

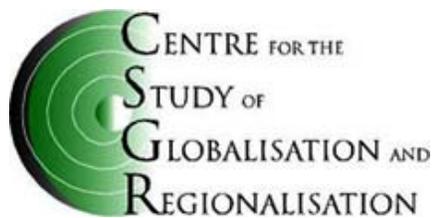
**“Formal and real fiscal federalism in Argentina”**

Martin Besfamille and Pablo Sanguinetti

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May 2003

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## **Formal and real fiscal federalism in Argentina<sup>1</sup>**

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### **Abstract**

In this note we describe, on the one hand, the formal institutional structure of the Argentine fiscal federalism. Then, on the other hand, we show how fiscal federalism really works in Argentina. We analyze data on fiscal behavior of the federal and provincial governments during the nineties. The goal of this note is precisely to point that one of the main issues of the current situation in Argentina is precisely the difference between ‘formal’ and ‘real’ institutions. At the heart of such difference is the lack of enforcement of national laws and formal inter-provincial agreements. We illustrate this by studying how formal rules to the provincial borrowing have functioned during the last decade.

Keywords: Argentina, institutions, enforcement of laws, fiscal federalism, provincial governments, provincial deficits, provincial debts and bailouts.

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<sup>1</sup>This research began with the presentation by Sanguinetti “Federalismo Fiscal y Estabilidad Macroeconómica: son los límites al endeudamiento provincial la solución? Lecciones de la experiencia de Argentina” in the Conferencia sobre Viabilidad de la Deuda Pública de los Estados, Universidad Panamericana, México D.F. Then it continued while Besfamille was visiting the Center for the Study of Globalisation and Regionalisation (University of Warwick), whose hospitality is gratefully acknowledged. We specially thank Javier Fronti, Ben Lockwood, Marcus Miller, Carlo Perroni and participants in the CSGR seminar for useful comments.

## **1. Introduction**

Argentina is historically and constitutionally a Federal Republic. Historically, the provinces created the nation by adopting in 1853 the first constitution. This Constitution establishes, both for the federal government and for the provincial authorities, attributions and prerogatives, either on the spending side or on the revenue side.

First, we describe the ‘formal’ rules that govern fiscal federalism in Argentina. Then we show how these formal rules ‘really’ work. To do that, we analyze data on fiscal behavior of the federal and provincial governments during the nineties. This enables us to realize that, in Argentina, there exists an important slack between formal rules and their real outcomes. Precisely, the second goal of this note is to point that one of the main issues of the current situation in Argentina is this mentioned difference between ‘formal’ and ‘real’ institutions.

At the heart of such difference is the lack of enforcement of national laws and formal inter-provincial agreements. We illustrate this by analyzing if formal rules that should constraint the provincial borrowing have indeed functioned during the last decade.

The note is organized as follows. In the first section, we describe the ‘formal’ institutional structure of the Argentine fiscal federalism. In the next section, we show the ‘real’ outcomes of this formal institutional structure. Then, in the last section, we show a special case of how formal rules work in Argentina: the limits to provincial borrowing. Finally, we conclude.

## **2. ‘Formal’ institutional structure of the Argentine fiscal federalism**

Argentina is, by constitution, a Federal Republic. The first section of the National Constitution of 1994 states that "*The Argentine Nation adopts the federal republican representative form of government*".<sup>1</sup> The country is divided in 23 provinces and the capital city, called the Ciudad Autónoma de Buenos Aires (CABA). The provinces are the only sub-national units with political representation at the federal level, i.e. in the National Congress.<sup>2,3</sup> To understand how federalism works in Argentina, it is important to stress the fact that the provinces were the creators of the nation, as the Preamble of the Constitution says: "*We, the representatives of the people of the Argentine Nation, gathered in General Constituent Assembly by the will and election of the Provinces which compose it, in fulfillment of pre-existing pacts, in order to form a national*

*union (...)"*. Section 5 characterizes the most important feature of the provincial autonomy, namely that *"Each province shall enact its own constitution under the republican, representative system, in accordance with the principles, declarations, and guarantees of the National Constitution, ensuring its administration of justice, municipal regime, and elementary education."*

In order to situate the reader, in the next table we show the main characteristics of the Argentine provinces.

[Insert Table 1 here](#)

As we can see, the provinces are different in many aspects. On the one hand, there are big provinces (like CABA, Buenos Aires<sup>4</sup>, Córdoba and Santa Fe) that account for 62.51% of the country's population and generate 74.16% of its GDP. On the other hand, there are very small provinces, either with low population (like Catamarca, La Rioja and Santa Cruz, all with less than 1% of the total population) or with a low participation in the GDP (like Catamarca, Formosa and La Rioja, all with less than 0.6% of total GDP).

The Federal government and the provinces have different attributions and prerogatives, either on the spending side or on the revenue side. On the spending side,

- Defense and foreign affairs are the only areas of the exclusive competence of the Federal government.
- The Constitution defines a broad area of public services (in economic and social infrastructure) where the federal government shares responsibilities with the provinces. Therefore, both levels of government can supply these kind of public goods.
- Finally, primary education, municipal organization and local services are the areas of the exclusive competence of the provinces.

On the revenue side,

- The Federal government has the exclusive right to tax foreign trade.<sup>5</sup>

- Indirect taxes are both under the domain of the Federal and the provincial governments.
- Finally, direct taxes are an exclusivity of the provinces. Nevertheless, the Constitution allows the Federal government to use these taxes under special circumstances.

As it is well known, any constitution is an incomplete social contract. It cannot completely define all attributions and prerogatives of the provinces because they are related to so many contingencies that they cannot be fully described in such general agreement. Therefore, the Argentine Constitution states, in Section 121, that "*The provinces reserve to themselves all the powers not delegated to the Federal government by this Constitution, as well as those powers expressly reserved to themselves by special pacts at the time of their incorporation*".

Last, it is important to stress how the Legislative power is conformed at the Federal level. There are two different types of representatives in the National Congress: "diputados" (which are representatives of provinces habitants' interests) and "senadores" (representatives of the provinces as political and administrative units).

### **3. 'Real' institutional structure of the Argentine fiscal federalism**

In the previous section, we described the formal institutions of the fiscal federalism in Argentina. But, in spite of the fact that the Constitution and the laws clearly define some issues, the Argentinian fiscal federalism works indeed very inefficiently, as it has been recognized by many economists and political scientists. The main problems are the following.

#### Vertical imbalance

Argentina has one of the highest degrees of vertical imbalance in the world. This is due to the fact that taxes are mostly collected at the federal level but expenses are generally undertaken at the provincial level. Concerning the tax collection, since the 30's and during all the last century, the provinces have "delegated" to the federal government the administration (determination of tax rates and tax bases, collection and other regulatory aspects) of most of the important taxes like personal and corporate income taxes, taxes on consumption (VAT, fuels, specific duties) and taxes on wealth.<sup>6</sup> In fact, the provinces only control taxes on production, real state and to the possession of cars. According to Piffano (1998), the Federal government collects 77.3% of the total tax revenue of the country, whereas the provinces collect only the remaining 22.7%.

Concerning expenditures at the provincial level, there has been a great decentralization trend in the last decades, specially in areas where the Federal government previously shared authority and provision of public goods with the provinces. The provinces are now currently in charge of most of the social expenditures (basic education, health services, poverty programs, housing) and also infrastructure (roads, ports). In spite of that, the Federal government maintains a significant regulatory power within these sectors. This trend has created one of the most decentralized public sectors in Latin America. Again, according to Piffano (1998), the Federal government is in charge of only 37% of the expenditures, whereas the provinces the 63%.

In the following table, we can observe the most important consequence of this fiscal vertical imbalance.

[Insert Figure 1 here](#)

The figure shows the percents of total provincial spending financed through federal transfers. We can observe a high dispersion around the average of 56%, between 8% and 93%.<sup>7</sup> Ten of 23 provinces finance less than 20% of their expenditures with their own fiscal revenues.<sup>8</sup>

#### Complex intergovernmental tax agreement

This high degree of vertical fiscal imbalance is solved through a complex system of intergovernmental transfers and the possibility for the provincial governments to borrow domestically and abroad. This system of intergovernmental transfers is based in a tax-sharing regime called “Coparticipación Federal de Impuestos”. This Coparticipation regime specifies the process by which the taxes collected at the federal level are reallocated to the provinces. The legislation regulating the Coparticipation regime is the Law 23.548 (1988). This law defines

- Primary distribution: from the common pool of national public funds, 42% correspond to the Federal government and 57% go to the provinces (the remaining 1% is for an anti-crisis fund)
- Secondary distribution: fixed percents that specify how the provincial funds are distributed among the different provinces. In Section 4 of the abovementioned law, the percents are set

as follows: Buenos Aires 19,93%, Catamarca 2,86%, Córdoba 9,22%, Corrientes 3,86%, Chaco 5,18%, Chubut 1,38%, Entre Ríos 5,07%, Formosa 3,78%, Jujuy 2,95%, La Pampa 1,95%, La Rioja 2,15%, Mendoza 4,33%, Misiones 3,43%, Neuquén 1,54%, Rio Negro 2,62%, Salta 3,98%, San Juan 3,51%, San Luis 2,37%, Santa Cruz 1,38%, Santa Fe 9,28%, Santiago del Estero 4,29% and Tucumán 4,94%.<sup>9</sup> Such percents have little economic justification. Moreover, they are so rigid that the distribution of federal transfers cannot respond to variations in time.

This law received its constitutional status in 1994. In the chapter describing the "Powers of Congress", Section 75 states that the "*Congress is empowered (...) to levy indirect taxes as a power concurrent with the provinces. To levy direct taxes for a specified term and proportionally equal throughout the national territory, provided that the defense, common security and general welfare of the State so require it. The taxes under this subsection are subject to joint participation, except for those which, in part or in all, have specific allocation. An agreement-law based on understandings between the Nation and the provinces shall establish systems of joint participation for these taxes, guaranteeing the automatic remittance of funds.*

*The distribution among the Nation, the provinces and the City of Buenos Aires, and among themselves, shall be carried out in direct relation to the jurisdictions, services and functions of each one of them taking into account objective sharing criteria; it shall be based on principles of equity and solidarity giving priority to the achievement of a similar degree of development, of living standards and equal opportunities throughout the national territory."*

The new Constitution also mandates to enact a new law by the end of 1996. In spite of this mandate, this new law has never been enacted. The Coparticipation regime is still supposed to be ruled by the original Law 23.548. But this law has been modified many times, by the mean of new laws and pacts between the Federal government and the provinces. These modifications have implied "pre-coparticipaciones" (i.e. when a given amount of funds is taken out from the common pool of taxes and send it to a province, to attain some specific goal) and also have created new transfers, aside from the general regime. All this makes the system so complex that

it has been called by Richard Bird, one of the leading tax experts in the world, the Argentine "fiscal labyrinth", as we can see in the following figure.

[Insert Figure 2 here](#)

The consequences of such problems are very important, as one can see.

**a. High and increasing deficits**

Table 2 shows the provincial deficits, as percents of total revenue (including federal transfers), during 1991 – 1999.

[Insert Table 2 here](#)

Throughout this period, the provinces have incurred in high and increasing deficits. Although a few large provinces (like Córdoba and Mendoza) achieved reductions in their deficits, many other provinces continue to carry very high deficits.

**b. Increasing provincial indebtedness**

The accumulation of deficits was reflected in an increasing provincial stock of debt, as we can see in Table 3, for the period 1994 – 2001.

[Insert Table 3 here](#)

During this period, in the aggregate, the stock of provincial debt grew from 40.65 of total annual provincial income to 82.32%.<sup>10</sup> Up to 1999, the increment was “only” of 18 points. Nevertheless, it should be stressed that this “small” increment was very much influenced by the financial behavior of a few large provinces.<sup>11</sup> Other provinces, like Río Negro, Corrientes and Tucumán, attained values that went beyond the 100% of their income. In the next table, we can see the detail of each provincial situation.

[Insert Table 4 here](#)

As we can see, many provinces were, during this period, in a critical situation regarding the sustainability of their finances.

It is also important to analyze the composition of such stock, as shown in Table 5 below.

[Insert Table 5 here](#)

The composition of the (aggregate) debt is stable, except in two components. During the period, there is an increasing use of public bonds and, at the same time, the provincial authorities use less arrears with suppliers and public employees.<sup>12</sup>

- c. The Federal Government had to bailout some provinces, in order to finance the unsustainably high provincial deficits. Only between 1992 and 1994 there have been seven cases of bailouts: Catamarca (1994), Corrientes (1992, 1994), Formosa (1994), Misiones (1994), Río Negro (1994), Santiago del Estero (1993, 1994) and Tucumán (1994).<sup>13</sup> They did not always imply direct money to the provinces, as Nicolini *et al* (2002) show. For example, the federal government decided to nationalize some provincial pension funds in distress.
  
- d. Some provinces perform poorly in their tax collection, as we can see in the following table

[Insert Table 6 here](#)

Saiegh et al. (2001) considered these figures as proofs of moral hazard in the provinces. The reason for that assertion is that the differences in the amounts collected between provinces cannot be explained in terms of economic differences. According to them, such differences were taken into account in the fact that they measure differences in percents.<sup>14</sup>

- e. The level of compliance with the national collected and then shared taxes (like the VAT) is poor, compared with other Latin American countries. Local tax authorities do not exert a high level of effort to enforce the collection of national (pooled) taxes.

- f. The tax mix is inefficient. As Tanzi (1996) argues, each actor in the sharing game (Federal government or provincial authority) will choose the less pooled tax to increase revenues, even if it is inefficient. On the federal side, national taxes on labor were high during the 90's.<sup>15</sup> On the local side, provinces rely heavily on the turnover tax, which is a tax with a great number of inefficiencies.
- g. Finally, in spite of the fact that the federal funds should promote a more equal supply of local public goods, there is a poor provision of basic public goods (like education) in some provinces. Although the sharing regime was thought to supplement local funds, Nicolini et al. (2000) found that the provincial administrations use the federal funds as substitutes for their own financing.

As we can see, fiscal federalism is quite inefficient in Argentina. One can argue that this is due to the lack of legal status of the sharing regime. Although this is true, in the next section we will show that even with explicit laws and mandates (or formal agreements between provinces) inefficient results emerge.

#### **4. A special case of how formal rules work in Argentina: the limits to provincial borrowing**

The provincial debts have some characteristics that call for restrictions to the capacity of borrowing of local authorities. The most important of such characteristics is the potential for generating spillovers. This may happen when a province increases substantially its debt and thus the probability of its default increases. Under that circumstance, other provinces may suffer from this increase in the probability of default because the interest rate they have to pay for issuing new debt may also increase. This is the main reason why it may be necessary to restrict the emission of provincial debt.

##### **Restrictions to provincial borrowing in Argentina**

There have been three different types of restrictions to the provincial borrowing in Argentina:

- Limits in the provincial constitutions,
- Restrictions designed by the Federal government and
- New laws of ‘solvency and fiscal responsibility’ (sanctioned from 1999).

#### Limits in the provincial constitutions

Many provincial constitutions put restrictions on the issue and use of the local debt. These restrictions are as follows:

- In order to borrow, the provincial authorities have to follow some specific procedures. The most common of such procedural restrictions sets that, in order to issue new debt, the provincial authorities need to obtain, from the Legislatura (provincial legislative power), the authorization under a given majority.
- There are also restrictions in the use of these funds. In many provinces, these funds cannot be used to finance current expenditures or deficits.
- Finally, there can be specific limits to the amounts of services of the debts.

In the next table we show each province’s restrictions.

[Insert Table 7 here](#)

#### Other restrictions designed by the Federal government

The (National) Ministry of Economics should exert a supervision of the provincial debts. By Resolution 1075/93 of the Ministry of Economics, the provinces have to be authorized by the Secretaría de Programación Regional to issue debt in foreign currency or to use federal funds (i.e. from the Coparticipation regime) as collateral for bank credits.<sup>16</sup> But this mandate does not establish any quantitative restriction neither on the amount of debt, nor on the percent of federal funds that can be used as collateral.

#### New laws of ‘solvency and fiscal responsibility’

Motivated by the rule of “balanced budget” adopted by the Federal government in September 1999, some provinces have enacted laws of "solvency and fiscal responsibility". Currently, nine provinces have adopted some type of budgetary rule that conditions the design and execution of

the provincial public budget: Catamarca, Chaco, Chubut, Formosa, Misiones, Neuquén, Salta, San Luis and Tucumán. In general, these provincial laws establish

- A chronogram of convergence towards the balanced budget in 2003
- Limits to the provincial deficits
- Limits to the increase in the provincial debt
- Limits to the increase in the current expenditures

In spite of the fact that these restrictions are not well designed, in the next section we show that deviations from these formal arrangements are so important that the real problem is one of enforcement, not of incompleteness.

### **Efficiency of these restrictions**

As we can see in the next table, many provinces have violated their own constitutional limits, especially those that concern the debt services/total income ratio.

[Insert Table 8 here](#)

Some comments have to be made on these figures. First of all, some provinces have violated such limits by a scandalous amount. The paradoxical case is Formosa, with a constitutional limit such that debt services cannot exceed 25% of the total provincial income. This province had debt services that amount up to 93.35% of its income in 1997! Moreover, such violations are not the exception but, for some provinces, the rule (in terms of years when the constitutional limits were violated). Another important case is Corrientes. In spite of the conditions imposed to bailout this province in 1992, the services if its debt increased during the period and finally violated their constitutional limit.

Next, we can observe in the following table that the Federal Ministry of Economics had indeed exerted a very weak control over the collateralization of the provincial debts.

[Insert Table 9 here](#)

Some of these authorizations were only bureaucratic acts. If not, no province could put as a collateral for new debt such a high percent of the Coparticipation funds. As we can see, many provinces put very high percents as collaterals, like Río Negro, Salta, Tucumán and Formosa.<sup>17</sup> Finally, concerning the accomplishment of the solvency laws, two cases can be analyzed: Chaco and Catamarca

- Chaco: the fiscal deficit in 2000 should not exceed 100 millions USD, then it has to decrease annually 20% to attain the equilibrium. In 2000, the deficit was 170 millions USD and in 2001, 231 millions USD.
- Catamarca: in 2000 the primary deficit cannot exceed 2% of the average of current expenses and capital expenses between 1998 and 1999. This yields to an estimated deficit of 11 millions USD. The primary deficit in 2000 was 31 millions USD.

As we can see, in spite of the fact that these laws were not imposed by the Federal government, they were violated by the same authorities that enacted them.

### **Is the market an alternative mechanism to explicit borrowing constraints?**

According to Lane (1993), only under some particular institutional conditions, the financial market can discipline the borrowing behavior of the sub-national levels of government. In fact, the vertical relation between the Federal government and the provinces creates a distortion in Argentina. As we mentioned above, the probability of bailout by the Federal government when a province faces a possible default is not negligible. Therefore, the financial markets anticipate this and they do not discipline the fiscal (mis)behavior of the provinces. This would be the case if, facing a critical financial situation, banks stop lending. But, as banks anticipate federal bailouts, they continue to lend. In the next table (taken from Zentner 1999), we can see that this is exactly what happened in Argentina.

[Insert Table 10 here](#)

This table shows, in an aggregate form, 64 lending operations to 15 provinces. With data on the interest rate and temporal structure of each operation, Zentner (1999) derived their temporal

term. Then the author estimated, using the Kiguel and Lopetegui (1997) framework, a relation between the interest rate and the temporal term of a financial operation. Finally, Zentner computed the spread as the difference between the estimated and the observed interest rate and constructed the average, for each province. As we will see, this methodology does not suffer from an endogenous selection bias because also provinces in bad financial situation had access to these credits.<sup>18</sup>

The most striking result concerns the province of Formosa. Not only this province has access to credit, with very poor financial indicators but, on top of that, it paid lower interest rates than other provinces in better fiscal situation. Therefore, the credit market was ineffective in discriminating between good and bad debtors and also did not penalize the latter.

In Argentina, the market discipline cannot be a substitute for internal controls and restraints to the provincial borrowing. The fact that the provinces can use the funds that come from Coparticipation regime and the expectations of bailouts create the incentives for bankers not to screen correctly the provinces.

## **5. Conclusions**

By Constitution, Argentina is organized according to the principles of the fiscal federalism. But this is only one face of the coin, namely the “formal” institutional organization. The other face, the “real” institutions of the country, shows a country where the provinces use their autonomy without responsibility because, in fact, they heavily depend upon federal transfers.

Moreover, a close scrutiny of this “real” world shows that formal laws and arrangements are seldom enforced. Precisely, the explicit rules that restraint the provincial borrowing in Argentina have been generally ineffective. One can find reasons for that, specially in problems of design: loose definition of the deficit or debt rule adopted, no mention about penalties in case of non-compliance, weakness of constitutional and bureaucratic controls.

In spite of all the reasons that one can find that support these evidences, one has to recognize that this phenomenon of “formal” vs. “real” organization of the country is at the heart of the current crisis. Argentina suffers from a lack of commitment and enforcement of rules. Our hope is to have shown that, no matter the rules or the laws, Argentina has to solve a problem that lies deeper: to enforce them.

## Acknowledgments

This research began with the presentation by Sanguinetti “Federalismo Fiscal y Estabilidad Macroeconómica: son los límites al endeudamiento provincial la solución? Lecciones de la experiencia de Argentina” in the Conferencia sobre Viabilidad de la Deuda Pública de los Estados, Universidad Panamericana, México D.F. Then it continued while Besfamille was visiting the Center for the Study of Globalisation and Regionalisation (University of Warwick), whose hospitality is gratefully acknowledged. We specially thank Javier Fronti, Ben Lockwood, Marcus Miller, Carlo Perroni, Sian Sullivan and participants in the CSGR seminar for useful comments.

## Notes

<sup>1</sup> Argentina enacted its first constitution in 1853. Then, in 1994 under the mandate of C. Menem, the 1853 constitution was reformed.

<sup>2</sup> This is the main reason why, in this note, we focus mainly on provinces and not in municipalities. Municipalities have no political representation at the federal level.

<sup>3</sup> The constitutional status of the capital is similar to the one of a province.

<sup>4</sup> CABA is situated geographically in the province of Buenos Aires. The main difference with the provinces arises because CABA has some administrative prerogatives, due to the fact that the Federal Government is situated there.

<sup>5</sup> The Constitution of 1853 eliminated interior customs between provinces, that were previously pervasive.

<sup>6</sup> During the XIX<sup>th</sup> and the beginning of the XX<sup>th</sup> century, the Federal government raised revenues mainly from international trade. The Great Depression created a sudden decrease in federal revenues. Since this moment, the Federal government started to collect taxes that were previously assigned to the provinces, invoking the “critical situation” argument mentioned in the Constitution. Because of historical reasons (i.e. when the consequences of the Great Depression began to be attenuated, the II<sup>nd</sup> World War creates another problem with revenues from international trade), these prerogatives remained in the federal hands.

<sup>7</sup> Argentina’s average for the vertical fiscal imbalance is not much different from the Latin American average. Nevertheless, it should be stressed that many of the Latin American countries that also have a high degree of vertical fiscal imbalance are centralized countries rather than

federations. Therefore, in such countries, the central government exerts a strict control over the actions of the sub-national authorities. As this is not the case in Argentina, we will see below that the incentives created by this vertical fiscal imbalance and by the way it is solved go in the wrong direction.

<sup>8</sup> Is this vertical imbalance a universal problem? We have to find empirical evidence in other federations, like Australia and Canada. And, in fact, it is not: Australia and Canada manage this vertical imbalance much better than Argentina. Precisely, one of the goals of this note is to relate the malfunctioning of the Argentinian fiscal federalism to the misbehaviour of its institutions.

<sup>9</sup> Tierra del Fuego is not included here because, in 1988, it was not yet a province but a National Territory, ruled by the Federal government.

<sup>10</sup> We prefer to use the measure stock of debt/total income instead of a measure like the Maastricht criterion (stock of debt/GDP) because the former gives a better idea of the sustainability of the provincial debt. The possibility of repayment is linked to the ability to obtain primary surpluses, and thus to income.

<sup>11</sup> For example, in 1997, the province of Buenos Aires initiated an aggressive program to reduce its debt obligations, especially with respect to the provincial state bank Banco de la Provincia de Buenos Aires.

<sup>12</sup> In spite of the fact that this component of the debt decreases, facing financial crisis, some provinces have arrears with public employees for months. Indeed, public employees were unpaid during long periods of time, for example 3 months.

<sup>13</sup> As a proof of the fact that the provincial finances are very complicated to manage, let's consider the two bailouts to Corrientes. Both bailouts were made when the province was under Federal intervention. This is a constitutional prerogative of the Federal government, when the provincial order is in danger. The provincial authority is dismissed and the Federal government sends an "interventor". The first bailout was made conditional on the adoption of some reforms in order to decrease the provincial deficit. In spite of the fact that the interventor has many powers to initiate reforms (even to fire people from the public sector), the province did not initiate such reforms and had to be bailout again, two years later.

<sup>14</sup> It remains to prove that these differences are not related to structural and geographical characteristics, like a very dispersed population in the countryside. If this were the case, even an

efficient local tax administration may face problems to collect taxes. We thank Ben Lockwood for this suggestion.

<sup>15</sup> The total amount collected from taxes on labor was above 40% of total payroll payments. This figure is above the Latin American average and also the average of industrialized countries in 1999.

<sup>16</sup> Dillinger and Webb (1998) state that using the promises of federal transfers as collaterals disciplines the fiscal behavior of the provinces. According to them, if a province increases its expenditures by issuing new debt collateralized with federal funds, the province has to anticipate that, after the reimbursement, the remaining of the federal transfers may not be enough to cover current expenditures. Therefore they will not engage in such expansionary policy. But this argument does not consider the possibility of federal bailout, as we mentioned above.

<sup>17</sup> In spite of the institutional disorder in Argentina, it is interesting to observe that this collateralization of debts has always been enforced. The Federal government sent the funds of Coparticipation to the accounts of the provinces in the Banco de la Nación Argentina (i.e. the National State bank) and, the amounts that were collateralized, were sent directly to the lenders. Therefore, the provinces keep only a small portion of the Federal funds. This can be possible only if the provinces expect that the Federal government will rescue them afterwards.

<sup>18</sup> This would be the case if only well-behaved provinces had access to these financial operations. In that circumstance, the test suggested by Zentner is incorrect.

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