game: “What one jurisdiction wins equals what another loses.” This closes the discussion before it begins, reducing reform expectations and inducing us to think that we are condemned to the status quo or, at best, to introducing minor modifications if the size of the pie increases. Although this vision of coparticipation is realistic, it is short-sighted –as were many of the

negotiations which shaped our federal fiscal system.

Finally, it is fair to acknowledge that resource centralization at the national level is a natural result of the Argentine political system. The Federal government has acted under the premise that, if the Federal Executive Power is strong and concentrates economic resources, it will be the only one capable of governing Argentina. Underlying is the belief that if the balance of power shifted in favour of the provinces, soon there would be a political crisis, as was the case in 1989 or 2001. Although this is a questionable premise, it can also be said that Argentina has not found a more equitable power distribution formula. 25 years after its return to democracy, the country needs to build institutions typical of a politically mature State. Among other things, this would allow us to overcome several foundational problems of the Argentine State, such as the

relations between the Federal government and the provinces. To accomplish this, the definition of a distribution system contemplating responsibilities and duties of each level of government is urgent, as indicated by our yet-to-be complied with Constitutional mandate.

Conclusions

Tensions between the Federal government and the provinces are historical. In the past, they blamed each other for the consolidated fiscal deficit. Today, the battle is for who gets to keep export taxes, the tax on banking debits and credits or with the surplus of the Social Security System.

The fall in automatic transfer pushes the provinces into claiming “more coparticipation.” For this reason, many voices requested coparticipating export taxes. This demand, however, goes against the Constitution and the Coparticipation Law, which explicitly excludes export and import rights from the coparticipation mass.

In this context, the Constitution provides some concrete guidelines for a reform: the new primary distribution system –between the Federal government and the provinces– should take into consideration the responsibilities of each level of government, meaning the services and duties that each one administers; and the secondary distribution criteria– among the provinces – should be equitable and provide equal opportunities for the entire population.

If the resources transferred to the provinces remained the same but secondary distribution were reformed so that every province received an equal amount per capita, 18 provinces would have to lose some share in order to compensate the four biggest districts,

which currently receive relatively less. This is politically unviable. Someone has to yield, and today it appears that the Federal government is the one to do it, to compensate for the provinces hardest hit by the current system.

Nevertheless, the need to maintain prudent fiscal policy must be attended, as it is one of the pillars of the economic model and its equilibrium. Hence, part of the solution implies collecting more taxes, at the national and provincial level, by effectively combating one of the main sources of inequality: tax evasion.

This may allow a more equitable and sufficient provision of a minimum level of basic services to the entire country. In this sense, much could be achieved by improving the secondary distribution criteria, as well as by simplifying the entangled automatic transfers, as well as ensuring transparency in the objectives pursued by federal expenditures.

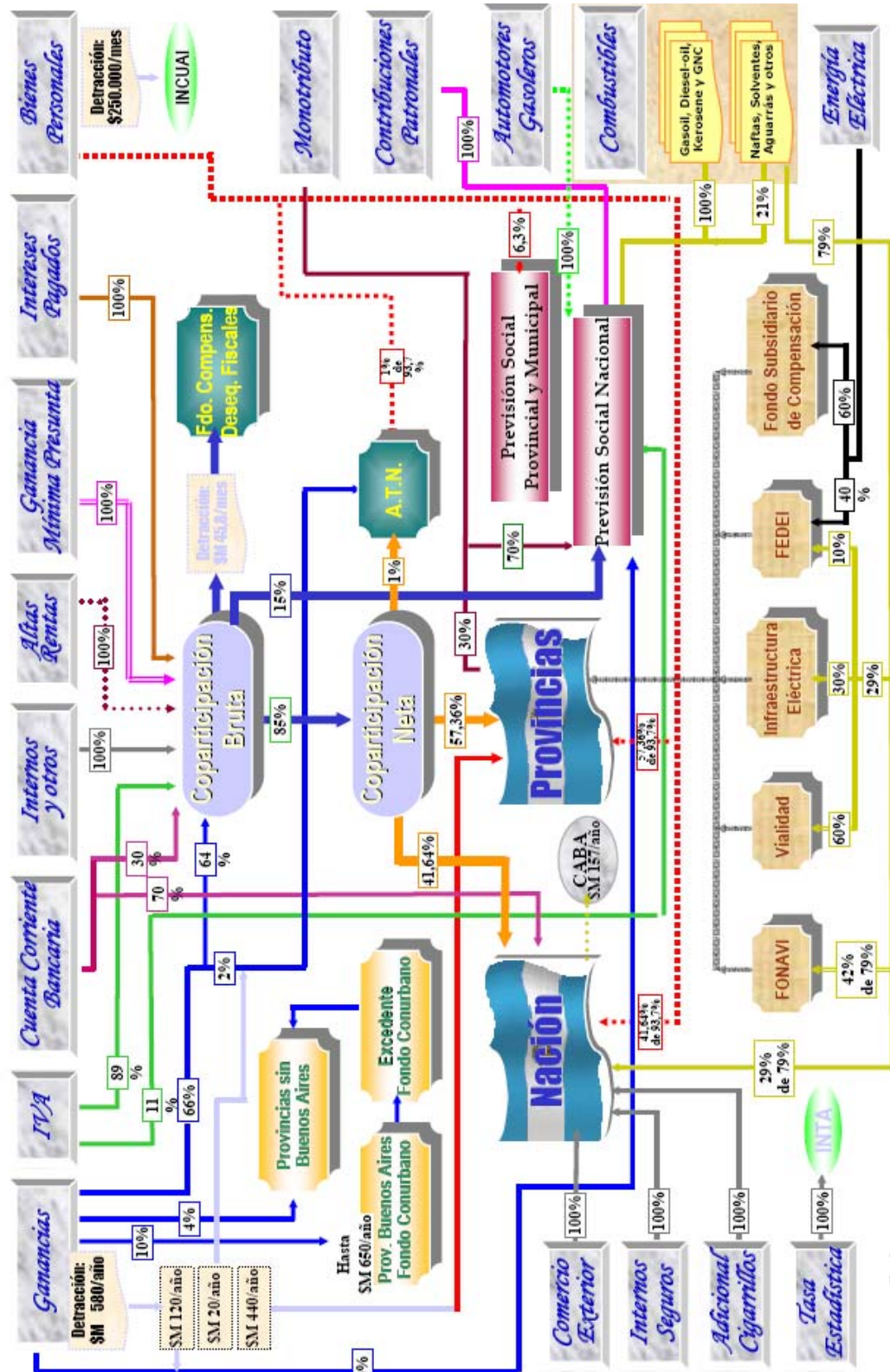
The importance of coparticipation transfers for the majority of the provinces, the complexity of the current system, and the political difficulties for a reform lead to a pessimistic perspective. However, leaving the system as it is, without changing its procyclicality, lack of transparency, inequity and perverse incentives reduces the nation’s development potential. Instead, if we dare to correct these flaws, higher growth and greater equity will increase the size of the pie to be shared. Then the reform will cease to be a zero-sum game. The current economic stage is complex, due to the uncertainty introduced by the international crisis, but good fiscal results at the national level and in several provinces would ease reform. The political stage is a serious challenge; however, if we focus on the long-term, we may aspire to an ambitious coparticipation reform that would allow a better future for all.

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Annex: The coparticipation labyrinth

República Argentina: El Nuevo Laberinto de la Coparticipación - Marzo de 2002



Anibal Oscar Berteau
versión 1.0

* Impuestos Internos Seguros y Adicional Cigarrillos: Se encuentran en discusión en el ámbito de la C.F.I.

Source: Federal Tax Commission: <http://www.cfi.gov.ar/docs/LaberintoCoprocesamiento032002.pdf>

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*The author's opinions do not necessarily reflect CIPPEC members' views on the subject.
This document was made possible by the support of the Center for International Private
Enterprise (CIPE) and by the Forum of Federations.*

If you wish to quote this document: Díaz Frers, Luciana: "In Debt with the Constitution: The Coparticipation Regime, Its Problems and Solutions" *Public Policy Recommendation Document #58*, CIPPEC, Buenos Aires, November, 2008.

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CIPPEC (Center for the Implementation of Public Policies towards Equity and Growth) is an independent non-profit organization that works for a just, democratic and efficient State which improves the quality of life of all Argentine citizens. To achieve this, CIPPEC focuses its efforts on analyzing and promoting public policies that promote equity and growth in Argentina. Our challenge is to translate into specific actions the best ideas from fields such as Social Development, Economic Development and Institutional Strengthening, through programs in Education, Health, Fiscal Policy, International Economics, Justice, Transparency, Local Development and Government Management.