

# **Is there a Substitution Effect on property tax through fiscal transfers in Peru?**

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1. Introduction:.....	2
2. Theoretical context of substitution and the flypaper effect.....	4
3. Structure of Local Governments Revenues.....	5
3.1. Transfers to Municipalities.....	5
3.2. Municipalities own revenues.....	6
4. Analysis.....	6
5. Conclusions.....	10
6. Bibliography.....	13
7. Biographical notes.....	14
8. Tables, Figures and Graphics.....	15
9. Resume.....	18

“The art of taxation consists of plucking the goose so as to  
obtain the most feathers with the least hissing.”  
Jean-Baptiste Colbert (1619-83)<sup>1</sup>

## 1. Introduction:

While enhancing local financial management capacity is a cornerstone of any effective decentralization process, it is often assumed that intermediate and local governments do a poor job of managing the few resources they control. It is argued that property tax –as the main local tax- is under-exploited, that local administration lacks managerial capacity and that user charges are set at levels which are not sufficient to cover costs. These arguments are not as compelling as they may first appear – or at least they need to be disaggregated and seen in more detail - as this paper tries to show.

Peru is a latecomer in the worldwide move towards more decentralized government; only in 2002 did it start a decentralization process by dismantling the Ministry of the Presidency, developing legal frameworks, electing regional governments and transferring some projects to the regional and local level. The hyper centralism of the Fujimori regime (1990-2000) was highly adverse and harmful to local institutional development. Followed by a transitional government, the new democratic regime up to and from mid 2001 reinstalled some of the municipal competences (formerly dismantled by the Fujimori regime<sup>2</sup>). The biggest challenge for municipal governments in Peru and elsewhere is the development and maintenance of urban infrastructure and the provision of urban services.<sup>3</sup>

<sup>1</sup> This remarkable metaphor I owe to Uri Raich (2002).

<sup>2</sup> Throughout the 90s different laws and executive decrees were little by little cutting into the competences and resources of municipalities. Cf. Blume, Ernesto: La Defensa de la Constitución a través de la Ordenanza Municipal. In: D’Acevedo, Martín (ed.): Temas Municipales, Gazeta Jurídica- CAL, 1998. The mayors of Lima who were opposed to the Fujimori regime were consequentially financially dwarfed. The dependence of municipal governments on national financing was during the Fujimori regime reflected in local election results.

<sup>3</sup> These services differ from country to country and from one local authority to the other but they can be broadly categorized into water provision, solid waste disposal, physical infrastructure provision and maintenance (roads, drainage), sewerage, health facilities, education, etc.

Municipalities in Peru are slowly evolving from a level of total scientific neglect to become an important subject of investigations.

The property tax is the single most important local tax in developing countries. Internationally, over 130 countries have some form of tax on property, albeit the relative importance varies substantially from country to country (World Bank 1999). Property taxes are generally used to charge for the generalized benefits of public services provided by local authorities. However, property tax yields in developing countries are significantly lower than in other more developed countries (while some countries can raise significant revenue from property taxes) in terms of their overall contribution to local budgets, relative to domestic revenues and compared to gross development product. The property tax yields on average are –unweighted- 4% of tax revenues in OECD countries and 2% for transitional countries.<sup>4</sup> In Latin America countries property taxes have been poorly developed and are, relative to GDP in 2002, around 0.6% in Argentina, 0.47%, in Brazil, 0.6% in Chile, 0.71% in Columbia, 0.13% in Nicaragua, and 0.21% in Mexico.<sup>5</sup> The property tax in Peru is less than 0.2% of GDP, which, even compared to the Latin American average, is extremely low.

The underlying rationale for property tax is to confront taxpayers with the cost of municipal services they consume in the pursuit of efficiency objectives (Dillinger 1991). Moreover, regarded as a relatively stable revenue source - especially when compared to other potential local tax sources like wage or turnover taxes - property tax is the only direct tax which is paid by a broad sector of the population (even part of the informal sector).<sup>6</sup>

Property tax administration in Peru is shared between central and local government, the first setting rates and valuation, the latter afterwards applying the parameters and collecting the tax. In theory a cooperative division of functions should combine local autonomy and familiarity with local conditions and central technical skills (cf. Mikesell, 2003).<sup>7</sup>

The 1,829 Peruvian municipalities (194 provincial and 1,635 district municipalities form the local government level) are characterized by big differences in size, unequal concentration of economic activity and high fiscal heterogeneity.

To summarize the general background: Peru is a lower middle income country with an average GDP of US\$/2,100 per capita, where poverty has returned to the levels of the mid 1990s due to a 4 year long recession between 1997 and 2001 and the extra costs incurred in the transition period after autocratic rule. In the country as a whole, 50% live in poverty and 25% in extreme poverty, with poverty concentrated in the highlands (Sierra) and the Amazonas basin (Selva).

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4 UK, USA, Korea and Japan all yield over 10% of overall tax revenue. In 1965 the average for OECD countries was still 8%, meaning that property tax has declined in relative importance.

5 Piza, Julio Roberto: Local Taxes: Lessons Learned on the Implementation of Real Property Tax. In: Burki, Shahid Javed et al. (ed.): Annual World Bank Conference on Development in Latin America and the Caribbean 1999.

6 Local administration has a better chance of bringing the population into the system than would administration imposed on them from the distant national capital which may help create a compliance tradition (Mikesell 2003).

7 Property tax systems in international comparison are going over the whole range from: a) Central Valuation, Central Collection, b) Central Valuation, Local Collection, c) Local Valuation, Central Collection, d) Local Valuation, Local Collection.

## 2. Theoretical context of substitution and the flypaper effect

In theory, a decentralization process requires subnational governments to determine the level of services and to raise a substantial portion of the revenues to pay for them. Strengthening local taxes as a source of funding local spending is a basic tool. Most tax experts suggest therefore a bigger role for property tax - as the main local tax (enhancing accountability and democratic control), even if this tax is believed to be unpopular and difficult to reform, (cf. Heady 2002; Shah 1999; or Ahmad et al. 1998). Others assume that the conventional case for property taxes is to some extent flawed and might be linked to the reluctance of central governments to provide subnational governments access to more lucrative sales or income taxes (Bird 2000).

Vertical fiscal imbalances are inherent in public finance systems all over the world. The limited tax power and size of expenditure responsibilities make it impossible for local government to face the resulting fiscal gap without the help of intergovernmental transfers. In most countries around the world these fiscal transfers represent the main source of revenue for local governments.

In the literature, two main rival explanations of the impacts of transfers on the local tax effort stand out. The first one has its roots on the assumption that increases in transfer will have a negative impact on revenue generation at the local level and actually substitute local governments' tax efforts ('fiscal laziness').<sup>8</sup> The main reason given for this effect is that municipal officers will seek to avoid the political and administrative costs of tax collection. The second explanation, generally referred to as the 'flypaper effect', suggests that 'money sticks where it hits' (Hines and Thaler 1995). According to this explanation, tax collection is not reduced and increases in transfers encourage local governments to raise their own resources.<sup>9</sup> The lack of data and the ambiguity of the relationship between intergovernmental transfers and tax effort make evidence of studies on both developing and industrialized countries up to now far from robust and sensitive to time frames and used models (cf. Raich, 2002).

The results of some recent studies in different countries about the issue do not show a homogeneous picture concerning evidence of a decrease in local fiscal effort linked to increased transfers:

1. Mexico: A recent study by Raich, 2002 using quantitative information and concentrating on one federal state of Mexico argues that the impact of the Fund for Municipal Social Infrastructure (FAISM) on the local tax effort was negative. A second investigation by Moreno, 2003, comes to a similar conclusion affirming the existence of a substitution effect by analyzing data of all Mexican municipalities and by differentiating between conditional and unconditional transfers. On the other hand it is shown that revenue-sharing transfers are not reducing the fiscal effort.
2. Colombia: While a study by Cadena Ordóñez, 2002, can't detect a substitution effect, and rather argues the contrary: that municipal tax revenue rises hand in hand with the transfers, especially the property tax; another study on Colombia (Sánchez; Smart & Zapata, 2002) detects some evidence that transfer growth has discouraged the tax effort by the municipalities. The study acknowledges on the other hand that despite the attenuation of tax effort, transfers have had a pronounced effect on local program expenditures. It is argued that most of the additional funds

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<sup>8</sup> Under tax effort is understood in this paper only the tax revenues collected by the municipalities, to user charges -while an important subject- it is made in this study only some allusion.

<sup>9</sup> Partly due to involved maintenance costs, administration and investment preparation.

- have been allocated by local governments to direct program spending, rather than government administrative costs.
3. Turkey: an investigation by Sa Sa/Ĝbafi, 2004 on the intergovernmental transfers in Turkey detects no substitution effect, rather the opposite: it finds that lump sum transfers have a stimulative effect on the level of public expenditures.
  4. For Peru: a study by Alvarado, 2003, finds a substitution effect for the years from 1994 to 2000 arguing that for any given unit of received transfers the municipalities reduce their investment expenditure from own revenues by 37% and at the same time redirect these into recurrent expenditures.

Even if academics and policy makers in Peru have a generalized suspicion that local governments react with fiscal laziness to the transfer of funds, the hypothesis of this investigation is that the fiscal transfers have not had a direct negative impact on own revenue collection at the local level.

### **3. Structure of Local Governments Revenues**

Overall revenues show a favourable evolution for Peruvian municipalities. Local government revenue rose from S/. 3,772 million in 2000 to S/. 4,940 in 2003, due to higher transfers and bigger local revenues.<sup>10</sup> The increase in discretionary budget allocation was somewhat smaller because a big portion of the increased revenues was earmarked. Nevertheless, these increases were not usually linked to an equivalent increase in expenditure responsibilities as one might think appropriate in the broader context of a decentralization process.

#### **3.1. Transfers to Municipalities**

All Peruvian transfers are to some extent conditional: firstly they are mainly linked to the obligation to invest in infrastructure in the case of the FONCOMUN, Canon and a minor transfer called “Renta de Aduanas”; secondly there is the basic food program which is channelled through the municipalities, called “Vaso de Leche” which lately received lots of bad press (eg. Alcázar, 2003); and thirdly some municipalities (those which are accredited, meaning fulfilling certain imposed requirements) are receiving transfers to implement small infrastructure projects formerly administrated by the Social Fund FONCODES as a first step in the ongoing decentralization process.

The two major national transfer programs are the FONCOMUN (based mainly on a 2% surcharge on VAT) and the Canon (consisting of 50% of the corporate income tax of enterprises exploiting natural resources like oil or minerals). The aim of FONCOMUN is to secure the functionality of all municipalities in Peru, and is therefore distributed with compensation and equity goals. Distribution is happening in two steps: in the first step the total amount is distributed to the 194 provincial municipalities in accord with an index of a) population and b) infant mortality. In the second step the amount is then distributed within each province between the provincial municipality (20%) and district municipalities (80%) based on populations (rural population is weighted double). From the Canon (there are different types of Canon: mineral, oil, wood and fish exploitation) municipalities are

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<sup>10</sup> The Peruvian currency Sol is almost stable since 2000, lately gaining some value against the US\$ (S/. 3.3 ~ US\$ 1).

benefiting only in regions where the exploitation of natural resources is geographically situated, meaning that it is concentrated on some regions/municipalities.

Fiscal transfers have been rising fast lately: in the last five years the FONCOMUN has increased on an annual basis by over 7.8% due to strong overall growth (see Annex: Figure 1), due to the bonanza at international mineral markets the Canon is also registering its highest levels: in 2004 the total amount increased to almost S/. 900 million - about half of the transfers channelled through FONCOMUN. In 2004, the overall transfer totalled S/. 3,124 million, coming from the following sources: a) participation of tariffs (Renta de Aduanas), S/. 177.6 million b) Basic Food program, S/. 270 million c) FONCOMUN, S/. 1,793 million and d) the various Canons S/. 884 million.<sup>11</sup>

### **3.2. Municipalities own revenues**

Municipalities in Peru can raise taxes on property, on property transactions (called “alcabala”, 3% of transaction values), on vehicles no older than three years (taxing 1% of value, received by the provincial municipality)<sup>12</sup>, public gatherings like concerts, movies etc. and gambling. The property tax is regulated by Executive Decree N° 776 which came into force in 1994, streamlining the local tax system by eliminating some of the then existing 21 different taxes – which were more costly to administer than the revenue collected. The impact of the legal changes introduced by this decree was that urban cities, and especially Lima Metropolitan, (which was then in the hand of the opposition) lost out to rural areas (Alvarado 1994).

The identification of taxable properties is based on the principles of “self assessment” (the so called “autoavalúo principles”) – the taxpayers are legally responsible for providing all relevant data regarding properties - but in practice the municipalities determine the value of a property by using the official index provided nationwide by the “Consejo Nacional de Tasación” (CONATA). The value of a property consists of the sum of the value of the land and the building, using a range of different parameters (like material of construction, material used for the floors, WC and doors, age of the property, energy and water connection...)<sup>13</sup>.

Local governments are applying progressive tax rates on property values (cf. Table N°1) fixed by the Municipal Tax Code (Ley de Tributación Municipal) meaning in practice that the nominal tax rates and the index for the valuation of property are centrally settled while the tax is locally administered. As in most countries, some taxable properties are exempt by law like charities, property related to education activities, international organizations etc.

## **4. Analysis**

Total tax revenues for Peruvian municipalities are quite low. Figure N° 2 shows that for Peruvian municipalities taxes are only 12% of total revenues. Within the overall tax revenue of local

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11 Meaning an average transfer per capita of about US\$ 30, in the 80s the total amount of transfers was at a very inferior level of US\$ 2 to 3 per capita.

12 Which in itself is quite a negative incentive, punishing less environmental damaging cars.

13 Other countries were showing favorable results when they introduced a simplified valuation methodology.

governments, the property tax is by far the most important which is responsible in 2003 for about 66% of all taxes levied; property transaction tax levies being about 10% and vehicle tax about 9%. Taxes on public gatherings and gambling make up together 7% (see Figure N° 3). It is noteworthy that the revenue from user charges (mostly local security, garbage collection, maintenance of parks) is 16% (2003) of total revenue which is higher than that from taxes.<sup>14</sup> Credit is 9%, which though still not substantial, is rising (for concerns about this see World Bank 2004). About 2/5 of total local revenue is coming from transfers (Canon, FONCOMUN, tariffs and the food program), without considering the Metropolitan area this ratio is even higher, meaning that own revenues in the province are on average more reduced than at the metropolitan stage (Carranza/Tuesta 2003). While the revenues of local governments during 2000 to 2002 were rising at an average rate of 4%, there was a huge increase from 2002 to 2003 with a 20.5% increase in total revenues: transfers and credit rising proportionally. The revenue from local taxes was also rising at an impressive 13.5%.

Total property tax nationwide was rising from S/. 308 million (2001) to S/. 333 million (2002) to S/. 367 million (2003), about 8% of total municipal revenues.<sup>15</sup> The property tax collected by all provincial municipalities is together S/. 111.5 million (2003) and of all district municipalities S/. 255 million (2003). Not taken into account the metropolitan area (the two provinces Lima/Callao and 45 districts), the provincial municipalities were able to collect only about S/. 78 million in 2003 and the district municipalities about S/. 61 million (there are roughly 10 times more districts than provinces) or the equivalent of 38% of the total property tax collected. Even if property tax outside the metropolitan area is not very substantial, it was possible to raise collection from S/. 119 million (2001), S/. 130 million (2002), S/. 139 million (2003). The property tax is yielding very little considering the vast territory of some 1700 districts and provinces outside Metropolitan Lima (metropolitan districts and districts of Callao, the harbour) with a tax collection of about S/. 139 million (2003), US \$ 40 million in all. While property tax collection is highly concentrated in the metropolitan area, the picture there is not very favourable either: the greater metropolitan area of Lima with around 8 million inhabitants was only able to collect around S/. 227 million in property tax (ca. US \$70 million) in 2003.<sup>16</sup>

Within the group of district municipalities, 25% are collecting less than S/. 200 /year. Half of the district municipalities have revenues from property tax of less than S/. 2000 /year; and 75% raise less than S/. 25.000 /year which is the (monthly!) minimum transferred from the FONCOMUN to each district. Within provincial municipalities 50% are collecting less than S/. 55,000 and there are only 12% of the provincial municipalities collecting more than S/. 1 million. Data indicates that property tax is highly correlated with urban settlements: while in the case of the biggest municipalities, property tax

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14 It is still an open question if local governments were more capable of improving the yields of user charges because the legal framework provided the local governments with more discretion over the tariffs compared to taxes. The rate of a particular user charge was linked to the valuation of the property and not by the use/cost of the service provided in the first manner. Meaning that increases for the fees were linked to an overall increase of the property value, but in this case not offset by the parallel raising of the UITs. The Constitutional Court was challenging in mid 2004 this practice: municipalities are obliged to take into account cost of services (property valuation might be only one of several parameters).

15 From the property transaction tax districts were able in 2003 to levy S/. 32.1 million (without Lima Metropolitan S/.13.2 million), provinces S/. 23.5 million (without Lima Metropolitan S/. 15.5 million) and from the vehicle tax S/. 53 million (but highly concentrated on the provincial Government of Lima and to a lesser extent Callao, without those two provinces the revenue for the rest of the provinces is only S/. 5.4 million). The property transaction tax is even more concentrated than the property tax (the municipalities which do not have any revenue from this tax is very high). If provinces have an established provincial development fund, 50% of the property transaction tax collected by districts should go into this fund, but in reality districts seldomly comply with this legal obligation.

16 Metropolitan benchmarking would be a helpful exercise.

has a rate of total revenues as high as over 20%, and this share gets smaller the more rural the municipality is. Rural municipalities have almost no revenue from property taxes. Law 27616 of December 2001 improved the finances of local governments by reinstalling the obligation that notaries had to -before registering a transaction of property- make sure that the respective property taxes were paid.<sup>17</sup>

CONATA, which is functionally part of the Ministry of Housing (Vivienda) and is operating without decentralised offices, is the organization technically responsible for assigning countrywide valuations of buildings and land parcels in the form of an extensive geographical based index (for the urban areas about 1629 square kms are included into this index, 629 square kms alone for Lima/Callao). The budget of CONATA for 2003 was about S/. 4.3 million (S/. 3.4 million were self collected, having a legally fixed share of 3/1000 of the collected property tax – however, not too many municipalities are complying with this transfer; some municipalities owe debts of several years, therefore CONATA was looking for extra income by providing services).

In the 1990s, CONATA struggled –for the already mentioned political reasons- to keep the index at least level with inflation (see Figure N°4).

Being the main goal of CONATA to increase the rates progressively, there was in 2003 an ill designed attempt to adjust the valuations considerably, meaning for some properties that the tax would have risen by more than 20%. After immense pressure from the media and from organized lobbies, CONATA modified this to a much more moderate increase. Nevertheless, in 2003 the adjustment was not based on a unique rate for all property. In fact, the rise was higher for valuable properties, and outside Lima the average rate was reduced by 16.7%. Overall adjustment for 2004 was about 4%, which is close to the inflation rate of 3.5%. Up to now CONATA has elaborated about 360 district maps with property rates (these are seldom updated annually, e.g. investment in infrastructure translates to a rise in valuation) of a total of 194 provincial and 1,634 district municipalities, concentrating on the municipalities with the biggest potential tax base.<sup>18</sup> A figure of 40% to 60% to adjust the general ratio of the appraised value by CONATA to the real market value has often been quoted (although no systematic evidence to back up this estimate is available), offering a big potential upwards.<sup>19</sup> There are no estimates of the market value of the property tax base in individual municipalities or for the nation as a whole. Revenues from property tax is rising faster than the adjustment by CONATA, meaning there are less tax arrears and the ratio of properties subject to paying tax has increased. It is important to mention that adjustment was partly offset by the annual raising of the UIT, which in the years between 2000 and 2004 increased on an annual basis by 2.5%, meaning that the ranges of property tax which municipalities have to apply are raising too (example: while the maximum scale of property tax

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17 Very favorable was that the property transaction tax was fixed by the same law as the percentage of the value of the commercial transaction and not the mostly lower indexed value of Conata. The property transaction tax is levied in the month after the transaction was legally endorsed, so that the legal changes are highly correlating with higher tax collection. Whereas in 2001 the property transaction tax for the provincial municipalities was around S/. 7 million , this jumped in 2002 and 2003 to three times this level.

18 As a self introduced incentive CONATA is giving preferences by updating those maps of the municipalities that are complying with the transfer of the share of 3/1000 of the property tax. However, it seems as that the local governments – with some exceptions- didn't show very much interest in the technical work of CONATA limiting their interest in applying the given indexes.

19 For example the most expensive spot in Lima are the square meters the Hotel Marriott is standing on which is valued at CONATA at ca. 170\$ the m<sup>2</sup>, the residential areas behind by 80\$. Market values are based on actual sale transaction data. Sales values are widely believed to be “adjusted” downwards before reported.

of 1% is applied on property in 2000 worth over S/. 174,000 in 2004 this raised to S/. 192,000, cf. Graphic N° 1).

Law 27616 of 2002, restated in 2003 by a ministerial resolution, regulates that every municipality should get a minimum assignment of 8 UITs/month, which totals S/. 25,600, for the benefit of poor rural municipalities, at the same time reducing the share that urban areas receive.

Due to the high number of 1824 municipalities in the territory, about 1/3 of the total FONCOMUN is transferred as a minimum assignment. Every municipality receives at least S/. 300,000, which is large amount compared to the very low revenue from property tax: for those 25% of district municipalities with a property tax yield below US\$ 60 a year and those 50% below a yield of US\$ 600 the minimum transfer, there is little incentive to raise own revenues from taxes due to these abysmal differences.<sup>20</sup>

Moreover, while there used to exist a legal obligation to spend the transferred amounts out of FONCOMUN in investment, adapting to reality the percentage was reduced in 2003 to 70% and from 2004 the expenditure allocation is at the discretion of the municipality (transfers from Canon have to be invested to 100% in infrastructure).<sup>21</sup> It is highly likely that this is in fact another disincentive because it is freeing local governments from the need to raise property taxes as a source for discretionary financing.

It is obvious that at the local level there exist serious shortfalls concerning the capacity and technical expertise of local government to handle the property tax. The tax collection ratio, which measures the share of property tax levy (property tax bills sent to taxpayers) compared to that which is actually paid, is below 50% in most municipalities (the same is valid for charges). In the following years overdue payments bring the payments close to 90%, meaning that about 10% of the property tax is not collected. The annual tax amnesty is a given praxis and widely expected by taxpayers: overdue taxpayers are not financially punished (no fines, no interest rates). Poor performance and little local authority mean that citizens perceive local taxes as the least urgent financial obligation. Local administrations tend to be characterized by apparent incompetence, high turnover, non merit based selection of professionals (a tradition exists that an incoming mayor changes a large part of the municipal personal), and salaries are not competitive enough compared to the private sector to attract the most highly qualified staff. Mayors more devoted to populism than to long term goals might try to avoid the collection of taxes due to the political costs involved, so that poor performance reflects also local government's greater vulnerability to local political pressure - a case of political responsiveness acting in the guise of technical incompetence (Dillinger 1991). Nevertheless, some mayors are embarking on a serious tax collection campaign. Peruvian municipalities show poorly maintained property records. Lots of municipalities -officially responsible for the local cadastre - do not possess one, and are apparently unwilling to spend resources and effort on this. According to the National Registry of Municipalities (source INEI) there are 367 municipalities with a cadastre, and lots of these

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<sup>20</sup> The article 87 of the Decreto Legislativo 776 foresees up from January 2006 an incentive for the municipalities concerning the transfer distribution of the FONCOMUN, the incentive is linked to auto generation of revenues and emphasis on investment in the local budget.

<sup>21</sup> In July 2004 the Law of Accreditation (Ley del Sistema de Acreditación de los Gobiernos Regionales y Locales, Ley N° 28273) was setting that only those local governments will be certified - the certification is linked to transfers of competences and resources - which are using the transfers out of the FONCOMUN at least for 50% for investment - which in practice will work as a legal restriction due the high interest of local governments to get this certification. Municipalities with only the minimum transfer are exempted from this condition.

are not up to date (also due to a high ratio of transactions).<sup>22</sup> There is no precise information available concerning the coverage ratio which measures the amount of actual property that is included in tax records (often called cadastral records): there is still no legal obligation to register property (even if the costs involved are not so high) - a legal disposition in the law of 2004 which creates a national cadastre was discussed and later discarded. As in many other Latin American municipalities there have been to date no connection between the property and the fiscal cadastres. Law N° 28294 of July 2004 has created an Integrated National Cadastre System which will connect progressively with the national register of property. The self-set goal is to have by 2011 a full functionally working national system of cadastre.<sup>23</sup> There are also problems concerning interchange of information between the National Register entity (SUNARP) and Municipalities. Two special projects PETT (registering of rural property) and COFOBRI (registering of urban property) (the former is financed by IADB, the latter by the WB) hasn't shown much contact with municipalities.

## 5. Conclusions

The data available does not show a substitution effect for the last four years. While the yield on property tax is low, there are no signs that increases in transfers have had on average a negative impact so far. Property tax has been rising slowly, hindered by various institutional constraints at the central and local level as well as by line ministries/entities. Nevertheless there exist a large unused potential for increased property tax collection.

The fiscal base of local governments in Peru remains small for the municipalities for various reasons. These include insufficient local capacity for revenue generation in the majority of municipalities, restricted revenue bases, excessive central control over bases and rates, and limited incentives from central government. Municipal revenues are dominated by central resources. It is noteworthy that in general few developing or transitional countries are currently giving local governments sufficient discretion – or responsibility – with respect to property taxes.

For the time being it might be objectionable but understandable behaviour for local authorities in Peru not to engage considerable resources to the enforcement of property tax because bases are narrow and have modest yield prospects. The tax base has eroded in the past due to the double connection with: a) the valuation set by CONATA which was offset even by moderate inflation and b) the indexing of the progressive property tax rates to the fast raising UITs. More or less passively accepting whatever revenue happened to come in might have been the most reasonable approach for most municipalities.

Underlying poor local governance, however, are political liabilities from the autocratic Fujimori regime (1990-2000) having neglected municipalities or even having been more interested in poor governance

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<sup>22</sup> Nevertheless the municipalities were obliged to spend in the last years three percent of the collected property tax in a cadastre, a legal obligation which many municipalities didn't follow, the amount of this earmarked share was raised to five percent by the amended Ley de Tributación Municipal in 2004 (in the early 90s this share was even 10%), dictating the creation of a Distrital Cadastre Fund ("Fondo de Apoyo al Plan Catastral Distrital") in every provincial municipality for the period 2005-2006. Municipalities are arguing that cost for employees, office etc. can be subsumised under this header. Impacts will to a big part depend on the will of central government to oversee this legal obligation.

<sup>23</sup> Related to the cadastre exists the very challenging issue to find solutions to the many litigations about frontiers of districts, provinces and even regions. According to the Dirección Nacional Técnica de Demarcación Territorial (DNTDT) there are about 320 registered territorial conflicts but the real number is supposed to be as high as 1.500.

on the local level, paralleling (partly with financing from international institutions) essential local service providing by decentralised specialized agencies (FONCODES, PETT, COFOBRI, PROVIAS, PRONAA etc.).

An evolving local institutional environment - as manifested in new laws, stronger public awareness towards local administration, and increased responsibilities – has to come up against serious flaws – incentive structure, institutional parallelism, poor local administration performance, no real voice of municipalities at the central stage which results in legal surprises (residual centralist tradition). It is possible that the current decentralization process in Peru will strengthen the position of municipalities and support local administrative capacities through the transfers of new responsibilities and resources. But Peruvian municipalities have until now not received a mayor functional increase through the decentralization process. Up to now only a part of the municipalities have benefited by the transfer of the projects (and budgets) of the Social Fund (FONCODES) but even those are supervised through framework contracts and monitoring. Provincial municipalities have benefited through the transfer of some projects of the food program PRONAA.

Up to now the revenue from property tax is, at 8% of total local revenue, quite low in itself and is at the bottom end when compared with yields relative to GDP internationally. Peru should therefore give serious thought to raising more revenue out of property tax, especially in view of the difficulties of raising other local revenues. The property tax can enhance accountability at the local level and is also important considering that most charges or transfers are earmarked such that property tax yields can cover discretionary finances.

Property tax revenues are highly concentrated in urban areas and especially the metropolitan area (high heterogeneity of municipalities). It is also noteworthy that the geographical areas of the mountain highlands and the Amazonas basin have on average much lower revenues from property tax (correlating with the higher incidence of poverty). Rural properties might not have big potential, in fact these are often taxed on a marginal rate or even excluded (informality in peri-urban and rural areas).

Although the blocking of a stronger role for property tax by vested interests in the current system is not detectable, the situation might better be described as that of relative indifference from the various institutions. While the legal changes in the Decreto Legislativo 776, introduced in 2002 and 2004 can potentially improve the tax revenue of the municipalities by (i) eliminating some exemptions, (ii) the obligation on notaries to verify the payments of local taxes before the registering of a new owner and (iii) the creation of a District Cadastre Fund, (iv) local municipal revenue collection is to be made one parameter of the transfer index (still to be applied) - there is still plenty scope of reform and further steps are necessary to increase the significance of the property tax.

The institution responsible for the valuation of property, CONATA, has made various attempts to increase rates (up to now with little success). Modern techniques of valuation like manual mass valuation approach, and use of CAMA (computer assisted mass appraisal) techniques are still not used in Peru but have shown that they can produce more equitable, up-to-date values in a transparent, cost effective, timely and sustainable manner.<sup>24</sup>

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24 A change of calculations of the assessed value from a multi based index to a more simplified valuation methods based on m<sup>2</sup> and area index have shown in some cities good experiences, e.g. Santa Cruz in Bolivia (Rojas 2004).

Disincentives at the local level must also be addressed. Given the inherent political liabilities of the property tax, sustained improvement is unlikely as long as more politically attractive means of increasing resources are available. The transfers of the FONCOMUN which in the past was earmarked for investment, a legal obligation which is now reduced for some municipalities and abolished for others might be the wrong route and be counterproductive for own resource mobilization.

Given the reduced policy options for municipalities, the central government is responsible for enabling conditions (promoting and facilitating revenues from property taxes). But because municipalities have only a restricted voice at the central level it is observable how the central government institutions are changing time after time the rules of the game (Canon, Foncomun distribution and use, regulation concerning fines).<sup>25</sup>

Willingness of the citizen to face their fiscal obligations is not the subject of this paper, but it is essentially for local politicians to show positive impact through quality of investment and reduced administrative costs. Because charges and fees are collected for almost every service provided by the municipalities, it is especially difficult for citizens to identify specific benefits for which they are paying property tax.<sup>26</sup>

Notwithstanding the reduced policy options at the local level there exist a couple of innovative examples of how municipalities can increase their own revenues. Positive innovations at the municipal stage (like semi-autonomous municipal tax agencies, the so called SATs can be mentioned as an example for international best practice) are now copied from other local authorities. The particular experience of the creation of semi-autonomous tax agencies can be seen as a result of an adaptation process in the 1990s to bypass negative impacts created by national policies. Important also is the newly included disposition of the Municipal Tax Code which from 2006 (now expected not before 2007) requires that the FONCOMUN will be distributed also on a basis of municipal efforts of own tax collecting which can be characterized as a major improvement (but is still not operational).

One problem induced by the transfers in general and especially with the minimum transfer assigned to each municipality is that it motivates the creation of districts to benefit directly from central subsidies. The number of districts in Peru has been rising fast and there are about 2000 *centros poblados* (minor villages), all of which may aspire to an upgrading to district municipalities.

While at the central level, investment as a share of expenditure has continually diminished in recent years, it represents with S/. 1320 million in 2003 around 33% of total municipal expenditure, situating the municipalities in percentual terms of total expenditure as the state entities with the highest share of investment (helped by different legal obligations to use transfers for investment). While with the reduction of conditionality, transfers could be used increasingly for recurrent expenditure (induced by the latest legal changes), local politicians understand that their political success depends on public works (“obras”).

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<sup>25</sup> The last legal surprise came in 2004 when the distribution of the Canon was changed in the mid of the budget year, benefiting some and harming others.

<sup>26</sup> Municipalities' charges in Peru are mostly not covering the real cost of services provided. Nevertheless, relying too much on user charges can lead to inefficient levels of service provision, and because of their "public goods" nature some municipal services would be underprovided.

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## 7. Biographical notes

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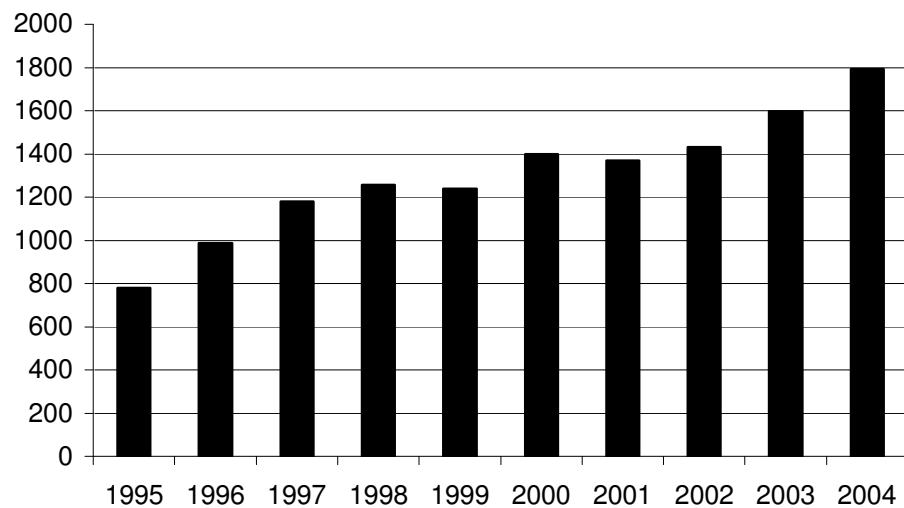
INICAM is a non-for-profit institution with more than 20 years of working, advising and investigating the subnational public administration level.

CIM – the Centrum fr internationale Migration und Entwicklung – is the human resources recruitment organisation for the German Development Cooperation.

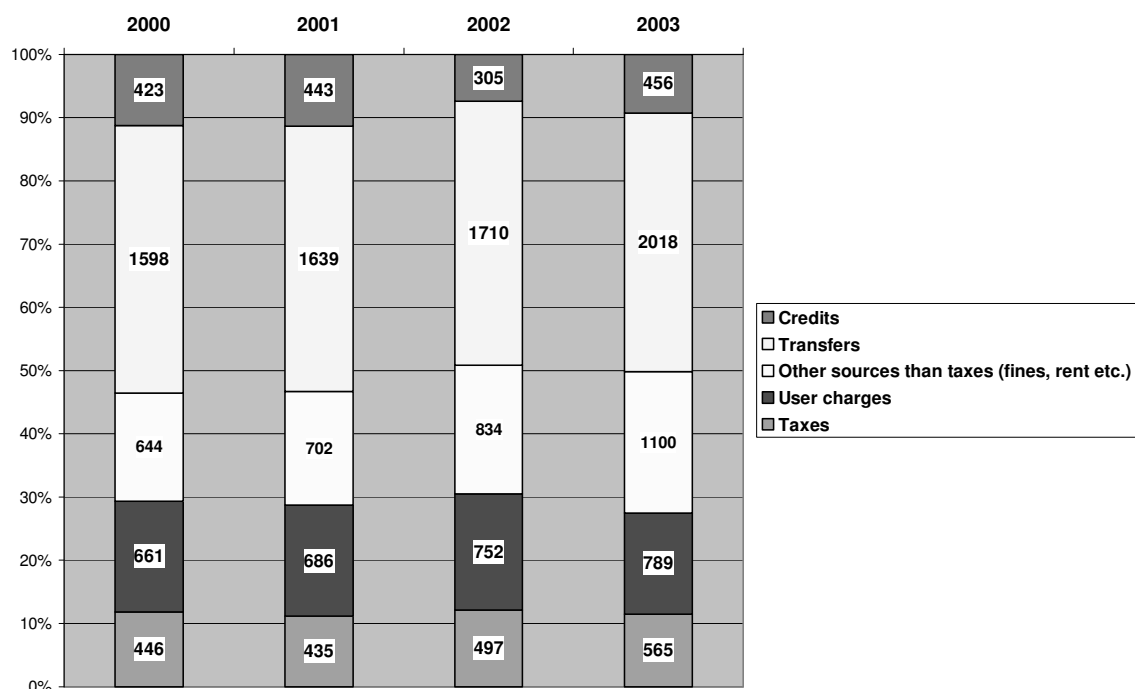
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## 8. Tables, Figures and Graphics

Figure N°1: Transfers out of FONCOMUN (in S/. million)



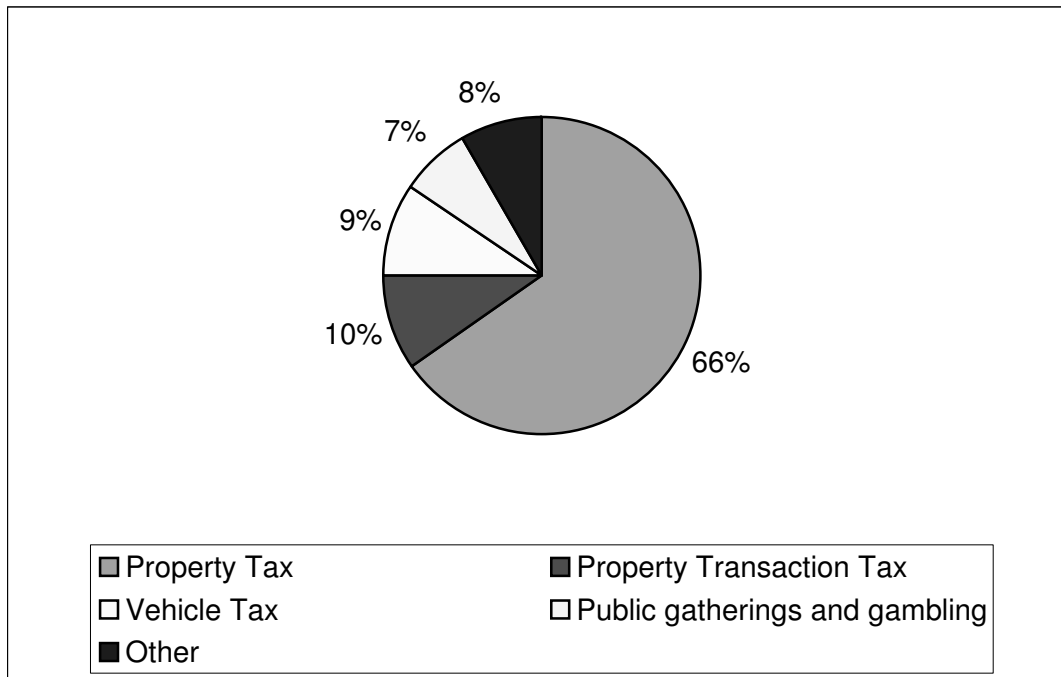
**Figure 2: Classification of Revenues of Local Governments (in S/. million)**<sup>27</sup>



Source: Contaduría Pública de la Nación, MEF and SUNAT

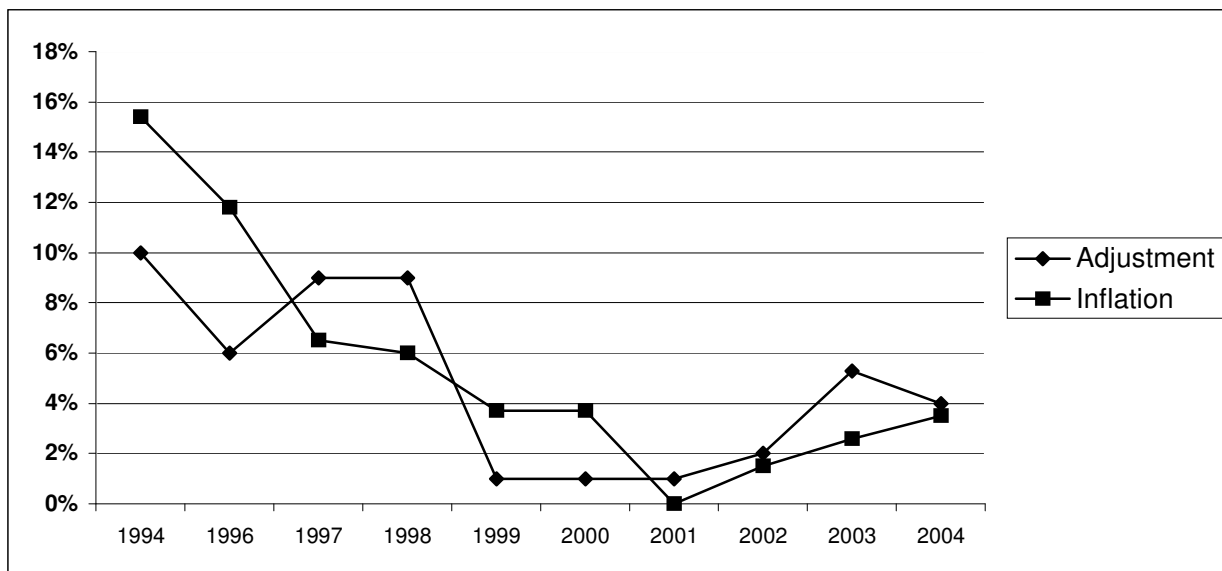
<sup>27</sup> Statistical data is not available for all local governments, the ratio included is anyway close to/over 90%, apparently the smallest municipalities are confronting problems to transfer data to the Contaduria Pública de la Nación.

**Figure N°3: Structure of Tax Revenues of Local Governments (2003)**



Source: MEF

**Figure N°4: Average Adjustment of Property Valuation in Comparison to Inflation**



Source: CONATA and INEI

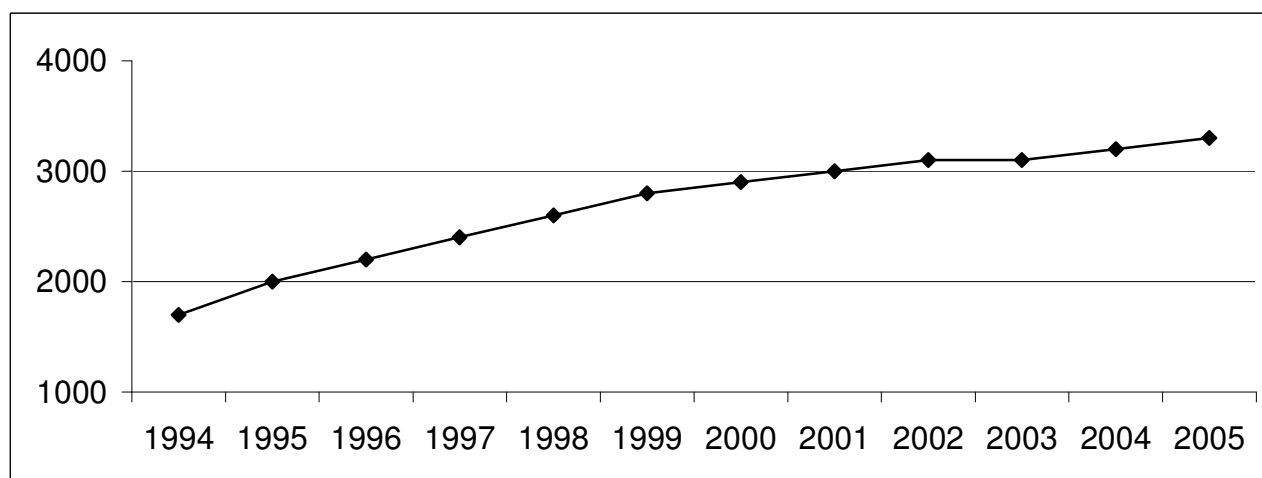
**Table N°1: Scales of property tax**

Scales of property valuation (AUTOAVALÚO)	Tax rate

Until S/. 15 UIT	0.20%
More than 15 UIT until 60 UIT	0.60%
More than 60 UIT	1.00%
Minimum Amount which might be established by the municipality	0.6% of one UIT

One UIT (Unidad Impositiva Tributaria) is in 2004 the equivalent of S/. 3200 (roughly 950 US \$).

**Graphic N°1: Value of the Unidad Impositiva Tributaria (UIT) en Soles**



## 9. Resume

This paper analyzes the impacts that fiscal transfers have had on the tax effort of Peruvian municipalities.

It is argued that while municipalities have shown little enthusiasm towards collecting more revenues on property tax, institutional constraints hindered local governments to do so: municipalities had little policy choice to improve revenues out of property tax due to the setting of rates and valuation at the central level. The data available does not show a substitution effect for the last four years. While the yield on property tax is low, there are no signs that increases in transfers has on average had a negative impact so far. Property tax has risen slowly, hindered by various institutional constraints at the central and local level as well as by line ministries/entities. Nevertheless there exists great unused potential for increased property tax collection.

The fiscal base of local governments in Peru remains small for municipalities for various reasons. These include insufficient local capacity for revenue generation in the majority of municipalities, restricted revenue bases, excessive central control over bases and rates, and not enough incentives from the central government. For the time being it might be objectionable but understandable behaviour for

local authorities in Peru not to engage considerable resources in the enforcement of property tax because bases are narrow and have modest yield prospects. The tax base has eroded in the past due to the double link to a) the valuation of property by a central governmental entity which was offset even by moderate inflation and b) the indexing of the progressive property tax rates to a fast rising reference value. More or less passively accepting whatever revenue happened to come in might have been the most reasonable approach for most municipalities.

Underlying poor local governance however, are political liabilities from the autocratic Fujimori regime (1990-2000) which neglected municipalities or even had been more interested in poor governance on the local level, paralleling (partly with financing from international institutions) essential local service provision by decentralised specialist agencies.