

## Chapter Six

# Chile

In contrast with decentralization strategies in Ecuador and Bolivia, which emphasize the role of growing and largely unconditional transfers, Chile gives priority to macroeconomic and fiscal restraint as well as to the development of incentives for overall productive resource use. It also favors selective and sectoral decentralization more than wide-open devolution of resources and competencies. However, Chile's adherence to tight macroeconomic and fiscal constraint—the country had consolidated fiscal surpluses for most of the period from 1985-97<sup>1</sup>—is akin to Brazil's recent fiscal correction and its Fiscal Responsibility Law.

Chile's approach to decentralization focuses on building institutions, developing processes and nurturing the “right” incentives in the rules and norms that flow from such processes and institutions. In the educational sector, the policy approach is to decentralize towards the municipalities and even to the school level.<sup>2</sup> For example, the Montegrande Project established a national competition system for 1,200 state-funded secondary schools to select models of school excellence. Participating schools managed their own funds as they saw fit in order to enhance academic performance.<sup>3</sup>

In the health sector, Chile decentralizes to markets and market-like environments. The country has a private system of competitive health insurance and a public scheme organized on the basis of a social security system that permits subsidized care to its beneficiaries. According to Larrañaga (1999, p. 223), while “the overall record of the Chilean health system is mixed, it has achieved universal coverage, high life expectancy and low child mortality relative to other countries at a similar stage of development.”

Chile's privatization and divestiture policies are an example of decentralization towards markets. Bitran, Guash and Serra (1999, p. 228) write that

<sup>1</sup> See Perry and Leipziger (1999).

<sup>2</sup> See Molina (2000) for the specifics of educational reform and in particular the emphasis on quality.

<sup>3</sup> See Cox and Lemaitre (1999, p. 171).

although Chile “has not succeeded in distributing the efficiency gains fairly between investors and users,” it is proceeding in the right direction, i.e., placing more reliance on incentive-based regulatory schemes than on cost-plus models. Galal et al. (1994, p. 17) report that while divestiture of public enterprises is widely referred to in Chile as privatization, “in recent years the latter term has been expanded to include everything from mixed public-private hybrids (for example, management contracts or leasing) to anything that makes public entities behave more like private ones (for example, incentive systems), to anything that makes private enterprises behave in practice more like they are supposed to behave in theory (for example, liberalization).”

Notwithstanding the unique characteristics of Chile’s decentralization policies, the country in its distinctive way is probably making more stable and effective decentralization progress than many others in Latin America. This is largely explained by the application of tight fiscal and budget constraint together with incentives to enhance the efficiency of overall public and private resource allocation.

In brief, Chile’s decentralization strategy balances a top-down approach (e.g., national sectoral policies and strong national institutions) with incentives and decentralized choices, management and evaluations.<sup>4</sup>

Chilean decentralization stands in striking contrast to the experiences of Brazil, Ecuador and Bolivia. For Latin American countries as a whole, the Chilean case offers guidance and best practices as to how to deal with specific problems.<sup>5</sup> While all countries are different and most reforms depend on historical and situational political contexts, some of Chile’s lessons may shed light on how to actually take advantage of the potential welfare gains offered by decentralization.

This chapter examines various aspects of Chile’s decentralization experience based on a series of interdependent questions. Is Chile’s a “centralist” country? Does it have a “unique” approach to decentralization? If so, what are its special features? What macroeconomic framework and institutional arrangements underpin Chile’s decentralization process?

## Macroeconomic Context

The importance of a stable macroeconomic environment to decentralization has been underlined throughout this book. Neither Ecuador nor Bolivia has

<sup>4</sup>For an examination of how well balanced this approach is, see Raczynski and Serrano (2001, p. 21).

<sup>5</sup>For a review of Chile’s reforms since 1973 and how they relate to those of nine Latin American countries, see Stallings and French-Davis (2001).

been able to fully meet this condition for decentralization, while Brazil, on the other hand, is rapidly moving in the direction of meeting it.

Chile maintained a consolidated fiscal surplus for most of the years between 1985 and 1997, and its positive outcomes have been attributed to “sound policies as well as sound fiscal institutions” (Perry and Leipziger, 1999, p. 4). By 1997, the Chilean economy had completed 14 years of continuous high growth that averaged 7.8 percent annually in the 1990s (Eyzaguirre and Lefort, 1999, p. 109).

Table 6.1 (Line I) shows that Chile’s overall combined public sector balance remained positive until 1998, when the economy was hit by recession. This situation was brought under control, and the combined public sector deficit was reduced to -0.3 percent by 2001. Since 1996, inflation has been below 6 percent. The current account deficit declined to -1.9 percent of GDP in 2001 from -5.1 percent in 1998. Interest payments on public debt have been below 1 percent of GDP over the past seven years.

For 2002, Chile agreed with the IMF to seek a central government “structural” surplus of 1 percent of GDP following a surplus of 0.2 percent in 2000. According to the IMF (2001a), “this new fiscal balance measure and target is defined with respect to the accounts of the central government, its derivation involving first a number of significant accounting adjustments to the traditional official measure, then the extraction of two estimated temporary components, both on the revenue side. One such component, standard in structural balance estimates, is the revenue effect of the deviation of output from its potential level. The other is an adaptation, which recognizes the significance of copper exports to government income in Chile and is based on the deviation of the copper export price from a specified reference price. The government announced that it would target a surplus of 1 percent of GDP of the resulting structural balance in each of the budget years 2001 through 2005.”<sup>6</sup>

Table 6.2 shows Chile’s macroeconomic performance over the past decade relative to other Latin American countries. Chile had the fastest GDP growth rate (6.5 percent) and, with the exception of Bolivia, the lowest inflation rate. It was the only country in the group to register a positive public sector balance (1.4 percent of GDP), and it had the highest investment ratio.

In brief, Chile’s macroeconomic management has probably been the best in the region over the past decade. Beyond these laudable figures, however, three questions emerge: 1) What policies explain these results? 2) Was decentraliza-

<sup>6</sup> Structural surplus or deficit is the one that takes into consideration, among other things, the economic cycle.

**Table 6.1 Chile: Key Economic Indicators***(Percent of GDP)*

Indicators	1995	1996	1997	1998	1999	2000	2001
<b>A</b> GDP real growth rate <sup>1</sup>	10.6	7.4	6.6	3.2	-1.0	4.4	2.8
<b>B</b> Current account balance <sup>1</sup>	-1.9	-4.1	-4.4	-5.1	-0.4	-1.4	-1.9
<b>C</b> Tax revenue (central government) <sup>2</sup>	15.5	16.7	16.3	16.3	15.6	16.4	17.2
<b>D</b> Pension contributions <sup>3</sup>	1.2	1.3	1.3	1.4	1.4	1.4	1.5
<b>E</b> Total revenue (combined public sector) <sup>4</sup>	22.5	23.3	23.4	23.4	23.2	24.4	25.1
<b>F</b> Total revenue (central government) <sup>3</sup>	20.9	21.7	21.7	21.6	21.3	22.5	23.2
<b>G</b> Total expenditure (combined public sector) <sup>4</sup>	20.0	21.3	21.6	23.1	24.5	24.3	25.4
<b>H</b> Total expenditure (central government) <sup>3</sup>	18.6	19.6	19.9	21.3	22.6	22.4	23.5
<b>I</b> Overall surplus or deficit (combined public sector) <sup>5</sup>	2.4	2.1	1.8	0.4	-1.3	0.1	-0.3
<b>J</b> Overall surplus or deficit (central government) <sup>3</sup>	2.4	2.1	1.8	0.4	-1.4	0.1	-0.3
<b>K</b> Transfers and subsidies from central government to private recipients <sup>1</sup>	4.2	4.5	4.6	4.8	5.5	5.5	5.9
<b>L</b> Pension payments <sup>3</sup>	5.2	5.4	5.5	5.9	6.6	6.6	6.9
<b>M</b> Interest on public debt <sup>3</sup>	0.7	0.5	0.4	0.6	0.3	0.4	0.5
<b>N</b> Transfers under Law 13, 196 <sup>1</sup>	0.5	0.4	0.3	0.3	0.3	0.4	0.4
<b>O</b> Education, health, social provision <sup>6</sup>	12.1	12.9	13.1	14.0	15.4	15.6	16.4
<b>P</b> CPI (end of period) <sup>1</sup>	8.2	6.6	6.0	4.7	2.3	4.5	2.6
<b>Q</b> Total revenue, public enterprises (combined public sector) <sup>7</sup>	13.5	12.2	11.7	10.4	10.8	13.1	14.4
<b>R</b> Unemployment rate <sup>8</sup>	7.3	6.3	6.1	6.3	9.8	9.2	9.1

Source: IMF (2001c) and Central Bank estimates.

<sup>1</sup>Source: Central Bank.

<sup>2</sup>Data as of 2001. Includes net tax inflows (including deductions for devolution of taxes). Source: Public financial statistics.

<sup>3</sup>Data as of 2001. Source: Public financial statistics.

<sup>4</sup>Central government. Source: Public financial statistics.

<sup>5</sup>General government. Source: Public financial statistics.

<sup>6</sup>Includes social expenditures. Source: Public financial statistics for 2001 and the Budget Law for 2002.

<sup>7</sup>Nonfinancial public entities (including CODELCO). Source: Public financial statistics.

<sup>8</sup>Average for January–March, April–June, July–September and October–December for each year.

**Table 6.2 Chile in the Regional Context, 1990–99***(Averages for the period)*

Country	GDP growth (%)	Inflation (%)	Public sector balance (% of GDP)	Current account (% of GDP)	Savings (% of GDP)	Investment (% of GDP)
Argentina	4.6	252.9	-0.8	-2.5	15.2	17.7
Bolivia	3.9	10.5	-2.3	-6.0	10.8	16.3
Brazil	1.8	843.6	-5.2	-1.8	18.8	20.8
Chile	6.5	11.7	1.4	-3.1	21.4	25.3
Colombia	2.8	22.3	-1.7	-2.3	23.3	21.6
Mexico	3.4	20.0	0.1	-3.7	19.1	22.9
Peru	3.8	807.9	-1.4	-5.3	16.0	21.3
Venezuela	2.2	47.1	-1.3	3.5	21.2	17.4

*Source:* IDB (2001).

tion a major priority within this overall policy framework? 3) What specific social gains were obtained from tight macroeconomic and fiscal environment?

With regard to the first question, Eyzaguirre and Lefort (1999, p. 120) report that “since the mid-1980s, Chile has sought a sustainable rate of growth through continuous control of internal demand expansion and an increasingly flexible exchange rate regime. It also has addressed traditional sources of macroeconomic instability, such as fluctuations in export receipts and capital inflows, as well as in the money supply. The positive results of this macroeconomic policy have fostered healthy capital market development, especially of the banking sector. In turn, the regulatory and supervisory efforts undertaken in both the banking sector and the bond and stock markets have contributed enormously to sound macroeconomic evolution. It is precisely the interaction between these policy areas that explains, in our view, the emergence of synergy between growth and capital markets.”

The strongest explanatory variable of Chile’s macroeconomic and fiscal success is the stability of the economic model over the past 20 years. Key structural reforms adopted in the 1980s—fiscal correction, central bank independence, privatization, financial reform, trade liberalization and regulatory reform—were maintained in the 1990s.<sup>7</sup> Today those reforms remain as largely shared principles of economic policy. The democratic governments of Presidents Patricio Aylwin and Eduardo Frei committed themselves in word and deed to not altering the essential elements of the economic model (Corbo, Lüders and Spiller, 2002, p. 81).

<sup>7</sup> Stallings (2001, p. 55) posits that “reforms, by themselves do not engender positive or negative results. They have to be considered within the broader context of international economics and other policies.”

As for the second question, decentralization was indeed part of the overall policy framework, but with a key caveat: it did not include a significant process of revenue sharing or large transfers from the national to the sub-national level. In 1993, the Regional Government and Administration Law, *inter alia*, established the regional governments and decreed that mayors could be directly elected by citizens. However, the administration of *la concertación* decided to duplicate investment resources allocated by regional decision mechanisms. Over 1992–97, regionally decided investments grew by an average of 28 percent annually (Serrano, 2001, p. 59).

With regard to the third question regarding social gains, it should be noted that reductions in levels of poverty and inequality are not one and the same. As Solimano (2000) has pointed out, achieving distributive justice involves much more than poverty reduction.<sup>8</sup> Chile has been more successful in reducing poverty than inequality (Valdez, 1999). Still, Table 6.1 shows that Chile increased social spending from 10.8 percent of GDP in 1990 to 14 percent in 2000, and the UN Human Development Index classifies Chile as a “high human development country” just below Argentina, Costa Rica and Uruguay.

“Chile has made remarkable progress in reducing poverty, both through macro policies which have produced a sustained rate of rapid growth, and well directed social programs,” notes a study by the World Bank (2001c, p. 9). “Few countries can match Chile’s record of cutting its poverty rate in half over a period of 20 years. However, problems do remain. Unemployment is high, particularly among the young.”

In sum, maintaining budget constraint and following prudent fiscal policy over two decades has compromised social and welfare gains in Chile. Most likely, it is the other way around: the country has substantially improved social welfare precisely *because* it followed such an approach, along with deliberate incentive-intensive policies that enhanced the effectiveness of social expenditures.

As summarized by Cowan and De Gregorio (2000, p. 148): “The income distribution in Chile today, is the fruit not so much of current social policies as of a combination of social policy, education strategy, health programs, and other initiatives put in place over the past two or three decades, if not longer.”

This point has also been underlined by Rodrik (2000) in his observation that “income distribution tends to be stable and fairly unresponsive to policy

<sup>8</sup>Solimano (2000, p. 32) writes: “The modern theory of distributive justice distinguishes between ‘outside’ (or morally arbitrary) factors (gender, race, initial assets, talent) and ‘personal responsibility’ elements (effort, risk-taking attitudes) in shaping the level of income, wealth, and welfare of the individual in society. Social inequality is a reflection of individual differences in these two sets of wealth-creating factors.”

changes.” This does not mean that income distribution does not matter; it matters perhaps more than anything else. Rather, as Solimano (2000) posits, it means that redistributive justice needs to be well understood in order for policies aimed at improving income distribution to be effective.

### **Intergovernmental Decentralization Framework**

Chile has a long tradition of state centralism. From its birth as a republic in the early 19th century, a strong president regime was the norm. However, according to Marcel (1999, p. 294) “over the past 20 years, major processes of decentralization have been undertaken, significantly changing the structure and operation of the public sector. These processes have had a political impact. For the first time all the municipalities in the country have mayors and municipal councils elected by local citizens; regional governments have been established with their own bodies, powers, and participatory arrangements.”

Chile’s decentralization process began in earnest in 1976, when the country was divided into 13 regions, 52 provinces and 325 *comunas*. In 1975, the National Fund for Regional Development (FNDR) was created to provide financing for investment in local infrastructure through a system of decentralized project identification. During the 1980s, the “municipalization” of primary education and health took place.

The 1991 constitutional reform introduced mechanisms to transfer more decision-making power from the central to the regional level and new formulas were devised for the allocation of resources to investment projects. Marcel (1999, p. 296) notes that with the increase in resources mobilized by the FNDR and other supplementary systems, regionally allocated public investment grew at an average annual rate of 21.4 percent from 1990 to 1997, increasing its share of total public investment from 13.7 percent to 26.6 percent.

Currently, “the municipalities and regional governments are endowed with specific responsibilities and powers in the areas of administration, delivery of social services, and investment in infrastructure. Most of these functions have been transferred from the central government, which has thus narrowed its scope of activity. This transfer of responsibilities has gone hand in hand with the transfer of considerable resources, varying from taxes and fees exclusively earmarked for municipalities to conditional transfers from the central government. Altogether, these resources represent some 5 percent of GDP, which is the equivalent of one-fifth of general government resources” (Marcel, 1999, p. 294).

Finally, in 1993 the Regional Government and Administration Law created the institutional entities of the “regional government” and the “regional council” as the two pillars of the subnational level of government.<sup>9</sup>

## Main Decentralization Instruments

Chile has in place the following five major instruments to implement its decentralization processes: 1) the Common Municipal Fund (FCM); 2) the National Fund for Regional Development (FNDR); 3) regionally allocated sectoral investment (ISAR); 4) locally allocated regional investment (IRAL); and 5) programming agreements.

### *Common Municipal Fund*

The Common Municipal Fund was created to redistribute resources from the fiscally strong municipalities to those with lower fiscal capacity. Hence, it has clear redistributive and equity purposes. The fund decentralizes resources and has a legal and institutional framework to assure that those resources reach the segments of the population in greatest need of public support. A proportion of municipal own-tax revenues was exclusively earmarked to be transferred from wealthy *comunas* to poorer ones.<sup>10</sup>

The Common Municipal Fund is a major instrument of decentralization. According to Schilling (1999, p. 6), its resources grew by 126 percent in real terms between 1992 and 1998.

### *National Fund for Regional Development (FNDR)*

Since its establishment in 1975, the FNDR has been a key decentralization instrument in Chile. During the 1982-83 crisis, it declined in importance, but in 1985, its spending tripled and new operational mechanisms were developed. The fund grew at a cumulative real growth rate of 80 percent between 1986 and 1991 (Marcel, 1999, p. 295).

<sup>9</sup>See Serrano (2001, p. 33).

<sup>10</sup>The main municipal bases that are “taxed” by this transfer are the property tax, vehicles, and fees (patents) on commercial activities. The resources are then distributed according to a formula that favors low-income groups.

The FNDR receives resources from the Inter-American Development Bank, directly from the national budget, and from the sectoral investment programs of line ministries.

According to a CIEPLAN study, the FNDR is one of the principal instruments of decentralized public investment, channeling about 40 percent of all regionally decided investment. The fund is popular because it is flexible and receptive to local and regional needs. In general terms, it focuses its operations in education and transportation (Serrano, 2001, p. 80).

The FNDR's participation in public investment over 1991-97 was stable at around 10 percent of total public investment, which grew by an average of 16 percent per year during that period (see Table 6.3) (Serrano, 2001, p. 50).

While FNDR now shares its influence with other fast growing instruments, (e.g., ISAR, IRAL) it remains critical to Chile's decentralization process, particularly because of its flexibility and capacity to finance small but strategic projects at the local level.

#### *Regionally Allocated Sectoral Investment (ISAR)*

Regionally allocated sectoral investment corresponds to those resources that line ministries distribute among the 13 regions. These resources grew significantly between 1992-97. Table 6.4 shows their relative participation in Chile's total public investment.

#### *Locally Allocated Regional Investment (IRAL)*

Regional investment resources are allocated locally through a program (IRAL) that began in 1996 to provide special support to municipal projects in the poor-

**Table 6.3 FNDR Participation in Chilean Public Investment**

(In percent)

	1991	1992	1993	1994	1995	1996	1997
<b>All 13 regions</b>	11.3	10.1	11.1	11.2	9.1	10.1	10.1

Source: Serrano (2001) and MIDEPLAN (2001, Table 5c, p. 157).

**Table 6.4 Relative Percent Share of ISAR Resources in Total Public Investment**

<b>All 13 regions</b>	1992	1993	1994	1995	1996
ISAR share	1.6	7.2	8.2	8.4	7.1

Source: Serrano (2001, p. 167).

**Table 6.5 Chile: Relative Shares of Programming Agreements between Regions and Ministries**

Level of government	1996	1997	1998
Regional	37.31	33.19	31.37
Ministries	61.75	66.54	68.63
Other	0.94	0.27	–
Total	100.00	100.00	100.00

est income groups. In terms of resources, IRAL is the smallest of the decentralization instruments. However, it grew by 32 percent in real terms between 1996 and 1999.

### *Programming Agreements*

These agreements began in earnest in 1996, when the Ministries of Public Works and Housing developed joint programs with regional governments to develop specific investment projects. In general terms, the largest share of the financing comes from the line ministries (Table 6.5).

### *Findings*

The articulation of these five decentralization instruments provides the framework for a large investment pool called regionally decided public investment (IDR), a unique configuration of institutions, funds, processes, and decision-making under a well-managed institutional web. The key strength is that most projects must compete with one another for resources. In other words, there are incentives that reward the best-prepared projects with additional resources, and all actors strive to access public resources in a competitive public environment.<sup>11</sup>

## **Redistributive Framework**

At the municipal level, Chile has a unique system of intra-municipal transfers from fiscally strong *comunas* to fiscally weak and poorer ones. The transfer finances the Common Municipal Fund. In 1990, this fund redistributed 40.9 percent of all municipal tax revenues (Table 6.6). While this share has grown only

<sup>11</sup> MIDEPLAN administers the National Investment System (SNI) according to well-known methodologies and procedures. The Integrated Project Bank (BIP) is part of the system.

**Table 6.6 Chile: Relative Share of the Common Municipal Fund (FCM)***(Millions of current Chilean pesos)*

Resources	1990	1995	2000
Total national tax revenues	1,448.251	4,750.119	7,237.238
Total municipal tax revenues	104.684	349.520	621.180
Common Municipal Fund	42.807	147.129	254.864
FCM as % of total municipal revenues	40.9	42.1	41.0

Source: Ministry of Finance Budget Office.

nominally to 41 percent in 2000, it will probably grow at a faster pace in the near future, as recent legislation authorizes municipalities to raise local taxes.<sup>12</sup>

### Intergovernmental Tax Structure

The characteristics of Chile's recent intergovernmental tax and financial flows make the country a special case. However, the important question is not so much whether Chile has a particular "model," but whether those characteristics are conducive to effective decentralization.

Table 6.7 shows that as a percentage of GDP, the tax share of Chile's municipal level grew during the 1990s. Municipal tax revenues represented 1.1 percent of GDP in 1990, grew to 1.4 percent in 1995 and reached 1.6 percent by 2000.

This growth of municipal tax revenues occurred while the national level share was also increasing from 14.5 percent of GDP in 1990 to 17.5 percent in 2000. This is similar to Brazil, where subnational tax performance grew as a percentage of GDP while the total for the federal government also grew (see Chapter Four).

Table 6.8 shows that municipal tax revenue as a percentage of total revenue grew from 7.2 percent in 1990 to 8.6 percent in 2000. A municipal tax share of 8.6 percent of the total is higher than the respective shares in Brazil, Colombia, Ecuador, Argentina, Mexico and Bolivia (Table 6.9). But this comparison may be misleading. After all, Chile has no significant "state" or "regional" level. For this reason, the comparison would have to be made between subnational sectors.

Table 6.9 shows that for the year 2000, Chile's "subnational" share (8.6 percent) of the total is much lower than those of Brazil (30.78 percent) and Colombia (19 percent) and higher than those of Ecuador (3.2 percent) and

<sup>12</sup> These are the revenue laws "Ley de Rentas I" in 2000 and "Ley de Rentas II" in 2002. The latter is still in progress.

**Table 6.7 Chile: Relative Shares of Tax Revenue by Level of Government**  
(Percent of GNP)

Level of government	1990	1995	1996	1997	1998	1999	2000
National	14.5	17.0	18.4	18.0	17.8	16.9	17.5
Municipal	1.1	1.4	1.5	1.5	1.6	1.7	1.6
Total national and municipal tax revenue	15.7	18.4	19.9	19.5	19.4	18.6	19.2

Source: Ministry of Finance Budget Office.

Note: This table refers to tax revenues collected by each level of government. That is, it excludes transfers among the states or levels. This is what could be called "own-taxes" by each level of government.

Bolivia (5.9 percent). But the interesting policy message is that Chile's municipal tax share is growing and will probably continue to do so, since new revenue laws (*Ley de Rentas I* in 2000 and *Ley de Rentas II* in 2002) are directed towards boosting municipal tax performance. In this respect, it could be said that Chile is moving towards a process of fiscal "municipalization," as is Brazil, Colombia and other countries in the region.

Table 6.10 shows a breakdown of the sources of tax revenues by level of government. At the municipal level, the largest increase in GDP terms (0.3 percent) took place between 1990 and 2000 in the territorial tax, which is the real

**Table 6.8 Chile: Tax Revenues by Level of Government**  
(Percent of total tax revenues)

Government level	1990	1995	2000
National	92.8	92.6	91.4
Municipalities	7.2	7.4	8.6
Total	100.0	100.0	100.0

Source: Ministry of Finance Budget Office.

Note: This table refers to gross tax revenues collected by each jurisdiction or level of government.

**Table 6.9 Subnational Tax Shares and Transfers in Selected Latin America Countries in 2000**

Country	Subnational tax shares	
	% GDP	% of total
Colombia	2.60	19.00
Brazil	10.21	30.78
Bolivia	1.10	5.90
Chile	1.60	8.60
Ecuador	0.50	3.20

Source: Table 1.1.

Note: Subnational tax revenues refers to municipal and state or regional own-tax shares.

**Table 6.10 Chile: Sources of Tax Revenues by Level of Government**

Tax revenue by government level	1990		1995		2000	
	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
<b>National</b>						
Income tax	2.6	16.4	3.9	21.0	4.4	22.8
Value added	7.0	44.9	8.2	44.8	8.5	44.3
Customs	2.4	15.4	2.1	11.3	1.5	7.6
Others	2.5	16.1	2.8	15.6	3.1	16.8
Total national level	14.5	92.8	17.0	92.6	17.5	91.4
<b>Municipal</b>						
Territorial tax	0.5	3.4	0.6	3.3	0.8	4.1
Municipal contributions	0.5	3.0	0.6	3.1	0.6	3.3
Municipal rights	0.1	0.9	0.2	1.1	0.3	1.5
Debtor fluctuations	0.0	-0.1	0.0	-0.1	-0.1	-0.3
Total municipal level	1.1	7.2	1.4	7.4	1.6	8.6
Total tax revenues (national and municipal)	15.7	100.0	18.4	100.0	19.2	100.0

Source: Ministry of Finance Budget Office.

state urban tax. Also in GDP terms, all major municipal taxes grew in the last decade.

Tables 6.11 and 6.12 provide another indication of Chile's gradual process of converging to a more conventional decentralization model that focuses on subnational shares of expenditure. While the subnational share in 2000 (2.6 percent of GDP) was low compared to most other Latin American countries, that share continues to grow. What is more relevant, however, is that in Chile, national expenditures and investment at the subnational level may provide for a more intense process of local participation. As stated earlier, all subnational projects in provinces and *comunas* have to compete for resources. In the end, a large portion of the benefits of decentralization is generated through this competitive and incentive-based process.

**Table 6.11 Chile: Intergovernmental Shares of Expenditures Net of Transfers**  
(Percent of GDP)

Expenditures by level of government	1990	1995	2000
National	18.1	18.7	22.4
Regional	0.2	0.3	0.4
Municipal	1.5	1.7	2.2
Total expenditures	19.8	20.7	25.0

Source: Ministry of Finance Budget Office.

Note: Excludes interest payments and financial investment.

**Table 6.12 Chile: Intergovernmental Shares of Total Expenditures Net of Transfers**  
(Percent of total)

Expenditures by level of government	1990	1995	2000
National	91.4	90.4	89.6
Regional	1.1	1.4	1.5
Municipal	7.5	8.2	8.9
Total	100.0	100.0	100.0

Source: Ministry of Finance Budget Office.

Whether these benefits are larger than those that could be engendered by a higher share of directly subnational-financed expenditures is hard to say. In any case, Chile is moving into a policy framework in which it will be able to reap the benefits of an approach that will combine the two incentive environments—one that comes from the current competition for access to national resources, and the emerging one in which municipal or subnational tax revenues gain ascendancy and provide the incentives for effectiveness.

Chile is particularly different from other Latin American countries in terms of transfers from the national to the subnational level. While these transfers can be as high as 5 percent of GDP in Colombia, 3.5 percent in Bolivia and 3.1 percent in Brazil, they amount to only 0.7 percent of GDP in Chile (see Tables 6.13 and 6.14).

**Table 6.13 Chile: National Transfers to Subnational Level**  
(Percent of GDP)

Country	National transfers to subnational level
Colombia	5.0
Brazil	3.1
Bolivia	3.5
Chile	0.7
Ecuador	6.6

Note: Subnational tax revenues refer to municipal and state or regional own-tax shares.

**Table 6.14 Chile: Relative Share of Transfers from the National to Subnational Level**  
(Percent of GDP)

Transfers	1990	1995	2000
National transfers to: <sup>1</sup>			
Regions	0.2	0.3	0.3
Municipalities	0.1	0.2	0.2
Total transfers	0.3	0.5	0.5

Source: Ministry of Finance Budget Office.

<sup>1</sup>These transfers are basically those related to the National Fund for Regional Development.

**Table 6.15 Chile: Relative Share of Municipal Revenues***(Millions of Chilean pesos for the respective year)*

Resources	1990	1995	2000
<b>A</b> Total municipal tax revenues	104.684	349.520	621.180
<b>B</b> Common Municipal Fund	42.807	147.129	254.864
<b>C</b> Total national tax revenues	1,448.251	4,750.119	7,237.238
<b>D</b> A/C (%)	7.20	7.40	8.60
<b>E</b> B/A (%)	40.90	42.10	41.00
<b>F</b> A as a % of GDP	1.10	1.40	1.60
<b>G</b> C as a % of GDP	16.00	18.00	19.00
<b>H</b> B as a % of GDP	0.46	0.56	0.67
<b>I</b> GDP	9,245,504	25,875,727	37,774,743

Source: Ministry of Finance Budget Department.

However, the relevant question is, why would larger transfers automatically imply more effective decentralization? Can it be said that when in Ecuador, Bolivia, Colombia and other countries the national government makes transfers to the subnational level, these countries are really inducing significant economic and social gains just from doing this?<sup>13</sup>

As was argued earlier in this book, the simple growth of transfers provides little indication that “real” and effective decentralization is taking place. Chile seems to abide by this nostrum, which is the correct approach. In most cases, unless transfers have an incentive to reward some desirable local fiscal and institutional behavior, they add little to effectiveness or to long-term subnational development.

Although Chile does not have a large system of national transfers to the subnational level, it has a unique mechanism through which wealthy *comunas* transfer, as a group, about 41 percent of their own-tax revenues to poor *comunas*. Table 6.15 shows that these intra-municipal transfers have been growing since 1990 and were equivalent to 0.67 percent of GDP in 2000.<sup>14</sup>

In brief, Chile’s transfers, while low in comparison to other countries, have been growing during the past decade. What matters is this policy trend.

Beyond the point of growing transfers lies the more important one of ultimate priorities. According to Arellano (2000, p. 166), “Chile has opted to

<sup>13</sup> In an insightful reversal of the transfer effectiveness argument between public intergovernmental levels, Ocampo (1999, p. 11) asks why transfers from the public to the private sector in the 1980s and 1990s under privatization schemes or foreign debt swaps are not considered as subsidies. Furthermore, he asks why they are not scrutinized as rigorously as other transfers.

<sup>14</sup> Regarding the evolution of transfers in Chile, see Marcel and Espinoza (1994, p. 58). These authors posit that between 1987 and 1992, national transfers excluding payments for education and health grew in real terms by 73.4 percent and absorbed up to 70 percent of permanent current revenues.

stress education rather than significantly increasing monetary transfers—as is shown in the figures for the past few years.”

## Findings and Conclusions

Does Chile have a unique approach to decentralization? If so, what are its special features? And, even more important, is it achieving in its own way decentralization results and attendant gains in welfare and efficiency? The answers to these questions are all affirmative. Yes, Chile has a unique way of capitalizing the potential benefits offered by decentralization. It anchors its model on tight budget constraint and incentive-intensive sectoral environment. And yes, the country is consolidating significant social and economic gains across income groups and regions.

Of particular note is that although Chile’s approach is different, it does not contradict fundamental principles of mainstream public economics or fiscal federalism. On the contrary, in terms of these conceptual frameworks, Chile is moving towards more intensive use of hitherto low-profile decentralization instruments and channels, slowing moving towards the enhancement of local tax authority and performance.

While still incipient, data clearly suggest that Chile is moving towards “municipalization” in terms of growing tax and expenditure shares at this level of government. While it is difficult to predict how Chile’s special model will evolve, the country is certainly well poised to capitalize on the benefits of the two incentive environments it is currently nurturing—one that comes from competition for access to public resources, and an emerging one in which municipal or subnational tax revenues increase and provide incentives for local institutional development and enhanced effectiveness.

Chile’s global approach to decentralization and subnational development is centered on the key premise that they are an integral part of overall public policy. That is, decentralization is not considered an independent process taking place apart from other public policies. Just as overall public policy is framed by market principles and by market-based operational approaches, so is decentralization policy.

Policymakers in Chile know all too well how imperfect markets can be and how costly it is for a country if it fails to make the right choices when confronted with the dilemmas of discerning market failures from strict market solutions. So far, Chilean policymakers appear to have made good choices

most of the time. The result for close to 20 years is a largely consistent policy framework.<sup>15</sup>

The point to underline about Chile's tight macroeconomic fiscal constraint is that it is based on a political consensus that practically dictates to all administrations that fiscal prudence must be the norm. This is the necessary pre-condition for the success of consistent macroeconomic policy. It is not a sufficient condition itself, since beyond that political restriction there is always the tough question of deciphering data, processes and transmission mechanisms to determine current fiscal results and those evolving underneath the surface of ordinary data.<sup>16</sup> Fortunately, Chile has the institutional and technical capacity to also meet this sufficient condition.

At the sectoral level, policy consistency is largely assured as a result of macroeconomic budget constraint. Once this constraint is a principle shared by all ministries, managers and heads of decentralized institutions will generally not try to stealthily subvert that macroeconomic order. Such constraint is not the rule in most Latin American countries, where ministries often promote programs that will adversely affect sectoral consistency and the common good of macroeconomic prudence.

Intersectoral policy consistency in Chile is also largely achieved through well-coordinated economic governance at the top. There is a sort of Executive Committee at the presidential level where key coordination is agreed to.

A key contributing factor leading to policy, project and program coordination is the National Investment System (SNI) and its Integrated Project Bank (BIP) managed by the Ministry of Planning (MIDEPLAN). This well established institutional arrangement selects the projects that deserve to be financed and exercises global surveillance to assure overall consistency.

In addition, Chile now has in place an ex post evaluation system to assess results of policies, projects and programs.

Given Chile's successful results with what amounts to a unique decentralization strategy, the question may arise as to the replicability of this model. In this regard, the usual caveat that all countries are different and have distinct institutional traditions is applicable. Hence, it is doubtful that Chile's approach is either replicable in its entirety or even advisable for most countries. What in principle does appear replicable, independent of historical idiosyncrasies, is the application of tight macroeconomic budget constraint. In fact, it would seem

<sup>15</sup> See Moguillansky (1999) for an analysis of Chile's experience with high market-based periods as well as with more interventionist ones.

<sup>16</sup> For a discussion of these complexities, see Easterly (1999).

that this feature must be a common denominator in all decentralization modalities, regardless of different country contexts.

However, this is only true in principle. What will be most difficult replicate is not so much macroeconomic budget constraint but the underlying political consensus that in Chile has established fiscal profligacy as a norm. Without prior political agreement on this condition, it is difficult to have tight budget policy.

On the replicability of Chile's model, Foxley and Saporelli (1999, p. 421), warn that "the country's historical development and context, the weight of its political institutions throughout its history, and the framework within which the transition process has taken place are, to say the least, uncommon." In brief, it would appear that while each country can and often must choose its own path in terms of a specific approach to decentralization, it may not be able to choose the underlying budgetary or macroeconomic policies. The benefits of decentralization will accrue only if macroeconomic budget constraint is tight.