To: Oscar Benavides, president of the Municipalities Association of Peru – AMPE

From: Henry Dyer-Cruzado

Subject: adjustment in property tax revenues for municipalities in the Peruvian State

This document aims at describing current challenges at revenue raising in property taxes for local governments amid an ample context of municipal weakness across the Peruvian State. Furthermore, I recommend to your organization to advocate for a change in the way the responsibility for property collection and vehicle tax collection is allocated for district and provincial municipalities. These recommendations are drawn mainly from IDB Peruvian chapter research paper on local governments revenue (IDB, 2015 with origins in Canavire-Bacarreza, Martinez-Vasquez and Sepulveda, 2012), although I will add some further rational for this policy change. Moreover, we start with a general broad description of the Peruvian municipalities system in order to frame the relative importance of this policy, which although important, addresses just a part of the policy challenges in local governments' revenues for Peru.

Peru is a unitary State politically distributed with a National Government, 25 regions, 196 provincial governments and approximately 1850 municipal districts (IDB, 2015: 199). Although income tax and sales tax combined represent two of the most important revenue sources for the States in countries like the US (Brunori, 2011: 1), these revenue resources are of National Government responsibility in Peru. In other words, neither regions, provincial government nor municipal districts have the right to collect taxes or approve policy changes within this realm. Furthermore, all three of them -regions, provincial governments and municipalities- are financially highly dependent on the National Government. To put it briefly, 95% of regions budget came from National Government transfers in years 2004 and 2008 (IDB, 2015: 204) and -in a similar vein- three quarters of municipal governments budgets -provinces and districts- were composed from National Government transfers for the same period (IDB, 2015: 204, 207). Sales tax or value-added tax is rather collected nationally, 2% of its total is distributed among municipalities for region, and municipal governments' trough a fund called FONCOMUN (accounts for nearly one third of municipal governments' budget).

In more detail, the FONCOMUN intends functioning as an equalization transfer program from the National Government to both Provincial and District municipalities -it was created in 1994-. As mentioned before, it is funded by the national 2% collection of the sales tax. Moreover, FONCOMUN's design includes three stages to allocate budget to the municipal governments (see table 1). For the first phase, the Ministry of Finance estimates a measure of unmet needs by the provinces considering population size and allocates these funds to Provincial governments. Furthermore, the second stage determines that Provincial governments keep 20% of total FONCOMUN revenues and allocate the resting 80% amid their District governments. In order to execute this allocation for their Districts, Provinces must follow three factors: *population*, which accounts for 85% and is distributed weighted by population -where rural population is assumed to need the double in expenses-; *managerial performance*, which accounts for 10%, and is measured as rate of growth in per capita revenue collection and proportion of FONCUMEN allocated to capital expenditures; and 5% to size of the district in kilometers. Finally, the third phase adds a minimum base of eight monthly UITs to every municipality[1] to ensure basic 'budgetary floor' (IDB, 2015: 215).

Moreover, the other main resource for the national transfers to the municipal governments are natural resources revenues called CANON, which are distributed among local governments with more weight on those that possess the natural resource (mining materials, gas, oil and others). This revenue source equaled to 32% of total revenues of municipal governments in average for year 2008. Furthermore, given that this revenue source allocates more money to those local governments where the natural resource is allocated, uneven distribution has appeared exacerbated by price changes in these commodities. For example, for the year 2008 (a year with high commodity prices) the Province government that received the biggest amount of CANON was given 25 times more money per capita for this concept (circa 24 thousand soles) than the Province government that received the highest amount from FONCOMUN (nearly one 950 soles).

In contrast, in terms of relevance, municipal Governments in Peru are responsible for property and vehicle taxes which were estimated as 9% of budget share in 2008 and charges & fees, 13% for the same year (IDB, 2015: 207). Furthermore, municipal governments currently have no discretion in setting tax -or other main revenue sources- rates. Municipal governments have the authority to collect revenues from vehicles property, bets & lottery games at the provincial level; and property taxes, property transfers, public shows and games at the district level (see table 2). All the rates for these sources of revenue -that in average account for 25% of their total income- are set by the Executive at the National level of Government in Peru.

[1] UIT is the Tributary Tax Unit (by its acronym in Spanish). The UIT is a legal monetary unit whose value has been set to 3,600 nuevos soles since 2010 (US$1,283 at December 31, 2010).

Specifically, property tax collection equals only 6% of municipal governments' revenue for the year 2008 (IDB, 2015: 207). Furthermore, municipal districts are the ones responsible for collecting this tax, while provincial local governments are those in charge for collecting the vehicle tax. Canavire-Bacarreza, Martinez-Vasquez and Sepulveda (2012) proposed to switch these responsibilities between provincial and district municipal governments given that property taxes collection requires more administrative capacity and a logic of economies of scale should be adopted.

This memo supports and adds another criterion constructed by Holland for an urban policy realm in the developing world (2015); namely, *forbearance.* According to Holland, even after institutional weakness -i.e. the local government lacks the administrative capacity to collect the property tax for this case-, there is an important extent to which local governments authorities in the developing world deliberately do not enforce the law in search of political gains. This, furthermore, differs, from the political pitfalls perspective depicted by Brunori (2011: 7) through which vested interest actors lobby to change the rules. In contrast, in many developing countries local authorities have enough informal influence to not enforce the law (property taxes payment, enabling street vending or squatter activities) in order to gain political support as a means of informal wealth distribution amid mostly poor households.

In this vein, the scholar adds that when local authorities are elected at a district level mainly poor they respond to these base by not enforcing law to be reelected. In contrast, when they are elected at the city level, they tend to be less sensitive to forbearance demand by their constituencies, given that richer households voter base have a better change to gain more weight (Holland, 2015: 357). Moreover, when Holland compared forbearance measures for street vending comparing between Bogota (with a city level election), Lima and Santiago (the latter two with district level election system), she found 71% and 78% less enforcement levels in poor districts in Lima and Santiago than in nonpoor districts for the same cities respectively and overall enforcement levels in Bogota (Holland, 2015: 358). Then, although with some external validity constraints, this suggest that provincial level authorities (with wider variations of wealth among their constituencies than district level authorities) will tend to have higher level of enforcement and, hence, collect higher levels of property tax revenues.

In this logic, this memo considers that a more concentrated responsibility to collect the property taxes among the 196 provincial governments instead of the 1850 municipal districts will enable better changes to control the current extended practice of *forbearance* to avoid property taxes collection in Perus' local governments.

Furthermore, I also agree with the recommendation made by Canavire-Bacarreza et al. (2012) about distributing the FONCOMUN directly to District municipalities. In the current system, the second phase provokes that districts with identical needs received different amounts of budget from FONCOMUN depending on which characteristics their neighbor districts have within the same Province. This logic goes against the equality orientation of FONCOMUN. Finally, I suggest that FONCOMUN incorporates in its equation the amounts of budget allocated per capita by the CANON (natural resource revenue) to an extent that it becomes more sensitive (or allocates more budget) to those municipal governments that are receiving net lesser transfers per capita. Moreover, a fixed set of year average should be considered for the CANON allocation in order to make it less sensitive to variation in commodities international prices.

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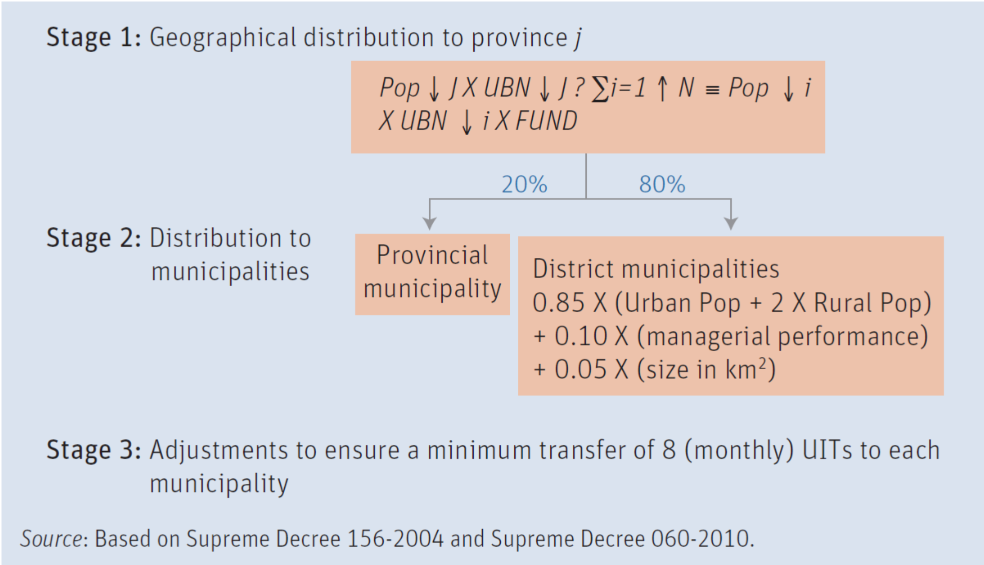
Table 1:

Distribution of the FONCOMUN to Municipal Governments



Source: Canavire Bacarreza, Martínez-Vásquez and Sepúlveda, 2015: 215
*UIT = Unidad Impositiva Tributaria or Tributary Tax Unit. The UIT is a legal monetary unit whose value has been set to 3,600 nuevos soles since 2010 (US$1,283 at December 31, 2010).

Table 2:

Revenues in municipal governments (provincial and district levels)

	Revenue shares		
District administration	**Districts**	**Provinces**	**Tax rates**
Land and buildings	100% (5% for cadaster maintenance)	0%	< 15 UIT*: 0.2% 15–60 UIT: 0.6% > 60 UIT: 1.0%
Property transfers	50%	50% (to Municipal Investment Fund)	3% (first 3 UIT exempted)
Games (pinball, bingo, etc.)	100%	0%	10%
Public shows	100%	0%	Bullfighting: 5% Horse racing: 10% Others: 15%
Provincial administration			
Vehicle property	0%	100%	1% (minimum: 1.5% UIT)
Bets	40%	60%	20% (horse racing: 12%)
Games (lotteries)	0%	100%	10%

Source: Canavire Bacarreza, Martínez-Vásquez and Sepúlveda, 2015: 208
*UIT = Unidad Impositiva Tributaria or Tributary Tax Unit. The UIT is a legal monetary unit whose value has been set to 3,600 nuevos soles since 2010 (US$1,283 at December 31, 2010).