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Fiscal Federalism and Performance Evaluation

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Preface

In México taxes are only collected in an amount equivalent to as little as 13% of Gross Internal Product (PIB), whereas in other countries, mainly in the most developed, the rate of collection with regard to the GIP fluctuates between 25% and 40%.¹ This is a truth that many know but a few conceive. A few people understand the relevance of low fiscal collection, it seems foreign to daily tasks of population. Most citizens think that this subject is exclusively a governmental issue and the results will only affect the government.

A serious problem in our country is the lack of financial resources that make possible a sustainable and viable development. If there are not resources, there is no possibility to have expenses, that is to say, lack of income results in no expense or the expenses only can be as much as the amount of this income.

In such technical, specialized and controversial matter, like is fiscal area, it is necessary to answer some questions to picture our situation, such as: Who should be in charge of collecting taxes? Who should collect resources that others spend? Who should contribute those resources? Who has the constitutional faculties to collect taxes? Who should design the expenses plan? And who evaluates the expense effectiveness and transparency?

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¹ *El Financiero*, note from Felipe Gazcón, "México, victim of fiscal violence", an interview with Carlos Elizondo Mayer-Serra, CIDE academic. February 13th, 2007.

México as a federation has members that subscribed a federal pact, which theoretically, should be take care of the subjects affecting all citizens, wherever they could be geographically. Usually, the States, members of a federal pact yield part of their rights and share responsibilities with the representing power of the federation, reason why in this work it is exposed briefly what fiscal federalism is, and its evaluation in the expense performance.

Problematic situation

One problem in Mexican Fiscal Policy is its regressivity in taxing matter, "big companies contribute with one percent of GIP, and whereas micro, small and medium size companies, landlords, professionals working in a freelance capacity and employees contribute with ten percent".²

Based on the information from Secretaría de Hacienda (Treasury Ministry) "at the end of the nineties taxpayers with income lower than 18 thousand pesos contributed 65% tax for individuals, while the people who earned income above 190 thousand pesos only contributed 8% form this tax".³ In addition to this, a high level of fiscal evasion and a culture of nonpayment of taxes, some media which has published that fiscal evasion reaches up to 40% from the collected amount, which means that the country can count on 40% of additional resources, only with making its collection more efficient. As far as the level of collection in the recent years is concerned, "96 pesos are acquired by the Federal Government from each 100 pesos collected, two by state governments and two by municipal ones".⁴

From the previous situation it is deducted that the federalist system of fiscal coordination is not working, reason why it cannot be spoken about federalism when a tributary joint responsibility between states, municipalities and federation does not exist; that is to say, a real commitment from the members that integrate the federal pact does not exist to take resources to the treasury of governments. The result is that, the Federal Government assumes the responsibility, almost exclusive, to collect taxes, whereas states and municipalities expecting patiently (sometimes not as much) participation from the corresponding income. Along with the previous situation, for some years an expense performance evaluation is being developed, reason why its translation into successful results in public policies and work effectiveness carried out by different public organizations is precarious.

² *Institute of Legislative Investigations of the Senate of the Republic (IILSEN). Mexican federalism (elements for its study and analysis). Edited by LVI legislature of the Senate of the Republic. Third edition. Mexico, 1998.*

³ *idem.*

⁴ *idem.*

The main subjects

The three orders of government (federal, state and municipal) and the powers that conform the first two, Executive, Legislative and Judicial, reintegrate taxes to the population in goods and public services by means of the execution of programs and projects contemplated in the public budget. Thus, the public sector becomes an intermediary of the society to redistribute the resources that contribute the taxpayers.

The allocations of the public expense are fundamental to reduce the restrictions of the economic development and the breaches of economic inequality between the population, by means of public policies for the development and the provision of goods and services that mitigate the disadvantage and inequality between the citizens; reason why the public expense becomes a tool of redistribution and creation of opportunities.⁵ But to have resources for the governmental expense it is necessary to have income. Here is where the Tributary Right plays an important role, in which exists a single active subject of the fiscal obligation: the State, because only it, as a sovereign being, is invested with the tributary power. In the States organized politically as federations, not only the Federal State owns sovereignty, but also federal organizations and they exert it with total independence from the central power (with the limitations imposed by the federal pact).⁶

In the Mexican Federal System, both the Federation and the states can exert the function of tax collection. This is the answer to one of the questions initially posed: Who should collect taxes? One of the main challenges is the low fiscal collection of the federal organizations and the municipalities that have the faculties and powers to do it.

Nevertheless, this is not done, so it can be that it is not subject of rights, but rather political one.

Fiscal federalism in theory helps to achieve a greater fairness in the fiscal aspect of transferences, the subsidies and participations. Through the balance in the limitations that some state and local governments can have, mainly in terms of technical capacity and infrastructure, with others that have a better position about it. Therefore, it is important, that members of the Federation joint and coordinate in the collection as well as in the expense approach. In regard of expense budget, we have more participation in states and municipalities, this,

⁵ Jorge A. Chávez Presa, *To Recover the Confidence in the Government*, F.C.E., 2000, pp. 25-26.

⁶ *Second Encounter of the Congresses in México: The Professional Legislator; Tuesday, March 11th, 2003, Legislative Palace in Saint Lazarus; Round Table: "Participation of Legislative Power in the conformation of fiscal Federalism", Speaker: Federal Deputy Jorge Alejandro Chávez Presa; Moderator: Representative Bernardo Borbón Vilches.*

from the political point of view, is more profitable. Resources can be required, say that there is not enough money and establish the appropriate formulas for the redistribution of fiscal income, the issue is to know who brings those resources.

The economical and political power of the government has been increased, at the decision and action capacity has been limited in the state and municipal governments. The same situation takes place between states and municipalities, where the state concentrates resources and power. Although there is reluctance of the states and municipalities to participate in tax collecting activities, the point is complicated and rejected by society, mainly by political issues. All this has distorted the operation of the federal pact, particularly the fiscal federalism, leaving behind the true collecting system and expense application development, under the principles of joint participation of all government orders.

The process toward a real fiscal federalism must necessarily go through some actions that guarantee results. Fortifying the attributions of the states and municipalities, but at the same time, generating the control, monitoring and evaluating mechanisms in all government orders. Only in this way they will be able to develop and consolidate effective tributary administration and transparent expense systems.

One more issue to consider in the federal federalism is the expense report that is transparent to citizens, enterprise organisms, and universities and, in general, the source of resources, size and application. In order to get population to be conscious of the financial situation of its government, specially the closest - the municipality, which makes a greater diffusion necessary of what its government has, source and application. It is not just enough to know how much and in what, the fiscal federalism should necessarily go through the transparency, in how much, from where and what for. We could begin to evaluate the financial efficiency and effectiveness of the governments, mainly, making them responsible when they don't fulfill a minimum effort to increase their financial capacity through the tax collection.

In current federalism necessary incentives do not exist, so that governments and taxpayers fulfill their respective responsibilities. There are no incentives, but there are no political, economic or legal punishments to help to invert the situation, it is easier to avoid collecting and avoid paying than fulfilling the obligation. A vitiated process that has to do with the institutional scaffolding.

Expense and the application of resources.

A part of fiscal federalism has to do with expenses and the application of resources, based on this, here come the question: who should spend, the Federal Government, the states or the municipalities? And who should pay the bills? They are subjects that have to take care, in parallel, with the achievement of resources. In the item of expense, Constitution assigns broad residual powers to entities, nevertheless their expense functions are not clearly defined. This is because the main powers are exerted along with the federation and sometimes with the municipalities, without delimiting the participation of each order of government.⁷

In regard of expense, the federation tends to dominate because of its greater control over public resources or simply thanks to the greater politic and economic capacity. In most of the cases, the specialization and professionalization of the government happened in the federal field. In the case of Mexico, there is a deeply rooted financial and political culture that consists of asking to a superior body: "Daddy government". The Federal Government and its faculties to administer the expense, even in the municipal level, was a factor inherited from the old PRI regime, where resources were used to apply political control over their different sectors. It was only enough with restricting the expense in certain community or state, to sensitize and align the governor o mayor in turn, leaving abandoned its population financial and politically.

"The lack of clarity in the allocation of powers has effect over the effectiveness of expense and the rendering of public services. Public politics are no defined, nor the public services are necessarily rendered, by whom has better information about the local preferences and needs. Also it turns more difficult to assume responsibilities for the performing in the rendering of services between the relevant authorities. That is to say, it is not clear which order of the government that is responsible at a certain time for the deficiencies in the services. Additionally, the definition of policies and planning becomes more complex by the uncertainty about the actions that will take the different orders of government".⁸

It is a fact that whoever can spend in the best way is the one that has the best information, since information causes that the best decisions can be taken. Although it happens, in many occasions, the one who knows the immediate needs of population is not the one who

⁷ *An agenda for public finances in Mexico; Fiscal federalism: diagnosis and proposals.* Gustavo Merino, Director of the Research Center in Public Policies of ITAM.

⁸ *idem*

can make decisions on the way to spend the resources. The municipalities are the closest bodies of government to daily problems of people, nevertheless, sometimes, the state or the federation are the ones that decide priorities and the items of expenses.

The federal and state expense

As of 1998 and as a result of the processes of decentralization, the local governments now exert greater resources than what the federation does, through the transferences that receive to finance multiple services. Previously, the federal expense was significantly superior to the one of the local governments. Nevertheless, although the transferences are greater it does not imply that these are necessarily translated into bigger power of decision of the local governments on regard of the expense”.⁹

Ways the federation exert the expense of federation in the entities:¹⁰

- Directly through federal public investment or in the rendering of some services. Its allocation is defined in a relatively independent way of the expense that the organizations consider high priority at a certain time, obeying rather to the plans and programs of the federal secretariats of state and to political factors.
- A bipartite expense is the one that make states and federation jointly. An example is the expense in the state universities, where the federation and each state grant resources in a proportion previously decree.
- Decentralized expense, which forms the major component of the federal expense in the states. It is made through the transference of the resources to the state authorities for the spent in specific areas. Normally they are areas that took care of in a time the Federal Government and during the decentralization processes responsibilities has been assigned to states and municipalities.

The big challenge before defining what the order of government that should make the expenses is, should be to know who is responsible for the activities that require resources. It is a hard task, after having lived so many years in a political centralism, reason why it is difficult to begin to decentralize activities and assign responsibilities.

The tributary powers

The Federal Government has powers on the main taxes, such as: income tax (ISR), value added tax (IVA), company assets (IMPAC),

⁹ *idem.*

¹⁰ *idem.*

foreign trade, hydrocarbon rights, specials on production and services and on new automobiles. In opposition, the tributary faculties of the municipalities are limited, since the taxes that can be collected are relatively low and, in some cases, hard to collect. The main tax that municipalities can receive is the property one and some rights. For the case of the states is the tax on the payroll (not all collect it), the taxes on public entertainment, and the tax on alcoholic beverages sale.¹¹

The result is an important imbalance among the tax collected by the federation, the states and municipalities. It is enough to see the numbers to demonstrate the comment above, “around 80% of public income is collected by the federation, whereas 14% is collected by the states, 2.4% by the municipalities and the remaining by Mexico City (D.F.), in comparison to other federal systems, the local governments collect the larger proportion of the public income.”¹²

Chart 1¹³

	COLLECTION	\$	%
A	FEDERAL GOVERNMENT INCOME:	1,511,815.70	66.9%
I	TAXES	1,003,841.00	44.4%
II	IMPROVEMENT CONTRIBUTIONS	17.60	0.0%
III	RIGHTS	471,353.20	20.9%
IV	OTHER TAXES	1,473.30	0.1%
V	PRODUCTS	7,721.80	0.3%
VI	LEVERAGINGS	27,408.80	1.2%
B	INCOME OF ORGANIZATIONS AND COMPANIES	726,596.80	32.1%
VII	ORGANIZATION AND COMPANY INCOME	589,663.80	26.1%
VIII	CONTRIBUTIONS OF SOCIAL SECURITY	136,933.00	6.1%
C	INCOME DERIVED FROM FINANCINGS	22,000.00	1.0%
IX	INCOME DERIVED FROM FINANCINGS	22,000.00	1.0%
	TOTAL INCOME	2,260,412.50	100.0%

Source: Internal with data obtained from article 1 of the Federation Income Law for the Fiscal Year 2007. Published in *Diario Oficial de la Federación* (Official Journal of Federation) on December 27th 2006.

To have a clearer idea of the prices that represent taxes under the federation control, in the following chart, the items integrating the total income of the federation for the fiscal year 2007 and the percentage that represents every one of them in the total sum of the budget. In the second chart, the items and the main taxes are shown; and they are 44.4% from the income total in the same concept.

	TAXES	\$	%
1	Income Tax	440,405.00	43.9%
2	Asset Tax	11,734.00	1.2%
3	Value Added Tax	428,710.00	42.7%
4	Special tax over goods and service production	59,995.00	6.0%
5	New Automobile Road Tax s.	17,286.00	1.7%
6	Foreign Trade Tax	27,585.00	2.7%
	Others	18,126.00	1.8%
	Total income because of taxes	1,003,841.00	100.0%

Source: Internal with data obtained from 1st article of the Law of Incomes of Federation for the Fiscal Year 2007. Publication of the *Official Journal of Federation* on December 27th 2006.

It can be observed that the Tax on the Rent and the Tax to the Added Value are the most important two sources to financing for the Federal Government.

It is necessary to mention that the high degree of centralization in the matter of income in Mexico is product of the National System of Fiscal Coordination (SNCF), which date from 1980. In the means of SNCF, the states were yielding tributary powers, including the capacity to modify the rates of some taxes that they still control, in exchange for greater federals transfers, specially, participations of the fiscal collection of certain taxes. "With the SNCF it was managed to eliminate the double taxation and other inefficient practices, at the same time as the collection was increased. Nevertheless, it derived in a high degree of fiscal centralism".¹⁴

¹¹ With data from SAT webpage, Offices of state treasury and *Diario Oficial (Official Journal)*, on December 27th, 2006, in which the Law of Income of the Federation for year 2007 was published.

¹² *An agenda for the Mexico's public finances; Fiscal Federalism: diagnosis and proposals*. Gustavo Merino, Director of the Center of Research.

¹³ Charts developed internally with data obtained from article 1 of the Law of In-

Participations and income of the States

At first, the participation system worked as a compensatory function for the states, for the income that would stop perceiving because of being part of the SNCF, nevertheless, as time went by the allocation criteria began evolving, although there is a slant in favor of the entities that perceive more since they are oil producers. The Fondo General de Participaciones (The General Fund of Participations) is the main component of the system of participations; in 1998 it represented 84% from the total. At present, the 45.17% from this fund is distributed based on the population of each entity, as a measure to promote more fairness. An equivalent proportion is distributed under the criterion of territoriality based on the assignable taxes, that is to say, those that are assigned to the place where they are generated independently of where they are collected. The rest is based in the inverse proportion to the participations by inhabitant".¹⁵

Elements considered for the General Fund of Participations:

- Population (measure to promote the fairness)
- Territoriality (where taxes are generated, independent of the place they be collected)
- Participation by inhabitant (inverse proportion)

The assignable taxes are:

- New automobile road taxes
- Special tax on production and services (gasoline, diesel and natural gas, alcoholic beverages and carved tobaccos).

In our participation system, the population element is an important measure to promote the fairness in the allocation of federal resources. The rule is: the bigger the population the bigger the resources, although is not definitive that this one is the best way to promote a more equitable development, since the criterion of distribution of resources does not consider the differences that exist between the entities in regard of their needs, public service cost, their fiscal capacity, the expense application efficiency. In fact, it does not give an incentive to the tax collection in the entities and on the contrary, it generates a vicious circle by "awarding" the states of larger population.

Within the total of participations, the amount of these represents around the 3% of PIB. If participations are considered part of the own income, the proportion of the public resources whereupon states and

comes of the Federation for the Fiscal Year 2007. Publication of the *Official Journey of the Federation* on December 27th 2006.

¹⁴ *Op.cit.*, Gustavo Merino.

¹⁵ *Federalism and fiscal coordination*. Amabilia Terrazas Solís. PRD fiscal coordination.

municipalities count is 25.8 and 5.23% respectively. At the same time, participation income represent an average around 80% of the total income of the entities (own income plus participations, excluding the Mexico City - Distrito Federal); what reflects that the entities have a high degree of dependency of the federal resources, that is to say, that the vertical breach in Mexico is elevated. "In many other federations, the dependency of federal transfers tend to be lower. Even so, the entities would exploit in an optimal way their tributary faculties, the fiscal breach would continue being ample, but could mitigate this problem with a better collection and the use of all the tax faculties available. Only five states and Mexico City (Distrito Federal) tax all the activities and services allowed by legislation (Coahuila, Mexico, Guerrero, Nayarit and Puebla). The tax to the payroll, for example, is applied only by 22 states".¹⁶

Municipal income

In the case of the municipalities, their main sources of income are the federal participations allocated by the state legislatures and the income tax. Although that the income tax has a high potential as a source of resources, at present its operation is not optimal, since many municipalities do not count on a suitable and updated property value system or simply they lack of an enough technical capacity. "At present the land value tax collection in Mexico represents the 0.2% of PIB. Even in years of high collection, this one has not managed to reach 0.3% of PIB and in some years it has been near or smaller to 0.1%. These numbers are compared in an incomparable way with the observed ones in other countries. The collection of income tax for other countries of OCDE represents in average 1% of PIB. In Argentina a similar relation is observed, meanwhile in Chile is almost 0.7% of PIB".¹⁷

The income tax is very clear and easy to collect, reason why is necessary to put order in the system of property registry. The taxpayer in Mexico is very clear in this tax and although is always uncomfortable to pay it, there is a good disposition to do it. Perhaps it has to do whereupon it is a tax that is related to the main patrimony of a family, their housing. This tax is a good source of resources for the municipalities; nevertheless, this is a tax in which the tributary base does not grow at the same rate of the needs of expense.

The municipalities obtain, in addition, income for rights, licenses and other concepts, nevertheless, in these sources of financing inefficiency in the collection appears. The prices of the services sometimes do not reflect the costs of providing them or the collection is

¹⁶ *Op.cit.*, Gustavo Merino.

¹⁷ *Op.cit.*, *El Financiero (The Financial)*, note from Felipe Gazcón.

irregular. This situation could be solved through the concession of the administration of collection to the individuals, although there are little municipalities that make use of the private sector for these aims. In Mexico, is very difficult that certain activities are transferred for their administration to the individuals because of corruption scandals that have appeared. Also, "between the obstacles to encourage a greater collection to municipal level are the short duration of the municipal administrations and the restrictions to legislate directly in fiscal matter. These institutional factors discourage the introduction of fiscal reforms, which can have immediate high political costs, but whose benefits in terms of greater collections are not obtained until many years later"¹⁸ as a result of the game of reputation of the politicians, that is to say, !that other do it and pay the political cost!

Better efforts

Which incentives it has to work in more efficient systems of collection if a significant variation between the states concerning to the proportion of the income exists that represent the participations. "Whereas in Nuevo León and Chihuahua, participation they represent in average 66% and 69% respectively of the state income, in Colima, Tabasco, San Luis Potosí and South Baja California, these come, during the same period, between 89% and 92% of the income of the state",¹⁹ Which has given rise to a discussion, that is promoted by the more efficient states in terms of collections, about the efficiency of the system of participations.

The approach is that, the current system does not incentive the state governments to become more efficient in the collection, is more, adverse incentives. The causes of, why not all the entities make the same tax collecting effort are varied. From cultural aspects to technological problems can be mentioned. It is not strange, from the cultural point of view, that states of the north are more efficient in the collecting effort that the states of the south. Nuevo León has a different culture from Chiapas or Oaxaca, combined to this, it has a higher education level and the technical development is outstanding.

The differences in the level of collection among entities are the result of diverse factors, between which are the capacity to generate income, because of differences in the taxable basis as a result of the degree of economic development and the productive activities, as well as the differences in the public administration of each state. In both cases the political development of the entity has an influence, that is to say, where a culture of provide accountability of the authorities to the

¹⁸ *Op.cit.*, Gustavo Merino.

¹⁹ *Fiscal Federalism*. José Gamás Torruco

citizens is more rooted and where there is a greater political alternation or a greater party competition, the public administration tends to be more efficient and to have a greater economic development.

Also, the present system of coordination generally creates a series of adverse incentives to the tax collection effort. Considering that fiscal bases that the states can exploit directly are generally narrow and sometimes poor, the political and administrative costs to raise this collection can be too high compared to the additional income obtained, mainly in comparison with the received by concept of participations and other federal transfers.

Conclusion

The Mexican Fiscal Federal System has brought about a big concentration of attributions in the Federal Government, leaving in a very comfortable situation, respect to the collecting activity, to the states and municipalities. In addition, of which the collection of taxes is an activity that politicians prefer to omit, deviate or transfer to someone else. Which originates a big concentration in the Federation, in comparison with the collected by states and municipalities. Between the diverse entities of the country there are differences. Thus, that under the same fiscal system some states is more efficient in the obtaining of the resources, when some states or municipalities present a greater political competition and a frequent alternating, which force them to make their collection and perform evaluation systems more effective. The competition for the power brings benefits, by improving the application of the expense and the accounting providing.

It is necessary to generate mechanisms, legislations and processes that try to transfer collecting responsibilities to the states and municipalities, beginning with making efficient the collection of the already established taxes, such as the income tax, to advance in the decentralization of other taxes. Also, to promote taxes of easy collection that at the same time fulfills the principle of fairness and proportionality, as is the case of IVA to foods where all would pay, and pay according to their level of consumption. At the same time, the governments would have to raise the necessary mechanisms to compensate the negative economic effects to the population with less resources.

Another important matter is to put incentives to the states and municipalities to make them more efficient and effective in the collection of taxes, because the reality, where the states that give more receive less resources is inefficient and promote the conformism in the states of low collection. It is necessary to implement a measure of

punishment for the states and municipalities that do not reach a minimum collection according to their demographic and economic profile

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