Venezuela
Decentralized Provision of Urban Services
Finding the Right Incentives

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CURRENCY EQUIVALENT

Currency Unit  =  Venezuelan Bolivar (Bs.)
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ABBREVIATIONS AND ACRONYMS

COPRE  Comisión Presidencial para la Reforma del Estado, Presidential Commission for the Reform of the State
CORDIPLAN Oficina Central de Coordinación y Planificación de la Presidencia de la República, National Planning Office
FIDES Fondo Intergubernamental para la Descentralización, Intergovernmental Fund for Decentralization
FUNDACOMUN Fundación Para el Desarrollo de la Comunidad y Fomento Municipal, Municipal and Community Development Foundation
I-ODT Ley Orgánica de Descentralización, Delimitación y Transferencia de Competencias del Poder Público, Municipal Code
TEM Transferencia Estado Municipio, State to Municipal Transfer
IESA Instituto de Estudios Superiores de Administración, Management and Business Administration Institute

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Emergence of Municipalities 1984-1996
This Report was prepared based on two missions to Venezuela during February, March and September 1996. The first mission, led by Victor Vergara (LASLG) included Hernando Garzón (consultant). The second mission was led by Victor Vergara and included Vitor Serra (LASLG), Vicente Freites-Cibils (LA3C1) and Keisgner Alfaro (LA3VE). Peer reviewers for the report included Tim Campbell (LATAD); William Dillinger (LA1PS) and Vitor Serra. Victor Vergara (task manager) had the responsibility for the production of the report and was assisted by Ms. María Eugenia Quintero. The report was improved by comments and suggestions from the following advisors: Mr. Norman Hicks, Mr. Daniel Morrow and Mr. Eduardo Wallentin (LA3C1); Mr. Eugene McCarthy and Mr. Francisco Wulff (LA3EU); Mr. Bruce Carlson (LA3VE); Ms. Dana Weist and Mr. George Gattoni (TWURD); Ms. Marisela Montoliu (EXC); Paul Smoke (MIT); Mr. Rafael de la Cruz and Mr. Henry Gomez (IESA). The report was possible thanks to the insight, support and guidance of Ms. María Nieves Acosta (FUNDACOMUN), Mr. Angel Hernandez (CORDIPLAN) and numerous state and municipal officials interviewed during the preparation.
Venezuela: Decentralized Provision of Urban Services
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Executive Summary

1. The provision of urban services in Venezuela is at a crossroads. As the most urbanized nation in LAC (92%) efficient and equitable urban centers are critical to Venezuela’s sustainable development. Seven years since the GoV began transforming service provision through a decentralization program the majority of municipalities have not been active in assuming their functional responsibilities and establishing effective provision of services. Compounding the problem the number of municipalities, mostly weak and small, has grown by more than 50%. As a result provision of urban services generally operates with unsustainable subsidies, poor quality and diffuse accountability.

2. Although the GoV has made remarkable progress in decentralizing political power and fiscal resources, efforts to decentralize service provision have thus far relied on passive mandates, supported by oil driven fiscal federalism, to entice local government in assuming service provision responsibilities. There is generalized consensus by the GoV and the national congress that this passive policy needs to change and the right political, functional and fiscal incentives must be given to local governments to induce and compel efficient and sustainable service provision arrangements. Without an effective national and state policy to guide autonomous municipalities, including an appropriate role for the private sector, unsustainable service provision arrangements will prevail until the deterioration of services force change to occur.

3. This report seeks to help the GoV define and establish a new vision for improving the effectiveness of urban service provision. The GoV is collaborating with the World Bank (the Bank) to synthesize past sector work as well as Venezuelan research within the analytical framework used in recent Bank research on urban services delivery. The new vision defines the necessary political, functional and fiscal conditions for effective service provision. The report is an account of dialog which is promoting action and yielding results. Selected recommendations including reform of the Fondo Intergubernamental para la Descentralización (FIDES), have been discussed with policy makers and legislators and have been adopted. In addition, the government has requested assistance for the implementation of key recommendations as part of a pilot effort to improve service delivery in two states. As a process and not a product this report will change and serve to promote change as it is discussed broadly with stakeholders. To facilitate dialogue the report is supported by self-contained annexes.

4. Effective urban service delivery will require adjustments to the political, functional and financial policies. Politically it is necessary to establish institutional structures that permit

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1 "Effectiveness" in service delivery refers to both the degree of responsiveness and to the preferences of the constituency in terms of the level, mix and coverage of services, as well as economic and technical efficiency (i.e., producing the maximum output per unit of input). The paper provides a general framework for non social urban services such as water, sewerage, solid waste management, roads, and public transport.

accountability and incentives for effective service provision. Functionally it is necessary to clearly
delineate the responsibilities of each level of government and the private sector in order to permit
accountability. Financially, a sustainable strategy that relies on user charges as a principal source
of revenue for operation and maintenance is required. The financing of urban services relies on
fiscal transfers. For example, tariff revenue for the provision of water and solid waste
management generally covers less than 40% and 20% respectively of operating costs. The
subsidies required for operation and maintenance are untargeted, and as a result regressive.
Paradoxically, recent willingness to pay studies for potable water in Caracas and the state of
Monagas clearly define a high level of demand and willingness to pay for these services.

5. A new vision of urban services differentiates between service provision and the actual
production of the service. Local government is constitutionally mandated to provide services;
however, local government in Venezuela should be considered the producer of last resort. Local
governments must establish an environment where the private sector is not crowded out and is able
to openly compete to serve the public. Local governments, though their regulatory framework and
investment policies, must assure access and affordability to users as well as an opportunity to
generate profits for the producer. Visionary state and local governments in Venezuela are realizing
that the political benefits of satisfied voters far exceed the political benefits of controlling
inadequate infrastructure and a cadre of relatively low paid political appointees.

6. The most perverse incentive in urban service provision is an outdated system of financing
capital works which is in urgent need of reform. Venezuela's fiscal federalism does not provide
systematic criteria for financing decentralized infrastructure. As a result political negotiation is
the principal mechanism for allocating resources for the provision of infrastructure. Sectoral
financing policies, either at the national or state level, could develop a system of matching grants
to finance infrastructure at the local level.

7. The principal entry points for reform have been identified by the government and include
the Municipal Code (the Code), municipal ordinances, intergovernmental fiscal relations
through the Transferencia Estado Municipio (TEM), the situado municipal and the Fondo
Intergubernamental para la Descentralización (FIDES). However, de jure reform is not
sufficient to establish de facto effective services. Institutional reform must provide reinforcing
incentives for producers and consumers of services. In Venezuela there are emerging examples
that provide evidence that change is feasible. Privatized sanitation services in the municipality of
Miranda and the mancomunidad which established the privately managed public enterprise Aguas
de Monagas are defining institutional frameworks for effective provision of urban services. To
understand these changes it is necessary to address political, functional and fiscal reforms.

Political Reform: Enabling Accountability and Capacity

8. Landmark reforms in 1989, including the direct election of mayors and governors have
begun the political transformation of Venezuela from a centrally-controlled country to one with a
government open to share power with states and municipalities. The emergence of local
democratic institutions is producing a new generation of political leaders who enjoy credibility
relative to state and central governments. However, reforms have not permitted political accountability for the provision of services. Political decentralization is undermined by legislation that breaks the link between the performance of local government and its political consequences.

- Mayors have the power to exonerate payment of taxes and user fees. This power undermines their credibility and effectiveness as service providers.
- Mayors are aware that the consequences of failing to fulfill their functional responsibilities is the dissolution of the municipality. This threat is not credible therefore ineffective.

**Functional Decentralization: Defining responsibilities and establishing credible government**

9. A principal constraint for sustainable provision of services is the lack of clear delineation of responsibilities among the levels of government. De facto definition of functional responsibilities in Venezuela is established through negotiation among levels of government rather than through the application of the legal system. For example, the Code enumerates municipal functional responsibility for municipalities but this definition is undermined by the non-exclusive nature of the services. The following conditions result from unclear functional assignments.

- Accountability and credibility is lost by concurrent provision by state and local government.
- Lack of clear functional responsibility prevents definition of appropriate revenue sources.

**Fiscal Reform: Financing Service Provision**

10. Evidence suggests that municipal government will not confront users with the costs of service provision as long as less politically sensitive revenue sources are available. The case of Venezuela fits this premise well. The unconditional nature of intergovernmental transfers has induced local governments to have low and declining levels of fiscal effort and increasing dependence on transfer revenue.

**Own source revenues**

11. Municipal own source revenue is low relative to its potential yield. A 1993 study of six municipalities revealed that on average each generated only 15% of their property tax potential. In addition, adjustment to municipal tax rates and user charges during the last seven years have not reflected even general price increase. Key bottlenecks include:

- Weak and deficient tax administration resulting in de facto voluntary payment by citizens.
- The Code limits cost recovery from betterment levies to 60% of the cost of the infrastructure.
- The Code does not mandate the use of own source revenue instruments.

**Recurrent Transfers**

12. Venezuela’s oil based fiscal federalism makes the level of transfers vulnerable to fluctuations. As such, it is clear that dependency on oil based transfers is an inappropriate long
term solution to financing local services. Transfers to states and municipalities - the *situado constitucional* and the *situado municipal* account for approximately 97% and 75% of total state and municipal revenue respectively. The design of the *situado constitucional* and *situado municipal* is fundamentally sound but requires adjustments to address the following issues:

- The Code establishes differentiated functional responsibilities for municipalities according to a classification scheme but the assignment of transfers does not reflect this differentiation.
- Transfers are made without assuring sound and efficient application of these resources.
- Transfers do not have the sufficient incentives to motivate local revenue mobilization.

**Capital Transfers**

13. An important source of inefficiency and inequity is the discretionary and uncoordinated allocation of resources for capital expenditures. More than 30 public enterprises have grant financing to allocate subjectively and independently to municipalities. The lack of an integrated public investment system in Venezuela does not permit coordination of investment. Furthermore, the lack of formal matching grants programs does not permit predictable financing solutions with participation of the federal, state and local government as well as of the beneficiaries.

14. There are two emerging financing instruments that have the potential to serve as coordinating points for public investment. The Intergovernmental Fund for Decentralization (*Fondo Intergubernamental para la Descentralización* - FIDES) and the State to Municipal Transfer (*Transferencia Estado Municipio* - TEM).

**FIDES**

15. FIDES was created to administer the share of Value Added Tax (VAT) resources assigned to states and municipalities. Revenue-sharing of states and municipalities has been designed to increase up to 30% of VAT revenue by the year 1998. FIDES is the only grant program whose allocation to states and municipalities is formula driven and includes unsatisfied basic needs as a principal criteria. A very slow start for FIDES is indicative of flaws in its structure that require attention. The principal issues that need to be addressed include:

- FIDES is highly centralized with all operations and approval of disbursements in Caracas.
- The cost sharing arrangements with municipalities are symbolic and ineffective.
- FIDES does not require municipal reforms to assure sustainability of investments.

**Transferencia Estado Municipio (TEM)**

16. The TEM is a mechanism to transfer resources from the state to its municipalities, incremental to the *situado municipal*, in order to induce municipal governments to assume their functional responsibility. This mechanism serves to rationalize the level of transfer revenue according to the functional responsibilities of state and municipal governments. Thus far the states of Aragua, Carabobo and Falcon, have pioneered the concept of incremental transfers from states
to municipalities. TEM has the potential to be one of the principal mechanisms to induce effective decentralization of urban service provision to municipalities in Venezuela. Significant lessons are being learned for the future design of TEM include:

- Political discretion of governors and mayors in TEM design reduces confidence of system.
- TEMs are isolated from other financing mechanisms and do not leverage additional resources.

**Summary Recommendations**

17. The GoV has initiated a reform process which includes most of the issues presented in this report. As such, the recommendations will assist in the analysis and debate to carry foreword and implement reform as well as help the Bank define an appropriate country assistance strategy.

**Reform to Key Legislative Instruments**

- Review and seek reform to the Municipal Code including articles 11, 20, 36, 40 and 115 to define functional responsibility, accountability, and financial sustainability for urban services.

**Reform of Intergovernmental Fiscal Relations**

- Review the allocation criteria of the Situado Municipal to assure that there are incentives for revenue mobilization, efficient service provision and consistency between functional responsibility of the municipalities and the level of transfers as well as.
- Review the regulatory framework of FIDES to ensure it contributes to the financial and institutional reform of services being financed by FIDES.
- Develop the design and implementation of TEM, ensuring that it incorporates basic principles of intergovernmental transfers as well as the lessons learned from ongoing TEMs.
- In context of the intergovernmental fiscal system, own source revenues, and beneficiary contributions develop and apply systematic sectoral financing policy. The focus of the policy would consist of conditioned matching grants for urban infrastructure.
- Establish an information system to permit objective monitoring and evaluation of financial flows and public expenditures.

**Building Local Capacity**

- Establish municipal technical assistance initiatives at the state level by consolidating federal, state and local initiatives.
- Promote institutional reform in the provision of municipal services through the establishment of privately management public enterprises as well as concessions to the private sector.
1. INTRODUCTION

1.1 This report is intended to provide input into the ongoing consultative initiative by the Government of Venezuela (GoV) to establish the necessary conditions for improving the sustainability and effectiveness of urban service provision. The GoV requested from the World Bank (the Bank) a synthesis of relevant past Bank sector work as well as Venezuelan research in light of recent Bank research on urban services delivery. The paper was prepared in coordination with the Ministry of Planning (CORDIPLAN) and the Fundacion Nacional para el Desarrollo de la Comunidad y Fomento Municipal (FUNDACOMUN).

1.2 Dialogue during preparation of the report has been rich and preliminary results have been achieved. Specific recommendations related to the financing of decentralized infrastructure through the Intergovernmental Fund for Decentralization (Fondo Intergubernamental para la Descentralizacion - FIDES) were discussed in the Venezuelan National Congress and changes were adopted into the new regulatory framework. In addition, the government has requested assistance to implement key recommendations in two pilot states. As a process and not a product, the report should evolve with further discussion by all stakeholders. The contribution of the Bank is to present a consistent analytical framework for defining policy options as well as to assist in the implementation of specific recommendations. The GoV is aware that important reforms are imperative to develop a sustainable urban sector. It is this awareness that has facilitated the production of this document.

A. OBJECTIVE

1.3 The work seeks to identify key issues which affect the effective and sustainable provision of urban services in Venezuela and propose recommendations to address these issues. Review of the Bank experience in urban service delivery suggests the need for developing a country strategy on institutional arrangement and incentives which can be applied consistently in the Bank’s dialogue with national and sub-national governments. The country strategy should attempt to define a limited number of key issues that the government and the Bank view as critical.

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1 "Effectiveness" in service delivery refers to both the degree of responsiveness and to the preferences of the constituency in terms of the level, mix and coverage of services, as well as technical efficiency (i.e., producing the maximum output per unit of input). "Sustainability" refers to effective supply of services to satisfy present and future demand.

2 The paper provides a general framework for core non social urban services such as water, sewerage, solid waste management, roads, and public transport.
B. THE PROBLEM

1.4 The provision of urban services in Venezuela is at a crossroads. Seven years since the GoV began transforming service provision through a decentralization program, municipalities have not been active in assuming their functional responsibilities. During this period, urban service provision has continued to operate with unsustainably high levels of subsidies, declining quality and sub-optimal coverage. For example, effective coverage for water in most urban areas is less than 40% and unaccounted for water in most municipal and regional systems is greater than 50%. Coverage for solid waste management in most municipalities is deficient, and outside Caracas there is no single operating sanitary landfills. A clear indication of the decay of urban services is the re-appearance, after more than 25 years of its apparent eradication, of water borne diseases such as cholera and dengue.

1.5 Current financing arrangements are not sustainable. In most municipal services including water and solid waste management tariff revenue generally covers less than 30% and 20% respectively of operating costs. Overall, urban services, including water, solid waste management, road paving, public lighting are financed principally through intergovernmental transfers. These subsidies are untargetted, and as a result are highly regressive. In aggregate tariff revenue within municipalities represent approximately less than 5% of total revenue. Thus, the benefits received principle, whereby a consumers are confronted with the cost of services that yield personal and community-wide benefits, is applied on a very limited basis.

1.6 This report identifies four major problems to overcome: (i) absence of clear incentives to induce and compel sustainable service provision and excellence in local governance and service provision; (ii) lack of clearly delineated responsibilities for service provision between levels of government and responsibilities for service production between government and the private sector; (iii) lack of sectoral financing policies in context of intergovernmental fiscal transfers, and (iv) a low level of capacity for service delivery at the local level.

C. THE ENTRY POINTS

1.7 The principal entry points for reform have been identified by the government. Perhaps the most important instrument for change is the Municipal Code (the Code). Promulgated in 1989 as a provisional document, the Code offers an opportunity for improving the incentive structure to enable the sustainable provision of services. Within the municipalities, complementary local ordinances are necessary in establishing a local regulatory framework. The development of efficient and equitable state/municipal intergovernmental fiscal relations through the Transferencia Estado Municipio (TEM) and the Situado Municipal will be critical to adjust the mismatch in revenue obligations and expenditure sources at the municipal level. At the federal level a reformed FIDES,
can serve as the reference mechanism to initiate systematic use of a matching grants to finance local infrastructure.

D. STRATEGIC IMPORTANCE OF URBAN SERVICES

1.8 Venezuela is the most urbanized nation in LAC. More than 92% of the population live in urban centers and depend on the government to provide services. The productivity of urban centers is essential to Venezuela’s development. Furthermore, urban areas hold the largest and fastest growing segment of the poor.

1.9 In the context of Venezuela’s decentralization program municipalities are *de jure* the most important providers of urban services. However, their recent creation and limited capacity contributes to the difficulties in establishing them as *de facto* producers of services. More than 31% of all municipalities in Venezuela were established during the last 12 years. Furthermore, 71% of all municipalities have a population of less than 50,000, but these account for less than 20% of all the population. In contrast, the 6 largest municipalities account for nearly 25% of the population.

1.10 Venezuela’s federalism and decentralization initiatives centers around the central government, 22 states and 330 municipal governments. The principal regulatory framework at the federal level is the constitution. States have vast functional responsibilities but limited ability to legislate. Municipalities are regulated through the Code and by the ordinances that legislated by the municipal council. Municipalites enjoy a high level of fiscal and regulatory autonomy as they can establish tax rates and tariffs. The three levels of government have elected executive branches and reelection is permitted at the municipal level. There have been three electoral cycles in municipalities since the 1989 reform.

1.11 The provision of urban services must be seen in the context of Venezuela’s oil based federalism and its emerging decentralization initiatives. Oil revenue is the principal source of funding intergovernmental fiscal transfers which in turn account for over 70% of municipal expenditures. In order to have sustainable provision of services the source of finance must eventually shift from volatile oil based transfers to contributions by those who derive benefits from the services. The shift will require a fundamental change in the incentive structure including compelling municipalities, through conditioned transfers and sectoral financing policies, to establish sustainable service provision.

E. PRIOR SECTOR WORK

1.12 Prior analytical work by the GoV and Venezuelan academic institutions provides rich insight identifying key issues limiting the sustainability of services as well as formulating policy options to address these issues. Complementing Venezuelan research, the Bank has produced two reports that, among other objectives, assess the design and
workings of the GoV at the national and sub-national levels. Prior sector work was carried out to help the GoV define the assignment of expenditures and revenue authority across levels of government and to propose reforms to address issues of local finance and reform the current federal-state fiscal transfer system. The recommendations from past sector work have contributed to the reform debate. The present sector work revisits and endorses salient recommendations by updating them and including new recommendations to reflect recent developments.

2. THE ANALYTICAL FRAMEWORK

A. TOWARDS BETTER LOCAL SERVICES: FINDING THE RIGHT INCENTIVES

2.1 The fundamental lesson from the Bank's urban services experience is that the quality, coverage, efficiency and sustainability of local services depends foremost on the system of incentives confronted by institutions, including the public and private sector as well as households. Reform to institute incentives that promote equitable and sustainable provision of services oftentimes requires modifying complex and unique structures that are the product of political economy and history. The first step in establishing sustainable service provision is to find a balance that enables good management translate to good politics. This requires reform to the political, functional and fiscal framework in order to establish at least four necessary conditions: (i) clarity on the division of functional responsibility; (ii) appropriate revenue assignments; (iii) efficient and equitable intergovernmental transfers; in the context of sound sectoral financing policies, and (iv) local capacity to provide services.

(1) Clarity on the division of functional responsibility between levels of government

2.2 Clarity on the division of functional responsibility between levels of government is an essential condition for any reform in the structure of urban service delivery. A clear linkage between a particular unit of government and a specific service is crucial if constituents are to hold that unit of government accountable for providing that service. Furthermore, constitutional responsibilities should be clearly and precisely stated to avoid concurrence of functional responsibility (overlap and duplication of authority for the provision of services). Although open ended central government involvement in nominally local responsibilities is often intended to compensate for local service failures, it undermines clear accountability for sound management of local service delivery. Clarity requires more than de jure allocation of responsibilities that often bear little resemblance to de facto practice. Making clear functional assignments credible requires, among other things, a system of managerial and financial discretion that permits local government to

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perform successfully the tasks that have been assigned to them, or to "fail" openly if they manage them poorly. Assigning responsibility to a level of government does not necessarily imply that the government should be the direct producer of the service in question. Involvement by the private sector can help improve performance in the delivery of a variety of municipal services.

(2) Reform in revenue assignments

2.3 Reform in revenue assignments is needed if a clear division of functional responsibilities is to be credible and is to establish the necessary incentives for sustainability. The particular structure of local revenues - the mix of user charges, taxes, transfers and credit - that is appropriate in a given context depends primarily on the functions that have been assigned to government. In short, finance follows function. Where the benefits of a service are largely confined to individual consumers, user charges are a desirable means of financing municipal services. Local taxes, in principle, are an appropriate means of financing municipal services whose benefits, though not confined to individual consumers, nevertheless do not extend beyond the municipal boundaries. The balance of revenue sources must respond to the political benefits but also political costs. Emerging local governments tend to minimize political costs by attempting not to confront users with the cost of provision. Thus, emerging local government will only confront users if no alternate source of revenue is available.

(3) Reform of Intergovernmental Transfers

2.4 Any attempt to reform the structure of urban service delivery must also address the largest source of local revenue: intergovernmental transfers. The use of transfers for financing local services must not distort the incentive structure that promotes sustainability, including benefits received principle and accountability. Transfers for recurrent expenditures and capital works can serve an important positive role as one of the sources of financing municipal services, permitting central governments to induce local governments to undertake sectoral expenditures that are of national - rather than local - interest and to use local governments as agents of national income redistribution policies. Reform is generally required to increase the effectiveness of transfers in achieving these sectoral and distributional objectives and to reduce the adverse side effects of badly targeted or badly administered transfers. Reform of intergovernmental fiscal relations

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7 Failure by local government is not a new concept. Deficient or unacceptable services have prompted local governments to reform their institutional arrangements for service provision. For example, concessions to the private sector for solid waste management, provision of water, billing and the management of specialized infrastructure such as libraries, cemeteries and others. More generalized failure of government should also be seen as a viable option for institutional reform. Since 1970 Mexico City, Bogota, New York, Cleveland, Philadelphia, Washington D.C, and Orange County California have temporarily lost authority due to financial failure caused by poor management. Failure is not a catastrophic event, but an opportunity to evidence the need for change and to incorporate reform.

8 Benefits received principle is the premise whereby the individual, household or community that benefits from a given service should pay in proportion to the benefits it received.
requires complementary adoptions in the institutional arrangements for intergovernmental coordination, planning, budgeting and implementation. Perhaps the most important measure governments can take is to reduce the uncertainty and bargaining that accompany intergovernmental flows. Intergovernmental flows should be predictable, transparent and based on objective criteria. Political bargaining should not be the instrument to allocate public resources. The systematic and subjective definition of the responsibility of each level of government and users in financing services should establish the financing structure (ie. matching grants). The system of conditioned matching grants requires the development of a sound sectoral financing policy.

(4) Adequate Capacity

2.5 Adequate capacity at the local level is a necessary condition for efficient service provision. Just as finance must follow function, capacity must follow accountability. Clearly delineated accountability for the performance of local government has generated strong incentives for capacity building at the local level. In addition, technological advances can overcome past bottlenecks in the preparation of budgets, accounting and management of the cadaster. Capacity has also been motivated by redefining the institutional arrangements for service provision. The privatization of local services and the creation of paramunicipal enterprises would enable local government to have an appropriate role as provider and regulator of services and not necessarily as producer of services.

B. DEMAND FOR URBAN SERVICES

2.6 The demand for reliable and effective urban services, particularly basic services such as potable water, sewerage, roads and solid waste management, is the driving force motivating reform in service provision. Perhaps the most important distortion in the demand for these services has been tariff policies which not only make subsidies necessary but also provide the wrong incentive for users who consider these services as entitlements rather than economic goods. Politically motivated pricing strategies, most often highly regressive, have had a profound influence undermining the sustainability of urban services. For example, citizens in Venezuela have generally been accustomed to tariff levels for public services well below production costs and in turn there have been no incentives for efficient production of these services. In addition, citizens are aware that municipal government traditionally has exerted a limited effort to collect revenue from users. These factors has contributed to developing what is popularly known as a lack of payment culture or cultura de pago.

2.7 However, it is well known that demand for urban services, many of them basic services, is highly inelastic and consumers universally value highly urban service reliability and quality. The lack of cultura de pago is nothing less than a rational response of consumers to the incentives they confront. Limited cost recovery effort in both the rates

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10 IESA, 1995a
charged and the billing and collection provides little incentive for payment. However, as
the quality and reliability of services deteriorates consumers express a greater willingness
to pay for services and are more open to reform.

2.8 Recent willingness to pay studies for water in the state of Monagas and in the
Caracas Metropolitan Area make evident the robustness of the demand for these services
in Venezuela. More importantly these studies illustrate the magnitude of misguided
subsidies. For example, in Caracas, the study reveals that 55% of the population would be
willing to pay 200% more for the current service if this would assure that the service
would not deteriorate. At this level of tariff, even if those unwilling to pay did not
contribute to the system, the total revenue would increase by 66% making it nearly
financially viable.

2.9 In the state of Monagas the willingness to pay study revealed that on average the
revenue maximizing tariff for improved water service was nearly 1000% of the current
payment. Indeed, the study revealed that the users of the system valued highly system
reliability and would have a very high willingness to pay for the service. The study
concluded that in the face of such demand a strong case cannot be made for systematic
and recurrent external subsidies.

2.10 The mobilization of household contributions to finance the provision of services is
a fundamental premise for sustainable service provision. It is necessary to assure that one
time subsidies to capital works, in the form of matching grants, do not distort the demand
and willingness to pay for services. Contingent evaluation studies in Venezuela
demonstrate that effective pricing strategies which capture the willingness to pay of each
income category for services is fundamental for the sustainable provision of services.

C. KEY TO SUCCESS - COMPLETING THE REFORM PROCESS

2.11 The sequence and timing of reform for the sustainable provision of services is
crucial. The elements of local service delivery, political, functional and fiscal reform must
be coherently developed in order to assure incentives for the sustainable provision of
services.

2.12 Successful reforms in the provision of services must be swift, predictable,
deliberate and transparent. As an inherently political process, the result of the reforms is a
shift in the balance of power and responsibilities. The final outcome will be determined by
the clarity of objectives and level of commitment at the local level.

11 Staff Appraisal Report Venezuela: Water and Sewerage Decentralization Project in the State of
Monagas ; Annex D. Willingness to Pay for Improved Water and Sanitation Services, 1996. and
Estudio de Disposición a Pagar por Servicios de Agua y Alcantarillado en Caracas Venezuela, ESA
Consultores, June, 1996.
2.13 Diagram 1 presents a summary of the reforms undertaken thus far and actions considered necessary to establish an appropriate incentive framework for the sustainable provision of services.

Diagram 1. Venezuela: Summary of Reforms in the Provision of Urban Services

| Political Reform | Functional Reform I→ | Fiscal Reform I→ | Functional Reform II→ | Fiscal Reform II/ Future → | Agenda
---|---|---|---|---|---
| Key Characteristics | Municipalities have autonomy but are protected from failing. | States and Municipalities are assigned formula driven recurrent transfers from the central government. Separate capital transfer mechanism is established. | States have incremental revenue but not obligatory incremental responsibilities. | Establish clarity in the assignment of functional responsibility to reduce and eventually eliminate concurrence. | Provide incentives for own source revenue generation and appropriate use of instruments for revenue generation according to benefit equity.
| Key Outcome | Concurrence in functional responsibility between states and municipalities prevents clear accountability as well as application of appropriate financing instruments. | States have incremental revenue but are not held accountable for providing incremental services and have no incentives for the generation of own source revenue. | Municipalities have incremental revenue but are not held accountable for the quality and coverage of services. | Establishment of institutional arrangements for service provision with a management scheme based on incentives. | Revised intergovernmental fiscal relations on recurrent and capital transfers that provide incentives for (i) efficient and sustainable provision of services; (ii) and own source revenue generation and (iii) use of matching grants
| | State governments are slow to assume additional responsibilities and costs of reform fall unevenly among them. | Capital works are uncoordinated. Independent negotiation between each local and state government and central government defines decentralized infrastructure investments. | Capital works are uncoordinated. Independent negotiation between each local and state government and central government defines decentralized infrastructure investments. | Municipalities increase own source revenue by applying benefits received principle.

2.14 The decentralization of urban service provision in Venezuela has been characterized by its prolonged, negotiated and non-impositive framework. Timing and content of functional and fiscal decentralization in Venezuela has been cautious, and a
second phase of action is necessary to continue the process and avoid the deterioration of service provision systems. The 1989 Code is a landmark document in Venezuela's decentralization and democratization process but it remains a transitional document that must evolve to include the necessary precision and clarity in the assignment of responsibilities and incentives for own source revenue generation and excellence in governance.

3. URBAN SERVICES AND DECENTRALIZATION

A. POLITICAL DECENTRALIZATION AND SERVICE PROVISION

(1) Background

3.1 Landmark reforms in 1989 including the promulgation of direct election of mayors and governors have begun the political transformation of Venezuela from a country with a centrally controlled government to one with a government open to share power with regions and municipalities. The emergence of local democratic institutions is producing a new generation of political leaders who generally enjoy a high level of credibility. However, at the state level, credibility has been constructed by financing public services, including recurrent costs, exclusively through intergovernmental transfers. At the municipal level, intergovernmental transfers and indirect taxes finance the majority of urban services. In general, the provision of services is largely based on a financially and managerially unsustainable strategy which generally avoids confronting users of services with the cost of provision. For instance, in a sample of 28 municipalities it was found that 90% of municipal revenue is from transfers and the industry and commerce tax.

(2) Issues

**Mayors and council members are protected from failing.**

3.2 Basic principles of political decentralization and accountability are undermined by legislation that breaks the link between performance of local government and its political consequence. If a municipality fails to provide services to its constituency, the state and/or the central government are obligated to step in and provide the service. Thus, a safety net protecting the failure of local government can mask poor management. Flexible responsibilities were considered necessary to facilitate a transition during functional decentralization and protect the public from deficient or non-existent services. However, the prolonged application of the policy has not protected the interest of the public at-large but provides a pervasive sense of security for local government.

**The threat of sanctions for not delivering services is not credible.**

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12 VENECONOMIA. April 17, 1996
13 Excluding services such as airports and ports that generate revenue through port fees.
3.3 The regulatory framework to assure that municipalities fulfill their functional responsibility is ineffective. Mayors are aware that if their municipal government does not fulfill its functional responsibilities during three consecutive years the state government can dissolve the municipality and incorporate it into a neighboring municipality as parroquia.\textsuperscript{15} This sanction is so severe that it has never been, and is unlikely to ever be, applied. Appropriate regulation to provide credible incentives is necessary. For example, incentives such as \textit{voto programático} are being practiced successfully in Colombia. If the mayor is unable to deliver his program he/she is held accountable and may be asked, by plebiscite, to renounce his/her position. While this may be an extreme measure, it is clear that there is a need for mechanisms to hold local government officials accountable for performance and the quality of services.

\textit{Exoneration of tributes diminishes credibility of mayors}

3.4 The Municipal Code provides the mayor with the capacity to negotiate and exonerate contributors from the payment of taxes and user fees.\textsuperscript{16} This discretionary power distracts attention away from managing the provision of services to political considerations in the application of the law and weakens the authority of the mayor.

\textbf{Proliferation of potentially unsustainable municipalities.}

3.5 The Code provides a simple mechanism and minimal requirements for the creation of municipalities. In addition, the intergovernmental fiscal system provides unconditional transfers to all municipalities. These incentives have motivated the proliferation of municipalities without concern for their sustainability. The rapid creation of municipalities has precipitated a set of well defined typology of problems as shown in table 1.

<table>
<thead>
<tr>
<th>Type</th>
<th>Number</th>
<th>Definition</th>
<th>Prevalent Administrative Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stable municipalities</td>
<td>149(45%)</td>
<td>Established municipalities that are 12 years or older.</td>
<td>Mayor subordinate to risk averse council reluctant to institute change.</td>
</tr>
<tr>
<td>Spin-off municipalities</td>
<td>101(31%)</td>
<td>Municipalities established less than 12 years ago which are generally small</td>
<td>No former institutional structures and limited administrative capacity.</td>
</tr>
<tr>
<td>Source municipalities</td>
<td>80 (24%)</td>
<td>Large municipalities from which other municipalities have emerged.</td>
<td>Municipalities with reduced fiscal base from loss of constituents.</td>
</tr>
</tbody>
</table>

\textsuperscript{15} Organic Municipal Code - Article 22.
\textsuperscript{16} Municipal Code - Article 115.
(3) Recommendations

3.6 As detailed in Annex 1 this report recommends a revision of the municipal code with focus to Articles 11, 22, 40 and 115 to establish the following conditions:

- Allow local governments greater accountability and establish a transparent mechanism to permit them to “fail” openly without compromising the provision of services.
- Hold local governments accountable for obligations and establish/apply credible threats to local government officials in order to motivate compliance.
- Limit power of mayors to exonerate payment of taxes and user fees.
- De-politicize service provision by promoting private provision of services as well as creating autonomous municipal and regional entities to provide public services.
- Increase accountability of mayors by designing and implementing programs such as the voto programatico.

B. FUNCTIONAL DECENTRALIZATION: LACK OF CLEAR ASSIGNMENT OF RESPONSIBILITIES

(1) Background

3.7 The definition of the functional responsibility of each level of government is a necessary condition for the efficient, equitable and sustainable provision of services. Furthermore, it is necessary to define the appropriate mix of financial instruments needed to finance services. In Venezuela de jure definition of municipal functional responsibility has been promulgated through the Code. Article 38 of the Code establishes a progressively complex set of service provision responsibilities to municipalities according to population category. The population categories are: less than 10,000; 10,000 to 50,000; 50,001 to 100,000 and more than 100,000 (see annex 1).

3.8 However, assignment of functional responsibilities does not always conform to the official definition. This condition is described eloquently through the following excerpt from recent analysis of the decentralization process:

Venezuelan federalism is based on a set of [implicit] agreements between the different levels of government and between government and the private sector. Thus, the definition of functional responsibility is the product of negotiation among levels of government rather than the product of an exact and precise legal system. Indeed, the relative speed of decentralization has been affected in a definite way by the negotiating skills of the executives.

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17 Rafael de la Cruz (1995) La Ruta a la Eficiencia
18 The basis for establishing a negotiated federalism has rested on the premise that this strategy enables a transition in assuming responsibilities by each level of government and the demands of each community. Further it has been argued that competition among levels of government may result in
3.9 The gap between the intent of the regulatory framework and actual practice is the product of an implicit strategy to rely on negotiated resolutions rather than normative application of a strict framework. Political negotiation to define functional responsibilities does not lead to sustainable service provision arrangements. A good example is the functional decentralization of social services which can be characterized as irregular. Selected states and municipalities, through a process of negotiation, have accepted responsibility for only part of a given service. This creates organizational tension. Another undesirable outcome is that citizens do not always know who to hold accountable for any given service.

3.10 The decentralization of functional responsibilities to municipal governments in Venezuela has at least four characteristics that make the issue complex. The process has been: (i) passive and solely demand driven—not obligatory; (ii) promotes concurrence of functional responsibilities as a "permanent" alternative; (iii) promotes open-ended functional assignments, and (iv) depends on a case by case decentralization with high transaction costs.

(2) Issues

Functional decentralization as an "optional" obligation.

3.11 The definition of most aspects of the functional responsibility of state and municipal governments in Venezuela is negotiated. Under the Decentralization Law and the Code, states and municipalities may choose whether or not to accept the responsibility of service provision. The definition of whether a state or a municipality will assume a responsibility rests on reconciling the incentives and risks (political and financial) that may be incurred in assuming or not assuming service provision. In some cases, governors and mayors have understood that in order to maintain the support of their electorate they have to become involved in the provision of services which are deficient and in rapid decay. However the prolonged process of functional decentralization is a symptom that the incentives to assume responsibility are either not sufficient, or not sufficiently clear, to motivate governors and mayors to assume new responsibilities or simply assume the responsibilities they have de jure received but de facto neglected.

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efficiency gains through competition. The transitional nature of negotiated functional responsibilities is an observable phenomenon but no study has demonstrated in Venezuela or elsewhere that intergovernmental competition for service provision leads to efficiency gains.

19 Once a state governor requests the transfer of a concurrent competence the state council must second the motion. The ratified request is considered by an ad-hoc committee established with members of the national and state government. This committee establishes a proposal that is presented to the national senate. Once the national senate approves the transfer of competencies, the national executive and the state must reach agreement on the terms and conditions of the transfer. The president can also initiate the process but this has never taken place. At the municipal level the process is similar. A municipality can remain passive and not claim responsibility for service provision. From Rafael de la Cruz 1995. La Ruta a la Eficiencia: Decentralizacion de Servicios Sociales. 1995.p. 10

20 Rafael de La Cruz. 1995
3.12 The central government has been slow to devolve services to the states. For example, as of May 1996 there have been 129 concurrent functions claimed by states and only 41 had been transferred. In contrast, by March 1995 out of 38 exclusive attributes that had been claimed by states, 31 had been transferred\(^\text{21}\). As long as there is concurrence there appear to be disincentives to demand devolution by the sub-national government. In addition there is a tendency for the central government to hold on to service provision for prolonged periods of time as devolution represents a new and diminished role for their institutions\(^\text{22}\).

3.13 Devolution of services to municipal governments follows the same pattern as central-to-state transfers. States have had a tendency to retain concurrent competencies regardless if municipalities or the private sector are capable of providing the service. In turn, municipal governments do not generally demand exclusive service provision obligations as this would leave the municipality solely accountable for service provision. A clear indication of this phenomenon is the fact that only the states of Aragua, Carabobo and Falcon, covering less than 8% of all Venezuelan municipalities, have a systematic program for state to municipal decentralization (TEM).

Box 1

### Incentives and Risks for Assuming Service Provision in Venezuelan Municipalities

<table>
<thead>
<tr>
<th>Political Incentives (+) / Risks (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ political credit for improving service provision</td>
</tr>
<tr>
<td>+ visibility to build political support</td>
</tr>
<tr>
<td>+ clarity in sense of political mission</td>
</tr>
<tr>
<td>- risk of poor service by local administration and loss of support by constituency</td>
</tr>
<tr>
<td>- quality services will require charging users for services which were never billed previously</td>
</tr>
<tr>
<td>- need to concession to privates sector and &quot;loose&quot; day to day control</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Incentives (+) / Risks (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Financially neutral system with improved quality will mean political gain</td>
</tr>
<tr>
<td>+ If service is sound, possible surplus to re-invest</td>
</tr>
<tr>
<td>+ Increased quality of services will increase the willingness to pay of services</td>
</tr>
<tr>
<td>- Lack of political will to index tariffs results in unsustainable subsidies.</td>
</tr>
<tr>
<td>- Lack of predictable financing sources for expansion of infrastructure</td>
</tr>
</tbody>
</table>

Based on informal interviews with 16 mayors in November 1995 and March 1996.

*Most urban services in Venezuela are de facto concurrent.*

3.14 Under the current regulatory framework, within any given municipality all levels of government may provide most--if not all--urban services.\(^\text{23}\) The concept of concurrence was developed as a strategy to enable a smooth transition in the definition of functional responsibility. In order to assure that the service is produced, the regulatory framework provides for flexibility and overlap in service provision. However, after more than seven years of service provision through the flexible regulatory framework, concurrence has proven to be a disincentive for assuming full responsibility of service provision and a bottleneck for the sustainable provision of services. Concurrence has led to several

\(^{21}\) IESA, 1996

\(^{22}\) Ibid. p 2.

undesirable outcomes: (i) bias towards politically visible infrastructure - including advertisements between levels of governments taking credit for the production of infrastructure; (ii) bias towards the provision of new infrastructure and not to less visible operation and maintenance; (iii) deficient or non-existent accountability for the adequate coverage, quality, sustainability and externalities generated by a given service; (iv) erratic investment linked to political cycles rather than to the demands of stakeholders; and (v) generation of redundant human and material resources for the provision of any given service.

Open ended functional responsibility.

3.15 The Code empowers local governments to provide virtually any service they desire. This has led to a proliferation of non-traditional municipal services including community banks, sports arenas, and commercial enterprises that extend the mandate of municipalities beyond what they can reasonably cover. The open ended nature of municipal functional responsibility assignment is not conditioned on meeting exclusive service provision at a minimum standard. Thus, resources may be allocated to non basic services even though basic needs may not be met.

The role of the private sector

3.16 Venezuelan municipalities generally rely on government personnel for the direct production of services. As with local government throughout most of the world local political leaders jealously guard the discretionary ability to assign employment to active supporters. This has contributed in most local governments to refrain from pursuing actively privatization policies.

3.17 Although no data on the private provision of local services are available, a sample of 16 municipal governments revealed that virtually no service, with the exception of solid waste collection, was being produced by the private sector. In fact, most mayors argue that is easier for them to provide the service than supervise a private enterprises. In one municipality a private concession for solid waste management was being terminated largely because grant capital financing by the central government could permit the local government to provide subsidized service at a lower costs.

3.18 The unsustainable level of subsidies to public services combined with low levels of efficiency in the production of services has promoted some municipalities to create autonomous municipal enterprises as well as to seek private provision of services. In principle autonomous municipal enterprises could serve as a transition to full private sector participation. However, municipal enterprises are not well regulated and can receive substantial subsidies from the municipal government.

**High transaction cost of decentralization**

3.19 Negotiations to decentralize functions with each state and within the states to each municipality is a laborious process with high political and financial transaction costs. After more than seven years of political decentralization, it is apparent that in order to induce decentralization of municipal services in Venezuela it is necessary to “wholesale” it using either the state or the sector as the unit for decentralization. Examples of this strategy are promising models to follow. For example, the _Transferencia Estado-Municipio_ in the State of Falcon could be a viable strategy to decentralize urban service provision responsibilities on a mass scale from the state to the municipal government (Annex 5). The initiative to restructure the provision of water in the state of Monagas establishes a precedent for sustainable sectoral reform at the regional level. Finally, FUNDACOMUN is establishing municipal strengthening programs at the state level. Advantages of “wholesaling” decentralization of services includes: (i) creating a critical mass of change to reduce the relative risk of each municipality; (ii) reducing political and financial transaction costs; (iii) establishing economies of scale for making private provision of services more likely; and (iv) facilitating the formulation of high quality and compatible municipal ordinances in a given region or state.

**Box 1. Wholesaling Urban Services Decentralization**

**Decentralization of Water Provision.** The _Ley Orgánica de Régimen Municipal_ includes water and sanitation services (WS&S) as part of the municipalities’ responsibilities. To this end, the mayors of the ten municipalities in the state of Monagas created in 1992 the _Mancomunidad Monaguense de Acueductos_ (Mancomunidad), in essence an association of municipalities, to deal with WS&S services management and operation in the state. In 1993, the state government and the _Mancomunidad_ created _Aguas de Monagas_ (AdM), to act as the responsible operating company for the services in substitution of HIDROCARIBE in the state of Monagas. The capital structure of AdM is public and comprises a 51% equity share from the _Mancomunidad_, with the remainder held by the state government. Under this structure, O&M as well as management functions will be contracted to the private sector.

**Wholesaling Technical Assistance.** FUNDACOMUN has been providing technical assistance to municipalities for more than 34 years. In 1995 it began to “wholesale” its technical assistance to municipalities through agreements with states. These contracts specify the technical assistance to be carried out, costs sharing arrangements, and modality of provision. Agreements have been signed with the states of Lara, Carabobo, Aragua, and Anzoátegui. One or more specialized institutions are awarded a contract to manage the provision of technical assistance. The agreements are establishing precedent for a matching grant system in the provision of technical assistance. (FUNDACOMUN 1996)

**Transferencia Estado Municipio (TEM).** The states of Aragua, Carabobo and Falcon are currently in the initial stages of transferring functional responsibility from the state to the municipalities, accompanied by incremental transfer of revenue as a piggy-back to the _situado municipal_. In the state of Falcon each municipality signs an agreement that specifies the responsibility being transferred and the amount which will be dedicated for its provision. In this form the negotiation with each municipality is simplified and the decentralization process is more transparent and agile. The TEM requires refinements but has the potential of facilitating decentralized service provision. (Annex 5).
(3) **Recommendations**

3.20 This report recommends that a detailed revision of the municipal code with special focus to Articles 11, 40 and 36 as well as model municipal ordinances in order to establish the following conditions:

- Clarify functional responsibilities between the state and local governments to eliminate concurrence in provision.
- Establish time bound, predictable, and mandatory programs for assuring the implementation of reforms to transfer functional responsibility.
- Restructure service production arrangements to include production of services by municipal institutes, mancomunidades or the private sector through concessions.
- Assure consistency of functional responsibility reform and application of appropriate own source revenue instruments to finance services.

In addition, it is necessary to provide technical assistance to:

- Define and implement TEMs to facilitate financing of service provision.
- Promote state-wide or regional reform in the provision of key basic services such as the provision of water using the model developed in the state of Monagas.

C. **Fiscal Decentralization and Urban Service Provision**

3.21 The particular structure of local revenues—the mix of intergovernmental transfers, user charges, taxes, and credit—that is appropriate in a given context depends primarily in the functions that have been assigned to each level of government and on the distribution of benefits generated by a given service. In Venezuela, the concurrent nature of functional responsibility limits the definition of an appropriate local government revenue structure. Local services provided by the state government are totally financed through state transfer revenue and very limited cost recovery is undertaken. Municipally provided services are financed principally through transfer revenue and the industry and commerce tax which account for approximately 90% of total recurrent municipal revenue.

3.22 The structure of municipal revenue in Venezuela reflects historically complex intergovernmental fiscal relations based on the distribution of revenue derived from oil. Since 1989 reforms have sought to establish a predictable system of financing services based on formula driven intergovernmental fiscal transfers as well as own source municipal revenue. However, the large proportion of discretionary allocations of resources is a determining force defining the provision of services.

3.23 The lack of an integrated financial system makes it impossible to establish the relative roles of discretionary and objectively defined fiscal instruments for the provision of services. However, diagram 2 presents an indicative display of the principal flow of fiscal resources to subnational governments as well as the provision of services. This section of the paper presents the four major intergovernmental sources of revenue for the provision of local services; including: (i) central to state fiscal transfers (situado
constitucional); (ii) state-municipal transfer (situado municipal); (iii) FIDES transfer; and (iv) transferencia estado municipio (TEM). Analysis of these intergovernmental fiscal transfers is presented in the annexes. Detailed review of municipal finance is found in annex 3.

3.24 In 1991 it was calculated that discretionary capital investment by sectoral ministries accounted for 70% of total infrastructure investment while state governments financed 25% and municipalities just 5%. Mayors have to negotiate unilaterally and hold constant dialogue with central government officials to assure the financing of a large proportion of the infrastructure produced in the municipality. In order to reduce the level of discretionality in the definition of public expenditure, it will be necessary to establish a transparent and decentralized system to finance public expenditure based on sectoral financing policies and a matching grant system.

Diagram 2. Venezuela: Intergovernmental Finance and Service Flows

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26 Mayors visit Caracas with such frequency that FUNDACOMUN has established an “Oficina del Alcalde” in its Caracas headquarters. This office supports visiting mayors with a place to hold meetings as well as with logistical support during their visit.
(1) Recurrent Intergovernmental Transfers

Background:

3.25 This section is limited to a summary analysis of the impact that intergovernmental fiscal transfers have on urban service delivery. Marginal modifications to these flows have the potential of achieving significant improvements in the sustainable provision services.

3.26 The principal intergovernmental transfer of revenue is from the federal government to the state government through the situado constitucional. The transfers to the municipalities, the situado municipal, is made through the states. The states transfer at least 20% of the situado constitucional to their respective municipalities. The situado constitucional is the largest source of revenue to state governments accounting for more than 95% of total revenue. The situado municipal is also the largest source of revenue to municipalities in aggregate accounting for approximately nearly 70% of municipal revenue. The following paragraphs briefly describe the transfers and their implication for urban service delivery.

Situado Constitucional

(1) Background

3.27 The principal intergovernmental transfer program is the situado constitucional, under which a fixed percent of federal general revenues are transferred to the states. Prior to 1989, this figure was set at 15%. Under the terms of the Decentralization Law passed in 1989, this transfer of federal general revenues was to increase in increments of 1% a year until it reached 20% in 1994. The Situado Constitucional is distributed to the states according to a formula under which 70% is allocated on a per capita basis and the remaining 30% is distributed equally among the states. The Decentralization Law of 1989 eliminated the former requirement that States investment projects have to be approved by the national government. Also, investments for the purposes of the situado constitucional are defined broadly. The situado constitucional is essentially an unconditional block grant; or, a conditional grant with sufficiently mild restrictions, which seldom constrain the behavior of the recipient state governments. The main condition is that 50% of the situado transfers must be devoted to capital expenditures.

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26 For more detailed treatment on intergovernmental relations please refer to World Bank 199. Venezuela: Decentralization and Fiscal Issues RN 11160-VE.

27 The pool of revenue for municipalities includes general central government revenue and oil revenue including taxes on state owned oil enterprises. The only major tax that does not enter into the pool of resources for intergovernmental recurrent transfers is the value added tax (VAT). The VAT is distributed through the FIDES.
3.28 The *situado constitucional* is funded principally through general government revenue dependent on oil revenue. As such, it is open to high level of fluctuations and uncertainty. Financing local recurrent expenditures with volatile revenue sources makes state government vulnerable. In addition, the high level of uncertainty in the magnitude of revenue reduces the likelihood that state government will increase the level of transfers to municipalities. The only sustainable solution is to assure sufficient level of own source revenue to buffer fluctuations in transfer revenue.

3.29 The *situado constitucional* is the lifeline of state governments. During the last seven years it has financed virtually all recurrent expenditures. However, incremental transfers have not been linked with incremental responsibilities. As a result there is a potential mismatch between the functional responsibilities of the state government and its transfers. State governments have assumed responsibility of providing concurrent services with the municipalities. This has served as a way to rationalize revenues with expenditures.

*Situado Municipal*

(1) Background

3.30 The *situado municipal* is the grant program that provides transfers from the state governments to the municipalities. Its structure is analogous to that of the *situado constitucional* in that a fixed fraction of state grants is transferred to the municipalities. Under the Decentralization Law, this fraction is supposed to increase one percentage point per year from 10% in 1989 to 20% in 1999. These funds are allocated among the municipalities according to the same formula used in the allocation of the *situado constitucional*: 70% is allocated on a per capita basis and 30%, equally among all the municipalities of a particular state. The *situado municipal* is thus an unconditional grant to the municipalities. On the average, the *situado municipal* accounts for 80% of municipal revenue for municipalities under 50,000 and 60% for the remaining municipalities. Also, municipalities receiving expenditure responsibilities beyond those specified in the Code receive a budgetary allocation based on current expenditure levels for that function.

(2) Issues

3.31 The level of *situado municipal* has historically been volatile as it depends principally on government revenue generated by oil. As such, it is not an appropriate

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28 There is no standard method or formula to define the level of financial transfers associated with a given service and are therefore the result of negotiations between the states and the municipalities.

29 From 1991-1994 the situatdo municipal showed important downward trend. In a sample of 35 municipalities 19 (70%) had real reduction of more than 10% and in 12 (44%) had reductions of more than 20%. Only 7 municipalities had real increases to the situado. (Mouchet, 1996.)
primary source for financing local public services. Even with increases in the proportion of government revenue transferred to municipalities real transfers declined in 1992 and 1993.

(From Mouchet, 1996)

3.32 Another issue is that the Code establishes differentiated functional responsibilities for municipalities according to four population cohorts. However, the magnitude of transfers to municipalities does not take into account the specific assignment of responsibilities of each of the four population cohorts. Thus, there are many cases where municipalities of very similar population receive the same level of transfers but have vastly different responsibilities.

3.33 The situado municipal obliges municipalities to use at least 30% of the transfer for capital expenditures. This condition was established to prevent municipalities from allocating 100% of the transfer for salaries. However, this condition does not prevent the municipalities from three major flaws: (i) lack of efficiency in governance and service provision; (ii) and evasion of cost recovery by financing services with transfers and (iii) altogether neglecting the provision of services.

3.34 Finally, while the regulatory framework mandates investment in infrastructure it does not mandate investment to assure the necessary capacity for efficient governance and service provision. Given the recent creation of the majority of the municipalities in Venezuela, it is necessary to link intergovernmental transfers to the strengthening of the institutions receiving the transfers.

(3) Summary Recommendations

3.35 Recurrent intergovernmental transfers are likely to remain a major source of revenue for states and municipalities. However, given the volatility in the level of transfers, it is apparent that municipalities who wish to have predictable revenue will have to increasingly rely on own source revenue. The situado constitucional and situado municipal should remain largely unconditional but complementary reforms to the Code
should assure that the availability of transfers does not provide disincentives for own source revenue generation through the application of benefit taxes and user fees.

- Reform the Code and the situado municipal to assure the correct application of revenue instruments according to benefits received principle.
- Reform the situado municipal to assure its allocation among municipalities is consistent with its functional responsibilities.
- Condition the situado municipal on the efficient and sustainable provision of services as specified in the Codigo Municipal.
- Reduce dependency of municipalities on transfers to levels that permit robust financing solutions for local services.

(2) Municipal Own Source Revenue

Background

3.36 Financial sustainability of local services depends on the ability of municipalities and private service providers to generate tariff and user fee revenue. Municipalities cannot rely on the situado municipal to cover recurrent expenditures. Revenue from transfers should ideally serve to compensate and fill financing gaps after reasonable fiscal efforts and efficiency in service provision has been fulfilled. Evidence from developed and developing economies suggests that municipal governments will not confront users with the costs of service provision, even where they have the legal authority to do so, as long as less politically sensitive revenue sources are available. The case of Venezuela fits this premise well. Given the current incentive structure local tax administrations are not vigorous at tax effort, also with low compliance in payment of the two main taxes and the almost non-existence of local tax enforcement, it could be argued that payment of local taxes is almost voluntary.\(^{30}\)

3.37 The importance of own source revenue goes beyond simply generating resources of finance services. Own source municipal revenue in the form of benefit taxes and user charges are the only mechanism to assure that the benefits received principle is fulfilled and that targetted subsidies reach the poor. This section of the report is limited to presenting the principal issues and recommendations in the design and administration of the most important own sources of revenue.\(^{31}\) Greater detail can be found in annex 3.

\(^{30}\) For example, in 1993 a study of 6 municipalities revealed that on average they generated only 15% of their property tax potential. In another case, vehicle tax collection was so weak that in a sample of 27 municipalities (1986-1994) revenue for this tax dropped in real terms more than 80%. (Mouchet, 1996).

\(^{31}\) The analysis is based on four representative municipalities as well as on the experience of FUNDACOMUN personnel who interact with all municipalities in Venezuela. Lack of empirical data prevents the development of more detailed analysis. However, in 1996 a study financed by FUNDACOMUN is expected to present the first detailed analysis of municipal finance using real expenditure data.
3.38 There are seven different kinds of taxes that municipal governments can legally levy within their jurisdictions. They are: (i) industrial and commercial patents (I&C), (ii) urban property tax, (iii) public show tax, (iii) vehicle tax, (iv) gambling tax, (v) advertisement tax, (vi) betterment levies, and (vii) rural land tax.32

3.39 In practice, however, own source municipal revenue relies on two local taxes: the Industry and Comme Tax (Patent) and the Urban Property Tax which typically accounts for more than 85% of municipal own source revenue.33 User charges are an untapped source of revenue for municipalities. In 1993 a study of 54 municipalities revealed that user charges represented less than 5% of total revenue. Given the nature of services provided by the municipality, including water and solid waste management, it is apparent that the application of user charges is poorly administered.

Property Tax

(1) Background

3.40 The property tax is based on a statutory tax base given by the capital (market) value of real estate including both land and improvements—although some municipalities use annual value as a tax base (i.e. yearly rents). Municipalities have the legal authority to assess property and set tax rates.

3.41 Under the annual value system owners were supposed to report to the municipal tax authority the actual or imputed annual rents in order to determine their tax obligations; as such, appraisals under the rental system were equivalent to self-assessments. Since the early 1980s local governments must apply only market value of property as the tax base.

(2) Issues

3.42 Both the annual and the capital value systems suffer from shortcomings including discrimination against improvements, and rent control practices freeze the value of the tax base affecting the buoyancy of tax revenues. In contrast, a site value system does not discriminate against improvements since the tax base is given by the capital value of land.

3.43 Under current practice, there have been no mass assessments of property for the past 15 years. The updating system is limited to the information and values reported to municipalities from property transfers. During the same period, the annual inflation rates have been about 30%. Consequently, not only are property values extremely low, but their cadastres cover a small portion of the actual urban areas. A study of 32 municipalities revealed that in real terms property tax revenue decreased nearly 70% from 1986-1993.

32 These taxes are established in Articles 111-113 of the Municipal Code.
33 In most countries there are two or three principal own sources of revenue for local government. As in the case of Venezuela the principal own source of revenue is not the most desirable from a benefits received principle. For example, in South Korea the principal own source revenue is the tobacco tax, in India it is the Octroi—a tax for transporting goods through a given jurisdiction, and in Mexico City it is a personal income tax.
3.44 Since property tax enforcement is weak or non-existent, tax payments are practically voluntary and yields are low. In 1995 the municipality of Valencia reported property tax revenues equivalent to Bs. 250 (US$3.00) per-capita, or US$13 per parcel. The cadastre office has 105 employees of which only six are professional real estate assessors. In addition, there are no vehicles for field work. In 1996, in the municipality of Jose Felix Rivas (118,000 inhabitants) per capita property tax was Bs. 220 (US$0.50).

(3) Recommendations

- Municipalities that apply a rental value system should shift to the capital value system.
- Large cites should be supported in developing new cadastres.
- Assessments should be subject to yearly adjustments taking into account the annual inflation rate
- Incentives should be incorporated in tax administration to upgrade tax collector performance (differential commissions to tax collectors)
- Local revenue administration should adopt electronic automation of tax administration.

Industry and Commerce tax (I&C)

(1) Background

3.45 The I&C tax is levied on the annual gross revenues from sales of industrial and commercial businesses. For tax purposes, businesses in general are classified in about 30 different types of economic activities by sub-sectors. Each sub-sector comprises several industries, and tax rates are generally set for each industry. However, in some cases industries under the same sub-sector also have different tax rates. The tax structure consists of an absolute fixed amount as the minimum tax for each industry and an additional rate given in a per thousand tax rate. Each municipality has the authority to set its own tax rates.
3.46 The I&C tax is not a sound source of general revenue. The direct incidence of the tax into commerce and industry; rather than households does not permit to link service benefits with own source revenue. Furthermore, as the tax is based on gross sales and not on profit which discriminates against high volume - low profit margin establishments. The tax will probably continue to be the principal source of own source general revenue; however, efforts should be made to move to a more transparent generation of own source revenue including the property tax and user fees.

3.47 A typical I&C tax structure may include as many as 250 rates. The minimum tax may vary between Bs.1,000 and Bs.50,000. Also, rates may vary between 1.4 and 50.0, although the most typical range is between 1.4 and 15.0 per thousand. Higher rates seem to be assigned to large industries and monopolies (e.g., public utilities), though the criteria for rate setting across sub-sectors and industries is not always consistent. The implicit incentive to use this tax, as mentioned above, is its comparative advantage as a local revenue source to other local taxes since part of it can be passed on to local consumers and "exported" to nonresidents.

3.48 For tax administration purposes, business are supposed to register their operations with the municipality, and must report their yearly annual gross revenues from sales to the municipal tax administration. But few actually register and report, and there is no guarantee that information from actual taxpayers is accurate. Although the sanction of revoking a patent (i.e. a permit to operate) exists, obtaining a new one is easy. For example, in Barquisimeto it was reported that at least 50% of businesses are unregistered. While larger business are more likely to comply than medium-sized and smaller ones, no verification is systematically made of the gross revenues reported, and audits are rare. Furthermore, tax payment is not required when gross annual sales are filed. The tax administration is supposed to compute the corresponding tax liabilities for each filer. But taxpayers are not billed; instead, they are expected to find out from the tax administration their tax obligations. The following recommendations are presented for the administration of the I&C tax.

(3) Recommendations

- In the long run user fees and property taxes should reduce reliance on I&C tax.
- In the short run--and to enable transition to adoption of more desirable sources of revenue--a program should be developed to provide technical assistance to local governments on how to design and administer the I&C including:
  - Establish a system of third-party tax withholders.
  - Simplify current tax rate structure using one rate for all sub-sectors.
  - Incorporate in the ordinances a price index to adjust the minimum tax.
  - Sanctions should be defined as percentages to avoid obsolescence.
  - Empower tax administration to shut down delinquent business
User Fees and Licenses:

(1) Background

3.49 Several potential sources of municipal revenues exist, including (i) specific fees for permits, licenses, and other certifications; (ii) property leasing (land and facilities); and (iii) municipal service charges. There are two kinds of service charges: infrastructure related to public utilities (e.g., water, gas and electricity); and other infrastructure (e.g., markets, slaughterhouses, cemeteries, urban transport network, and transport terminals).

(2) Issues

3.50 Fees are generally direct payments for services provided by the municipal government, and are expected to cover only the cost of the service (as opposed to licenses or permits which are mainly mechanisms of control and revenue raising instruments). Once established, fees are seldom increased so that services become, in essence, subsidies to the beneficiaries and a financial burden for local budgets.

3.51 Under the current institutional structure where service provision is imbedded in a political structure, it is unlikely that user fees or other direct payments will be effectively applied. Solutions to introduce the generalized application of user fees require changes to the structure of service provision. Paramunicipal enterprises (Institutos) or regional public enterprises under private management have proven to be a viable option to protect the integrity of financing mechanisms from political considerations.

3.52 The Code establishes limits on the level of cost recovery that can be legally charged beneficiaries through betterment levies. Only 60% of the cost of infrastructure can be charged to users as betterment levies. This implies mandated subsidies of 40% and a strong disincentive for the production of infrastructure. The following recommendations are presented for the administration of user fees.

(3) Recommendations

- If private concession of the service is not immediately possible then promote the creation of municipal and regional public enterprises whose principal source of revenue should be market defined user fees.
- Fees should be adjusted on a regular basis to reflect the true costs of local public services. The adjustments should be systematic and defined through formula.
- Evaluate and monitor the cost structure of local services. Particular attention must be given to operation and maintenance cost caused by over-staffing.
- Full cost recovery fees should be phased in for cost-effective solutions to insure financial viability;

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34 Municipal Code Article 113.
• Financial managers of public utilities should be provided with training and technical assistance in cost accounting, methods to determine full cost recovery tariff structures, and collection methods.

(3) Capital Revenue - Uncoordinated Finance of Capital Works

Background

3.53 The objective definition of transparent financing arrangements in the provision of local infrastructure is critical for the sustainable provision of urban services. In Venezuela the financing and production of local and regional infrastructure is largely the product of a political process of negotiations between the three levels of government. Venezuela does not have coordinated local/regional/national investment planning to assure the efficient, equitable and predictable allocation of resources to finance public infrastructure. The lack of such a system can be attributed in large measure to the concurrent nature of service provision and to a lack of sectoral financing policies. In addition, the budgeting system has not provided incentives for the central, state and local governments to seek complementary financing arrangements for the provision of infrastructure and services--ie. development of a matching grants program for financing infrastructure. Lastly, the lack of coordination in financing infrastructure limits the possibility of implementing necessary reforms to increase the efficiency, accountability and sustainability of services. States and municipalities that are not prepared to reform the provision of services will seek funding sources that do not require reform.

3.54 There are two emerging initiatives that can address the deficiencies generated by a lack of coordination in financing infrastructure investments. At a national level the FIDES has the potential to establish a framework for decentralized financing of services using matching grants to mobilize local revenue as well as enabling the reform of service provision to assure its sustainability. At the state level the TEM can complement the objectives of the FIDES as well as facilitate functional and fiscal decentralization from the state to municipalities. The reform of FIDES and the promulgation of TEMs in each of the 22 states has the potential of establishing a financing system that will coordinate and rationalize decentralized public expenditures. In order to facilitate dialog and consultation into reform of these two important instruments the report presents reference annex on FIDES (annex 4) and on TEM (annex 5).

FIDES

(1) Background

3.55 FIDES was created in 1993 to administer the share in the resources from the Value Added Tax (VAT) for states and municipalities. FIDES revenue sharing is provided in addition to the Situado Constitucional and Situado Municipal. The percent shares in VAT revenue according to Law-Decree 5132 is defined as a band between 15 to 20% of total VAT revenue. The precise proportion is defined by the congress on an annual basis.

3.56 FIDES resources must be allocated for the financing of capital expenditures related to concurrent and exclusive functions. An agreement must be signed or a state law must be passed in order for FIDES to be able to disburse these funds. It must be noted that sources of capital for FIDES depends on VAT revenue defined as a ceiling; rather than minimum or fixed proportions. In practice, this design has become a problem since it has legally allowed the central government to allocate amounts substantially below the maximum limits.

3.57 FIDES has the responsibility to determine, allocate, and administer the overall pool of resources. FIDES operates two funds or accounts: one for states and one for municipalities. States and municipalities each have their own council of directors (CDs) who are in charge of managing these two funds. Expenditure budgets are approved annually by their corresponding CDs. States and municipalities must apply for funds subject to the submission of specific projects. FIDES, at their office in Caracas, must evaluate the state and municipal projects and programs and its board of directors approves disbursements.

3.58 The allocation criteria among states and among municipalities is by formula. The allocation criteria among states and municipalities is by formula which takes into account three variables with different relative weight: (i) 45% population; (ii) 45% according to an infrastructure deficiency and poverty index currently being developed and (iii) 10% in relation to the surface area. The interim poverty index being used takes into account only interjurisdictional deficits in basic public services. relative deficits were measured with respect to a national average. Only jurisdictions with magnitudes above the national average qualified for compensation.

3.59 FIDES is supposed to finance projects and programs related to the decentralization of functions including new investment in those sectors in which transfers of functions have occurred; programs on institutional capacity/modernization to facilitate the absorption of new functions as part of decentralization policy; technical assistance to states and municipalities.

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36 The original law decree which created FIDES (No 3265 November 25, 1993) left open the funding of FIDES by stipulating the maximum share of the VAT and not the minimum contribution. This design flaw did not permit predictable funding and induced politically complex negotiation regarding the funding of FIDES. As part of the preparation of the sector work timely recommendations contributed to the resolution of this design flaw.
municipalities—which must be provided in coordination with FUNDACOMUN; and studies related to decentralization and regional development.

3.60 If states or municipalities are unable to commit all the resources made available to them, their entire uncommitted amount must be subtracted for the year following the current fiscal year. The subtracted amounts will be used to constitute a special reserve to finance those programs and projects of states or municipalities who have exhausted their allocations. This system of deductions was to start operations beginning in fiscal year 1995. All states and municipalities are supposed to co-finance their programs and projects. FIDES finances between 95% and 98% of project cost with the balance being contributed by the state and local government.

(2) Issues

3.61 FIDES has had a slow start. In early 1995 the institution was in the process of developing its administrative and operational set up, including; organizing its physical plant, hiring staff, designing a strategic plan to start up, and promoting its objectives among states and local governments.

3.62 In 1995 FIDES approved a total of 84 projects (for Bs. 7.1 billion) covering 11 states and 11 local governments. Out of 16 states, those of Merida, Falcon, Aragua and Zulia are the main beneficiaries. It must be noted that these states are among the richest, and therefore the ones with least fiscal needs but the most capable to demand and actually absorb new resources. In this sense, technical assistance to low income states and municipalities with the potential to grow and with fairly large populations is needed.

3.63 Road and street construction (48%) and health services (39%) have been the main public goods for which financing has been provided. Sport facilities (4%) are the third type of physical infrastructure for which resources have been allocated.

3.64 It should be noted that in 1994 FIDES received Bs.15 billion, which was about half of what it should have received according to the ceiling established by law. In 1995 the resources were much greater, but FIDES was able to approve projects for only Bs. 7.5 billions. The following summary recommendations, which are developed with greater detail in annex 4, are presented for FIDES. These recommendations, among others, are currently being considered by the national congress as part of the reform of the FIDES.

(3) Recommendations.

- The FIDES law should provide clarity in the definition of FIDES sources and magnitude of funding.
- FIDES operations should be decentralized to the state and municipal level.
- As long as FIDES' mission is decentralization, eligibility criteria should be revised. Only projects that lead to effective decentralization should be eligible, so that financing is consistent with FIDES objectives.
FIDES financing should not only benefit new infrastructure; it also should include rehabilitation and expansion.

Co-financing should be increased to encourage local revenue mobilization, prioritization of projects and commitment.

Transfer allocation criteria for sub-national governments should not only include the magnitude of service deficit, but also on local tax effort.

Investment should require the necessary local reform to enable sustainable and efficient provision of services. Local reform should assure the inclusion of maintenance as well as explicit cost recovery policies.

Financing should include incentives to promote and facilitate privatization of services that can be produced more efficiently by the private sector.

Transferencia Estado Municipio (TEM)

(1) Background

3.65 From 1989 to 1996 states increased their revenues through the Situado Constitucional from 15% to 20% of total government revenue. The increase in revenue to state governments has not been systematically accompanied with additional functional responsibilities. To a large extent state revenue has been dedicated to financing municipal concurrent and exclusive responsibilities. The state governments have a mandate to cover the deficiencies of the municipal governments as well as political incentives to assure their constituency is being served. However, for many state governments the provision of municipal services is, or has the potential to become, a political liability rather than an asset.

3.66 Three states, Aragua, Carabobo and Falcon have addressed this issue through the creation of state-municipal transfer (TEM) to oblige municipalities to clarify and assume responsibilities for service provision as well as to establish coordination and complementary of the state and municipal investment programs. The TEMs can be considered pilot programs from which significant lessons will be learned regarding the design and operation of intergovernmental transfers from the state to the municipalities. It is apparent that TEM arrangements are a logical evolution in the functional and fiscal decentralization of service provision. TEMs will need to be developed throughout Venezuela as part of a second phase of functional and fiscal decentralization.

3.67 This section presents a summary of the lessons learned in the TEM in Aragua and Falcon and a set of recommendations in the design of future TEM. Details are presented in Annex 5.

37 When a state government requests the transfer of a responsibility it negotiates with the federal government on the transfer of resources to cover service provision. These resources are in addition to the Situado Constitucional.

38 Services are currently being provided with no cost recovery or maintenance policies. Thus, their sustainability is precarious. The sustainable provision will require reform in the manner that these services are provided specially with regards to cost recovery.
3.68 TEM transfers are earmarked for capital expenditures. During its first phase the program was limited to the transfer of financial resources. In 1991, at the start of the program, Aragua State transferred to its municipalities an amount equal to the Situado Municipal, which was 11% of the Situado Constitutional. In other words, Aragua State municipalities received 22% of state revenues. These resources were increased in 1992 by 1% in a similar fashion as the Situado Municipal. In practice, there was a trend in many municipalities to use these resources as revenue generation in terms of interest on bank deposits. The above circumstances, together with the pressure of the state fiscal deficit, led the state government to reevaluate TEM's operations in 1994. One of the findings of the reform was the critical importance of modernization of the municipal administrative structure to make its objectives viable. Thus, it was determined to allocate resources, as part of the TEM, to develop the administrative capacity of the municipalities. An amount equivalent to 30% of the revenues from transfers is currently earmarked for the above purpose.

3.69 The distribution criteria before 1994 was 50% for each municipality in equal parts, and 50% based on municipal population. As of 1995 the criteria takes into account several indicators, which include: poverty levels and unsatisfied basic needs (UBN). The new design has made the system fairly re-distributive, and apparently has contributed in the reduction of some inter-jurisdictional imbalances.

3.70 Another problem with TEM design was lack of input by beneficiaries. When local investment plans were being decided, most mayors had ignored town committees and neighborhood organizations. Hence, the TEM system reformed the modality in the use of resources. As part of the 1994 reforms the Solidarity Plan was established, which currently requires that 50% of TEM's resources must be allocated with the direct participation of the community.

3.71 The state policy tried to make the system a demand-driven revenue mechanism. However, due to both the weakness in functional decentralization and local institutional capacity, particularly for project preparation and implementation, TEM's financial resources were not being fully disbursed. Allocation of resources then became highly discretionary. In 1995 investment decision-making was top-down automatically compromising resource allocation efficiency, and in particular demand efficiency. The principal weakness of the TEM is that in practice the design has not been applied and the discretionary allocation of resources has prevailed.

39 However, it is not clear what specific weights are given to these two variables of poverty and unsatisfied basic needs (UBN); and, whether other variables are taken into account to allocate TEM's resources. Also, it should be determined whether the system is completely formula driven or whether some allocations are made on a discretionary basis. In addition, it is not clear how it is determined which municipalities are eligible and which are not.
3.72 The TEM has been in operation since 1991. The TEM in Falcon was designed as a simple mechanism to transfer functional responsibilities and resources from the state to all of its municipalities. The TEM is based on an annual contract between each municipality and the state government. The contract specifies the transfer of a conditional grant from the state to each municipality to finance the recurrent and capital costs of providing a specific set of services including health, sports, education, culture, roads, municipal strengthening, security, and agriculture. The transfer is piggy-backed on the monthly transfer of the situado municipal and the informal understanding has been that it should be equal in magnitude to the situado municipal of each municipality. Specific application of the funds among eligible sectors is programmed jointly by the municipality and the state through the comite de planificacion y coordinacion and the each local government. Since there is no cost accounting it is not known whether the amount assigned to a given activity is sufficient or excessive.

3.73 The TEM does not require institutional or regulatory reform to establish the minimum conditions for sustainable service provision. For example, the TEM system is indifferent about financing services that may be overstaffed or whose recurrent cost is excessive. Furthermore, the TEM does not require, or at least provide incentives, for the facilitation of private sector participation in the provision of services.

3.74 In 1994, an election year, the TEM suffered a setback as the state government unilaterally reduced TEM funding by 50%. The reduction in the TEM undermined the predictability and confidence in the system. Municipalities since 1994 have become cautious in including TEM financing as part of their budget process. In addition, the lack of predictability has reduced the likelihood that municipalities would undertake institutional and regulatory reforms for service delivery without having a secure source of financing.

(2) Recommendations

3.75 The development of predictable and objective intergovernmental relations between states and municipalities, particularly in the financing of infrastructure and the reduction of the level of concurrence in service provision is a necessary condition to enable the sustainable provision of urban services in Venezuela. The TEMs in Venezuela raise important issues that need to be addressed as other states move to modernize their fiscal relationship with their municipalities.

- Programs should be designed to fulfill performance criteria including revenue adequacy, equity, predictability, efficiency, simplicity, and ability to safeguard grantors objectives.
• TEM should require sufficient and appropriate counterpart financing from municipal government to assure commitment to reform and leverage of local and beneficiary resources.

• The programs should remain a simple mechanism which assures a minimum of administrative overhead to operate and provides transparency to municipalities.

• TEM should consider complementary reductions to staffing at the state level as municipalities take responsibility for the provision of services.

• Local budgets should include an account for maintenance of physical works as well as incremental current expenditures. User fees should provide for the additional expenditures whenever applicable.

• Investment requirements should include either a project’s economic evaluation or, at least, a minimum cost solution, as well as technical, financial and institutional evaluations particularly for projects of magnitudes above certain cost levels.

D. LOCAL CAPACITY FOR THE PROVISION OF SERVICES

(1) Background

3.76 Municipalities in Venezuela need to develop capacity to enable them to fulfill their functional responsibilities. There are three principal areas that require strengthening: (i) institutional arrangements; (ii) human resources and (iii) information and management. Technical assistance in Venezuela is evolving in these three areas. However, the magnitude of the challenge will require sustained and coordinated effort.

Institutional Arrangements

3.77 Municipalities in Venezuela are regulated by the Code and by the local ordinances legislated by their council. The ordinances in most municipalities have been prepared by relatively inexperienced municipalities during the last six years. Many of the ordinances do not incorporate the necessary rigor to assure good governance or the conditions for sustainable provision of services.

3.78 The fundamental guideline defining the institutional arrangements in service provision are provided by the Municipal Code. Changes to the Code, which is widely recognized as an imperative for the modernization of the municipal sector in Venezuela, must establish incentives for improving the internal institutional structure of service provision. Municipalities; through the reform of antiquated ordinances, need to establish streamlined and responsive service provision units with the capacity to regulate, monitor and enforce production of services by municipal institutes or the private sector. Reform of municipal ordinances is difficult and challenging. Consistent and forceful incentives must be provided by FIDES and TEM mechanisms to assure support for reform at the local level.
3.79 Service provision arrangements within municipalities need to change to permit the sustainable provision of services. The production of services through departments of the municipalities are considered to be poor as the employees do not have sufficient incentives to meet client demands. Municipal production of services through line departments should be eliminated and replaced, to the extent possible, by paramunicipal enterprises or by concession of the service to the private sector.\(^{40}\)

**Human resource constraints**

Since political decentralization, municipalities have benefited by the election of highly motivated mayors and councils. Mayors are a heterogeneous group but tend to be professionals and relatively young. Reelection has motivated mayors to perform well and has permitted informed public scrutiny of local government performance. However, while mayors are motivated most are new to politics and public administration and do not have experience in handling complex institutions.

3.82 The inexperience of mayors during the first two electoral cycles since the 1989 reform can explain many of the deficiencies in local public administration. Since the inception of elections, there has been no systematic attempt to provide practical technical assistance to enable mayors to learn basic skills to manage their municipalities. In addition, up until 1995 there was no organized effort to develop the consciousness of citizens who contemplated running for office.

3.83 However in 1995 two national initiatives were launched to improve the quality of the local executive: The *Escuela de Alcaldes* and the *Escuela de Vecinos*. *The Escuela de Alcaldes* is an effort by FUNDACOMUN to provide technical support for mayors from election until the last day of their mandate. Mayors participate in workshops to provide them with basic information on the operation of the municipality as well as their obligations. The *Escuela de Vecinos* is a grassroots organization which facilitates consciousness building among the community, candidates and local elected officials regarding the need for good local governance.

3.84 There have also been important state and national efforts to increase the quality of municipal management. These include workshops and seminars as well as the publication of materials. In 1995 FUNDACOMUN began to consolidate previously uncoordinated municipal technical assistance programs sponsored by the state governments, the private sector and state-owned oil companies. The coordination of technical assistance is necessary to assure that scarce resources are brought together as matching grants to provide technical assistance.

\(^{40}\) Autonomous agencies appear to have a comparative advantage over general local government in capital project financing, implementation and management. This advantage may stem from the enterprises' autonomy in management, potential for relying on user charge financing, and general freedom from the local political process. A major factor determining the importance of the local government sector, then, is the ability of local government to create autonomous enterprises activities (Bahl and Linn p. 47).
3.85 The content of municipal technical assistance in any given municipality tends to reflect the willingness of the municipality to undergo scrutiny and accept assistance to address flaws. The “demand driven” nature of technical assistance has merits but can result in sub-optimal results. Compulsory technical assistance based on needs assessments essential to develop local capacity.

3.86 A principal issue that must be addressed is the lack of modern human resources management policies. States and municipalities are autonomous institutions that are legally permitted to establish human resources management and development policies independent from national practices. However, municipalities have copied the Ley de Carrera Administrativa Nacional, widely regarded as an inadequate framework for the development of human capital and the provision of reliable and high quality public services.

3.87 In addition to the administrative framework, the political process has affected the recruitment of staff. Numerous accounts by municipal authorities reflect the highly subjective and political process for staffing of municipalities. Political pressure has motivated municipal authorities to have redundant staff. In order to define the level of redundancy it is necessary to carry out management studies including empirical analyses of staffing.

**Informational Constraints**

3.88 Most states and virtually all municipalities face severe informational constraints for effective decision making. In addition to outdated cadasters the most serious informational constraint refers to financial and planning information. Budgets have been traditionally prepared manually through complex and non-transparent mechanisms that did not permit effective planning. Political decentralization and accountability to local stakeholders has changed the incentive structure, and local governments are currently demanding effective analytical tools to enable them to carry out their budgeting and accounting functions at a high level of proficiency and transparency, including the ability to assess the performance and impact of programmed and executed public expenditures.

3.89 At an aggregate level the informational deficiencies do not permit holding local government accountable for its performance. Since there is no coordination in public expenditures at the municipal level there is no incentive to develop and use an integrated information system which accounts for the revenue and expenditure in each municipality. The information generated by such a system would be valuable to program, monitor and evaluate public expenditures. There are important initial efforts to address the informational constraints to municipal management. FUNDACOMUN has developed and is distributing to more than 150 municipalities user friendly and effective budgeting and accounting software. It is expected that reform minded municipalities will use this planning tool to rationalize revenue effort and expenditures.
3.90 With a budgeting and accounting system, automatization of information such as budgets and real expenditure data would be relatively simple to carry out. In this manner, state governments, financial intermediaries, credit rating agencies and the public could have access to each municipal budget and monthly accounts. The availability of information would not only facilitate planning but would permit monitoring the performance of local government and force accountability in their performance.

Box 2. Effective Municipal Budget Process

In 1996 in the municipality of Chacao FUNDACOMUN piloted budgeting software with great success. During budget deliberations the council made amendments to the budget which would normally result in delays of several weeks. With the use of the software the planning analysts were able to provide legislators with real time impact analysis of budget modifications. Furthermore the production of the budget documents took several hours rather than several weeks. Each council person left the review meeting with a copy of the revised budget.

(2) Recommendations

3.91 Capacity building in Venezuelan municipalities requires a program that addresses the need of a diverse set of municipalities. In order to ensure impact of technical assistance it is necessary to provide effective and intense technical assistance to the six largest municipalities which account for more than 25% of total population. The remaining municipalities, including the 230 municipalities with a population under 50,000 also require technical assistance. In order to structure effective and cost effective technical assistance it is necessary to develop programs at the state level. The following recommendations are presented:

- Establish mandatory technical assistance based on an objective needs assessment
- Establish coordinated technical assistance programs at the state level with the participation of the federal, state and municipal government.
- Provide technical assistance to municipalities to enable them to prepare modern human resources management policies independent of the Ley de Carrera Administrativa.
- Extend coverage of the financial management software prepared by FUNDACOMUN to permit the development of integrated financial management for municipalities and states.
- Establish and disseminate performance and impact indicators to monitor the quality, efficiency and reliability of services to enable accountability of local government.

4. RECOMMENDATIONS

4.1 This report proposes recommendations for addressing key bottlenecks in political, functional and fiscal dimensions of urban service delivery. The recommendations outlined in the main text and detailed in the annexes are considered necessary to complete the
governments decentralization program and avoid the deterioration and collapse of urban service provision systems. Summary recommendations include:

- Develop sectoral financing policies based on matching grants
- Reform Municipal Code
- Reform to FIDES with a focus toward private production of services
- Provide technical assistance for the creation of TEMs
- Provide technical assistance and financial support to mancomunidades
- Continue support for municipal financial management
- Provide technical assistance to increase the capacity of local government

4.2 The sequence of reform is important. Political reform to enable accountability and functional responsibility through modifications to the municipal code and its subsequent implementation should spearhead the reform process. Municipal ordinances should then be legislated locally to assure that the local regulatory framework is consistent with the Municipal Code. Technical assistance to permit the municipalities to take advantage of reforms should closely follow the reforms to Municipal Code and the ordinances. Finally, reform to the intergovernmental transfers, principally the TEM and the FIDES should take place.

4.3 In effect, the process of reform in Venezuela is following roughly the sequence outlined in the preceding paragraph. The consultative process for reform of the Municipal Code has initiated. Experienced mayors, public administrators and experts in municipal law have convened to brainstorm on the reforms. It is within this framework that the report recommends the following action:

A. REFORM OF KEY LEGISLATIVE INSTRUMENTS

(1) Review of the Municipal Code

4.4 It is proposed that institutions such as FUNDACOMUN and the National Congress organize a working group to carry out a study of the reforms that are needed to the municipal code. The study could build on work developed in the past workshops as well as on the findings of this report.

4.5 The proposed study will form the basis for dialog at a regional level to assure the input of each of the 330 municipalities. Regional workshops would be developed by FUNDACOMUN and the findings would be systematically recorded.

4.6 The reports and the recommendations would be presented to the Congressional Committee on Service Delivery. as well as related committees in the congress that have competency over the municipal code. In this manner deliberations within the congressional committees would be based on informed and structured dialog.
B. REFORM OF INTERGOVERNMENTAL FISCAL RELATIONS

(1) Review for the FIDES law

4.7 The review of FIDES law has been initiated and has followed a methodology similar to the one proposed for the municipal code. FUNDACOMUN facilitated national legislators recommendations on addressing key issues in FIDES reform. Among their recommendations were those presented in this report. The proposal is currently under discussion as part of the reform of FIDES and most of the recommendations have been adopted into the reform resolutions.

(2) Reform of TEMs

4.8 Appropriate lead institutions such as the association of state governors should organize a working group to carry out a rapid study of the basic principles to follow in the design and implementation of TEMs. The working group should be represented by state government officials, municipal officials, neighborhood representatives, municipal service representatives, and the private sector. The lead institution would prepare a brief report to serve as the starting point for dialog. The brief report could be based on material presented in this study. The outcome of the consultation would be the design of a technical assistance program to provide assistance to states in the design, implementation and monitoring of TEMs.

(3) Reform to the Situado Municipal

4.9 The congressional committee on intergovernmental transfers should assure compatibility between the functional responsibility of municipalities and the level of the mandated Situado Municipal. This will imply a study and review of the criteria for distributing the transfer from the state to the municipalities. The proposal should be discussed with appropriate stakeholders including the association of governors, representative municipalities, CORDIPLAN, FUNDACOMUN and neighborhood associations.

(4) Establish Sectoral Financing Policies

4.10 The reform of TEM, FIDES and Situado Municipal should have as a final objective establishing clear, transparent and predictable sectoral financing policies in the form of a matching grant program. The sectoral financing policies would define the relative participation of the federal, state and municipal governments in the financing of public capital works. In addition it would establish guidelines for leveraging private investment for the provision of services. The reform could be initiated on a pilot basis in a state and if proved successful could be mandatory on a national scale.
C. CAPACITY BUILDING

(1) Municipal Administration

4.11 Municipal technical assistance programs should be designed at the state level based on a matching grant basis between the federal government, state government and the municipalities. The design of the program should be based on an objective needs assessment. The matching grant financing of the program will serve to rationalize technical assistance expenditures including eliminating redundancy in the technical assistance programs.

(2) Municipal Regulatory Framework

4.12 Technical assistance should be provided to update municipal ordinances so these conform to changes in the Municipal Code. The ordinances should provide the necessary incentives for the sustainable provision of services including quality of services, cost recovery, and maintenance and expansion programs.

(3) Municipal Financial Management

4.13 Technical assistance being provided by FUNDACOMUN to computerize budgeting, accounting and monitoring of expenditures should be expanded and evaluated periodically to assure the systems meet objectives. The municipal information systems should form the basis of an integrated financial system to be constructed at the state level by consolidating the municipal systems. A capital account should be incorporated into the information system to establish the flows of resources from the federal ministries and state institutions.

(4) Alternative Institutional Structure for the Provision of Urban Services

4.14 FUNDACOMUN should establish a program to provide technical assistance for the consolidation and creation of para-municipal enterprises to provide local urban services. Where there are economies of scale and scope for the provision of a given service technical assistance should be provided to municipalities to establish mancomunidades. The mancomunidades can establish privately managed public enterprises to provide services following the model being developed in Aguas de Monagas.

(5) Implementation of TEMs

4.15 Technical assistance should be provided to state governments to establish TEMs. The technical assistance would be designed from the findings of a consultative workshop. FUNDACOMUN could establish a full time specialists who would be based in the field offices to assist state governments in the implementation of TEMs.
References and Bibliography


FIDES (1995b). Lineamientos par el acceso de los Municipios a los recursos del Fondo Intergubernamental para la Descentralización.


Gaceta Municipal Municipio de Miranda. 25 October 1995. “Reforma Total a la Ordenanza que Crea la Fundacion para el Desarrollo Del Municipio Miranda”.


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The *Ley Organica de Regimen Municipal* (the Code) was promulgated on August 1988 and was made effective January 1, 1990. The code was viewed as provisional document that would enable the first steps toward functional, fiscal and political decentralization. Eight years after it was drafted there is wide consensus that it must be revised to reflect the lessons learned from municipal performance under the regulatory framework.

This annex provides a summary of key issues that would need to be addressed in the reform of the municipal code. The annex is not a comprehensive review of the municipal code, rather, it highlights key aspects of the code whose reform would have the greatest short-run impact towards establishing incentives for sustainable provision of services. The Code establishes the broad regulatory framework that defines the incentive structure for municipal governance and local service delivery. Individual municipalities operationalize the code through their municipal code and specific ordinances. Any changes to the Code would also require updating ordinances. The annex builds on proposals presented by municipal scholars, interviews with national, regional and municipal government staff and a workshop on the reform of the Code. The informal translation of the paragraph is presented in bold followed by text commenting on the article.

**Article 11**

3. The central and/or state government can provide a local service or infrastructure—or improve them—when the municipality does not build or provide the service or it provides it in an deficient manner.

4. This article leads to a perverse incentive for the municipality as it promotes a structural dependence by municipal government on central government. As long as municipal government does not have to be fully responsible for the consequences of its actions it will not develop a sustainable management. A fundamental definition of a local government includes complete accountability for the fulfillment of its functional responsibility. Rather than bail out the central govern should allow to local government to fail. The safety valve to assure sustainable service provision is the free election of local government and a high level of autonomy. Venezuela should rely on the rejection by the public to poor service provision rather than on bailouts by the central or state governments that propagate governments that can't fulfill their functional responsibility. The exemption to this rule can only be in case of emergency services causes by natural disasters.

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Article 12

5. Municipalities are not obligated to pay, either partially or in whole, works or services that would have been built or provided without a contract or agreement.

6. The municipal code must establish the need to limit political discretion in intergovernmental relations. In Venezuela the central government establishes informal agreements for the provision of infrastructure with the state and municipal governments. These political agreements are not easily documented in contracts since they represent a political and not an administrative or management issue. There needs to be a uniform and coordinated investment contract that establish precisely the financing terms. The federal government should establish transparent and equitable relations with states. State governments must also establish provide transparent and equitable relations with municipal governments.

Article 16

7. The municipalities and the Metropolitan Districts should dispose of sufficient own sources of revenue to fulfill the objectives legally established for the municipality.

8. The article establishes that there should be sufficient own source revenues in the municipalities to fulfill functional responsibilities. The article is passive and no municipality is held accountable to comply. There are no incentives for making this article effective and it is in conflict with article 11 which establishes that the central or municipal government is obliged to provide services if the municipality fails or is not able to provide them. The spirit of the article could be made effective by requiring that the municipalities finance services with appropriate revenue instruments according to benefits received principle and linked to the cost of service provision. For example, if certain services had to be legally financed through users fees, benefit taxes and licenses then municipalities and the Metropolitan District would have sufficient own sources of revenue to fulfill the objectives legally established for the municipality.

Article 18 (first part)

9. For a creation of a municipality the entity fulfill four requisites:

- A population of no less than 10,000 or the presence of a consolidated social group with permanent links to the community.
- A delimited Territory
- An urban center of no more than 2,500 persons to serve as the seat of the municipal government.
- Have the capacity to generate sufficient resources in order to fulfill its functional responsibility including providing the minimum set of basic services.
10. This article has the same characteristics as article 16. It mandates that municipalities must have sufficient own sources of revenue to finance the provision of services. In fact, this article has not been applied. In addition, the flexible interpretation to define potential municipalities—as either having a population of 10,000 or a consolidated community—has lost any normative sense. The result of the current incentive structure is evident by the fact that there are municipalities with a population of less than 10,000. It is estimated that at least 50% of these municipalities currently do not have the institutional capacity or the fiscal resources to provide services in a sustainable basis. More importantly, the municipalities tend to be politically weak and do not have the political legitimacy to confront users with the cost of service provision. The incentive structure to transform incipient municipalities into viable governmental entities is not present.

Article 18 (second part)

11. In order to define the capacity of a potential municipality to generate resources the Legislative Assembly shall consider the economic base and the capacity to generate resources.

12. This article has been ineffective for several reasons: (i) there have been no systematic fiscal capacity studies carried out; (ii) economic base is not a good predictor of revenue generation and service provision. In Venezuela there are no independent agencies that have developed objective fiscal assessments. When studies are carried out it is done so under assumptions of very low willingness to pay for services and are not based on a systematic improvement of the finances.

Article 22

13. When a municipality is not able to meet the conditions for a viable municipality—during three consecutive years—stated in article 18 then the municipality shall be downgraded to a parroquia and it will lose the attributes of a municipality.

14. The effects of this article are so severe that in effect the incentive is never to apply it. Intermediate sanctions need to be applied; for example, elimination of the intergovernmental transfer when the municipality fails to provide services as well as open dissemination of the performance of the local government. This information will permit the local political process to take place and constituents demand quality provision of services.

Article 36

15. Municipalities, in order to satisfy the needs and aspirations of the community, shall promote any kind of activity it deems fit.
16. The openness and vague definition of functional responsibility provides the incentive for local government to get involved in any activity it sees fit. This has created undesirable outcomes. Municipal competencies must be defined with sufficient precision to not permit municipalities to venture into any activity while compromising the fulfillment of basic functional responsibility and crowding out the private sector from financially viable activities.

17. Many of the functional responsibilities are not being carried out by the municipalities and in some cases the Venezuelan municipalities have competencies in which the local government does not have a comparative advantage for service provision, for example creation of popular credit institutes. The code reinforces the lack of precision by the last lines of the article which state that competencies include others that belong to the local well-being and those attributed to the municipality by other laws.

**Article 38**

18. Municipalities will have the following functional responsibility according to population:

<table>
<thead>
<tr>
<th>Population</th>
<th>Responsibilities</th>
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<tr>
<td>10,000 or less</td>
<td>public lighting</td>
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<td>cemeteries</td>
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<td></td>
<td>solid waste management</td>
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<td>water and sewerage</td>
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<td>public markets</td>
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<td>urban planning</td>
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<td>street signs</td>
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<td>10,001-50,000</td>
<td>public lighting</td>
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<td>street signs</td>
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<td>Civil protection</td>
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<td></td>
<td>daycare and pensions</td>
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<td>family planning</td>
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<td></td>
<td>fire-fighting</td>
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<td></td>
<td>public sport facilities</td>
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<td>50,001-100,000</td>
<td>public lighting</td>
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<td>cemeteries</td>
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<td>solid waste management</td>
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<td>Civil protection</td>
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<td>fire-fighting</td>
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<td>public sport facilities</td>
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<td>100,000 or more</td>
<td>public lighting</td>
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<td>cemeteries</td>
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<td>solid waste management</td>
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<td>fire-fighting</td>
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<td>public sport facilities</td>
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<td>urban transport</td>
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<tr>
<td></td>
<td>environmental management</td>
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<td></td>
<td>food hygiene</td>
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19. The delimitation of functional responsibilities by discrete population cohorts is an important attribute of the Code. However, revenue assignment, principally from intergovernmental transfers do not reflect the differentiation of responsibilities. For example. A municipality with a population of just over 50,000 must assume the responsibility for civil protraction, daycare and pensions, family planning, fire fighting and public sport facilities without additional revenue to cover the cost.
Article 40

20. The municipalities can convene with central or state institutions the study or service provision in order that within the jurisdiction services meet the minimum requirement stated in article 38.

21. This article, reinforced by article 11, permits negotiation between the municipal government with state and federal governments for service provision. The article undermines the detailed enumeration of competencies under article by making all service provision negotiable.

Article 92

22. The municipalities with a population equal to or greater than 100,000 inhabitants and all metropolitan districts shall have an autonomous comptroller. Municipalities with less than 100,000, may if they so desire, establish offices of the comptroller.

23. Only municipalities of more than 100,000 must have a comptroller. Since 90% of all municipalities have less than 100,000 this creates a serious lack of incentive for acceptability of local governments. With no internal auditor the local government must rely on internal control mechanisms to assure transparency in the use of public resources. The lack of a comptroller also reduces the ability of the state and national government to have actual expenditure data to establish and maintain performance indicators.

Article 110

24. Each municipality or district shall conform a cadaster.

25. Since the cadaster is used principally as an input for the property tax, which is a very limited revenue source, there is no incentive to establish or update the cadaster. The property tax is considered by mayors to have a high political cost and unless clear incentives are established the municipalities will not take action.

Article 113, 30

26. The amount that can be charged as betterment levies cannot exceed what is stipulated in the national legislation or 60% of the total cost of the works and equipment.

27. This article prevents full cost recovery from infrastructure services, even from the wealthiest users. In effect, the article establishes a broadcast subsidy on all infrastructure without specifying cost recovery policy. It provides strong disincentives for local governments to produce infrastructure.
28. Exoneration of charges will be granted initially for a period of three years and can be extended for a total of no more than 6 years.

29. Allowing no-payment of tax obligations on a discretionary basis for up to 6 years provides a negative incentive for payment. Municipal codes throughout the world use strict language to not allow flexibility in payment of obligations.
Criteria for the design of intergovernmental fiscal arrangements

**Autonomy.** Subnational governments should have complete independence and flexibility in setting priorities, and should not be constrained by the categorical structure of programs and uncertainty associated with decisionmaking at the center. Tax base sharing -- allowing subnational governments to introduce their own tax rates on central bases, formula-based revenue sharing, or block grants -- is consistent with this objective.

**Revenue adequacy.** Subnational governments should have adequate revenues to discharge designated responsibilities.

**Equity.** Allocated funds should vary directly with fiscal need factors and inversely with the taxable capacity of each province.

**Predictability.** The grant design should be neutral with respect to subnational government choices of resource allocation to different sectors or different types of activity. The current system of transfers in countries such as Indonesia and Sri Lanka to finance lower level public sector wages contravenes this criterion.

**Simplicity.** The subnational government’s allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that “grantsmanship” is not rewarded, as appears to occur with plan assistance in India and Pakistan.

**Incentive.** The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance the deficits of subnational governments. The current system of central transfers to finance subnational government deficits in India, South Africa, and Sri Lanka, and state transfers for the same purpose in Malaysia, clearly violate this criterion.

**Safeguard of grantor’s objectives.** The grant design should ensure that certain well-defined objectives of the grantor are properly adhered to by the grant recipients. This is accomplished by proper monitoring, joint progress reviews, and providing technical assistance, or by designing a selective matching transfer program.

The various criteria specified above could be in conflict with each other and therefore a grantor may have to assign priorities to various factors in comparing policy alternatives.
1. The Municipal Code (the Code) empowers municipalities to impose specific taxes and user fees. However, municipalities have relied on the *situado municipal* rather than on locally imposed taxes, fees, and to a very limited extent on credit. Although considered much more fiscally autonomous than the states, municipalities are limited by weak institutional capacity to levy and collect taxes.

2. Concurrence in functional responsibility has created great difficulties in correctly applying revenue instruments. The lack of clarity of the services that need to be provided by each level of government created confusion. In practice the central government covers a substantial part of the cost of basic local services on an unconditional basis. This acts as an implicit system of disincentives, so that most likely user-fees will not be adjusted and subsidies will continue. Also, over-staffing can prevent services from being cost-efficient. Under current conditions it is difficult to justify making the current beneficiaries finance the high operating cost of most urban services. As such, current circumstances are a strong incentive for cost-inefficiencies.

3. Other than the local social pressure on popularly elected mayors to address multiple local needs, local governments (LGs) have little incentive for an effective local revenue mobilization. Since local governments have the legal autonomy to set their own taxes and tax rates, it is essential to design built-in incentives to encourage local revenue mobilization. To decentralize basic urban services, it is now appropriate to adjust the fiscal transfers (i.e., the *situados*) and other key sources of central government financing such as the *Fondo Intergubernamental para la Descentralizacion* (FIDES) and the *Transferencia Estado Municipio* (TEM). A new fiscal design should require local governments to increase own source revenue effort by matching gradually, through progressive criteria, and in modest proportions, central government transfers such as FIDES and TEM.

### Municipal Revenues

4. The popular perception is that municipalities have abundant revenue sources and enjoy considerable autonomy and financial flexibility, but this is the case for only a minority. Although the constitution and the Code provide municipalities legal authority to raise revenues from a wide range of sources, municipalities take limited advantage of these possibilities. Among smaller LGs (i.e. less than 50,000 inhabitants) central government transfers (i.e. the *situado*) represent about two thirds of their total revenues. Their relative weight drops for larger local governments. In Maracay (Girardot Municipality), for instance, they represented 27 percent in 1995. On the average across local governments they are equivalent to nearly 70%. Taxes are the second major source of municipal revenue. The industry and commerce tax (I&C) is the most important tax. Revenues from the I&C tax can be as five times larger than property tax yields, which is the second major tax.

#### a) Local Taxes

5. In practice, however, municipal finances rely on two local taxes: the Industrial and Commercial Tax (Patent) and the Urban Property Tax. However, the former is more appealing to LGs because they do not have to confront taxpayers directly. Also, part of the incentive to put more emphasis in the Industry and Commerce Tax is because part of this tax can be exported to other jurisdictions. Local tax administrations are not vigorous at tax effort, also with low compliance in the
two main taxes and the almost non-existence of local tax enforcement, it could be argued that payment of local taxes is almost voluntary. Perhaps, the main incentive for low tax effort is not only the degree of centralization in local service provision, the several types of fiscal transfers to LGs, but also the weakness in local accountability.

6. Related to the above, it must be noted that mayors in Venezuela according to the Municipal Tax Code have the authority to exonerate local tax liabilities. This is an unusual weakness of the local tax system may be fairly complicated in the context of political factors. This power should be given in its entirety to a tax court.

i) The Urban Property Tax

7. Its statutory tax base is given by the capital (market) value of real estate including both land and improvements—although some municipalities use annual value as a tax base (i.e. yearly rents). Whether tax rates are applied on the capital value or the annual value of the property, municipalities have the legal authority to assess property and set tax rates. Rates vary across municipalities; a typical example of tax rates under the rental value system are those applied in Guaicaipuro Municipality:

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>TYPE OF PROPERTY</strong></td>
</tr>
<tr>
<td>Rented Property</td>
</tr>
<tr>
<td>Unimproved</td>
</tr>
<tr>
<td>Owner occupied</td>
</tr>
<tr>
<td><strong>IMPUTED ANNUAL RENT</strong></td>
</tr>
<tr>
<td>8,001 - 20,000</td>
</tr>
<tr>
<td>20,001 - 40,000</td>
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<tr>
<td>40,001 - 70,000</td>
</tr>
<tr>
<td>70,001 - 100,000</td>
</tr>
<tr>
<td>100,001 - and over</td>
</tr>
</tbody>
</table>

Source: Guaicaputo Municipal Ordinance

8. Under the annual value system owners were supposed to report to the municipal tax authority the actual or imputed annual rents in order to determine their tax obligations; as such, appraisals under the rental system were equivalent to self-assessments.

9. Since the early 1980s LGs must apply only the market value of property as the tax base. A typical tax rate structure of the property tax (Impuesto de Propiedad Inmobiliaria Urbana) under the capital value system may be illustrated by those applied in Lagunillas municipality:
Lagunillas Municipality: Property Tax Rate (1994)

<table>
<thead>
<tr>
<th>Value Classes (Bs.)</th>
<th>Marginal Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 200</td>
<td>0.00%</td>
</tr>
<tr>
<td>200 - 1000</td>
<td>0.25%</td>
</tr>
<tr>
<td>1,000 - 2,500</td>
<td>0.35%</td>
</tr>
<tr>
<td>2,500 - 4,000</td>
<td>0.50%</td>
</tr>
<tr>
<td>4,000 - 6,000</td>
<td>0.60%</td>
</tr>
<tr>
<td>6,000 - and over</td>
<td>0.70%</td>
</tr>
</tbody>
</table>

Source: Municipality of Lagunillas

10. Both the annual and the capital value systems suffer from some shortcomings. First, the rental value system, as well as current practice under the capital value both discriminate against improvements. For comparable locations the larger the value of improvements, the greater the actual value of the tax base, and therefore of tax liabilities. The value of annual rents and improvements are expected to correlate, and, hence, annual value discriminates against improvements. Second, rent control practices freeze the value of the tax base affecting the buoyancy of tax revenues. Third, there is a problem of horizontal inequity between comparable properties rented under short term and long term leases. Fourth, the use of expected or notional rents for non-rented property is subjective, and the legal rate of return on capital value that must be applied to impute rents is arbitrary. Finally, the definition of the tax base in itself is inequitable since it does not allow for different maintenance cost.

11. In contrast, a site value system would not by definition discriminate against improvements since the tax base is given by the capital value of land only (i.e. improvements are tax exempt). However, some argue that it would be "unfair" and politically "unwise" to tax two comparable properties (in lot-size and location) the same when one might hold a skyscraper and the other might be a vacant lot. This might be true under the assumption that a land (site) tax should be sort of equivalent to an income or wealth tax. Ideally, real property taxation by itself cannot and should not attempt to play this role. There are other tax instruments specifically designed for those purposes.

12. Under current practice, there have been no mass assessments of property for the past fifteen years. The updating system is limited to the information and values reported to municipalities from property transfers. During the same period the annual inflation rates have been about 40 percent. Consequently, not only are property values extremely low, but their cadastres, when still being used, cover a small portion of the actual urban areas. The case of outdated cadastres and their negative effects on municipal revenues are more severe in the larger cities which have had the largest urbanization rates. In general, most municipalities do not have cadastres, and in those few that use them their coverage is extremely limited. For instance, in Valencia (population: 1.1 million) the current number of properties in its cadastre ranges between 24 to 40 thousand out of a total estimate of approximately 240 thousand parcels. At best 15 percent of the properties are within the cadastre. Furthermore, property assessments, as mentioned above, are dramatically outdated. This is true, for instance, in Caracas, Maracaibo, Valencia, and Barquisimeto which are the larger urban centers.

13. Unfortunately, not all those registered comply with tax payments, and there is no system to determine who has and has not paid. Moreover, property files are handled manually, making it almost
impossible for the administration to determine the total value of taxes in arrears. Since property tax enforcement is weak or non-existent, tax payments are practically voluntary. Valencia municipality reported property tax revenues equivalent to Bs. 1500 (US$ 3.00) per-capita, or US$13 per parcel. The cadastre office has 105 employees of which only six are professional real estate assessors. In addition, there are no vehicles for field work. In Jose Felix Rivas Municipality (population 118,000) per capita property tax was Bs. 220 (US$1.29).

14. Poor financial management results in a low tax collection efficiency which, in turn makes the tax system inequitable. Still, there are some circumstances (e.g., popularly elected mayors) which now favor the mobilization of local fiscal revenues, particularly from the unexploited potential of the urban property tax. Other large cities share similar situations.

Recommendation

15. Municipalities that apply a rental value system have been required by Resolution of the Supreme Court to shift to the capital value system. Additional reforms are still desirable. The current practice under the capital value system should adopt differential tax rates between land and improvements. Tax rates on land values should be greater than those on improvements. An appropriate design of differential tax rates could minimize the distortionary effects on improvements, typical of a capital value system. Some of the major reasons for the property tax's poor performance is the inherent difficulty in administering it. In contrast, the site value solution, characterized by its economic neutrality, it is argued that by definition does not have to deal with improvements, but only with the value of land; which would "evidently" simplify its administration. However, an urban property tax, based on the site value, generally has to compute the value of land by subtraction from the capital value of a property as a whole. Therefore, the alleged simplification is more apparent than real. In this sense, a capital value system using differential tax rates between land and improvements could not only offset potential distortions on improvements; but, differential rates could minimize both the alleged inter-property unfairness (since both land and improvements would be taxed) and the apparent political difficulties of switching to a pure site value system.

16. As a first priority, large cites should be supported in developing new cadastres. However, cadastres alone will not be enough to improve municipal financial management in general and the property tax in particular. Improving the property tax requires other efforts, including: i) assessments should be subject to yearly adjustments taking into account the annual inflation rate; ii) incentives should be incorporated in tax administration in order to upgrade tax collection performance (differential commissions to tax collectors); and iii) a taxpayer’s up-to-date current accounts is a sine-qua-non for an adequate tax administration (i.e., electronic automation is fundamental).

17. Currently, most mayors argue strongly in favor of cadastre systems. This could not only contribute to improve property tax collection, but would also help identify potential taxpayers of other local taxes, such as the industry and business tax (impuesto de industria y comercio--I&C). LGs

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1 Because mayors are now elected by popular vote, they are more accountable to their constituencies and many of them are interested in upgrading local government finances, to be able to satisfy public demands.
should receive technical assistance on urban and rural property tax designs, fiscal cadastres, and tax administration. Local revenue administration should adopt electronic automation of tax receipts not only for efficiency purposes but to eliminate irregularities, particularly in cash management. Manual processes become an incentive for corruption.

ii) Industry and Commerce Tax (I&C)

18. This tax is levied on the annual gross revenues from sales of industrial and commercial businesses. For tax purposes businesses in general are classified in about thirty (30) different types of economic activities by sub-sectors. Each sub-sector comprises several industries, and tax rates are generally set for each industry. However, in some cases industries under the same sub-sector also have different tax rates. The tax structure consists of an absolute fixed amount as the minimum tax for each industry and an additional rate given in mills—i.e., a per thousand tax rate. Each municipality has the authority to set its own tax rates.

19. A typical I&C tax structure may include as many as two hundred and fifty (250) rates. The minimum tax may vary between Bs.1,000 (US$ 2) and Bs.50,000 (US$ 100.00). Also, range in mills varies between 1.4 and 15.0 per thousand. Higher rates seem to be assigned to big industries and monopolies (e.g., public utilities), though the criteria for rate setting across sub-sectors and industries is not always consistent. The main criteria seems to be ability-to-pay. Yet, even this would be at best a guess since the I&C tax base, or any tax base for that matter, does not measure ability to pay. In essence, the different tax rates across sub-sectors and industries are usually inconsistent and arbitrary. The implicit incentive to use this tax, as mentioned above, is its comparative advantage as a local revenue source to other local taxes since part of it can be passed on to local consumers and "exported" to nonresidents.

20. For tax administration purposes, business are supposed to register their operations with the municipality, and must report their yearly annual gross revenues from sales to the municipal tax administration. But a few register and report, and there is no guarantee that information from actual taxpayers is accurate. Although the sanction of revoking a patent (i.e. a permit to operate) exists, obtaining a new one is easy. In Barquisimeto it was reported that at least 50 percent of businesses are unregistered. While big business are more likely to comply than medium-size and smaller ones, no verification is usually made of the gross revenues reported, and audits are rare. Furthermore, tax payment is not required when gross annual sales are filed. The tax administration is supposed to compute the corresponding tax liabilities for each filer. But taxpayers are not billed; instead, they are expected to find out with the tax administration what are their tax obligations.

21. In 1995, in Miranda, for instance, the I&C revenue per-capita was equivalent to Bs. 80 (US$0.20). In a similar fashion to the urban property tax, municipal tax enforcement is extremely weak and as such, compliance is practically voluntary.

Recommendation

22. The I&C tax suffers from several shortcomings—and that one applied in Venezuela is not the exception. Some of these flaws, should be minimized while better revenue instruments; including
greater user of property tax and user charges are developed. Some of the potential improvements of the I&C tax, to be able to make use of its actual revenue mobilization capacity, may be summarized as follows: i) establish the obligation for taxpayers of calculating their own tax liabilities as it is done, for instance, for the income tax; ii) require advance partial payments of tax obligations for large business; iii) require full payment of the tax for small business at the time of filing tax returns; iv) establish a system of third-party tax withholders; v) simplify the current tax rate structure using, ideally, one single rate across all sub-sectors and their respective industries (instead of 250 different tax rates); vi) incorporate in the ordinance a price index to adjust the minimum tax (which currently is defined in fixed and absolute terms) in order to correct for inflationary effects; vii) pecuniary sanctions should be defined as percents to avoid their automatic obsolescence due to inflation; viii) empower the tax administration to shut down business of delinquent taxpayers; pay differential commissions to tax collectors; ix) allow for the option to hire private contractors for audits and collection of tax arrears, x) eliminate the discretionary power to charge interest on arrears and, rather, make them legally binding; xi) interest rates on arrears should be greater than the prime rate of the financial market; xii) establish reciprocal exchange of information between the municipal tax authority and the federal corporate income and value added tax authority in order to detect tax evasion, tax avoidance, and under-reporting; and xii) establish clear sanctions for tax administrators and tax collectors that violate tax rules and regulations; xiii) develop a program to provide technical assistance to LGs on how to design and administer the I&C.

iii) Vehicle Tax

23. The vehicle tax is a municipal tax, and, until recently, vehicle registration, and corresponding fee collection, was the responsibility of the municipal authorities. But with the establishment of the Permanent Auto Registry by the central government (CG) to allegedly keep complete and updated information on vehicles, owners no longer need to show tax receipts to register their cars with the CG authorities. This makes for an even greater tendency than before to leave vehicle taxes unpaid, except when a car is bought or sold. In Maracay, Jose Felix Rivas, and Miranda, for instance, the vehicle tax is equivalent to half a percent or less of local taxes—i.e., Bs.20. Furthermore, municipal vehicle registers are substantially incomplete and outdated, their management is cumbersome and the ordinance are poorly designed.

24. Regarding tax design, in most ordinances, the tax is established as an absolute fixed amount, and in many cases these amounts vary depending on the weight of the vehicle. Under this system taxes lose their real value due to inflation and their administration is complex and costly. With respect to tax administration, the norms and procedures are at best vaguely defined.

Recommendation

25. A reform is needed to insure that the CG require municipal vehicle tax clearances, so that potential yields of the municipal vehicle tax are not lost. The municipal vehicle tax has the advantage of being a rapidly growing tax base which lifts local revenues. It would also assist decentralization, and expansion and maintenance of current urban transport networks and would help finance local environmental protection programs due to the social costs associated with motor-vehicle use.
26. In principle there are three options for solving the current loss in revenues. One, the commitment of the CG authorities to require either a proof of municipal tax payment, or else a clearance from the municipality for vehicle registration. Second, return to the old system where registration is not permanent but is required on an annual basis, along with the commitment of municipal governments to report on vehicle registration to CG authorities. Third, transfer the authority of both vehicle registration and vehicle tax collection to the states for their administration. In any case, the vehicle tax yields should remain those of the municipalities.

27. Some of the key implications of these three options are as follows: The first option, although fairly logical, implies that the current system of vehicle registration would need to be reformed from a permanent to a yearly basis. It would also mean that municipalities should bear the cost and overcome current administrative limitations for establishing reporting and clearance systems. The second option would simplify tax administration for LGs, but CG would have to rely on LGs for vehicle registration. This option existed before the reform but was not chosen, apparently under the belief that vehicle registration at the local level was impractical. The third approach would partly eliminate current centralization in vehicle registration, and would split collection authority from spending authority which may compromise, again, tax collection. Though, technical and administrative capacity is more likely at the state level than at the LG level, tax proceeds would have to be redistributed among municipalities based on vehicle-owners residency. Local public expenditures on local road/street construction and maintenance are directly related to the number of vehicles in a jurisdiction. Hence, tax proceeds should revert to LGs and road users.

28. In regard to the issues related to the current tax design, it is recommended that the vehicle tax should be ad-valorem. Also, tax rates should be revised at least once every three years. In addition, agreements across neighboring LGs regarding tax rates should be reached in order to avoid potential distortions. For a sound financial planning some relation should exist between vehicle taxes and the cost of providing the service of street maintenance and repairs. However, earmarking or rigid formulas should be avoided so that efficiency in resource allocation is not compromised.

29. With respect to its administration, ordinances should clearly spell out: i) the legal obligation of vehicle owners to register their vehicles also with the municipality, ii) the time period to fulfill this obligation, iii) the sanctions for not registering or registering late, iv) a new role for the police consisting of enforcing vehicle registration and, hence, contributing to tax compliance; v) the interest on arrears, vi) the liability of owners for every year of ownership unpaid, vii) the obligation of sellers to submit to buyers a tax clearance, and viii) the obligation to register vehicles in the same municipality of owner’s residency. Furthermore, tax exemptions should be drastically reduced. Private vehicles of LG officials, for instance, should not be tax exempt.
### Table 2. Revenue Sources for Selected Venezuelan Municipalities (1995)

<table>
<thead>
<tr>
<th>CONCEPT</th>
<th>GIRARDOT Aragua State</th>
<th>Jose Felix Rivas Aragua State</th>
<th>Miranda Falcon State</th>
<th>Carirubana Falcon State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>423,827</td>
<td>118,594</td>
<td>162,532</td>
<td>180,961</td>
</tr>
<tr>
<td>Total Revenue (Million Bs.)</td>
<td>2650</td>
<td>984</td>
<td>712</td>
<td>1843</td>
</tr>
<tr>
<td>Per Capita (Bs.)</td>
<td>Bs.6250</td>
<td>Bs.8260</td>
<td>Bs.4360</td>
<td>Bs.10184</td>
</tr>
<tr>
<td>Situado</td>
<td>734</td>
<td>353</td>
<td>315</td>
<td>454</td>
</tr>
<tr>
<td>% of Rev.</td>
<td>27.6%</td>
<td>35.8%</td>
<td>44.2</td>
<td>24.6%</td>
</tr>
<tr>
<td>Per Capita</td>
<td>Bs.1730</td>
<td>Bs.2960</td>
<td>Bs.1930</td>
<td>Bs.215</td>
</tr>
<tr>
<td>Taxes:</td>
<td>1770</td>
<td>562</td>
<td>223</td>
<td>1161</td>
</tr>
<tr>
<td>% of Rec. Rev.</td>
<td>66.7%</td>
<td>57.1%</td>
<td>31.3%</td>
<td>62.9%</td>
</tr>
<tr>
<td>Per Capita</td>
<td>Bs.4170</td>
<td>Bs.4720</td>
<td>Bs.1370</td>
<td>Bs.6415</td>
</tr>
<tr>
<td>US$</td>
<td>US$24.52</td>
<td>US$27.76</td>
<td>US$8.05</td>
<td>US$37.70</td>
</tr>
<tr>
<td>Property Tax:</td>
<td>238</td>
<td>27</td>
<td>14</td>
<td>101</td>
</tr>
<tr>
<td>% of Taxes</td>
<td>13.4%</td>
<td>4.8%</td>
<td>6.2%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Per capita</td>
<td>Bs.560</td>
<td>Bs.220</td>
<td>Bs.80</td>
<td>Bs.558</td>
</tr>
<tr>
<td>US$</td>
<td>US$3.29</td>
<td>US$1.29</td>
<td>US$0.47</td>
<td>US$3.28</td>
</tr>
<tr>
<td>I &amp; C:</td>
<td>1386</td>
<td>500</td>
<td>161</td>
<td>960</td>
</tr>
<tr>
<td>% of Taxes</td>
<td>78.3%</td>
<td>88.9%</td>
<td>72.1%</td>
<td>82.6%</td>
</tr>
<tr>
<td>Per Capita</td>
<td>Bs.3260</td>
<td>Bs.4200</td>
<td>Bs.980</td>
<td>Bs.5305</td>
</tr>
<tr>
<td>Vehicle:</td>
<td>10</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>% of Taxes</td>
<td>0.5%</td>
<td>0.5%</td>
<td>0.4%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Per Capita</td>
<td>Bs.20</td>
<td>Bs.20</td>
<td>Bs.6</td>
<td>Bs.6</td>
</tr>
<tr>
<td>US$:</td>
<td>US$0.11</td>
<td>US$0.11</td>
<td>US$0.03</td>
<td>US$0.03</td>
</tr>
</tbody>
</table>

b) Other Own-Source Revenues

30. Several potential sources of municipal revenues exist, including (a) specific fees for permits, licenses, and other certifications; (b) property leasing (land and facilities); and (c) municipal service charges. There are two kinds of service charges: (a) infrastructure related to public utilities (e.g., water, gas and electricity); and b) other infrastructure (e.g., markets, slaughterhouses, cemeteries, urban transport network, and transport terminals).

31. Fees are generally direct payments for services provided by the municipal government, and are expected to cover only the cost of the service (as opposed to licenses or permits which are mainly
mechanisms of control and revenue raising instruments). Once established, fees are seldom increased so that services become, in essence, subsidies to the beneficiaries and a financial burden for local budgets.

32. However, because of the implicit system of disincentives in which the central government covers a substantial part of the cost on an unconditional basis, most likely fees will not be adjusted, and subsidies will continue. And, over-staffing prevents most services from being cost-efficient. Therefore, under current conditions it is difficult to justify making the current beneficiaries finance the high operating cost of most urban services. There is not one level of government or institution that is fully accountable for the financing of local public goods and services. Under these circumstances there is a strong incentive for cost-inefficiencies.

Recommendation

33. For an adequate and effective financial management, fees should be adjusted on a regular basis to reflect the true costs of local public services. At the same time, a sound financial management should evaluate the current cost structure of local services. Particular attention must be given to operation and maintenance cost caused by over-staffing. Full cost recovery fees should be levied for cost-effective solutions to insure financial viability. The Decentralization Fund (FIDES) has the comparative advantage to play a significant role in operationalizing solutions making its grants conditional to structural reforms in the cost structure of local services. Financial managers of public utilities should be provided with training and technical assistance in cost accounting, methods to determine full cost recovery tariff structures, and collection methods. Both decentralization and enforcement of local revenues is economically and politically more difficult if they are linked to financing inefficient cost structures. Most urban services are still provided by central government institutions, and, because of the size of many of their liabilities, decentralization efforts have already run into many obstacles. Also, tighter procedures and more transparency and performance indicators (e.g. assets yield per unit) are needed to monitor financial management.

c) Capital Financing

i) Borrowing

34. Although municipalities (as well as states), are legally permitted to obtain credit, they would have to meet extremely difficult requirements and the limited credit opportunities may take a year or more in meeting all the conditions and negotiations. Among the many restrictions there is, for instance, a clause in the Ley Organica de Credito Publico prohibiting municipalities (and states) from obtaining external public credit (Article 40). As for internal public credit, local governments are not permitted to utilize own revenues or goods credit guarantees. Consequently, the only guarantee are fiscal transfers (i.e., the Situado). To obtain public credit, a local government must comply with the following requirements: (a) authorization from the national Congress through a law solicited by its Municipal Council; (b) a Central Bank assessment and approval of the economic and fiscal implications of each proposal; (c) transmission of the request to the national Congress by the national government; (d) intervention by the Ministry of Finance to oversee the contracting of each credit. The only exceptions to these requirements are credits to procure goods and services to finance regular operating expenditures of public entities. Following a financial assessment by the Congressional Finance and
Annex 3
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Comptroller Committees, these contracts must be presented by the Ministry of Finance for presidential approval of the Council of Ministers.

35. In 1980 the central government had to assume the debt of sub-national governments. Since then, financial performances have failed to improve adequately to guarantee that municipalities would not default again. This motivated the arduous conditions required to be eligible for internal credit, as stated above.

Recommendation

36. Requirements for municipalities (and states) to obtain domestic credit should be drastically simplified. Current conditions are extremely impractical and hinder financial operations. The ability of sub-national levels of government to borrow on the domestic financial markets should be given on the basis of their credit-worthiness, their capacity to provide lenders with a collateral, and the effect of the government's monetary policy on the availability of credit. It must be noted, however, that the availability of grant financing through institutions like FIDES even if current stiff requirements were removed the effective demand for credit is not expected to be automatic; particularly when current fiscal transfers and grant programs (e.g., FIDES) do not require co-financing through matching grant schemes. The use of matching grants could act as an incentive to LGs to make use of financial markets subject to the removal of current constraints.

ii) Other Sources for Capital Financing

37. LGs' capital financing is achieved mainly through fiscal transfers by the CG to the states (situado constitucional), which in turn transfer resources to the municipalities (situado municipal).

38. The main transfer program is the situado constitucional under which a fixed percent of federal general revenues are transferred to the states. Prior to 1989, this figure was set at 15 percent. Subsequently, the Decentralization Law passed in 1989 established that, the percentage of federal general revenues transferred to the states was to increase in increments of 1% a year in order to reach 20% in 1994. The situado constitucional is distributed to the states according to a formula under which 70% is allocated on a per capita basis and the remaining 30% is distributed equally among the states. The 1989 Law eliminated the former requirement that States' investment projects should be approved by the CG; also, before 1989, state co-financing was compulsory. The co-financing requirement was removed from the states, apparently due to their weak revenue base and their high dependency on fiscal transfers. Currently, investment options for the purposes of the situado constitucional are fairly broad. The situado constitucional is essentially an unconditional closed-ended block grant, or a conditional grant with sufficiently mild restrictions, which seldom constrain the behavior of the recipient state governments.

39. The situado municipal provides transfers from state governments to LGs. Its structure is analogous to that of the situado constitucional in that a fixed fraction of state grants is transferred to the Municipalities. Under the Decentralization Law, this fraction is supposed to increase one percentage point per year from 10% in 1989 to 20% in 1999--i.e., for 1996 their level is 17 percent. These funds are allocated among the municipalities according to the same formula used in the allocation of the situado constitucional: 70% is allocated on a per capita basis and 30%, equally among
the municipalities. The *situado municipal* is thus a closed-ended unconditional grant. On the average the *situado municipal* accounts for 30% of municipal revenues; however, the dependence\(^2\) varies widely across municipalities, with the smaller municipalities showing the greatest degree of dependence on intergovernmental transfers.

40. The *situado municipal* neither makes transfers conditional to local revenue mobilization (i.e., it is not a matching grant), nor includes any incentives to increase local tax effort. It could be argued then, that it must discourage local revenue mobilization. In practice, local taxpayers may see the *Situado* as costing them practically nothing; hence, they will not be disturbed if the money is spent with less than maximum efficiency. Local decision-makers, mayors, and local taxpayers are not the exception to this type of behavior.

41. Since the current design of the *Situado*, does not have any conditionality (or built-in incentives) regarding tax effort, it is not contributing to enhance local accountability to LGs’ constituency. The principle being that if there is local accountability, local decision-makers and managers are more likely to allocate resources more efficiently. This may be so if LGs are both responsible for specific local public goods (free of concurrence problems) and if part of their financing comes from local taxes. Generally, this is the case for goods whose inherent nature do not allow for cost recovery policies via user fees; such as services related to physical and social infrastructure. In addition, it is more difficult making the provision of services sustainable, if there is no incentive to make their provision cost-efficient.

**Recommendations**

42. The local revenue mobilization issue bears the question of whether fiscal transfers can in practice be designed to stimulate local governments to find ways to increase tax effort? Theory and practice suggest two possible ways: first, tax effort incentives can be built into the formula; second, transfers may be designed as matching grants.

43. Also, there are several alternatives to strengthen accountability, which should be considered in a reform of the *situado municipal* or any additional state grant program: i) make LGs at least accountable to the state government (make sure that services are being appropriately provided in terms of quantity\(^3\) and quality); ii) ensure that "minimum standards" are being met; iii) introduce matching grants in suitable service; iv) include incentives in the system’s design (i.e., in its distribution formula), to reward those municipalities that show improvements in both in local tax effort (revenue efforts), and in upgrading "minimum standards" in the quality of local services. Some states have introduced reforms in the distribution criteria of transfers from the states to the municipalities (TEMs)\(^4\). In general, the main concern is efficiency and interjurisdictional equity. These efforts

\(^2\) For instance, in 1995, in Miranda Municipality (160 thousand population) they were equivalent to 44 percent of the LG recurrent revenues; while in Girardot Municipality (420 thousand inhabitants) the situado was equivalent to 27 percent.

\(^3\) The term *quantity* refers also to the actual coverage of a service.

\(^4\) TEMs’ actual and recommended role is addressed in Annex 5.
should be supported and pilot cases should be considered in order to test alternative ways of meeting common goals.

44. Furthermore, it is worth noting that the equity effect of the criteria of distributing 30 percent of the resources in equal parts across LGs (or states) should be reconsidered. In practice, the criteria is equivalent to allocating resources inversely proportional to population (and roughly to actual needs): the greater the population, the smaller the transfer in per capita terms; and, the smaller the population the larger the situado per capita. It should be noted, also, that typically the largest magnitudes of people living in poverty are not necessarily located in the least populated areas. Clearly, in terms of the actual local budgets the relationship would be the opposite: the smaller the budget the greater the transfer in relative terms and conversely, the larger the budget the smaller the relative transfer. However, comparison of budgets in absolute terms have little or no meaning without controlling for the jurisdictions' population size. Ideally, if the objective is equity, grants should be distributed inversely proportional to per capita income across jurisdictions.

45. Current distribution criteria, has also been encouraging the creation of new municipalities due to the incentive of automatically being entitled to receive fiscal transfers. This feature has incentive the proliferation of new municipalities should be eliminated. The ability of a LG to finance at least a specified minimum of operational expenditures should be part of the requirements to receive fiscal transfers.

d) Revenue Administration

i) Tax Administration

46. Local governments have overlooked tax administration. Lack of incentives for mobilizing local revenues has been predominant, and poor tax administration has worsen the limited capability to generate revenue from local taxes.

47. As mentioned earlier, identification of potential taxpayers is weak, and registration is near voluntary. This is the case for the two main local taxes—the property tax and the business tax. Also, there is almost no assessment and verification of the accuracy of the tax liabilities reported. The backlog in updating taxpayers current account, and worse, the sometimes non-existence of individual current accounts, make it easy for taxpayers to evade tax liabilities; and, as such, it is almost impossible for the municipal administration to enforce payments. Hence, tax compliance is practically voluntary, making tax collection at best highly inefficient. Under these circumstances it is difficult to foresee an effective billing system to each taxpayer's address. This is aggravated by a system of sanctions and penalties which is either weak in its design or is simply not enforced. Furthermore, municipalities have little capacity to conduct audits. The latter is particularly aggravated by the legal requirement that only municipalities with population greater than 100,000 are required to hire an internal controller.

48. Because of the lack of appropriate enforcement and control mechanisms, local taxes (e.g., urban property tax) are easily avoided. A property tax system must be based on a cadastre which is periodically updated and reevaluated, but most municipalities are unable to administer this system, and
updated cadastres are costly. Another way that property tax information is obtained is through taxpayers declarations or from property transfers (buy/sell operations), in which it is in the interest of both parties to undervalue the property. There are few sanctions against underpayment and it is widespread.

49. As in most LGs throughout the world it is also necessary to address the problem of local corruption. This includes (a) non-recorded payments in the municipal treasury (an action which has incited many taxpayers to take legal action); (b) "disappearance" of amounts owed to the municipality from manual and computerized fiscal accounts; and (c) granting of false tax clearance statements to taxpayers owing considerable amounts to the municipalities. These problems could be reduced by better auditing and control procedures and by more effective prosecution of malfeasance.

**Recommendation**

50. In order to correct the present situation, a technical assistance program in municipal tax administration is fundamental. The Central and state governments should consider making current fiscal transfers, particularly those from FIDES and TEM, conditional to a technical assistance program and the actual implementation of basic recommended changes. The experiences of other countries in the region could offer lessons for progress. Municipal tax administration should be reorganized in its common operational elements by functions as opposed to by taxes (e.g., taxpayers identification, registration, current accounts, audits). Also, current administrative practice should be strengthened through simplification. For instance, it is futile to try to enforce compliance with over 250 different tax rates for the Industry and Commerce tax.

51. Also, taking into account the difficulty and costs involved in keeping fiscal cadastres updated, some form of simplification should be adopted. However, this should be done without compromising either revenue, efficiency, or equity goals. Special attention should focus on simplifying the physical description and assessment of improvements of urban property. More emphasis should be given to land assessments whether improved or not, and the option of introducing differential rates for land and improvements should be considered. Higher tax rates should be imposed on land and lower taxes should be levied on improvements. This is to provide an incentive for efficient land use, as well as not to discourage the development of improvements, particularly on low income housing. The system could be easily designed to yield the same revenues of a single rate system and should simplify cadastre maintenance.

### ii) Administration of non-tax revenues

52. Weaknesses in fees and user charges administration include lack of incentives which have resulted in inadequate registration procedures, weak technical capacity, partial coverage of beneficiaries, and inadequate system of legal sanctions. In terms of registration, revenue rolls are out of date in most municipalities. Furthermore, many businesses operate in zones which are not designated for commercial activities, and hence, are not granted permits. While this is meant to deter such activities, it only results in lower revenues for the local government and poor urban planning. In Consucre, for example, only 11 percent of the business in the Marices zone have municipal permits. The municipal registers have weak data on who owes fees, how much is owed, and the status of the accounts.
53. Another problem is the unwillingness of local officials to keep fees and user charges current with inflation because of the political costs. This again is linked to not having a structural incentives system, clear assignment of financial and administrative responsibilities, and, until a few years ago, political accountability. As long as the political cost of poor provision is less than the political cost of cost recovery the problem will remain chronic. Structural incentives need to change this balance in decision-making.

54. Some municipalities have computer systems for data collection and payments and receipts, but most carry out these procedures by hand. Wealthier municipalities also used mass-media (e.g., radio, newspaper, television) to inform the public of their fiscal responsibilities and how to carry them out. Also, municipal staffs devoted to revenue collection are inadequate, taking into account both the minimum requirements and the quality needed for an effective accounts management. The tendency is to concentrate on revenues that are easiest to collect and also on the largest bills, particularly when collectors are paid commissions on amounts collected.

55. Another administrative issue is legal sanctions for those who fail to pay. In essence, the payment notifications sent by the municipalities are perceived as an enticement to pay the local government. To circumvent this difficulty, many municipalities have offered rebates and partial exoneration to beneficiaries of services and to taxpayers who fulfill their obligations early or who pay past debts. The latter is exacerbated, by the Municipal Code that empowers mayors to exonerate from tax and non-tax liabilities. This feature also weakens the local political system.

Recommendation

56. There are several actions which are essential for improving the performance of non-tax revenue sources. The most important are: a) most important, a clear assignment of responsibilities in public service financing for which LGs should be held accountable is crucial. b) user charges and fees should be revised and updated on a systematic basis; c) specific programs to train local officials as trainers on cost accounting, record keeping, and collection enforcement methods should be established; also, technical assistance in pilot cases should be provided in parallel with training; and d) differential commissions should be established as an incentive for tax collectors. It must be emphasized that without clear financial responsibilities and accountability, efforts in other areas may yield unproductive results. The Municipal Tax Code should be reformed regarding tax and non-tax exoneration powers. Also, transparency of financial accounts should be enhanced by making financial information public.

e) Revenue Performance

57. Most municipalities are in weak financial positions--i.e., local revenues are not enough to operate, maintain and expand services at reasonable levels. The limitations municipalities face in generating resources from local revenue sources, particularly local taxes, result mainly from the lack of a clear assignment of responsibilities; and current financial practice discourages local revenue mobilization. This is particularly due to the nation's traditional reliance on oil revenues for the

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5. A single percent rate, as opposed to differential rates depending on magnitude of tax liabilities.
provision of most urban infrastructure and services. The current system design and actual practice create incentives to use current local revenue instruments inefficiently. However, it is also true that financial constraints are caused by the inefficiencies of local government’s revenue administration.

58. In general, poor revenue performance stems from several factors: a) the high level of centralization in the provision of municipal services; b) until recent years, the lack of a political commitment by mayors within a local constituency— in addition to the inability of local residents to pressure remote centers of power for more and better quality of services; c) the fairly high dependency of the municipalities on fiscal transfers— particularly in medium-size and smaller municipalities, as opposed to larger ones which are not as financially dependent; and d) the low level of technical and administrative capacity of most LGs—all municipalities have to propose and approve their own tax systems, tariff, and user charges.

59. Mayors now elected by popular vote are more politically committed to their local constituencies and more interested in improving revenue collections. Before the decentralization law, and the political reform, it was unnecessary (and perhaps not even desirable) for LGs to raise additional local revenues since local expenditure responsibilities had been subtracted by the central government.

Recommendation

60. Taxation has the most potential for raising revenue. But the ability to administer the system— much less to collect new receipts—varies widely, and some local governments are incapable of establishing an efficient tax system. One problem is the lack of institutional and administrative capacity. For some municipalities, the current costs of administering taxes may outweigh actual collections. The role of the private sector in tax collection and the role of para-municipals should be strengthened.

61. Until the legal responsibility that LGs have for the provision of specific infrastructure and urban services is actually devolved, LGs revenue efforts might remain fairly low. In other words, it will be difficult, both in practice and politically, for LGs to justify a greater local revenue mobilization— particularly through higher local taxes. Current decentralization efforts make devolution practically open to negotiations between the LG and the state and Central Government. The underlying incentives have not been conducive to make decentralization effective. In principle, the system of incentives should be mutually beneficial for an effective decentralization.
Intergovernmental Fund for Decentralization - FIDES

Background:

1. The purpose of the Intergovernmental Fund for Decentralization (FIDES) is to support financially and administratively the Venezuelan decentralization process. FIDES was created on November 1993 (Law-Decree 3265) and amended January 3, 1997. Its operations are overseen by the Ministry of the Interior. Its function is to administer resources from the Value Added Tax (VAT) allocated to states and municipalities. Funding of FIDES corresponds to between 15 to 20% of VAT revenue depending on allocation of funding by congress. These resources are provided to state and municipal governments in addition to the Constitutional Transfers situado constitucional and the situado municipal.

2. FIDES resources must be allocated for the financing of concurrent and exclusive functions. An agreement must be signed or a state law must be passed in order for FIDES to be able to disburse these funds.

Operations Design:

3. FIDES has the responsibility to determine, allocate, and administer the overall pool of resources to be transferred to state and municipal governments. FIDES operates two funds or accounts: one for states and one for municipalities. Each, states and municipalities have their own Council of Directors (CDs) who are in charge of managing the day to day activities of these two funds. Expenditure budgets are approved annually by their corresponding CDs. States and municipalities must apply for funds subject to the submission of specific projects. FIDES must evaluate the state and municipal projects and programs and its Board of Directors approves disbursements.

4. Financing is limited to qualifying programs and projects associated with the decentralization of specific public goods and services. Recurrent expenditures associated with proposed projects are not funded by FIDES. Projects and programs submitted to FIDES must first be sent for consideration to the State's Planning and Coordination Committee. FIDES must carry out a technical evaluation of every program and project. Project evaluation must be performed jointly with the corresponding Planning and Coordination Offices of states and municipalities.

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1 The original design of FIDES had allocated to FIDES “up to” a percentage of VAT revenue increasing to 30% by the year 2000. In practice, this design became problematic since it allowed the central government to allocate amounts substantially below the maximum limits--during preparation of the sector work; and as requested by counterparts, opportune recommendations were proposed to assist in redefining of the FIDES law.
5. Disbursements are made through local commercial banks who must administer FIDES' resources in the form of trust funds. States and municipalities are required to sign agreements with their respective local commercial banks for the management of such funds. FIDES is in charge of monitoring all financial operations through a management information system designed for this purpose.

i) Allocations Between States and Municipalities:

6. FIDES was originally conceived principally as a mechanism to intermediate resources to the state government. Reform in 1997 shifted the criteria and currently 60% of FIDES funds are destined to state governments while 40% to municipalities. The administration of FIDES, including project evaluation, is limited by decree to 0.5% of FIDES annual budget.

ii) Eligible Investments

7. FIDES is supposed to finance projects and programs related only to the following type of investments:

a. New investment in those sectors in which transfers of functions have occurred.

b. Programs on institutional capacity/modernization to facilitate the absorption of new functions as part of decentralization policy.

c. Pending debts on labor compensations incurred by the central government in those services being devolved to states and municipalities. Debt payments may account for up to 20% of the corresponding annual allocations to states and municipalities.

d. Project preparation costs--such as feasibility studies and projects design.

e. Technical assistance to states and municipalities--which must be provided in coordination with FUNDACOMUN; and

f. Studies related to decentralization and regional development.

8. Municipal programs and projects must be cleared with the State’s Planning and Coordination Committee-SPCC. The SPCC has 15 days to respond to a clearance request. Failure to respond during this period gives municipal mayors authority to proceed in their applications for FIDES transfers.

9. In case that states or municipalities are unable to commit all the resources made available to them, their entire uncommitted amount must be subtracted for the year following the current fiscal year. The subtracted amounts will be used to constitute a special reserve to

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2 Beginning in year 1993 the share for states was to start at 90%; while the share for municipalities (i.e., the difference) was to begin at 10%. Also, starting in fiscal year 1993 the states share was to decrease in favor of LGs in annual changes of 4% down to a level of 70% for states and 30% for municipalities by year 1998.
finance those programs and projects of states or municipalities who have exhausted their allocations.

10. FIDES may also finance municipal police and justice. Recurrent cost associated with investments on the eligible programs and projects are not to be financed by FIDES. Financing of current cost must be made with municipal own sources. Other costs financed with FIDES funds are: its own operations and expenditures that might be directly related to FIDES's objectives.

   iii) Co-Financing

11. FIDES finances between 95% and 98% of projects' cost. The definition of the level of matching grant is not established by decree and has been left up to the discretion of FIDES management. The level of contribution takes into account the level of revenue from constitutional transfers situado constitucional and municipal transfers situado municipal, as well as the presumably local fiscal effort. The magnitudes of the matching requirements have historically been very low. Until 1997 if LG’s current municipal transfers (i.e., situado municipal) was below the national average, LGs were supposed to contribute with 2% of the investment’s total cost; for the rest of the municipalities their matching contributions was 5% of the total project cost. LG have the obligation of documenting the 2% or 5%, either through the corresponding municipal budgetary appropriation, or must submit proof of the project’s actual total cost once it is completed.

12. The system, as stated above, has been created to encourage and support decentralization. Therefore, FIDES funds, in practice, must be made available only when a service has been effectively transferred from the central government to the municipality. However, there are provisions that permit and even encourage concurrent service and infrastructure production.

FIDES’s Design: A Normative Evaluation

13. Though the system is formula based and has most of the features of an automatic revenue sharing system (i.e., fiscal transfers to states and municipalities); in practice, however, it is a matching grants program conditional to project’s submission. However, it may finance a fairly broad type of projects and programs with fairly small matching requirements. What follows is an economic assessment of its design and its most relevant features.

   i) As described, the system of fiscal transfers (grants) is subject to the request and approval of specific projects and programs and very modest co-financing requirements. As such, transfers are conditional with specific matching requirements. The conditionality refers not only to the submission of specific projects and programs but
only if they are among those goods and services eligible for decentralization. The system of transfers is by design closed-ended; however, due to the existence of a Special Reserve Fund, transfers might be, practically, open-ended.

ii) The definition of the pool of resources to be transferred is formula base. In this sense its magnitude is predictable; and in principle, it allows for financial planning across the three levels of government. Percent shares of the VAT for both states and municipalities as a whole can increase gradually according to review of FIDES operations and the velocity of decentralization. The above should also facilitate investment planning and the absorption of new responsibilities. The calculation of the specific pool of resources, for each states and municipalities, is simple, transparent and of easy administration.

iii) In regard to the economic impact of FIDES' resource allocation criteria (in terms of efficiency and equity effects across states and municipalities), it may be argued that: The use of population as a principal variable may, in principle, generate positive income redistribution effects; assuming that income needs are directly related to population size; though, in some jurisdictions this clearly is not the case. Also, since transfers are conditional to specific projects, as well as to local co-financing (though a fairly modest proportion), expected efficiency effects of the system are also positive. In addition, the use of the variable "relative deficits" of local services should also, in principle, have a positive impact on both equity and economic efficiency, since disbursements are, again, subject to specific projects and programs, and these are locally identified—i.e., both production and demand efficiency would benefit. The variable extension, though with the smallest relative weight for determining resource allocation is worth considering. The use of extension assumes that need for financial resources is directly related to the geographical size of the jurisdictions (states and municipalities). In fairly broad terms this might be the case (i.e., assuming fairly similar population densities and economic bases). Therefore, more accurate indicators would be a combination of economic base and population density, or local revenue generating capacity weighted by extension. Though, statistics on the value of local economic base or revenue capacity are difficult to find; extension should then be weighted by population. This would contribute to a more equitable allocation of transfers.

iv) It is worth analyzing the economic effects on efficiency and equity of the feature of subtracting uncommitted resources. In terms of economic efficiency it appears as a positive contributing factor. However, in practice it may compromise it. First, the jurisdictions with relative less developed institutional capacity may not be able to apply immediately for FIDES resources, despite potential efficiency gains. Secondly, those more capable jurisdictions may be able to allocate more resources, particularly when they are practically free. On the equity considerations it is clear that developed
jurisdiction may not necessarily have greater needs than poorer ones, but have more absorbing capacity and greater ability to manifest demand. Therefore, the system in practice and over time could drastically compromise its equity objectives. However, to ameliorate this shortcoming FIDES finances, technical assistance, project preparation, and local institutional capacity development programs. This design assumes that poorer jurisdictions will take advantage of the TA and will avoid having resources subtracted from their allocation in subsequent years. Past performance suggests that municipalities have not had incentives to access the TA. A better feature would be to set deadlines for the commitment of resources. Deadlines before the end of the fiscal year may serve the same purpose without the disadvantage of permanent subtraction.

v) As described above, the system was created to promote decentralization. Therefore, it is crucial to assess its potential effects on devolution. The rule intention has been that those LGs who decide to assume the effective responsibility for local services (currently provided by the CG) will in principle qualify for financing. However, the regulatory framework establishes that for concurrent services, if there is an agreement between the CG and the municipality for cooperation in service provision, then the municipality may also qualify to receive financing. This, discourages a complete and effective decentralization, and may hamper accountability in general. The trend towards making the system every time more flexible may end up defeating the system's main objective.

For instance, not only effective decentralization has been relaxed with the incorporation of broader rules to qualify for funding; but also, project evaluation criteria has been made less rigorous. The application of project appraisal rules now have been made only conditional to investment magnitude and type of economic sector.

vi) In addition, the design of the system implies that in those services where there might not exist a need for new investments there would be less incentive for decentralization. Or, equivalently, for the system to operate there must exist significant deficits in the provision of those goods and services that are eligible for decentralization. Presumably there are fairly large deficits of public goods and services across most states and municipalities. Also, resources could be utilized for other purposes different to new physical infrastructure, such as technical assistance (T.A), institutional development, and need of payment for labor debts of services to be decentralized.

vii) There is not a clear incentive in the distribution formula for sub-national governments (with the largest deficits--i.e., those above the national average) to eliminate their current gaps in service provision because the larger their deficits (with respect to the national average) the greater the magnitude of the resources they might receive. The problem here is that the formula is based only on given sizes of deficits. The formula does not directly link transfers to changes (reductions) in the magnitude of such deficits, such that it may affect behavioral patterns. Also, it must be taken into account that LGs traditionally have not been the institutions who have had the authority, or
have been accountable for the provision of most local services. Though, the current situation has been gradually changing due to other factors different to FIDES' actual role.

viii) The current design does not address the problem of sustainability in service provision. FIDES financing should be made conditional to cost recovery policies particularly in public utilities. Also, financing should be provided for rehabilitation, expansion and completion of existing infrastructure projects. Financing for investments in new or old infrastructure should require specific budgetary rules for the automatic allocation of resources for operation and maintenance (O&M). Failure to maintain physical infrastructure should be considered as a reason for not qualifying for FIDES grants. Furthermore, the feature of concurrence in service provision makes difficult the application of cost recovery and O&M policies; it affects negatively a clear division of responsibilities, and hence it harms accountability. In addition, the feature of concurrence does not promote financial discipline.

ix) The system does not explicitly encourage local revenue mobilization. Implicitly, it assumes that sub-national governments finance their 2% or 5% matching obligations with resources from their situados. This is not the ideal way to promote strong local financial conditions and financial discipline. Without strong local finances O&M suffers, the quality of services drops, and ultimately the sustainability of the service is compromised. Generally, low quality and insufficient service coverage primarily affects the poor. The system's design should incorporate indicators of the progress made in coverage and quality of services, as part of the criteria to allocate fiscal transfers. Behavioral indicators would be more effective criteria to incentive a better service provision--which is currently missing in the system.

Empirical Evaluation

14. FIDES has had a slow start. In early 1995 the institution was in the process of developing its administrative and operational set up, such as: organizing its physical plant, hiring human resources, designing a strategic plan to start up, and promoting its objectives among states and local governments.

15. In 1995 FIDES approved a total of 84 projects (for Bs. 7.1 billions) covering 11 states and 11 local governments. Out of 16 states, the states of Merida, Falcon, Aragua and Zulia are the main beneficiaries. It must be noted that these states are among the richest, and therefore the ones with less fiscal needs but the most capable to demand and actually absorb new resources. In this sense, technical assistance to low income states and municipalities with potential to grow and with fairly large populations is needed.
16. Roads and street construction (48%) and health services (39%) have been the main public goods for which financing has been provided. Sport (4%) facilities (4%) are the third type of physical infrastructure in which resources have been allocated. The above three are equivalent to 91% of FIDES resources. Projects that have not been approved yet concentrate in the same three main types of physical infrastructure.

17. It should be noted that in 1994 FIDES received Bs.15 billion which was about half of what it should have received according to the ceiling established by law. In 1995 the resources are much greater, but FIDES was able to approved projects for only 7.5 billions, about half of the resources available in 1994. Clearly, supply of resources is much greater than actual demand.

18. The three main services in which resources have been allocated are concurrent functions. In this respect, there is the potential, at least, that these responsibilities are effectively being decentralized through FIDES initial support. However, it is not know whether FIDES financing really entails that these services have become exclusive responsibility of the corresponding municipalities remains to be seen. Further examination of FIDES conditionality should determine how effectively the objective of decentralization is being met, as well as how effective is the sustainability of the physical infrastructure being financed.

19. As a summary analysis of FIDES table presents the principal issue and recommended actions. The issues table takes into account the criteria for the design of intergovernmental transfers (Annex 2) which include autonomy, revenue adequacy, equity, predictability, simplicity, incentives and safeguarding grantors objectives.
## Table 4. FIDES: Incentives and Impact on Urban Service Delivery

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Issues</th>
<th>Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue adequacy</td>
<td>FIDES resources were not accessed fully, principally due to lack of information and absorption capacity.</td>
<td>Establish coordination and rationalization of different financial sources. Adjust allocation criteria based on current deficits of services and physical infrastructure.</td>
</tr>
<tr>
<td>Equity</td>
<td>The current allocation of funds favors states over municipalities. The formula used to allocate funds among states and municipalities is redistributive and inter-jurisdictional redistribution takes place.</td>
<td>The allocation of resources should favor local governments rather than states to be consistent with FIDES decentralization objectives.</td>
</tr>
<tr>
<td>Predictability</td>
<td>The definition of the pool of resources to be transferred is formula within a Band. Thus the magnitude of resources is somewhat but not totally predictable.</td>
<td>The formula should be adjusted to assure multi-year commitments and predictability in funding.</td>
</tr>
<tr>
<td>Efficiency</td>
<td>In principle, the use of allocation criteria such as population, need of basic services, and infrastructure, as well as modest cofinancing, makes the allocation of FIDES resources more efficient than other intergovernmental transfers. However, one of the main incentive of FIDES investment is the bias toward new construction and equipment rather than maintenance of existing infrastructure.</td>
<td>The bias in favor of new investments should be corrected. FIDES should also finance rehabilitation of existing physical infrastructure. In addition, maintenance programs should be a condition to access FIDES resources.</td>
</tr>
<tr>
<td>Simplicity</td>
<td>The FIDES mechanism is relatively simple but adjustments could increase its effectiveness and integrate it into the overall financing scheme of services. FIDES operations are currently overly centralized.</td>
<td>FIDES operations should be decentralized. FIDES should delegate to the state planning offices the coordination of expenditure planning under consistent criteria.</td>
</tr>
<tr>
<td>Incentive</td>
<td>There is no incentive for efficient provision and sustainability of public goods financed by FIDES. Also there is no incentive for sound fiscal management of states and municipalities. In practice, current criteria rewards deficits in capital accounts.</td>
<td>Performance targets should be based on monitorable indicators. Condition transfers to a minimum level of efficiency in service provision and require cost recovery for operation and maintenance to make services sustainable. Hold state and local governments accountable in their performance to qualify for new resources and require transparency in financial management.</td>
</tr>
<tr>
<td>Safeguard Grantors Objectives</td>
<td>The current policies and practice of FIDES does not consistently generate incentives to safeguard the objective of a sustainable provision of decentralized services. Also, the relatively low matching rate of local contribution and the lack of institutional and regulatory reform associated with FIDES projects does not establish sufficient incentives to ensure sustainable service provision.</td>
<td>Increase the matching rate to assure local commitment for project success. Establish objective criteria for necessary institutional and regulatory reform to enable the sustainable provision of FIDES financed projects.</td>
</tr>
</tbody>
</table>
Conclusions and Recommendations

20. FIDES may offer an opportunity to support decentralization and effective provision of local services. However, some adjustments to the system are necessary, so that it can meet its objectives. The main strength of the system is that it is formula based, meaning it has in principle ruled out arbitrariness in resource allocation.

- Despite decentralization being FIDES' main objective, its operations are completely centralized in the nation's capital. Decentralization of its operations is fundamental. State planning and Coordination Offices could play a more substantive role in resource allocation. It should be considered the option of having FIDES administration being handed over to States under FIDES supervision. Also, only fairly large projects should be assessed by a FIDES' central office.

- The sustainability of public goods and services (e.g., physical infrastructure) should be made part of FIDES's objectives. The attainment of this objective should not limit FIDES operational capacity. Also, there should be accountability and strong incentives at the local level to guarantee sustainability.

- Specific norms and procedures should be established to ensure the sustainability of local public goods and services. They should include, among others: pricing, cost efficiency indicators and coverage of low income areas. Also, funding should be made conditional to the minimum reforms to ensure sustainability.

- FIDES' eligibility criteria should be revised. Only project that lead to effective decentralization should be eligible, so that financing is consistent with FIDES objectives. It appears that FIDES is experiencing substantial pressure to allocate rapidly growing financial resources due to insufficient demand. Decentralization is practically voluntary and FIDES investment incentive might not be enough. [this preliminary conclusion will be supported with empirical data on FIDES' performance in Section 4 above].

- FIDES project selection criteria should be more specific. The selection criteria should include, among others, some indicator of the project's impact in terms of FIDES' objectives. Also, the eligibility criteria to qualify for FIDES financing should be narrower. Currently, a fairly broad range of projects may qualify for FIDES financing.

- FIDES financing should not only benefit new infrastructure; it also should include rehabilitation and expansions. This would not only protect the social and economic
benefits of former investments but would eliminate the inherent bias in favor of large and new investment projects.

- **Co-financing** is extremely modest and their is not explicit operational criteria for its definition. It does not encourage: local revenue mobilization, prioritization of projects and in many cases not even actual local financial commitments. In principle, transfers allocation criteria for sub-national governments should not only include *deficit size*, but also local tax capacity. Also, matching rates should be related to tax capacity. However, in Venezuela states have no taxes and LGs have traditionally been given by the Federal Government (FG) most public goods and services; therefore, differences across jurisdiction had been created mainly by FG’s discretionary policies. Therefore, it would be rather unfair to ask sub-national governments, overnight, that they are in charge of closing the service gaps, they did not create. Co-financing should be phased in gradually, together with the strengthening of local revenue sources.

- On the other hand any attempt to at least narrow these gaps, through devolution of responsibilities, should require adequate *maintenance* as well as explicit *cost recovery* policies to make local services sustainable.

- Also, FIDES financing should include incentives to promote *private sector participation* in certain local services. Currently, this type of incentives are missing in the system’s design. Incentives toward greater cost efficiency in service provision should also be part of the systems design as well. It should be established that **FIDES resources should not finance services that can be provided by the private sector more efficiently.**

- FIDES resources should support *institutional changes* in service provision, such as concessions with the private sector and the constitution of municipal autonomous agencies. In addition, the financing of liabilities due to workers’s welfare benefits should be made conditional to reductions in staff in order to make local service provision more cost effective.

- FIDES should support financing of projects whose construction period might be longer than a year. Multi-year investment planning is important for physical infrastructure, such as roads and water supply.

21. Furthermore, basic conditions should be established for the use of fiscal transfers. Among others, the following should be considered:

i) A mechanism should be devised to determine where each LG stands with respect to present and future projects. An *inventory of local projects* should be
carried out; this inventory should register the status of each project (e.g. it should determine whether the project is identified only, designed and evaluated, under construction, or other status); a data base or Project's Bank should be the tool to meet this need. FUNDACOMUM jointly with FIDES could play a leader's role on this matter.

ii) All local projects should be registered in the Project's Bank; the above would not only could contribute to rationalize local investments but should control for arbitrariness in investment decision-making and improvisation;

iii) All LGs should be required to develop multi-year investment planning; ideally no less than three years plans; which should work as a rolling-investment-program. The investment plan should be consistent with sectoral investment policies.

iv) All projects to be placed in the rolling-plans should specify their financial sources and, as a whole, the plan should be both linked and fully consistent with the budgeted resources for annual capital expenditures.

v) No project should be contracted out or implemented if it: has never been registered, is not part of the multi-year investment plan, and has not been considered for the corresponding annual plan and, therefore, has no budgetary appropriation for its financing. Local financial discipline must translated into compliance with appropriate norms and procedures.

vi) Local budgets should include an account for maintenance of physical works. Also, annual budgeting of current expenditures should reflect, whenever appropriate, the additional recurrent costs due to the operation of new services.

vii) Internal control should be in place not only in an ex-ante form (i.e., control previo); but also, through ex-post verifications (i.e., control posterior).

viii) Investment requirements should include either a project's economic evaluation or, at least, a minimum cost solution, as well as technical, financial and institutional evaluations particularly for projects of magnitudes above certain cost levels.

ix) Priority sectors should be at least identified to guide the allocation of fiscal transfers; resource allocation should be consistent with the major deficits in physical infrastructure and local services.
x) Community participation in project's decisions should be assisted making annual investment plans open to the public, progress reports should be issued at least once per semester.

xi) All LGs should provide FIDES and FUNDACOMUM with a copy of the executed and estimated budgets on an annual basis for the corresponding years.

xii) Financing should make explicit those contributions (pecuniary or in kind/their monetary equivalent) from community participation.

xiii) Annual reports to FIDES should include the progress made in local service provision. Particularly, it should be reported the number of connections or families served and deficits reductions in each municipal service. Also, the number of staff and blue-collar workers employed in the provision of each local service should be supplied.
Transfers from State Governments to Municipalities (TEM)

Objective

1. This annex analyses the TEM programs in order gain insight to assist in the necessary reforms of current systems and in the design of future TEM initiatives. TEM has the potential to be the principal mechanism to induce effective decentralization of urban service provision to municipalities in Venezuela.

Background

2. There are two grant programs in Venezuela: The situado constitucional, which transfers funds from the central government to the states, and the situado municipal, which transfers funds from the states to the municipalities. Also, there are projects financed by the line ministries which effectively transfer funds from the central government to the sub-national governments. In addition, as part of fiscal decentralization, states that request and assume responsibility for providing certain services receive the national revenues previously budgeted for the transferred service. Some states, such as Aragua, Carabobo and Falcon have introduced their own system of transfers from the state to the municipalities (TEM). This annex presents a summary analysis of the TEM programs of the states of Aragua and Falcon. Particular attention is given to both the system of incentives implicit in their designs as well as the effects of these systems in local service delivery.

Falcon State

A Normative Evaluation of TEM

3. The TEM has been in operation since 1992. It was designed to support the objectives of the decentralization law and to enable municipalities fulfill their functional responsibilities. The TEM in Falcon has been designed as a simple mechanism to devolve concurrent functional responsibilities from the state to its municipalities. The TEM is based on an annual agreement signed between the governor and the mayor of each municipality. The agreement specifies the total transfer of the TEM as well as the sectors in which the expenditures must be made. The total transfer is linked to the situado municipal and an informal understanding has been that it should be equal in magnitude to the situado municipal. Each municipality reaches a negotiated agreement on the proportion of resources to apply in the eligible sector which include health, sports, education, culture, roads, municipal strengthening, security and agriculture. The Falcon TEM covers capital and recurrent expenditures. Application of the funds is programmed jointly by the municipality and the state through the comité de planificacion y coordinacion and the each local government.

1. However, there does not appear to be a standard method or formula on how are transfers supposed to be defined for the second and subsequent years--after the first year of decentralization of a particular service. Apparently this is open to negotiations between the estates and the central government (sectoral ministries).
Investment Decision-Making Effects

4. One of the principal weaknesses of FALCON's TEM is the annual nature of the TEM agreements. Fragmentation in planning does not provide the necessary incentives to municipalities to assume full and permanent responsibility for service provision. Ironically, state governments is aware of this weakness and it must maintain infrastructure to assist municipalities should they not be able to provide the services financed by the TEM. Thus, the TEM provides the right message to the state and municipal administrators but it is not sufficiently strong to motivate institutional change. The lack of security for reform is based on the politically volatile nature of TEM. In 1994 state governments cut TEM commitment by 50% and left municipal governments to solve a complex service provision problem.

Budgetary Effects

5. The TEM is conditional. As such, these transfers have limited distortionary effects in resource allocation. The distortionary effects have been softened through the influence that the municipality has to establish the relative expenditure on each of the TEM financed services. This programming exercise is not as transparent as the definition of regular budget expenditures as it does not include public scrutiny and citizen participation.

Local Revenue Mobilization Effects

6. The TEM does not establish systematically conditions to enable sustainability of the services or infrastructure produced. For example issues of cost recovery and the maintenance of the infrastructure is not a systematic condition for use of TEM resources.

Equalizing Effects

7. The TEM in Falcon is defined under the same criteria as the situado constitucional. Therefore, within the state, the distribution of TEM resources will have the same limited progressive distribution among municipalities. However, each municipality—in coordination with the state planning office—defines the application of TEM resources to the eligible sectors. Any given municipality can chooses to design its TEM taking into account the potential income redistribution effect of the expenditures.

Empirical Evaluation of TEM

8. Since 1992, with the exception of 1994, TEM transfers to municipalities have been equivalent to the situado municipal. In 1994, an election year, the state transferred reduced the TEM by 50%. Given the lack of cost accounting for the services provided through the TEM it is not possible to know the adequacy of the transfers. The adequacy of the transfer has not been an issue of contention between the states and the municipalities since many of the functions legally have to be provided by the municipality and strictly speaking no grant would be required.
9. With the exception of education and health, the TEM in Falcon is not monitored with the same level of detail as state expenditures. The municipalities must provide the state with TEM implementation reports every six months and must permit field inspection by state officials to confirm the municipal reports. However the municipalities are not provided with unitary costs benchmarks or service production criteria to assure efficiency and quality of services. In addition the TEM does not take into account users perspective as an evaluation criteria.

Aragua State

10. In the state of Aragua the TEM system has been in operation since 1991. It was designed to support the objectives of the Decentralization Law. TEM transfers are earmarked for capital expenditures. During its first phase the program transferred capital resources using the distribution criteria of the *situado municipal*. In 1991, the beginning of the program, Aragua State transferred to its municipalities an amount equal to the *situado municipal* which was 11% of the *situado constitutional*. In other words, Aragua State municipalities received 22% of state revenues. These resources were increased in 1992 by 1% in a similar fashion as the *situado municipal*.

11. In practice, there was a trend in many municipalities to use this resources as revenue generation in terms of interest on bank deposits. This flaw was caused by incoherent timing and sequencing of revenue assignment and functional decentralization. As revenue assignment precedes incremental functions to be carried out with the resources transferred municipalities reacted almost predictably to the incentive structure and derived substantial resources by simply investing excess funds.

12. In several local governments the contracting and actual implementation of investments in the provision of local services was substantially decreasing. The above circumstances, together with the pressure of the state fiscal deficit, led the state government to reevaluate TEM's operations. As a consequence the TEM was reformed in 1993; state transfers were reduced\(^2\) for those municipalities that did not demonstrate an adequate project implementation performance, and was strengthened for those who were meeting the objectives of the program. The state policy tried to make the system a rather demand-driven revenue mechanism. However, due to both the weakness in functional decentralization and local institutional capacity, particularly for project preparation and implementation, TEM's financial resources were not being fully disbursed. Allocation of resources then became highly discretionary. In 1995 investment decision-making was top-down automatically compromising resource allocation efficiency, particularly demand efficiency. Also, as stated below under the Empirical Evaluation Section, current practice makes current resource allocation unpredictable.

\(^2\) However, it must be determined whether all municipalities still receive some transfers and how it is determined. Implicitly the third criteria (in addition to poverty and UBN) is performance in project implementation. However, it is not clear whether this operates automatically, based on some performance indicators, or whether discretion enters into the decision-making process of resource reallocation.
13. One of the main conclusions of the reevaluation of the program was the crucial importance of modernization of the municipal administrative structure to make its objectives viable, and specially linking resources with functions. The allocation of resources by itself did not guarantee the success of the program, particularly when the institutional capacity at the local level was lacking. Taking into account the above experience it was established to allocate resources, as part of the transfers, to develop the administrative capacity of the municipalities. Approximately, an amount equivalent to 30% of the revenues from transfers must be used for the above purpose. The so called General Plan of Institutional Strengthening relies on three components:

i) technical assistance and training programs to municipal governments,

ii) financing of projects to support institutional development (e.g., automatization of administrative processes, cadasters, revenue collection.) and,

iii) new distribution criteria of resources allocated to municipal transfers.

14. In 1994 the fiscal transfers program introduced the above elements to its operations. The implementation of the above Plan, however, has been fairly slow and limited. FUNDACOMUN’s regional office in Aragua is currently supporting this approach.

15. Also, new distribution criteria was established in 1994 regarding how TEM resources are supposed to be allocated. The distribution criteria before 1994 was 50% for each municipality in equals parts, and 50% base on municipal population. The 1994 criteria takes into account several indicators, which include: poverty levels and unsatisfied basic needs (UBN). This design in principle would make the system fairly re-distributive; however, in practice (as will be discussed below) the above indicators have not been considered for the current allocation of TEM’s resources.

16. Part of the reasons, in 1994, to redesign the system was the argument that the final allocation of resources had contradicted the core objectives of the program. When the local investment plans were being decided, most mayors had ignored community participation (i.e., town committees and neighborhood organizations), which was against the goal of decentralization and ultimately of democratization in the decision-making process. Hence, the TEM system, reformed the modality in the way resources should be used. Therefore, as part of the 1994 reforms, it was also established the Solidarity Plan, which required that 50% of TEM’s resources must be allocated with the direct participation of the community. These rules, however, have not been fully applied, and a substantial part of TEM’s resources have been decided by the state government, as described below under the empirical evaluation of the system.

3. However, it is not quite clear what are the specific weights given to these two variables: Poverty and Unsatisfied Basic Needs (UBN); and, whether other variables are taken into account to allocate TEM’s resources. Also, it should be determined whether the system is completely formula driven or whether some allocations are made on a discretional basis. In addition, it is not clear how it is determined which municipalities are eligible and which are not.
A Normative Evaluation of TEM

17. In brief, the system has not evolved to a more equitable and efficient mechanism for resource allocation. Also, transfers are practically conditional to specific investments not always identified locally. Also, the system as a whole is closed-ended and concentration of resources in some municipalities may occur due to current system in resource allocation. Thus, the system does not fully operate as a demand driven mechanism. Its administration is fairly simple, since the pool of resources to be distributed is for the most part formula driven, while their allocation is fairly discretionional. The 1994 requirements regarding monitoring of municipal performance in project implementation and community participation imply a fairly broad administrative and operational set up; in practice, however, fairly little on these two areas is currently accomplished.

18. What follows is an evaluation of the main economic effects of TEM's current design. The evaluation also examines the implicit system of incentives that might appear relevant in local service delivery.

Allocative Effects

19. Several important economic elements may be affected by the system's design regarding resource allocation. This section examines the most relevant.

Investment Decision-Making Effects

20. Before 1994 investment decision-making was mainly in the hands of municipal mayors; though, investment plans, as part of the annual budgets, have to be approved by municipal council members. Since the reform of 1994, at least 50% of transfers for investment must be decided directly with community participation. It would be logical to expected that community participation should contribute significantly to allocate resources to those services that people want. In this sense, one would expect that under these rules, if applied, the allocation of resources would be more efficient.

21. There are other important effects of community participation. It may be argued that participation might make the system, as a whole, more transparent; also, it may be asserted that the local government as well as municipal council members would be more accountable to the residents.

Budgetary Effects

22. Fiscal transfers may cause different local budgetary effects, or distortions, on resource allocation. This is specially the case of conditional grants for specific public services. Budgetary distortions are reflected in greater local expenditures than what a local government would have incurred in the absence of a grant. In practice, they lower the relative "price"

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*See footnote 4 above.*
(strictly, the cost to the municipality) of the particular service; Or, in the case of unconditional transfers (e.g., for investment in general) they have a budgetary income effect that not only add new resources but also free others.

23. TEM’s current design, if fully applied, it may be argued, would be fairly unconditional. Transfers would have only a relative “price” effect and would be less distortionary in resource allocation than conditional grants. Less distortions would occur because local governments (together with community participation) would decide among themselves how to allocate the additional resources based on their local needs and own priorities. It must be noted that financial resources from TEM’s proposed approach and formula, if fully applied, would be fairly predictable and as such its design would facilitate local investment planning and a more efficient resource allocation. However, one aspect that needs to be addressed explicitly in TEM’s program is the sustainability of the services it finances. Effective planning for operation and maintenance (O&M) of services should be part of TEM’s requirements.

Local Revenue Mobilization Effects

24. Potential distortions typically occur in local revenue mobilization as a consequence of grant programs like TEM. The effects of external free resources are generally reflected in low local tax effort. The above motivated by the apparent political cost associated with taxation, or its benefits if tax collection efforts are relaxed. The effects of this posture, however, are extremely perverse when it affects user fees collection, which compromises operation and maintenance, and ultimately the sustainability of local services. Consequently, TEM’s program might be affecting negatively local revenue mobilization efforts. It might be distorting resource allocation as whole (between private and public goods); and, as such it may not be contributing to an efficient allocation of resources in the local economies. Therefore, it is important to introduce incentives in a redesign of the distribution formula to correct for these shortcomings.

25. Furthermore, in the worse case scenario, the current design, if fully applied, might lead to lack of financial discipline which may translate into local fiscal deficits which the grantor later on has to cover. This is why, among other things, it is desirable to make local governments as financially accountable to their own residents as possible. If a strong local financial accountability is not viable in the short term, it should be attempted, at least, the achievement of the same effects through explicit incentives in the distribution criteria of the TEM grant program. Such incentives should be designed to correct for the above distortions, which would contribute to make the equalization grant program less distorting. Therefore, specific incentives should be incorporated in the grant design to strengthen local revenue mobilization (e.g., matching rates, or requirements regarding maintenance of tax effort, or conditions setting user fees and collection efficiency at levels not any lower than before the grant program enters into effect).

5. Strictly, a general purpose subsidy for fiscal equalization might actually increase tax effort depending on the type of public good benefiting from the subsidy and on the strength of the income-elasticity of demand for local government goods. Empirical studies have indicated that the effect on tax effort may also depend on the size of local government. Usually small LGs are the most likely to substitute transfers for local tax effort.
Equalizing Effects

26. It may be argued that TEM's new design could substantially contribute to inter-jurisdictional fiscal equalization. Also, and indirectly, it could contribute to interpersonal income redistribution, and specifically to poverty alleviation. Because small municipalities and rural local governments have little capacity to support improvements in physical infrastructure, social services and the modernization of their own institutional capacity, a system of equalizing grants would seem fairly equitable.

27. However, it must be noted that if transfers were not to be used efficiently in some jurisdictions, there would be an opportunity cost associated with these resources. Transfers could be used somewhere else not only for equity purposes but to support greater urban productivity, economies of scale, and in general economic growth. Although, TEM's current design may contribute to desirable distributional goals there would be a tradeoff in terms of less economic efficiency in the allocation of the program's resources.

Empirical Evaluation of TEM

28. TEM resources, as already mentioned above, have not been automatically allocated to the municipalities based on the criteria established in 1994. Allocation, has been fairly discretionary. Multiple factors which combine: actual needs, equity considerations, partisan objectives, and alternative sources of capital financing may have determined actual allocation of resources. For instance, in 1995, TEM allocated Bs.900 million for public works discretionality selected by the state government. They included, among others, projects related to streets maintenance, sidewalks construction, playgrounds and parks, water distribution (pipe lines) and sewers.

29. The state government is currently considering a new reform to the criteria established in 1994. The new policy attempt to make resources conditional to the submission by the municipalities of specific projects, rather than automatic capital transfers via formula. Projects, however, should be part of a multi-year municipal investment plan. Plans would be developed at least for a three-year period. TEM is also considering to develop a data base of municipal projects to follow up on their status. TEM would finance not only projects on physical infrastructure but also activities and equipment related to institutional modernization. The latter still consistent with the 1994 approach.

30. It must be emphasized the crucial need at the municipal level for technical assistance and training regarding project preparation and evaluation as well as investment planning. If the above need is not met the allocation of resources most likely will favor the larger cities which have the greater institutional capacity. In contrast to the 1994 approach, the new policy may generate a concentration of financial resources in the wealthier LGs aggravating current disparities.
Conclusions
31. TEM offers an opportunity to support decentralization and an effective provision of local services. However, fundamental adjustments to the system are necessary, so that it can be more effective in meeting its objectives. The main strength of the system is that it is formula-based in the definition of the pool of resources to be allocated. Also, there exists at least in principle a design established by state law in 1994 regarding the distribution of resources across local governments. TEM's fund, however, are not being allocated based on the criteria (formula) established in 1994. Instead, lots of discretion and other objectives (different to decentralization) are currently present in TEM's resource allocation. Discretion in resource allocation should be eliminated. If resources are not to be automatically transferred to the municipalities, but are to be allocated subject to project submissions, investment ceilings and technical assistance become crucial to avoid a bias in resource allocation, in favor of the largest cities. In any case, resources should be tied to the decentralization of specific functions.

32. A new design should attempt to minimize the current tradeoff between equity and efficiency. In general, the allocation formula should favor redistribution of resources at the same time that should make them conditional to specific projects and functions. Consideration should be given to a formula to establish investment ceiling across municipalities (given their own characteristics) and available resources per municipality should be conditional to the submission of specific projects. Technical assistance should be offered to those municipalities with less institutional capacity regarding investment planning and decentralization to correct for distortions in demand and make the system viable. Investment ceilings should be revised and adjusted based on needs and performance.

33. There is a need to rationalize public investment. Coordination between TEMs and FIDES is fundamental. Though both mechanisms are designed to support decentralization, TEMs appears to have a greater comparative advantage working with municipalities, while FIDES seem have the advantage of working with the states. Also, TEMs seem to emphasize more on equity goals and decentralization, while FIDES has a greater comparative advantage in efficiency objectives and decentralization.

Specific Observations
34. In 1994 TEM's design was substantially reformed. The program introduced into the system's design criteria related to the performance in project implementation. Given this fundamental change, it was expected that under the new system the allocation of resources would be more efficient. However, the criteria of performance has not been applied.

35. Also, the new feature of community participation on investment decision-making was supposed to make the system, as a whole, more efficient and transparent. In addition, these changes were expected to make local governments and municipal council members more accountable specially to local residents.
36. TEM’s financial resources were supposed to be fairly predictable and as such its design was supposed to facilitate local investment planning and a more economically efficient allocation of resources. However, there was and still there is a need to address the sustainability of the services financed by TEM. The operation and maintenance of TEM projects are supposedly assumed by the local governments. However, there is not a guarantee that TEM projects will be adequately sustained by the LGs and/or their final beneficiaries. It is, therefore, recommended that financial planning for operation and maintenance (O&M) be part of TEM’s requirements to LGs and/or beneficiaries to be eligible to this resources. Cost recovery policies should be adopted to make local services sustainable. Ultimately, adequate cost recovery would facilitate privatization of specific services.

37. Since transfers are unconditional to local revenue efforts and do not require any matching arrangement, TEM’s program would most likely discourage local revenue mobilization. Also, fiscal transfers generally distort resource allocation (between private and public goods); and, as such they may affect resource allocation in the local economies as a whole. Consequently, there is a need to correct for these shortcomings.

38. Specific incentives should be incorporated in the grant design to strengthen local revenue mobilization. It is recommended to consider, for instance, matching rates, rewards to tax effort, user fees collection efficiency, and rewards to deficit reductions in basic services. Matching rates would incentive local revenue mobilization and they could use differential rates considering different fiscal capacities to make the system more equitable. A specific indicator of tax effort could be incorporated in the distribution formula to reward tax collection efficiency. Also, indicators of good management including deficits reductions may be included in the formula.

39. Although, TEM’s program may be contributing to desirable distributional goals there is a tradeoff between inter-jurisdictional equity and economic efficiency in the allocation of the program’s resources. Therefore, there is a need for stronger monitoring of the system’s performance. Monitoring should include at least indicators of project completion and project sustainability. Specific recommendations include the following:

Summary of Issues and Actions

40. TEM represents the first state fiscal decentralization initiative in Venezuela. In order to systematically analyze the transfer it is necessary to gauge its performance against criteria commonly used in the evaluation of intergovernmental fiscal transfers. Table below presents an analysis of the TEM using revenue adequacy, equity, predictably, simplicity, incentives and safeguarding grantors objectives at the performance criteria.
### Table 4. TEM: Incentives and Impact on Urban Service Delivery

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Conditions</th>
<th>Actions Necessary</th>
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<tbody>
<tr>
<td>Revenue adequacy</td>
<td>FALCON: Not known assignment ad-hoc as cost of services being financed is not defined. ARAGUA: In practice, allocation is discretionary. In addition, differentiated municipal needs, functions and fiscal capacities makes system fairly inadequate.</td>
<td>FALCON: Need for empirical base to define present cost of service provision as well as target structure based on efficient delivery of services. ARAGUA: Make transfers conditional to projects, establish adjustable investment ceilings, and provide Technical assistance and training.</td>
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<td>Equity</td>
<td>FALCON: System has the same limited equity attributes the <em>Situado Constitucional</em>. ARAGUA: Legally, 70% of transfers are supposed to be distributed based on population; however, in practice, allocation has been discretionary. As such, equity is uncertain.</td>
<td>FALCON: Compensatory criteria based on service deficits should be included in the allocation. ARAGUA: An adjustable formula and investment ceiling should substitute for current discrentional allocations.</td>
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<td>Predictability</td>
<td>FALCON: Non-predictable there is an antecedent that TEM resources are vulnerable to political discretionality. ARAGUA: Municipalities cannot predict incoming resources since current allocations are discretionary.</td>
<td>FALCON: TEM agreement must be solid and not permit negotiations once it has been established. ARAGUA: De jure makes resources available based on formula driven funds and subject to project evaluation.</td>
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<td>Efficiency</td>
<td>FALCON: Investment decision making is based on negotiations with the state government. ARAGUA: In theory investment decision making is participatory; however, in practice, it is top-down and discretionary compromising resource allocation efficiency, particularly demand efficiency.</td>
<td>FALCON: Since the transfer covers recurrent expenditures it should form part of the mainstream budgeting process and should be decided locally. ARAGUA: Investment needs and priorities should be decided locally.</td>
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<td>Simplicity</td>
<td>FALCON: Very simple as it is piggy-backed on the <em>Situado Municipal</em>. ARAGUA: Fairly simple; however, based on current practice its efficiency and equity are compromised.</td>
<td>FALCON: TEM should evolve to define appropriate levels of transfers according to unitary cost of service provision. ARAGUA: A formula should substitute for current discrentional allocations.</td>
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<tr>
<td>Incentive</td>
<td>FALCON: Does not induce efficient provision of services; cost recovery, private provision of services and community participation. ARAGUA: It does not encourage investment planning and financial discipline.</td>
<td>FALCON: Modify regulatory framework to introduce incentives for multiyear financial planning and sustainability in service provision. ARAGUA: Adopt clear and transparent rules for resource allocation.</td>
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<td>Safeguard of</td>
<td>FALCON: Incentives are not sufficient to reduce concurrent provision of services and promote efficient urban services. ARAGUA: There is an inconsistency between the objectives in the law (primarily a redistributive goal) and actual practice.</td>
<td>FALCON: Objectives should be clarified and reforms to attain objectives should be institutionalized. ARAGUA: Objectives should be redefined and practice should adhere to objectives.</td>
</tr>
<tr>
<td>Grantor's Objectives</td>
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*FALCON*: Federal Agency for Local Development and Competitivity

*ARAGUA*: Autonomous Region of Aragua
General Recommendations for the Design of TEM

41. As an intergovernmental fiscal transfer TEM design should incorporate basic good practice criteria including: revenue adequacy, equity considerations, predictability, efficiency, simplicity and safeguard grantors objectives. Specifically, the report recommends that in Venezuela state to municipal conditional grants should consider the following issues:

   i) Priority sectors should be at least identified to guide the allocation of fiscal transfers; resource allocation should be consistent with the major deficits in physical infrastructure and local services. Therefore, a service needs assessment is recommended.

   ii) Community participation in project identification should be verified and assisted making rules for financing open to the public.

   iii) Financing should consider contributions (pecuniary or in kind/their monetary equivalent) from community participation. Proposed matching rates should take them into account.

   iv) Local budgets should include an account for maintenance of physical works. Also, annual budgeting of the current expenditures should reflect the additional recurrent costs due to the operation of new services. User fees should provide for the additional expenditures whenever applicable.

   v) Investment requirements should include either a project's economic evaluation or, at least, a minimum cost solution, as well as technical, financial and institutional evaluations particularly for projects of magnitudes above certain cost levels.

   vi) Internal control should be in place not only in an ex-ante form but also through ex-post verifications.

   vii) Annual reports to TEM should include the progress made in local service provision. Particularly, it should be reported the number of connections or families served and deficits reductions in each municipal service. Also, the number of staff and blue-collar workers employed in the provision of each local service should be supplied. All LGs should provide TEM with a copy of the executed and estimated budgets on an annual basis for the corresponding years.

   viii) All LGs should be required to develop multi-year investment planning; ideally no less than three years plans; which should work as a rolling-investment-plan.

   ix) All projects in the rolling-plans should specify their financial sources and, as a whole, the plan should be both linked and fully consistent with the budgeted resources for annual capital expenditures.