

**Taxation, fiscal decentralization and legitimacy –
The role of semi-autonomous tax agencies in Peru**

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Abstract

This paper shows that semi-autonomous tax agencies can play a significant role in strengthening the effectiveness, efficiency and legitimacy of decentralized tax systems. It does so by analyzing the *Servicios de Administración Tributaria* (SAT), which currently operate in nine Peruvian cities. Findings indicate that the SAT collects local taxes and non-tax revenues more effectively than conventional tax administrations. Also, although the SAT-model *per se* does not generate strong incentives for the promotion of efficiency, there is some evidence that efficiency may become more important once the SAT are consolidated. Finally, there are hints that the Peruvian SAT contribute to the legitimacy of the tax system thanks to higher levels of transparency and client orientation.

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1. Introduction

Until recently, the issue of local revenue generation has not been a particularly prominent sub-field of developmental studies. Research on domestic revenues and tax reform in developing countries has focused almost exclusively on the national level, accounting for the fact that the percentage of public revenues generated at sub-national levels is typically rather insignificant (Fjeldstad and Moore, 2008; Aizenman and Jinjara, 2009). Decentralization has been a major topic in development policy and research, but given the high dependency of local governments on central state transfers, scholars have paid more attention to central-local fiscal relations, and less to local revenue generation as such (Bird, 2000; Oates, 2006; Hankla, 2008; Shah and Shah, 2006; Weingast, 2009). Donors have been increasingly interested in “good financial governance”, but their main focus has been on budgetary issues, trying to make sure that their taxpayers’ monies would be well spent (Leiderer and Wolff, 2007).

These days, however, local revenue generation is beginning to receive more attention by development researchers and practitioners. This has something to do with three major challenges developing countries face world-wide:

- First, as an outcome of urbanization and decentralization, local governments all over the world assume new functions as providers of public services (UCLG, 2008).¹ In this context, financing local government and public infrastructure is a crucial and frequently quite conflictive issue. The decentralization of tasks and competencies is not always accompanied by an adequate decentralization of funding (Bird and Slack, 2008).
- Second, many developing countries fall short of realizing their potential of internal revenue generation. For instance, most Latin American countries share a long history of low tax pressure (Perry et al., 2006: 92-97; ECLAC, 2007: 134). In previous years, structural revenue gaps could often be compensated through increased revenues from other sources, such as remittances, royalties, credits, etc. Today, however, the financial crisis is affecting public finance world-wide, making it necessary to mobilize resources in a much more active way. Tax administration reform and the fight against tax evasion and fiscal fraud will become a priority for many governments in the near future. This includes untapping the potential of local revenue generation.
- Third, issues such as fiscal accountability and legitimacy acquire additional relevance in development financing, as donors and international finance organizations introduce new development assistance modalities. The beneficial effects of tax administration reform, it is argued, go well beyond a mere increase in revenues. Raising the effectiveness, transparency and rule-obedience of tax systems contributes to a higher credibility of public administration in general, encouraging taxpayers to hold authorities accountable for their spending decisions and to push for additional public sector reform (Moore, 2008; Ross, 2004; Timmons, 2005). Local tax systems are particularly well-suited to promote good financial governance, since they collect revenues from a broad group of taxpayers. Also, the link between taxes and public services is assumed to be closer at the local level.

¹ With the term “public services” I mean to refer to the whole range of goods and services provided by public entities, including basic social services, security and legal protection, public infrastructure, etc.

Starting in the 1980s, some developing countries have founded so-called semi-autonomous tax agencies as a reaction to problems of revenue generation. These agencies are autonomous in their budget decisions, internal organizational structure and human resources management. Their main source of finance is a commission on the taxes and non-tax revenues they collect. Currently, they exist in a total of ca. 30 countries.² There are only few cases, however, where semi-autonomous tax agencies have been established at the local level.

Financing tax administration through a commission entails strong incentives to raise tax collection. At the same time, transferring tax authority to entities outside the core public administration involves certain political risks – especially, if a more robust tax collection does not go hand in hand with tangible improvements in public service delivery. Against this background, the main question to be discussed in this paper is whether semi-autonomous tax agencies are in fact an adequate response to problems of fiscal decentralization, revenue mobilization and good financial governance.

The paper presents the findings of an empirical study carried out in Peru in 2008/09. At present, Peru is the only country where the model has been applied on a broader scale at both, the national and the local level. So far, nine Peruvian cities have founded so-called *Servicios de Administración Tributaria* (SAT), with two other agencies to be inaugurated soon. The study combines a quantitative analysis of data on municipal revenues, provided by the Peruvian Ministry of Economy and Finance (*Ministerio de Economía y Finanzas*, MEF) with a qualitative research approach based on 66 semi-structured interviews in five Peruvian cities (Lima, Trujillo, Piura, Arequipa and Tacna).

The findings presented in the following sections indicate that semi-autonomous tax agencies can play a significant role in strengthening tax systems, even though they are certainly no panacea for every fiscal problem that may arise in the development process. (1) Peruvian SAT collect local taxes and non-tax revenues more effectively than conventional tax administrations. (2) The SAT-model *per se* does not generate strong incentives for the promotion of efficiency, but there is some evidence that efficiency may become more important once the SAT are consolidated. (3) Finally, although no conclusive evidence was found concerning the relationship of semi-autonomous tax administration and legitimacy, there are hints that the Peruvian SAT contribute to the legitimacy of the tax system thanks to higher levels of transparency and client orientation.

The following chapter provides a conceptual framework for the assessment of local tax systems (*section 2*). The paper then introduces the semi-autonomous agency model as applied in Peru since the 1990s (*section 3*), before presenting the findings of the field work with respect to effectiveness, efficiency and legitimacy (*section 4*). Based on these findings, the concluding chapter summarizes the strengths and weaknesses of the SAT model (*section 5*).

2. Assessing local tax systems

This section addresses the role of local tax systems from three different perspectives:

- Fiscal decentralization (or fiscal federalism) theory provides the basic criteria for analyzing local tax systems in terms of efficiency and effectiveness. From a fiscal federalism viewpoint we would look at increased efforts for local revenue generation as a reaction to hard budget constraints and growing expenditure needs at the local level.

² See Mann (2004); Taliero (2004) and von Soest (2008) for comparative analyses of semi-autonomous tax agencies in developing countries, and Fjeldstad and Moore (2008: 249-255) for a comprehensive summary of the debate.

- Starting in the 1980s, the New Public Management (NPM) approach has generated guidelines for public sector reform, emphasizing the introduction of private sector management tools and incentive structures. The establishment of semi-autonomous tax agencies can be considered a reform very much inspired by this approach: From a public management perspective we would regard these agencies as a response to deep-rooted problems of effectiveness, efficiency and transparency in tax administration.
- Recently, contributions to fiscal governance and fiscal contractualism have studied tax systems from a different angle, stressing their importance in terms of legitimacy and trust. From this perspective we would consider semi-autonomous tax agencies to be important factors of change in the relationship between (local) government and citizens.

2.1 Fiscal decentralization

The conceptual foundations of a decentralized provision of public services have been laid out by Oates's *decentralization theorem*.³ This theorem states that under the conditions of regionally different preference orders and the absence of economies of scale, a decentralized provision of public services will be more efficient than a centralized provision. Decentralized systems provide public services more efficiently, because they are better suited to respond to geographically diverse preferences of citizens or local collectivities, thus reducing over- or underconsumption. Also, the transaction costs linked to information, contract monitoring and accountability may be lower in decentralized systems because of the proximity of citizens (as "principals") and public authorities (as "agents").

A related argument in favour of fiscal decentralization refers to the principle of *fiscal equivalence* or *fiscal correspondence*.⁴ Fiscal equivalence is achieved when there is "a match between those who receive the benefits of a collective good and those who pay for it" (Olson, 1969: 482). In a world of perfect fiscal equivalence there is a complete congruence of economic, political and fiscal spaces. As a matter of fact, this principle bears close resemblance to the older and more general principle of *subsidiarity*. Subsidiarity means in this context that the production and provision of services should take place at the lowest collective level that allows for the complete internalization of costs and benefits. For both principles, the absence of externalities leads to efficiency.

Yet, taking a closer look at fiscal federalism theory teaches us to be cautious with decentralizing fiscal competencies, out of four reasons:

First, the principle of fiscal equivalence may turn out to be difficult to apply in real life. To begin with, it is often impossible to avoid cross-border externalities. In some cases, it may be too difficult or expensive to determine the exact distribution of costs and benefits. Also, tax systems may turn out to be overly complex if fiscal equivalence is pushed to its limits. Some public policies – such as education or environmental protection – lead to a new distribution of costs and benefits between generations, something fiscal equivalence hardly accounts for (Shah and Shah, 2006: 11). If jurisdictional and public service boundaries do not match perfectly, service providers and consumers have to deal with spillover effects.⁵

Second, efficiency gains from decentralization may turn out to be lower than efficiency gains from *economies of scale* through larger-scale revenue collection. Often, it is easier and less expensive to levy fees and taxes at the intermediate or national instead of the local level – even if from a fiscal equivalence perspective a local solution would be preferable. Collecting

³ See Oates (1972: 35) for the original formulation, Oates (2006: 3-12) for a recent discussion.

⁴ See Olson (1969), resp. Oates (1972: 33-35).

⁵ Eusepi (2000: 309) has coined the term "contractual fiscal equivalence" to account for the internalization of spillovers through contractual relations between individuals or jurisdictions.

different taxes through a single agency may provide additional benefits in terms of efficiency and effectiveness (*economies of scope*).

Third, focusing on local preference orders alone may endanger the minimum standardization of public services necessary for social cohesion in modern nation-states. Such a situation is especially dangerous in societies with weak internal cohesion, important ethnic or territorial cleavages, or highly segmented economies. Therefore, some central government transfers may be required for the sake of political unity, even though they may have adverse effects in terms of accountability and efficiency (Shah and Thompson, 2004: 22).

Fourth, public policies are often executed in steps or sequences, involving various institutional actors within a multi-level governance system. It is not always easy to determine which part has to be decentralized and which part should remain under central government control. This holds true for the tax system as well: Many taxes are neither purely centralized nor purely local (Bird, 2000: 16).

Strengthening local revenue collection can be considered an important part of fiscal reform. The fiscal decentralization literature suggests that anybody concerned with fiscal policy should be suspicious of situations where the costs of public services and the benefits arising from their consumption do not fall upon the same group of actors. Therefore, a fiscal system based exclusively on central government transfers to finance local public services would hardly be considered suitable. Even accounting for the limitations of local tax collection,⁶ a certain degree of tax autonomy would be required.

2.2 Public management reform

Public financial management and fiscal decentralization are crucial reforms from a new public management (NPM) perspective. Rather than referring to a consolidated body of theory, this approach is based on a diverse set of principles, guidelines and management tools geared towards higher levels of efficiency and effectiveness in public administration. It came into being as a response to fiscal crises and bureaucratic rigidities that plagued the industrialized countries in the 1970s and 80s. The basic idea was to improve the efficiency and quality of public administration by introducing private sector management tools. Among the reforms promoted by the approach, the following stand out:⁷

- Introduction of results-based management instead of management by rule. Deconcentration of responsibilities within individual organizations or administrative branches. Establishment of internal cost centres and introduction of double-entry bookkeeping or accrual accounting as opposed to traditional public sector or cash-based accounting.
- Promotion of market competition in public service provision, either through private sector participation (privatization of public enterprises, sub-contracting and licensing, public private partnerships, etc.), or through the encouragement of competition within public entities (benchmarking, market simulation, contract management, etc.).
- Improvement of allocative efficiency⁸ through better accessibility of public services (extended office hours, larger variety of access channels, establishment of one-stop service centres, simplification of processes) along with a more active participation of stakeholders in public policy design, budgeting and public service delivery.

⁶ Traditional fiscal federalism would recommend a local tax system based on property taxes and user charges (Bird and Slack, 2008: 225-226).

⁷ See Manning et al. (2008); Hood (1991); OECD (2004), OECD (2005a); OECD (2005b).

⁸ Allocative efficiency “measures how well service or infrastructure bundles match consumer preferences” (Campbell et al., 1991: 6).

- Strategic use of information and communication technologies (ICT) for the automation and simplification of procedures, the procurement of goods and services, the interaction with customers and the transaction of administrative processes (e-government).

With its focus on internal decentralization, institutional diversification and case-by-case modernization, NPM has paved the way for the introduction of semi-autonomous tax agencies. Although the approach has sometimes been criticized for its strong emphasis on public sector downsizing and privatization (Minogue, 2001), its key contribution to public sector reform refers to the fundamental change from bureaucratic input control to management by results. In addition to this, NPM has contributed to lowering the barrier for outsourcing public service delivery and introducing private sector management tools.

In terms of the general guidelines of public sector reform, NPM has led to a new vision of public administration. Modern public entities regard themselves above all as service providers and problem solvers for clients and citizens, whereas traditional public administrations (especially those with a strong Weberian legacy) perceive themselves to a much larger extent as embodiments of public authority and executors of a superior common interest.

2.3 Fiscal governance

In recent years, a significant strand of the literature on fiscal policy has begun to examine the influence of fiscal regimes on legitimacy, trust and democratic rule.⁹ From this perspective, a fiscal regime based on equity and accountability would be considered a key asset of a political order seeking legitimacy.

What are the conceptual links between tax policy and legitimacy? Basically, three arguments are put forward: (i) A fiscal policy that strengthens social cohesion enjoys higher levels of legitimacy. (ii) Dependency on taxes (as opposed to other revenue sources) eventually leads to fiscal contractualism between governments and citizens, thus contributing to legitimacy. (iii) A tax system based on transparency, technical capacity and procedural legality may acquire its own “stock” of legitimacy. The following paragraphs take a closer look at these arguments.

Social cohesion: Modern states are expected to grant their citizens minimum access to basic services such as education, health, legal protection, etc. But beyond that, citizens need to regard the social order they are living in as reasonably “just” or “fair”, in order to feel fully included. This has something to do with social mobility and equity. Mobility means that there should be no barriers to higher levels of welfare and social status other than individual merit. Equity means that the social distribution of wealth and income should enable the largest possible part of society to make a decent living out of their individual or household incomes (ECLAC, 2007).

Because of the relevance of mobility and equity, societies with high levels of cohesion shape the public revenue system so that the tax burden is distributed in a fair and equitable way. Usually, this implies the tax burden to be shared evenly between members of the same social strata, avoiding excessive subsidies in favour of particular groups (horizontal equity). In addition, the richer sectors of society are supposed to contribute a larger share of their income than those who have less (vertical equity). Hence, an important distributive function of the state refers to the implementation of a broad-based, equitable and progressive tax regime (Stewart, Brown and Cobham, 2009).

Fiscal contractualism: Another line of arguments would point out that states whose revenues depend mostly on taxes tend to be more responsive to the demands of their citizens compared

⁹ For instance, see Ross (2004); Mahon (2005); Moore (2007); Moore (2008); Fjeldstad and Moore (2008); Manning et al. (2008); OECD (2007: 29-65); OECD (2008a); OECD (2008b: 41-42).

to states with alternative sources of revenue. At the same time, citizens who pay taxes are more inclined to demand and make use of their right to control the government and hold authorities accountable for their decisions (Mahon, 2005).

The basic trigger here is the emergence of a contractual relationship between the state and the taxpayers. Although there is always a certain element of coercion in taxpaying (nobody actually *likes* to pay taxes, not even in the most democratic and equitable setting), governments usually find it easier to obtain tax compliance when offering something in return (e.g., better services), instead of relying on force alone (Timmons, 2005: 530; Moore, 2007: 14-15; OECD, 2007: 33).

Legitimacy of tax agencies: The legitimacy of complex political orders is hardly ever based on a single quality (such as, for instance, rule of law or charismatic leadership). Rather, there are different *legitimation patterns* which are employed simultaneously by different political actors or entities and which refer to different aspects of the political process. By drawing on specific legitimation patterns, tax collection agencies acquire their own legitimacy, thus contributing to the overall legitimacy of the political order. This is especially true for semi-autonomous agencies with an independent organizational structure and public image. The following patterns appear to be especially important (von Haldenwang et al., 2009: 36-41):

- Procedural legality and transparency: Adherence to procedural rules is an important source of legitimacy. By acting in accordance with the law and keeping their constituency well-informed, tax agencies may be able to establish a relationship of trust which in turn may enhance the legitimacy of tax collection – especially in cases previously characterized by nepotism and unlawful behaviour of tax collectors.
- Technical capacity: Tax agencies may legitimate themselves by gaining a reputation as technical, non-political bodies with a high level of professional expertise and capacity. This is a legitimation pattern similar to the one employed, for instance, by central banks or constitutional courts.¹⁰
- Reference to shared values: Finally, tax agencies may allude to values widely shared by their constituency, such as fairness, justice and respect. By broadening the tax base, cutting corruption and nepotism and improving the way taxpayers are treated at the counter, tax agencies may aspire to be regarded as legitimate expressions of the public interest, rather than epitomes of arbitrariness and extortion.

This section has shown that the debates on fiscal decentralization, public management reform and fiscal governance provide relevant criteria for the analysis of semi-autonomous tax agencies. The following section gives a brief introduction to the Peruvian case.

3. Fiscal decentralization and local tax collection in Peru

In fiscal terms, Peru is still a rather centralized country. In the ten year period from 1998 to 2007, the 1.834 municipalities¹¹ collected only between 1.7% and 2.2% of total tax revenues. The local share in public spending, however, has risen steadily, from 9.2% in 2004 to 14.0%

¹⁰ The pattern builds on Max Weber's notion of "office charisma" (*Amtscharisma*). See Weber (1976: 142-148 and 671-679).

¹¹ At the end of 2007, there were 1.640 district municipalities (*municipios distritales*) and 194 provincial municipalities (*municipios provinciales*). The relationship between both is not totally clear. In a number of public service issues, the provincial municipalities assume supervisory or coordinating functions for the districts that lie within the respective province, but mostly they just cover the affairs of the "central district" (*cercado* or *zona metropolitana*). Looking at fiscal competencies, only provincial municipalities collect motor vehicle taxes and traffic ticket fines, covering the whole provincial area.

in 2007. Another 16.8% are spent by the 25 regional governments¹² who depend entirely on transfers from the central government. This leaves the national level with a 69.2% share of total public spending (INDE Consultores, 2007: 7).

The growing participation of subnational levels in public spending is partly due to a decentralization process which has taken off in 2001/02, but has yet to be completed. Under Presidents Toledo and García, the Peruvian Government succeeded in transferring a number of competencies to the local and regional levels. However, the centrepiece of the reform, the creation of five macro-regions in replacement of the *departamentos*, failed to receive the necessary approval in a referendum in October 2005. The 25 *gobiernos regionales* are elected by popular vote, as are the mayors (*alcaldes*) and municipal councils (*concejos municipales*).

Local authorities have the right to collect a number of taxes and non-tax revenues (see Table 1), but only a few of the larger municipalities use the full range of revenue raising opportunities granted to them by law. On the other end of the spectrum there are over 500 municipalities with less than 5000 inhabitants, many of which do not generate any revenue at all, depending entirely on central government transfers.

Table 1: Local revenue sources

Own revenues	Non-tax revenues (<i>Recursos directamente recaudados</i>)	<ul style="list-style-type: none"> – User charges (<i>arbitrios</i>) – Administrative service charges – Licence fees – Proceeds from the sale of municipal assets – Income from rents and leases – Betterment fees – Fines
	Municipal taxes (<i>Otros impuestos municipales</i>)	<ul style="list-style-type: none"> – Real estate tax (<i>impuesto predial</i>) – Conveyance tax (<i>impuesto de alcabala</i>) – Motor vehicle tax (<i>impuesto al patrimonio vehicular</i>) – Tax on non-sportive public events (<i>impuesto a los espectáculos públicos no deportivos</i>) – Gambling tax (<i>impuesto a los juegos</i>) – Betting tax (<i>impuesto a las apuestas</i>)
Transfers and other revenues	Transfers	<ul style="list-style-type: none"> – <i>Canon</i> (from mining and other activities)¹³ – Fund for Municipal Compensation (<i>Fondo de Compensación Municipal, FONCOMUN</i>)¹⁴ – Participation in customs duties – Royalties from mining – The “Glass of Milk” programme (<i>El Vaso de Leche</i>) – Camisea Fund for Socio-economic Development (<i>Fondo de Desarrollo Socioeconómico de Camisea, FOCAM</i>)
	Other sources of finance	<ul style="list-style-type: none"> – Donations and other transfers (e.g., development assistance funds) – Credits from domestic capital markets – Credits from foreign capital markets

Source: CAD, 2004: 12-15; Boza Dibos, 2006: 17-21

¹² In addition to the 24 *departamentos*, the *Provincia Constitucional de Callao* (Peru’s major port) has a regional government.

¹³ The *canon* is a coparticipation scheme whereby a certain share of the corporate income tax of specific economic activities (50% in the case of mining companies) is allocated to the municipalities and regions affected by that activity. Apart from mining, which is by far the most important sector, there are *canon* transfers in the fishery, forestry, gas, oil and hydro-energy sectors. See Boza Dibos (2006) for a comprehensive discussion.

¹⁴ Together with the *canon minero*, the FONCOMUN constitutes the most important transfer mechanism. It is financed mainly through the “Municipal Promotion Tax” (*Impuesto de Promoción Municipal, IPM*), a surcharge of 2% on the national sales tax (*Impuesto General a las Ventas, IGV*). See López-Cálix, Alcazar and Wachtenheim (2002: 5); Rühling (2005: 5).

Although Peruvian municipalities have been given some fiscal competencies, they enjoy little fiscal autonomy (Ahmad and García-Escribano, 2006: 13). Taxes and tax rates are established by national law and cannot be modified by local governments. Also, user fees are mostly determined by central government regulations. These regulations can be rather demanding.

For all that, local governments have witnessed a substantial increase in their revenues in recent years; thanks largely to the dynamic growth of the economy.¹⁵ Locally collected revenues have grown by 6.4% annually in nominal terms between 1998 and 2006. However, transfers have been growing even more, leading to a declining role of local revenues in overall municipal financing. At an aggregate level, locally collected taxes and non-tax revenues financed 44.3% of the municipal budgets in 1998. In 2006, this share had been reduced to 27.3%. At the same time, the *canon minero*, which accounted for 6.8% of total local revenue in 1998, covered 34.3% of municipal budgets in 2006, making it the biggest single source of income for local governments.

While the recent revenue *bonanza* has been welcomed by local governments, their growing reliance on transfers has also caused concern.

- Both the FONCOMUN and the *canon minero*, which together accounted for over 80% of total transfers in recent years, are based on rather volatile income sources. Their volumes vary in accordance with the economic cycle and fluctuating commodity prices at the global markets. This complicates medium-term budget planning at the local level.
- Also, transfers are often subject to conditions in terms of spending and accountability (Ahmad and García-Escribano, 2006: 7). Many municipalities have experienced severe problems in executing their budgets, due to cumbersome conditionalities in combination with deficient project planning and executing capacities.
- Finally, the Peruvian transfer system fails to ease existing problems of territorial heterogeneity. In fact, it rather exacerbates them. This is above all the result of the *canon minero*, which is distributed to regions and municipalities with mining activities, regardless of their socioeconomic situation. Other transfer mechanisms partly account for socioeconomic development, but the overall distributional effect of the transfer system is clearly regressive (Ahmad and García-Escribano, 2006: 21; INDE Consultores, 2007: 11; Polastri and Rojas, 2005: 764).

As a result of growing spending responsibilities in combination with low levels of fiscal autonomy and stability, local revenue collection has remained an important issue, even under the condition of fiscal affluence in recent years. It is in this context that local governments have turned to tax administration reform and to the establishment of semi-autonomous tax agencies.

3.1 A short history of the SAT

The first SAT started operations in Lima in 1997, following an example set by the national government. President Fujimori had created the National Superintendence for Tax Administration (SUNAT) in 1988. Starting up in 1992, it was among the first semi-autonomous tax authorities worldwide. SUNAT's strong performance, together with Fujimori's tough fiscal centralism, motivated the municipal government of Metropolitan Lima to found its own SAT under the direction of a former head of SUNAT. Two other cities (Trujillo in 1999 and Piura in 2000) followed suit, together forming the first generation of SAT in Peru. Four further cities (Chiclayo, Huancayo, Cajamarca and Ica) started operating their SAT in 2003, constituting the second generation of SAT foundations. The current, third generation began with Tarapoto in

¹⁵ The following numbers are based on data provided by the Peruvian Ministry of Economy and Finance (MEF, 2007).

2007 and Huamanga in 2008 and will probably include Tumbes and Chimbote in the course of 2009. Other cities, such as Cuzco, are considering the SAT model as well. At the same time, there have been some experiences – most notably, Arequipa, Peru’s second largest city – where the introduction of SAT has failed and local governments have returned to conventional tax administration.

The motivation for founding a SAT has changed over time. The first generation (Lima, Trujillo, and Piura) can be seen as a reaction to excessive centralism and drained resources brought onto the provincial municipalities by the Fujimori Administration. After 2001, SAT were established in the context of a decentralization process which granted local governments more responsibilities, requiring them to improve their fiscal management. In addition, more recent SAT are building on the successes of the older SAT with regard to revenue collection and the enforcement of tax liabilities.

In legal terms, founding a SAT is not a difficult thing to do. Local governments have the competence to create decentralized agencies (*Organismos Públicos Descentralizados*, OPD) by means of a municipal council resolution. As OPD, the SAT have their own budgets¹⁶ and organizational structures. They can hire their personnel irrespective of public sector staffing policies, and pay competitive salaries within the limits of OPD regulations. The SAT make their own investment decisions, independently of the municipal investment budget. Typically, they run their own offices, separated from the municipality building, and create an own corporate image by means of uniforms, logos, slogans, etc.

However, the SAT are not completely autonomous. Most importantly, SAT directors are appointed by the mayor, and their continuance in the position hinges above all on the confidence the mayor places in them. Also, the commission levied on taxes and non-tax revenues is determined by the municipal council.¹⁷ Thus, maintaining close relations with the council is a key aspect of SAT management, regardless of the council’s formally weak position with respect to the SAT budget. At the end of the day, the degree of SAT autonomy vis-à-vis the local government is less a question of formalities. Rather, it is contingent on the political will of the authorities and the value they place on the longer-term benefits of a more independent SAT. In this context, an older SAT is presumably in a better position to resist political pressure, since it already has a record of achievements and good practices to bring into play.

4. How do the SAT perform on effectiveness, efficiency and legitimacy?

In general terms, it can be said that the SAT have fared well with regard to the effectiveness of tax collection. Concerning the efficiency of tax administration, evidence is less clear, but there are some indicators for efficiency gains, especially if compliance costs are taken into account. With respect to legitimacy, the initial experiences of the first SAT (especially of SAT Lima) have been mixed. However, with the consolidation of the SAT model, the modalities of tax collection and public relations have changed and civic acknowledgment of the SAT as an “appropriate” institution appears to have grown. In the following paragraphs, these observations will be discussed in detail.

4.1 Effectiveness

In order to assess the effectiveness of tax collection, the revenues raised by the seven SAT founded before 2007 were compared to those of 22 municipalities with conventional tax ad-

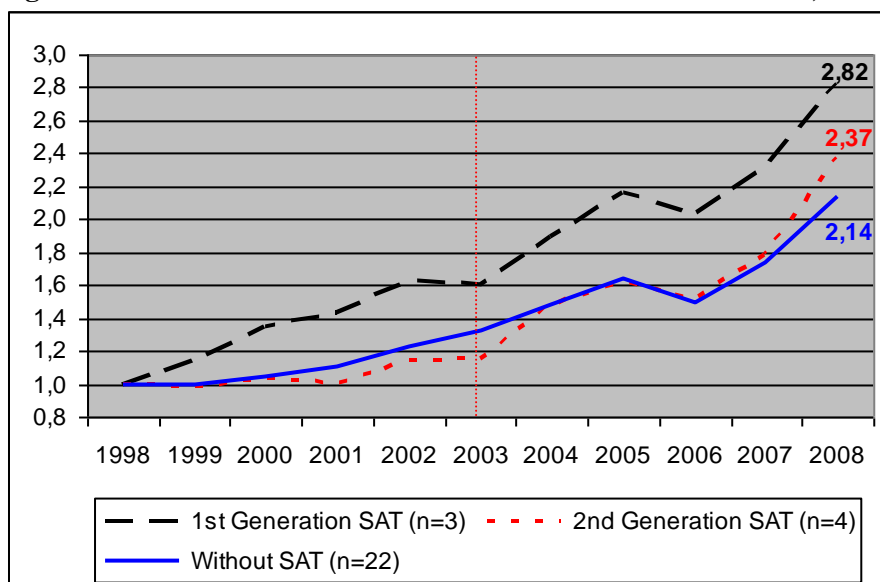
¹⁶ The budget has to be approved by the Ministry of Economy and Finance (MEF), and is subject to control by the Comptroller General (*Contraloría General de la República*).

¹⁷ Currently, commission rates lie between 4.5% and 10%, covering between 40% and 70% of the SAT budgets.

ministrations. The analysis used data provided by the Peruvian Ministry of Economy and Finance (MEF). The comparison group comprised provincial municipalities with property tax revenues over 900.000 soles in 2006¹⁸ and for which data were available for the whole observation period (1998-2008).

Over this period, cities with SAT achieved a non-weighted mean annual growth rate of 13.4%. The cities of the control group raised their revenue collection by an average of 9.2% per year.¹⁹ This is a significant difference. One should bear in mind, though, that the number of SAT is small and the period of observation rather short, since four of the seven SAT started to operate as late as 2003. In cumulative terms, local revenue generation of the three older SAT was 2.82 times higher in 2008 than in 1998. The four SAT founded in 2003 achieved a cumulative growth of 2.37, compared to 2.14 obtained by the cities with a conventional tax administration (see Figure 1). It should be noted, though, that the four second-generation SAT performed worse than the control group in the years before 2003.

Figure 1: Growth of tax collection in cities with and without SAT, 1998-2008



Source: Own calculations based on MEF data.

Several cost factors are not included in the figures mentioned above. On the one hand, some SAT received an initial amount of investment capital from the municipality which does not appear in the statistics. Also, local governments presumably had to assume additional costs from the dismantling of the former tax administration units. On the other hand, in the figures provided by the SAT group the actual costs of tax administration are already deducted, since they are covered by the commission and other fees charged by the SAT *before* transferring the

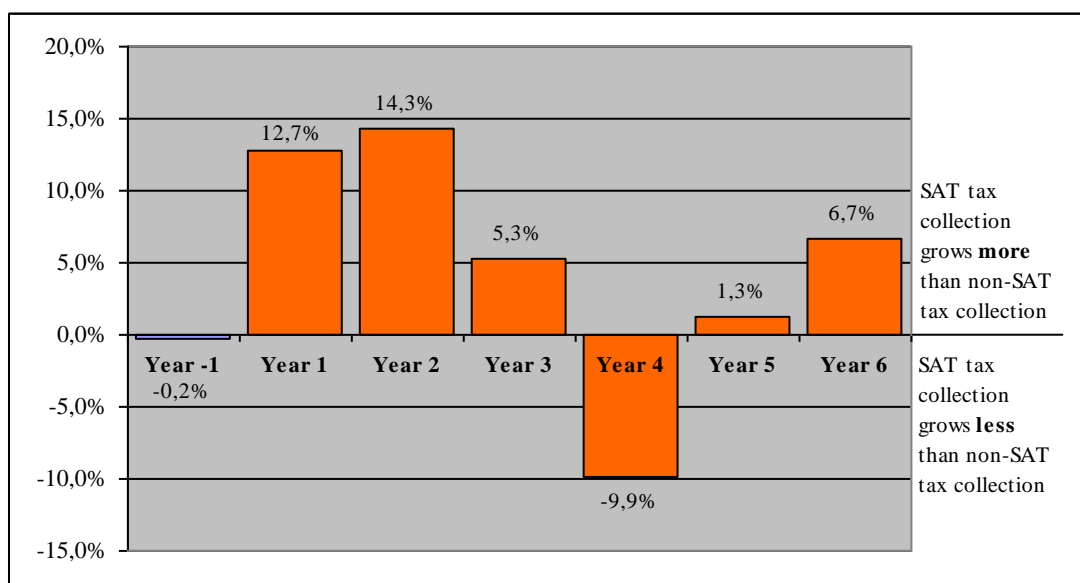
¹⁸ Approx. EUR 213.700, as of 31.12.2006. Two provincial municipalities passed this threshold, but could not be included in the sample because data were incomplete. Further, various *district* municipalities, most notably in the Lima metropolitan area, achieve higher (in some cases, much higher) incomes from property tax than the 900.000 soles mentioned above. However, since provincial municipalities and district municipalities have different competencies in terms of tax and non-tax revenues, the latter group was not included in the comparison.

¹⁹ All numbers cited in this paragraph refer to *nominal* growth rates. The city of Tarapoto established a SAT in 2007. Consequently, it was excluded from the control group and included in the SAT group for the period 2007 and 2008. Huamanga founded a SAT in 2008 and accordingly changed groups in that year.

collected funds to the municipality. For cities with conventional tax administration, in contrast, those costs appear only at the expenditure side of the budget. Taking this difference into account, and although information on the real costs of revenue administration in conventional municipalities is not available, it is fair to assume that the actual performance of the SAT is even better than shown by the comparison.

Another observation refers to the fact that the performance of the SAT vs. conventional tax administrations varies over time. Especially in the first two years after the establishment of a SAT, growth rates are substantially higher, as increased efforts in tax assessment and enforcement lead to an activation of older liabilities and to a broadening of the tax base (see Figure 2). This is in line with findings from other cases,²⁰ but the question remains whether the SAT can outperform the conventional tax administration over a longer time span.

Figure 2: Yearly performance of SAT relative to conventional tax agencies



Source: Own calculations based on MEF data

The present paper does not provide a conclusive answer to this question. For the complete group of seven SAT included in the analysis, data exists only up to the sixth year of their existence. In five of these six years, average SAT growth rates exceeded those of the control group by margins between 1.3% and 14.3%.²¹ This seems to indicate that the SAT maintain their good performance over time. However, the number of cases is too small and the observation period too short as to constitute a robust support for the thesis of longer-term SAT superiority.

²⁰ See von Soest (2008: 10-32) with reference to semi-autonomous revenue agencies in four African countries.

²¹ In the fourth year of their existence, however, SAT perform almost 10% worse than non-SAT municipalities. This striking underperformance has to do with the fact that for four of the seven SAT this year falls on calendar year 2006. In that particular year, revenue collection has been diminished by a series of adverse factors, all of which affected the SAT more than conventional tax administrations. For instance, incoming President García kept a campaign pledge and cut traffic ticket fines by half. In cities with SAT, those fines account for 13.7% of incomes (1998-2006), while in the 22 cities without SAT, they only contribute 7.4% to locally collected revenues. Also, being 2006 an electoral year, SAT were under a lot of political pressure to limit the unpopular enforcement of tax liabilities. Other factors include a Constitutional Court ruling against user charges (see Flores Apaza, 2007: 3) and a fire that devastated the Chiclayo SAT in September 2006.

Finally, an important aspect of effectiveness refers to the steadiness of incomes. An improved collection of revenues from property taxes and user charges should in principle contribute to a lower variation²² in local revenues. In fact, looking at the period 2003-08 (with seven SAT operating), SAT register a variation of 12.9% compared to 18.5% for the cities without SAT. If just the three oldest SAT (Lima, Trujillo, and Piura) are taken into consideration, the variation is even lower (10.2%). Again, the numbers should be read with caution, but they can be taken as initial support for the thesis that the SAT contribute to a stabilization of local revenues.

The superior performance of SAT compared to conventional tax administrations can be traced back to a combination of strategies and tools:

- Increased efforts in tax liability assessment and the broadening of the tax base;
- Increased efforts in enforcing tax payments and in lowering default rates;²³
- Reform of internal organization and planning processes;
- Strategic human resources management;
- Investments in infrastructure, especially in information and communication technology (ICT).

Many of these strategies and tools could also be employed by conventional tax administrations. In fact, reform-oriented local governments, such as for instance the city of Tacna, have implemented a number of the above-mentioned reforms with considerable success. However, the incentive structure embodied in the SAT model leads to a *sustained* interest and a higher *persistence* in the pursuit of tax administration reforms. This is typically not the case in public entities, where reforms are carried through in an on-off manner and are frequently abandoned once the initial impetus is lost.

4.2 Efficiency

The SAT collect more revenues than conventional tax agencies, but this could be due to an increased input of resources rather than to the approach itself. Next to meeting revenue collection targets, the actual costs of tax administration should be another important criterion for the quality of SAT operations. SAT efficiency can be analysed from a perspective of internal (production) efficiency or from a broader perspective of allocative efficiency, including above all the costs of tax compliance.

A financing model based on commissions does not *per se* engender stronger incentives for efficiency, compared to the conventional model of integrated tax administrations. In fact, high revenue growth rates may even cause a relative loss of efficiency. There is a certain risk that the SAT model may bring about self-privilegization or sumptuous spending, for two reasons:

- First, tax agencies are not subject to market competition. They act as monopolists on behalf of the municipality. Compared, for instance, to private sector companies working under a concession model, the SAT have fewer incentives to raise their internal efficiency.
- Second, there is an underlying problem of information asymmetry: The municipal council as principal may find it difficult to assess the cost efficiency of its agent, the SAT, because the assessment has to be based on information provided by the SAT itself.

²² The variation coefficient measures the standard deviation from the trend line of incomes divided by the mean income. The lower the numbers mentioned in the text, the smaller the oscillations of locally collected revenues with respect to the mean value.

²³ The default rate refers to the total of *notified* liabilities in relation to actual tax collection. It does not account for *potential* liabilities to be generated through increased tax assessment efforts.

Evidence on SAT efficiency gains is inconclusive. Above all, the available data does not allow comparing the internal efficiency of the SAT to that of the control group because there is very little information on the efficiency of conventional tax administrations. However, there are some findings which suggest that internal efficiency acquires more relevance once the SAT are consolidated. Concerning overall efficiency, the SAT focus specifically on lowering compliance costs.

Internal efficiency: The basic approach to internal efficiency in tax administration is to raise labour productivity by reorganizing and automating administrative procedures, by linking databases and by simplifying processes. Without exception, the SAT invest heavily in ICT, both in terms of infrastructure and software development. In Lima, the most advanced of the SAT in terms of ICT, 95% of internal transactions are digitalized. The other SAT are lagging behind, but our interviews with Peruvian experts indicated a broad consensus on the superiority of SAT infrastructure over conventional tax administrations.

There are different opportunities for efficiency gains at different points in time. A look at the cost structure of SAT Lima reveals that spending (without debt servicing) went down from 60.3 million Soles in 2005 to 38.7 million Soles in 2007. More importantly, there was a 43% cut in unit costs, which sank from 0.16 Sol per Sol collected in 2005 to 0.09 Sol in 2007.²⁴ This was largely due to a lower intensity of tax liability assessments, which are rather labour intensive. In the first years of SAT operations, efforts go into broadening the tax base, particularly with regard to property taxes and property-related user charges. Once the tax registers are brought up to date, a first assessment of liabilities has taken place and the credibility of tax collection is established, agencies are in a good position to take in efficiency gains.

Through the fixing of commission rates, local governments (mayors and municipal councils) are able to exert pressure on the SAT with regard to internal efficiency. For instance, the municipal council of Trujillo decided to lower the commission of its SAT from 8% to 3% in 2008.²⁵ This was by far the lowest rate among the Peruvian SAT. In most cases, commission rates are currently set at 8% to 10%. SAT Lima operates with a 5% commission.

As yet, however, there is little evidence referring to the strategic use of commission rates on behalf of municipal councils. For instance, municipalities do not seem to engage in any benchmarking regarding the existing SAT. Also, changes of commission rates appear to be negotiated on an ad-hoc basis, rather than set in an incremental and pre-announced way. This makes it more difficult for the SAT management to adjust its medium-term investment and budgeting targets.

Allocative efficiency: The information provided by the SAT shows that making tax paying less costly and complicated for citizens and enterprises is considered a key success factor. All SAT employ the following mechanisms: (i) extended office hours (evenings, weekends), (ii) installation of one-stop service desks, (iii) simplification of processes and requirements, (iv) reduction of waiting time at the counter and (v) the opening of additional access channels for information, service delivery, and payments, mainly through call centres and the internet.

In some cases, employees received special training on how to treat customers at the counter. Also, many SAT have followed the example of SUNAT in establishing special units for the most important taxpayers (*principales contribuyentes* – PRICOS).

²⁴ Data provided by the SAT Lima Management in February 2008.

²⁵ Originally, the commission was to be set at 5%, since various important investment projects had been concluded in 2007. The additional 2% cut came as a total surprise to the SAT management. For 2009, the rate has been raised again, up to 4.5%. See GTZ (2009: 2).

Various SAT (especially Lima and Trujillo) have begun to gather information on compliance costs, for instance by measuring the average waiting time and by assessing client satisfaction. Customer surveys show that taxpayers do appreciate these service improvements.²⁶ So far, however, SAT do not use customer surveys as a means to monitor and evaluate client satisfaction (or compliance costs in general, for that matter) in a systematic way. In combination with the setting of internal targets and the publication of results, customer surveys could be a powerful instrument to assess and further strengthen the allocative efficiency of the SAT.

At present, the SAT have not fully exploited the potential of efficiency gains arising from the cooperation with other agencies or public entities. For instance, most SAT insist in developing their own tax administration software, instead of pooling resources or learning from each other. Also, there is still little systematic exchange of data with other public bodies, such as the municipal land registry office or the National Superintendence of Public Registers (SUNARP).

4.3 Legitimacy

Typically, the SAT come into being after years of laxity and corruption in local revenue collection. As they aspire to bring about a fundamental change in the prevailing tax culture, they tend to put pressure on local taxpayers, especially in the first phase of operation. Consequently, first generation SAT had to face a lot of popular resistance in reaction to their robust behaviour. Second generation SAT have fewer problems with credibility, since they can build on the image created by the first SAT. The third generation SAT founded these days are in an even better position to refer to the older agencies as examples of good practice in public administration – especially since the local SAT and the national SUNAT perform rather well in public administration quality surveys and competitions.²⁷

Over the years, however, the SAT have remained a conflictive issue in local politics. In various SAT cities, mayors have been elected on the pledge to fight “SAT abuses” and even dismantle the agency altogether. Yet, in no case this promise has actually been kept. Once in office, it seems, the incumbents quickly learn to appreciate the benefits of an effective tax administration.

There is a variety of causal relationships between the legitimacy of local revenue collection and the operation of the SAT.²⁸ In some cases, the relationship works in favour of legitimacy, while in other situations it may contribute to weaken the legitimacy of the tax system. Among the positive factors, the following stand out:

Setting limits to political influence: The SAT have established themselves as technical agencies working independently from the otherwise ubiquitous pressure of local political interests. Also, the SAT have ended the widespread practice of tax amnesties, which were often used as an instrument for political clientelism. Furthermore, the SAT appear to select their staff on the basis of individual merit and competence instead of political or personal connections. In all the SAT visited, both management and staff members emphasized the importance of a transparent and merit-based staff selection process.

²⁶ For instance, in January 2008 a survey at the SAT Trujillo showed that 84% of the customers were satisfied with the waiting time. 71% found that the time needed to attend their request was adequate. 75% were satisfied with the information offered by the SAT. Survey data provided by SAT Trujillo in March 2008.

²⁷ For instance, see Mann (2004: 18). Since 2005, the public sector watchdog NGO “Ciudadanos al Día” (CAD) organizes a yearly competition on good practices in public management (*Premio a las Buenas Prácticas en Gestión Pública*). In various cases, SAT have been among the winners. See www.ciudadanosaldia.com/premiobpg2009/default.htm (accessed 04.06.2009), with additional references to previous years.

²⁸ The following observations are based above all on interviews with Peruvian stakeholders conducted in 2008.

Fighting corruption: Typically, endemic corruption has been a key motive for the creation of a SAT in the first place. With regard to tax systems, corruption results in lower revenues, lower tax compliance and, in general, lower levels of trust and credibility in public administration. Corruption in tax administration is influenced by (i) the frequency and duration of contacts between staff and customer, (ii) the (lacking) transparency of laws, regulations and procedural norms, (iii) the complexity of proceedings, (iv) the quality of internal checks and balances, (v) the perceived individual risk of engaging in unlawful behaviour, (vi) existing salary and incentive schemes, (vii) political influences and clientelistic networks, and (viii) public opinion towards corruption.

From our interviews with Peruvian stakeholders and experts it appears that the SAT have been quite successful in fighting corruption. So far, only one case of intended corruption connected to a SAT has been reported, whereas stories of corruption involving conventional tax administrations abound. Although no institutional setting offers complete protection from corruption, the SAT have acted upon the above-mentioned risk factors by (i) improving the procedural transparency through the use of ICT and the automation of proceedings, (ii) creating internal control bodies (*oficinas de control interno*) and cooperating with external control organizations such as the ombudsperson's office, (iii) accelerating and simplifying the contact between taxpayers and staff and improving the information basis of taxpayers, (iv) starting operations with a completely renovated staff, thus cutting existing bonds of clientelism and corruption, as well as (v) employing professional staff and paying attractive salaries.

Enhancing transparency and customer-orientation: As public agencies (*Organismos Públicos Descentralizados*, OPD), the SAT are subject to the Fiscal Responsibility and Transparency Law.²⁹ Almost all the SAT have internal ombudspersons who deal with taxpayers' complaints. Also, they engage in public campaigns in order to raise awareness concerning the importance of taxpaying. Even more importantly, the SAT put much effort in their customer-orientation, (i) introducing new payment modalities, (ii) simplifying procedures, and (iii) improving customer attendance at the counter. This not only leads to lower compliance costs, but also to higher degrees of client satisfaction and legitimacy.

Strengthening equity: By broadening the tax base and enforcing tax compliance, the SAT contribute to promoting the principle of equity, which is crucial for the legitimation of modern democratic regimes. However, the study found little evidence of the SAT ever using this principle as a legitimizing device. In their public relations the agencies seem to put little emphasis on this aspect of their work.

Various features of the SAT model and its operation modalities have affected the legitimacy of tax administration in a negative way:

Limited impact on public service delivery: Above all, SAT legitimacy has been put into question by weak linkages between tax collection and public service delivery. Apparently, many local citizens live under the impression that they are now obliged to pay for public services which have not improved in equal measure. This may be due to an unavoidable time lag between rising revenues, new public investments and the effects these investments have on infrastructure and service delivery. Also, municipalities may have used parts of the additional revenues to cut subsidies instead of improving services.

However, there is also a crucial institutional factor: Being separated from the core municipal administration, the SAT find it difficult to establish close communication links with the local service providers. As they intensify the collection of taxes and user charges, they are often the first to receive citizens' complaints concerning service delivery. Still, in none of the cases

²⁹ República del Perú: Ley de Responsabilidad y Transparencia Fiscal, N° 27958 of 2004.

analyzed in the study a regular, systematic exchange of information between tax agencies and service providers has been put into practice.

Excessive use of coercion: As has been mentioned above, the SAT encounter low levels of tax compliance and credibility at the beginning of their operations. Often, they resort to coercive means of tax collection. This is especially true for Lima, being the oldest and by far the biggest of the Peruvian SAT. The most visible instrument of coercion is the impoundment of private property, above all vehicles, but taxpayers feel also harassed by frequent reminders, urging letters and phone calls. The “zero-tolerance policy” employed by SAT Lima in 2004 and 2005 was received with a flood of negative reports in the mass media, focussing for instance on the higher salaries of SAT employees compared to public sector officials. In the electoral year 2006, most SAT were obliged to refrain from coercive collection, which led to diminishing revenues. In recent years, the SAT seem to be more aware of the need to find a balance between coercion and the promotion of voluntary compliance through other means.

Lack of rule-obedience: Related to the use of coercion, there have been some widely publicized cases where SAT have actually exceeded their competencies. In 2005 and 2006, the ombudsperson’s office published two reports on illicit behaviour of tax agencies, again singling out SAT Lima as the main perpetrator (Defensoría del Pueblo 2005 and 2006). Most cases refer to the flawed assessment of user charges (*arbitrios*) and to the unlawful embargo of properties. According to information provided by the Defensoría del Pueblo and the Fiscal Court (Tribunal Fiscal) in 2008, however, there have been very few complaints ever since.

5. Conclusion

The SAT model appears to be an interesting approach to local revenue generation, but it should not be taken as a panacea. The previous section has shown that the municipalities with SAT were able to increase local revenue generation more than comparable municipalities with a conventional tax administration. Further, there is some evidence that the SAT may obtain internal efficiency gains in the long run, and that they have succeeded in lowering compliance costs, thus improving the allocative efficiency of the local tax system. With regard to legitimacy, there seem to have been some serious problems in the years previous to 2006, but there are also hints that the SAT model is consolidating itself as good practice in tax administration, and that there is growing public acknowledgement of the benefits the model offers both to citizens and local government.

Still, the findings have also highlighted various important weaknesses of the SAT model, such as the lack of incentives for efficiency improvements and the risk of legitimacy problems arising from robust revenue collection. Hence, the Peruvian case provides relevant insights with reference to the three lines of thinking introduced above: fiscal federalism, new public management (NPM) and fiscal governance.

From a *fiscal federalism* perspective, the application of the SAT model can be considered a positive move, showing a strong commitment to revenue generation on behalf of local governments. Following this line of thinking, national governments would be well advised to stimulate the founding of local semi-autonomous tax agencies, most notably by decentralizing the needed fiscal and administrative competencies, and by imposing hard budget constraints on sub-national governments.

At the same time, however, national governments need to be aware of the fact that the model will only suit a small number of big and advanced cities. There will be hardly any case where the SAT model can be taken as a solution to local revenue generation as a whole. Quite to the contrary, national governments should be prepared to face a growing polarization of local

conditions, as SAT cities are going to improve their service delivery as well as their fiscal situation, while the rest of local governments will probably lag behind.³⁰ Hence, the promotion of semi-autonomous revenue agencies in the bigger cities would have to be inserted into a broader strategy geared toward local revenue generation and the rationalization of existing transfer mechanisms.

The SAT model incorporates basic *New Public Management* (NPM) principles, such as the introduction of results-based management, private sector management tools and the reform of existing incentive structures. From this perspective, the positive results documented above would be considered a corroboration of the premises of this approach.

To a certain extent, however, the SAT also reflect some of the weaknesses often attached to NPM: By concentrating on individual institutions, the approach tends to create islands of modernity in a sea of backwardness. This may be suitable for a modern, rather homogeneous and well-equipped public sector, where successful innovations in one place might eventually spread out to other institutions. However, in the case of a heterogeneous, ill-equipped and weak public sector characteristic for many developing countries, such an approach may turn out to be unsustainable. The semi-autonomous character and high level of competence of the SAT may lead to situations, where the principal (the local government) is unable to effectively monitor and control the agent (the SAT) and where spill-overs to other governmental bodies will be difficult to achieve. Public management reforms incorporating the SAT model would need to address these issues.

Finally, from the viewpoint of *fiscal governance* and legitimacy, the SAT experience would be welcomed with regard to the broadening of the tax base, the improvement in terms of tax justice and equity, and the strengthening of ties between tax administrations and tax payers.

There is a risk, though, that the strong focus on revenue collection and liability enforcement inherent in the approach may trigger legitimacy problems, especially if communication with local service providers is limited. The Peruvian example shows that in the short run the local constituency strongly resents higher tax pressure since citizens simply do not expect their payments to result in better service delivery. Positive effects on fiscal governance and legitimacy will materialize to the degree that reforms cover the whole fiscal cycle, including budget formulation and execution. Therefore, the founding of SAT would have to be embedded in a broader context of fiscal reform promoting transparency and accountability.

³⁰ In the case of Peru, some SAT (for instance, Trujillo) have offered to administer the taxes of the surrounding district municipalities. There are some obvious benefits to this approach, both for the municipalities (increasing revenues) and for the SAT (economies of scale and scope), but there are also some important problems with respect to political accountability, local autonomy and transparency. Although useful in specific contexts, in general terms this does not appear to be a viable approach to overcoming the revenue generation problems of smaller local units.

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