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Federalism in Argentina and the Reforms of the 1990s

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Abstract

Federalism in general and fiscal federalism in particular are crucial axes of Argentina's history, of Argentina's current situation, and of Argentina's possible futures. This paper provides a tour of the recent history of fiscal federalism in Argentina, and an overview of its current configuration and main problems. It focuses on the relationship between federalism and the market-oriented reform process of the 1990's, on the evolution of the federal fiscal system itself, and on its implications for the quality of public policies in the social sectors. It also explores some of the connections between federalism and the Argentine crisis of 2001/2002.

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I. Introduction

Federalism in general and fiscal federalism in particular are crucial axes of Argentina's history, of Argentina's current situation, and of Argentina's possible futures. This paper provides a quick tour of the recent history of fiscal federalism in Argentina, and an overview of its current configuration and main problems. It focuses on the relation between the structure of political and fiscal federalism, and the economic reform process of the 90's; on the attempts at reforming the federal fiscal system itself; and on the implications of Argentine federalism for the performance of the social sectors.

The rest of this introduction provides a brief introduction to Argentina and to fiscal federalism in Argentina. Section II looks at the way in which features of Argentine federalism impinged upon the economic reform process of the 1990's. Section III looks at the evolution of the federal fiscal system in the 1990's, at the largely failed attempts at reforming it, and at the connections between federalism and the Argentine crisis of 2001/2002. Section IV explores the federal connection in the evolution and reform of the education sector.

I. 1. Some Basic Facts about Argentina

History. The Argentine nation was born out of the union of various colonial regions with differing economic and social characteristics.[1] In 1810 the city council of Buenos Aires deposed the last Spanish viceroy, marking the beginning of the independence movement. In 1816, delegates from different parts of the country convened in Tucumán to sanction the declaration of independence of the United Provinces of the Rio de la Plata. The first four decades after independence were characterized by violent struggles with regards to the constitution of a national government. That process lead to the Constitution of 1853, which established a constitutional federal republic. This Constitution suffered some important modifications in 1860, with the Province of Buenos Aires finally endorsing that Constitution. The provinces were recognized precedence over the Nation, and were granted autonomy in the administration of their territories. A specific set of federal government functions was established, the provinces were granted residual powers over any matters not specified to be federal functions, and the internal economic union was promulgated with the elimination of internal customs controls. Despite some later modifications (including the recent reform of 1994), the essential federalist structure of the 1853-1860 Constitution remains in force today. [2]

[1] In spite of being a former Spanish Vice-Royalty, fiscal and military technologies at the time of independence were such that what later became Argentina was a collection of political units (now provinces) which deep local roots. Hence, Argentina is, in the words of Stepan (1999), more of a "coming together" federation than of a "holding together" one. See also Escudé (1988).

[2] The National Constitution was sanctioned in 1853, and reformed in 1860, 1866, 1898, 1949, 1956, 1957, 1972, and 1994. Argentina had a very interrupted democratic history since 1930. Military dictatorships ruled the country in the periods 1930-1932, 1943-1946, 1955-1958, 1962-1963, 1966-1973, and 1976-1983.

By the beginnings of the 20th century, Argentina was one of the most developed countries in the world. (In the 1890's, Argentina was the sixth richest country in the world in per capita terms; and in the 1920's it was among the top ten, ahead of nations like Germany or Italy). However, after the Great Depression, as a combination of democratic breakdown and poor economic policies, Argentina entered a path of economic decline that, except for brief spells (most notably the early and mid 1990's), continues to the present. The reliance on statist and inward-looking growth strategies resulted in massive public sector deficits, accelerating inflation and economic stagnation. Pervasive growth of the state eventually brought public expenditures to about 50% of GDP. Although industrial promotion programs were initially popular among the growing pool of urban workers, they ultimately led to an onerous taxation of agriculture, Argentina's prime source of wealth, and contributed to major reallocation of resources. The debt crisis of the early 1980's led the government to resort to money creation to meet financial responsibilities. To avoid a growing inflation tax, Argentines withdrew their resources from the financial system, saving and investing abroad at record levels. Economic stagnation ensued. By the end of the 1980s, labor productivity had fallen, social services and basic infrastructure had deteriorated, and poverty had become a serious and growing problem. When the Menem Administration took office in July 1989, Argentina was gripped by recession and monthly inflation of up to 200 percent. During the 1990's the country underwent a market-oriented transformation that created the expectation of renewed prosperity. Sadly, after almost a decade under the illusion that things had started to change, the country has recently regressed to its historical downward trend.

Political Institutions. Argentina is a federal republic, with a presidential form of government and a bicameral legislature. The members of the Chamber of Deputies (currently 257) are elected from 24 multi-member districts, the 23 provinces and the federal capital, for four-year terms. The deputies are elected from closed party lists using the D'Hondt divisor form of proportional representation. One-half of the Chamber is renewed every two years, with every district renewing one-half of its legislators. The 24 jurisdictions send to the national congress a number of deputies in proportion to their populations. The Argentine system tends to strongly over-represent the smaller provinces, through a floor of five deputies. Until the 1994 Constitutional reform, all the districts were represented by two senators, elected indirectly for nine-year terms by the provincial legislatures, using the plurality formula. The new Constitution introduced a third minority-party senator for each province, as well as the direct election of senators, which went fully into effect in 2001.

Provinces: General/Political. Besides political powers, subnational and local governments have ample constitutional independence in fiscal and spending functions. Furthermore, electoral rules and party statutes and practices make provincial governors (as regional party leaders) individually and collectively very powerful actors in national politics.[3] As I will describe in more detail later, this feature interacts with a large degree of federal fiscal imbalance, which makes provinces very dependent on "common-pool" funds, creating very particular incentives for exchanging votes in national congress for money to the provinces.[4]

[3] See Jones, Saiegh, Spiller and Tommasi (2001 and 2001b) and Spiller and Tommasi (2001).

[4] Each province has a lower level of government, municipalities, which have their own elected mayor and legislative body; they differ substantially in size and importance. Each province has autonomy to organize

Provinces: Economic/Demographic. The provinces have diverse geographic and demographic characteristics. The province of Buenos Aires is by far the largest, with almost 14 million people. Then there are about three jurisdictions with around 3 million people each (Córdoba, Santa Fe and the City of Buenos Aires). Mendoza has 1.6 million inhabitants, followed by 7 provinces with populations in the 0.8-1.3 million range. Another 12 jurisdictions have populations that range from 200.000 to 620.000. Finally, there is Tierra del Fuego, at the tip of the continent with about 100.000 inhabitants. The level of economic development varies dramatically as well. The high population provinces are at the top of the scale, while other provinces are blessed with particularly strong natural resource bases (prime land in the humid pampas, or the oil riches of the south). There is a concentration of lesser-developed provinces in the north. In addition, even in the more developed regions, migration has led to pockets of poverty (for example, in the province of Buenos Aires, there are densely populated slums outside the federal capital).[5]

<Table 1: Basic Characteristics of the Argentine Provinces>

I. 2. Fiscal Federalism

Revenue. Although the Argentine Constitution establishes substantial room for subnational taxation, in practice provinces have delegated to the national government large amounts of revenue raising responsibility (income, sales, excise and fuel taxes), leading to the situation depicted in Table 2

Table 2
Revenues year 2000 (percentage of total)

	Level of Government			
	Federal	**Provincial**	**Municipal**	**Total**
Income tax (personal and corporate) & capital gains tax	19%			19%
Social Security contributions	21%			21%
Good, services and transaction taxes	38%	10%	0.1%	47%
Wealth tax	2%	4%	0.3%	6%
Trade taxes	3%			3%
Other	1%	3%		5%

its territory into local municipal jurisdictions, according to its provincial constitution and supplementary provincial laws. There are approximately 2150 municipalities and towns in Argentina. The legal autonomy, expenditure responsibilities and financing arrangements of local government vary across provinces. Municipal governments are responsible for about 7 to 8 percent of total public expenditures in Argentina. In most cases their activities are restricted to traditional urban functions of local street maintenance, street lighting, municipal parks, and solid waste disposal.

The members of the national and provincial Courts of Justice are nominated by the Executive Powers and respectively appointed by the Congress and the provincial legislatures.

[5] The rich province of Buenos Aires has about 1/3 of the poor in Argentina.

Total	**83%**	**17%**	**0.4%**	**100%**

Spending. The resulting revenue concentration contrasts with a spending decentralization process whereby the responsibility for key social functions is in provincial hands. The only activities that are the exclusive competence of the national authorities are those associated with defense and foreign affairs. In the areas of economic and social infrastructure, the national government shares responsibility with the provinces, while the latter have exclusive competence in primary and secondary education and local (municipal) organization and services. The Constitution defines a broad area of public services for which national and provincial authorities can both participate in legislation and public service provision, though the tendency in the last two decades has been for the national government to decentralize the direct operation to the provinces. Thus the provinces are currently in charge of most of the social expenditures (including basic education, health services, poverty programs, housing) and also economic infrastructure. In spite of that, the national government maintains significant regulatory power in many of these areas and directly manages many programs within these sectors, such as social security, income support to the poor, and complementary educational programs subsidizing the poorest schools. Table 3 shows the assignment of responsibilities.

<Table 3: Assignment of Responsibilities by Level of Government>

As we can see in the next table, subnational governments are responsible for almost 50% of the total consolidated public sector expenditures.[6]

<Table 4: Expenditure by Level of Government>

Transfer System. Given these expenditure decentralization and tax centralization, a high degree of vertical fiscal imbalance results. In 2000, for example, 56 percent of total resources received by the provinces came from the common pool of national taxes, while only 44 percent was financed directly by provincial revenues. Figure 1 shows the percentage of total revenues coming from central sources, by province.

<Figure 1: Vertical Fiscal Imbalance>

Figure 1 indicates not only that the vertical fiscal imbalance is in general quite large, but also that it is quite asymmetric among provinces. Fifteen of the 24 provinces finance less than 30% of their spending with their own resources.

[6] Regarding the overall extent of involvement of government in the production of goods and services, it has diminished abruptly in the 90's after the economic reforms (described in more detail in section II), especially through a reduction at the national level. It dropped from 4.27% of GDP (22% of total spending of the National Government) in 1990 to 0.56% (3%) in 2000. The largest component of this drop is in the Energy and Fuel sector. On the other hand, the share of economic activities in provincial government spending has been relatively constant, at about 1% of GDP (10% of total provincial public spending).

Argentina addresses this large vertical fiscal imbalance through a complex system of intergovernmental transfers. The most important component of this system is the tax-sharing agreement (TSA, called "*Coparticipación*"), which is the process by which part of the taxes collected by the central government are reallocated to the provinces. Over time, the system has tended to redistribute in favor of the most backward and low-density provinces, in large part due to their overrepresentation in the national Congress. Even though in a general sense the pattern of redistribution goes "in the right direction", it is very far from being objective and transparent.

The last Coparticipation Law, sanctioned in 1988, established a set of taxes to be shared; that the federal government retains 42 percent of the revenue from these taxes, while 57 percent is distributed among the provinces and the remaining 1% is set aside "to finance unforeseen crises in the provinces".[7] The law also set the percentages of "secondary" distribution, i.e., the share of that 57% going to each of the provinces. That law has been supplemented by several other laws regulating the distribution and destination of some specific taxes that finance a set of predetermined activities. In the early nineties there were several important changes introduced through "fiscal pacts" that will be explained in more detail later in the paper. In 1992-1993 the national government was able to obtain a 15% reduction in the amount to be shared with the provinces, in order to finance the deficit of the pension system, which grew substantially as a consequence of social security reform (described in Section III).

These various reforms introduced new types of transfers besides Coparticipation per se. Additionally, a variety of special channels link some fractions of specific taxes to specific, often economically unrelated, spending purposes. Figure 2 depicts Argentina's so called federal fiscal labyrinth as of 1997.

<Figure 2: Federal Fiscal Labyrinth>

The 1994 Constitutional reform stipulated that a new tax revenue-sharing agreement had to be decided and put in place by January 1st, 1997. The constitutional mandate remains unfulfilled. In the 1999 and 2000 fiscal pacts, the (then new) national government promised to the provinces some fixed-sum transfers and some minimum revenue guarantees, assuming the role of residual claimant. These clauses were violated by the national government during the 2001 crises, and the grievances over those obligations were a compounding factor in the political stalemate leading to the demise of President De la Rúa and to Argentina defaulting on its debt in late December 2001.

Borrowing.[8] Within Argentina's federal structure all levels of government are generally permitted to borrow both domestically and abroad. During the 1980s both levels of

[7] Section III provides more details.

[8] Please note that this description of the system is based on its workings before the catastrophe of late 2001. Argentina has entered a political and economic twilight zone, and it is very hard to predict what monetary, financial, and fiscal system Argentina will have at the end of this process. Several of the statements in the text might no longer be true by then.

government borrowed extensively, reflecting the weak fiscal management of the period. In addition, both accumulated sizable arrears on payments of wages and pensions, to suppliers and for debt service. (During the 1990s the federal government tried to consolidate those arrears; the clearance operation added up to a total of 9 percent of 1995 GDP). [9]

Provincial state banks had in most provinces a legal status that makes them very dependent on the provincial executive power. Thus in practice they acted as captive sources of financing. In this sense, the provincial government banks were considered to be akin to the central bank of each province: they provided funds to the provincial governments upon demand and, in turn, received rediscounts from the Central Bank.[10] Given their portfolio of bad assets (resulting to a significant extent from lending to provincial governments) provincial banks were among the prime candidates for restructuring and consolidation, process that was accelerated after the 1995 Tequila crises induced a run against most provincial financial institutions. As of mid 1999 only eight provincial banks remain in the hands of the provincial public sectors.

There are no ex ante limitations on the ability of provinces to borrow from commercial banks. The main steps taken throughout the 1990's consisted in the (almost) elimination of the provincial banks as sources of credit to the provinces. The 1991 convertibility law ended the ability of provincial banks to rely on the central government as a lender of last resort. The central bank can no longer discount any loans from provincial banks.

Provincial bonds and some provincial loans are subject to ex ante federal government controls. Bonds have to be reviewed and registered by the Ministry of Economy, which reportedly exercises this role with a light touch (Webb, 1999). There have been even some bond issues on the international market without prior review by the Ministry of Economy.

The borrowing control mechanisms now center on the arrangements that the provinces make to collateralize their debt. Usually this is done with a pledge of *coparticipación* as collateral. These are generally handled by the Banco de la Nación, which is a semi-autonomous federal agency that, among other functions, handles the distribution of *coparticipación* to the provinces.[11] Provinces with a weak credit position have to give an

[9] In many provinces, the provincial Constitution imposes some restrictions on the borrowing ability of the government. In some jurisdictions it requires an extraordinary legislative majority to approve new debt; they also impose restrictions on the level of indebtedness and on the use of debt. Nevertheless, often these restrictions are not fulfilled, and in many provinces they are too loose to be binding (Braun and Tommasi, 2002). It is not surprising then to find that borrowing limits have little effect on the fiscal behavior of provinces (Jones, Sanguinetti and Tommasi 1999). As a matter of fact, it seems that the effectiveness of rules for sub-national indebtedness is also quite limited in the Colombian case, in spite of what looks like a fairly sophisticated "traffic lights" system. Echevarría, Rentería and Steiner (2000) show that 17 out of 27 departments, and 13 out of 26 municipalities are actually in red. See Braun and Tommasi (2002) for an argument against the use of "rules" when there is not an adequate governance structure for their enforcement.

[10] For example, those rediscounts amounted to over 2 percent of annual provincial spending during 1983-1990.

[11] There were times at which the central government would delay payment of shared taxes (especially during inflationary times.) Several complaints and struggles eventually lead to this more automatic system.

irrevocable instructions for Banco de la Nación to deduct the debt-service payments up-front from their *coparticipación*. Provinces with a stronger credit rating are able to satisfy their creditors with a less onerous pledge, namely that the creditor can collect from Banco Nación only if there is a default in payment. Table 5 shows the percentage of tax-sharing revenues that is withhold for this purpose from each province.

<Table 5: Percentage of *Coparticipación* Withheld from Each Province>

During 2001 and 2002, there was a large increase in the emission of provincial bonds, quasi-money, to pay wages and other inputs, which amounts to more than $ 5000 million. This operation was started by several provinces, most notably Buenos Aires, and it was followed by an attempt of the national government to coordinate the process, leading to a "federal" provincial bond (LECOP) of national circulation. These "bonds" might be a threat to the possible re-establishment of monetary and fiscal sustainability in the future.

II. Market-Oriented Reforms of the 1990's: The Federal Connection

In the 1990´s Argentina lived through a process of sweeping transformation in some economic institutions and policies, an experience that has been regarded in the literature (at least until recently), as a salient case of radical and "unconstrained" reform. Yet, a closer scrutiny of the process and its outcomes portrays that the building and maintenance of the political support for the reforms determined the pace, depth and characteristics of the "new policies and institutions." The idiosyncrasies of Argentina's political institutions and political configurations, including prominently the federal dimension, conditioned the coalition-building strategy, and hence the outcomes.

The 1989 economic crisis provided the incentives that led President Menem to initiate the reforms, and triggered a series of delegation patterns conducive to the adoption of the reform agenda. Yet, the political and institutional process of implementing these reforms left a heavy imprint on the outcomes. Even in the context of a favorable partisan composition of key institutions as Congress, with high concentration of political power, there were limits set to the reforms by the coalition that combined economic interest groups with the (backward) provincial base of electoral support of the Peronist party. These limits were translated in concessions of design and sequencing. Though many features associated with a state-led model were dismantled, some "illiberal enclaves" were left in the labor market, in the health market, and (quite relevant for this paper) in the provincial economies and intergovernmental arrangements.

II.1. The Reforms

The Argentine process of the 1990's has been defined as a successful case of radical economic reforms. For instance Rodrik (1993, p. 356) argues that "... reforms had already gone further than those adopted over a period of decades in the outward-oriented East Asian countries which long served as the example of choice for countries like Argentina." However, when comparing the results from each policy area with the set of recommendations derived from the Washington Consensus, we have to qualify that statement.[12] Lora's (1997) index of structural reform illustrates the point. Argentina performed particularly well (on average) during the 1988-1993 period, comparing with the rest of Latin America (Figure 3). But its disaggregated performance in different policy areas, illustrated by sub-indexes, presents sharp variations. In particular, Figure 4 indicates that labor market reform and fiscal reform lag behind the Latin American average. It is worth noting that one of the limitations of Lora's index is that it does not include the subnational dimension, or the qualities of intergovernmental arrangements. (That is not

[12] For simplicity, we follow the standard definition of the Washington Consensus as the reform blueprint against which actual achievements are measured. Many analysts (including this author) have been critical of that Consensus; see for instance Naim (1999) and Acuña and Tommasi (1999).

Lora's fault, since those components were not explicitly included in the "ten initial commandments").

<Figure 3: General Index of Structural Reforms 1985-1995>
<Figure 4: Structural Reform Indexes by Policy Area 1985-1995>

The transfer of office from President Alfonsín to President Menem was moved forward by six month due to a (then) unprecedented economic and social crisis. Upon taking office in July 1989, the new administration passed through Congress far reaching legislation (*Economic Emergency Law* and *State Reform Law*) delegating reformist powers to the executive, sidestepping the need for Congressional intervention. The State Reform Law allowed the Executive to privatize most state-owned enterprises. Early privatizations and a deepening of trade liberalization were the most notable outcomes of the first stage of reform. Yet, stabilization during this period failed, resulting in renewed inflationary episodes in 1990 and the resignation of two Ministers of the Economy.

The Convertibility plan of 1991 marks the beginning of a second stage during which most of the structural reforms were enacted: monetary policy (Convertibility Law and Central Bank independence),[13] fiscal reform (simplification of the tax system and strengthening of the tax collection agency), liberalization of domestic and external markets, and strengthening of the privatization program. Table 6 provides a summary of the main reform measures.

<Table 6: Main Policy Reforms>

II.2. The Politics of Reform[14]

The case of Argentina has attracted a lot of attention, among other things, because the reformist government was not only democratic, but also based on a populist party, traditionally associated with state-centered and inward-looking economic policies. According to Rodrik "it is ironic that these reforms were instituted under a Peronist president, Carlos Menem, since Peronism has been virtually synonymous with populism and protectionism." (1993, p. 356).

The crisis experienced by Argentina towards the end of the 1980's forced the President to embark in actions leading to economic stabilization, a collective good whose stakes rose in this context. Unlike subnational governments, the National Executive is the only political actor in the Argentine institutional framework that is elected by a nationwide constituency, and thus has "more encompassing" interests. Hence, it is the only one who might <u>possibly</u> initiate such reforms. But why <u>did</u> Carlos Menem embark on that reform process?

[13] It is a sad paradox of Argentine policy-making that the architect of these measures, Domingo Cavallo, was the same Minister of the Economy that ten years later, in 2001, was to start dismantling both Convertibility and Central Bank independence.

[14] This and the next section are based largely on Bambaci, Saront and Tommasi (2000), and references there, especially Gibson and Calvo (1997).

As Geddes (1994) and Torre (1998) among others have recognized, the primordial interest of the politician is the survival of the structure from which he/she derives power. Consequently, a crisis of a magnitude that puts at stake this structure generates the incentives to embark in actions leading to ensure its survival, even if it imparts costs to his/her constituency.[15] Also, at the time of initiating the reforms, the population was more tolerant to experimenting alternatives than at other points in time. The urgency of the situation also lead to a series of delegation patterns[16] that also increased the chances – and hence the expected political payoff – of implementing wide changes in policy orientation. There was a window of opportunity for "some" deep policy changes. The "content" of the reformist agenda was determined by the ideas that scholars, policy makers and the international community shared. After the 1982 debt crisis, a new consensus of the causes of the recurrent crises and possible solutions for Latin American economies, the so-called Washington Consensus gained popularity.[17] Some contextual conditions, such as the honeymoon effect, blaming the previous government for the crisis, and a favorable international atmosphere did facilitate the reform process.[18] But there were crucial political and institutional features, to which we turn now.

The partisan distribution, the delegation of legislative faculties to the Executive, and his control over the Supreme Court, as well as the use of certain resources of dubious constitutionality enabled the Executive to concentrate political power. The electoral results throughout Menem's presidency were favorable to the party in government (Table 7). Favorable electoral results were mirrored in the resulting distribution of institutional power. Between 1989 and 1997, the Peronist party was entitled to the plurality of seats in both Chambers of Congress, as well as to a large fraction of the provincial administrations (Tables 8, 9, and 10).

<Table 7: Electoral Results, 1989-1997>
<Table 8: Partisan Composition of the Chamber of Deputies, 1987-1999>

[15] "Given the instability that led to his initial electoral victory, Menem's reelection prospects depended largely on his ability to deliver macroeconomic stability, a collective good that he, as the only politician elected in the nation-wide electoral district, was uniquely poised to deliver. ... "Menem's successful attempt in 1994 to change the constitutional limit of one presidential term attests to his great interest in re-election upon taking office in 1989..." (Eaton, 1997, p. 106).

[16] Analyzed in some detail in Bambaci, Saront and Tommasi (2000).

[17] For a more eclectic view of such a consensus see for instance Naim (1999) and Acuña and Tommasi (1999).

[18] At this point, Menem's credentials as a Peronist had a double effect. On the one hand, they generated a major disruption, in as much as the policies he was propounding constituted a dramatic break with the populist policies Peronism traditionally embodied. This break produced resistance and criticism inside the party, yet both the intellectual efforts devoted to "rebuild" the Peronist identity as well as the concessions used to construct support, helped moderate these tensions. [For an insightful analysis of labor-based parties adaptation to contemporary processes of social and economic change, drawing on an analysis of the Peronist case, see Levitsky (1999).] On the other hand, it was on behalf of his political credentials that Menem was able to build the acquiescence of popular sectors related to Peronism. This "Nixon goes to China" effect is analyzed in Cukierman and Tommasi (1998) and (1998b).

<Table 9: Partisan Composition of the Senate, 1986-1998>
<Table 10: Partisan Composition of the Provincial Governments, 1987-1999>

In addition Menem did frequently use decrees of "necessity and urgency" and line-item vetoes in his bargaining with Congress. The favorable partisan composition at key institutional nodes was furthered by a law that increased the number of members of the Supreme Court from 5 to 9. Through this device Menem was allowed to appoint (with agreement of the Senate) four judges. When one of the previous judges resigned in protest, Menem was granted the opportunity for a fifth appointment.[19] This power composition implied that several of the pivotal political negotiations were with actors within the party, most notably, union leaders and provincial powers.

Contrary to some superficial readings of the political economy of reforms in Argentina, the economic reform process was not carried out by an Executive power in isolation of social, political and institutional actors. Rather, reforms were the product of a series of transactions between the Executive and some key actors (mostly within the governing coalition) at every step of the process.

In Bambaci et al (2000) we sketch a vote-buying theory to explain the choices of the Executive throughout the reform path. We can think of the Executive as facing a price schedule for legislators' vote in favor of his desired policies.[20] The spot price to be paid will depend on the intertemporal political linkages between the President and each legislator or group of legislators. These linkages in the Argentine case are mediated by provincial party leaders, especially when those coincide with the provincial government (which is almost always the case in Argentine provinces whenever the party is in charge of the provincial Executive).[21]

Cheapest votes (probably price zero, or even negative) will be those of actors who directly benefit from the reform package. From the actors who do not benefit from the package, the cheapest votes will come from those legislators with whom there are credible intertemporal reward mechanisms. These mechanisms will include future appointments in the executive or in the party. Legislators from the same party will be first in line, legislators from small independent parties will come second, and legislators from the main opposition party/parties will be the most expensive. The spot currency used to buy votes might include outright

[19] For a longer historical analysis of political interference with the Supreme Court and its effects, see Iaryczower, Spiller and Tommasi (2001).
[20] In the present account we focus on legislative coalition building, since it is the main channel through which the federal connection has operated. In a broader account, we should also include arenas other than the legislature, and political instruments other than legislative votes. For instance, in Bambaci et al (2000) we describe how key business groups were brought on board through benefits in the privatization process, and how friendly union leaders were given cozy jobs, as well as assurances that the main sources of union funding (mostly the "*Obras Sociales*") would be maintained. *Obras sociales* are union-administered sectoral welfare organizations, which play a major role as insurers and providers (this latter role is declining) in the health market.
[21] For more details on this see Jones, Saiegh, Spiller and Tommasi (2001 and 2001b) and references there.

bribery, policy benefits to the relevant (mostly provincial) constituency, or exemptions sparing reforms costly to the relevant (mostly provincial) constituency.

Which votes are actually purchased out of this schedule will depend on the rules of the game (for instance, what is the required majority), and on the actual composition of the legislature at the time of the reform. In the Argentine case under Menem, it turns out that the pivotal votes where some in the Peronist party (from provincial blocks and from union-related legislators) as well as some of the small provincial parties.

In the next section we explore the logic of the concessions and relate them to the broader issues of federalism that are the focus of the paper.

II.3. The Federal Connection

In Jones et al (2001) and (2001b) we provide detailed evidence showing that national legislators are weak players in the Argentine political game. They last little in Congress (the mode is one term), they do not develop specific policy expertise, and they have little incentives to cultivate a personal vote.[22] As we put it in the (2001) paper, national legislators are professional politicians but amateur legislators, and their political careers and incentives have a very strong subnational drag. To put it succinctly, they are pawns of their provincial party leadership.

The lists of congressional candidates that are presented to the voters are made up at the provincial level, using a variety of mechanisms, most of them driven by the local political elite. De Luca, Jones and Tula (2000) show that the decision to hold a primary depends first and foremost on whether or not the party controls the governorship at the provincial level, and secondarily on whether or not the incumbent governor is eligible to seek reelection. As governors are likely to bear a disproportionate share of the costs of any divisive primary, they have both the incentive to and means by which to arrange a negotiated list of candidates. The governor should be able either to impose his or her candidates, co-opt potential opponents, and/or successfully negotiate an agreement with other party factions. In contrast, when the provincial-level party is in the opposition at the provincial level, the resources at the disposal of its leader are minimal in comparison to those of a governor. Hence, the ability of this party leader to avert a primary is much weaker than that of a governor, increasing, then, the probability of a primary being held.

Jones et al (2001b) develop and test a game-theoretic model that helps to understand the strategic interaction between local party bosses and incumbents that shapes legislative careers, and thus, their brevity. Local party bosses make their decisions to re-nominate or transfer incumbent politicians based on two political objectives: keeping their job, and maintaining good representation in the national legislature. Incumbent legislators find it hard to stay in the legislature unless they are very valuable to their local party bosses. Surviving

[22] This last effect is consistent with Carey and Shugart's (1995) general mapping between electoral formulas and the incentives to cultivate a personal vote.

deputies are either politically "harmless" or they are more dangerous at home than in the national legislature.[23]

So far we have established that provincial governors are key players in national politics, a fact that is strengthened by the fact that, as indicated in Table 8, the national executive has had own party contingents of around 50% throughout the period, increasing the marginal value of the block of votes under any given provincial party leadership. We now focus on the particular importance that small "peripheral" provinces have in general, and especially within the Peronist coalition.[24] As stated in the introduction and shown in Table 1, the bulk of the Argentine economy is concentrated in a few districts: the city and the province of Buenos Aires, plus the provinces of Santa Fe, Cordoba, and Mendoza concentrate almost 80% of economic activity and 70% of the population. The saliency of these areas, plus some salient aspects of Argentine history (military dictatorships, the visible ties of Peronism to the urban labor movement) have lead many observers to the mistaken impression that "the action" in Argentine politics takes place in "Plaza de Mayo" (the square in front of the Presidential palace).[25]

Non-metropolitan provinces have an institutional representation that far exceeds their population.[26] In the period of market-oriented reforms, the peripheral regions held 40 out of 48 seats in the Senate (83% of the total). The degree of overrepresentation in the Upper House of Argentina is perhaps the worst in federations across the world. Stepan (1999) utilizes three indicators of malapportionment across twelve modern federal democracies, and in all the indicators Argentina is the worst case.[27]

This over-representation is not limited to the Senate. In the Chamber of Deputies the peripheral region held 52% of the seats. While the original Constitution establishes that seats in the Chamber of Deputies would be allocated proportionally to district population, the 1976-1983 military government introduced amendments that bolstered representation of the peripheral region in that body.[28] These amendments added three additional deputies to

[23] Tenure in office has a negative effect on the length of time that a legislator stays in the Argentine chamber of deputies. The hazard is mitigated by the relative value of the different legislators. Legislators who hold leadership positions in the chamber have a lower risk of removal.
[24] On the latter point we are making free use of the insightful findings of Gibson and Calvo (1997).
[25] Notable exceptions to this mistaken perception are Sawers (1996) and Gibson and Calvo (1997). See also the collection of essays in Mora y Araujo and Llorente (1980) that analyzes the pivotal electoral role played by backward and rural regions in the generation of Peronist electoral majorities between 1946 and 1973.
[26] This characterization of the two components of the Peronist coalition (metropolitan and peripheral) is taken from Gibson and Calvo (1997).
[27] Note: perhaps this information should be provided in the introductory chapter by T.N and company, for the cross-section of countries we will have in the book. As a guide, see Stepan (1999) Table 1.
[28] This was not the first time that the outgoing military tinkered with political institutions to favor those provinces which they believed will be closer to them in the future. (This in itself is a reflection of the relevance of subnational politics in Argentina.) In 1972, the 1966-1973 dictatorship promulgated law 19.862 that also furthered malapportionment in the Chamber of Deputies. The outgoing military government also promulgated the 1973 Coparticipation law that increased the degree of redistribution towards some backward provinces.

each province beyond those allotted on the base of population, and established that no province would be represented by less that 5 deputies. As a result, the degree of malapportionment has been increased.

This institutional overrepresentation, together with the "subnational drag" on legislators' incentives described above, meant that no national winning electoral or legislative coalition could be put together without the support of the regional structures of power in the periphery.

From its inception to the present, the interior has been a central part of the coalition that makes up the Peronist Party.[29] Numerous studies have shown that the principal sources of Peronist support have been not just the working class of the largest industrial cities, but also the rural voters in the least developed parts of the interior. (Sawers, 1996, pp. 199, and references there). The Peronist share of the vote has been highest in the least developed provinces.[30]

Malapportionment has also been fostered by the strategy of Peronist and military governments of converting national territories into provinces, also as a means of increasing congressional and subnational political power for themselves. Currently, 88% of Argentines live in the 15 original districts (dating from the time of national consolidation in the mid- 19th century), while only 12% live in the 9 provinces of more recent creation.

[29] "Interior" is an expression used in Argentina to denote the non-Pampean regions of the country.

[30] In 1946 during Perón's first campaign for the presidency, he allied himself with local *caudillos* in the interior that in turn gave him the votes of their clients. Support for Perón by the rural poor in the interior was also the result of a deliberate strategy on his part. The Peronists "discovered" regional inequality in the 1940s and tried to do something about it. Perón lost no opportunity to show his concern for the interior, or - as his detractors would have it- lost no opportunity to skillfully exploit ancient regional resentments.

Peronism's popular support in the interior grew as the years passed. The growth in support for the Peronists in the interior was probably not unrelated to the wide array of Peronist programs that benefited the interior. For example, in 1946 the federal revenue-sharing program was restructured to redistribute funds away from the pampas to the interior. Interior provinces found that their federal funds doubled or tripled by this change. This had its most dramatic impact in the interior. Perón's constitutional reform gave extra congressional representation to the interior beyond what the 1853 constitution had offered. Two territories were made into provinces during his presidency and were called Presidente Perón and Eva Perón (now Chaco and La Pampa). Between 1946 and 1955, the Peronists built thirty-seven hydroelectric plants, virtually all in the interior. The length of the national highway network in the interior nearly doubled in this decade. Employment in the federal government doubled, and many of those with the new jobs came from the interior. The interior responded to these policies by voting for Peronists.

With the return of electoral politics in 1983, the interior continued to play a crucial role in the Peronist Party. The Radicals, whose base is still on the pampas, won the presidency, but only eight provincial governments. Excepting Santa Fe, the more developed provinces supported the Radicals. The Peronists ran best in the poorest and least developed provinces. With the help of a few small provincial parties, the Peronists gained control of the Senate. From 1987, the Peronists controlled both houses of Congress (with the help of smaller provincial parties in the Lower House) because of their strength in the interior provinces. It was this political power in Congress that allowed the interior to extract an avalanche of resources from the national government described in the1988 law. Provincial governments used these resources in narrowly partisan ways to build political support for their own machines, thereby becoming even more entrenched.

Provincial parties have also played an important role in lending presidents the support needed to pass legislation in Congress, as shown in Palanza and Sin (1997). In particular, during the Menem reform years the Peronist Party (PJ) had the majority of seats in the Senate, but not in the Lower Chamber. (The President chose to present his bills through the Senate.) Despite the general agreement attained with the main opposition party UCR –which guaranteed the PJ would always have the required quorum in Congress, Menem faced several obstacles when he tried to pass his reform projects. The way out of the gridlock was to buy in provincial party support. Palanza and Sin (1996) have documented the denial of support made by provincial party legislators during first rounds of negotiation, and how their positions changed to be aligned with the PJ when voting. Examples of legislation which was sanctioned thanks to the aid provided by provincial parties are, among others, law 23809 (Privatization of Altos Hornos Zapla), law 23871 (Fiscal Reform), law 23897 (Payment of Oil royalties), 24154 (Transformation of YPF SA –the later privatized oil company).

In sum, the peripheral coalition played an important role in bolstering the political capabilities of the reformist Menem administration. That is why the burden of the costs of reform was shouldered predominantly by the metropolitan constituency. The reform process was sequenced in such a way to spear (initial) suffering from the small peripheral provinces.

II.4. Reform-Mongering Tactics to Buy off the Peripheral Provinces

The reforms were timed in a fashion that did imply earlier and heavier hits on the central provinces, as well as differential benefits in favor of peripheral provinces. In this subsection, I present some evidence showing: (i) the asymmetric distribution of benefits from tax revenue increases, (ii) the asymmetric distribution of the costs of some reforms, and (iii) some specific handouts utilized to buy off support.

The main impact on provincial tax revenues in the reform process came from the increase in tax revenues due to Olivera-Tanzi effect from the substantial drop in inflation, from tax reforms increasing and generalizing the Value Added Tax, and from the consumption boom in the early years after Convertibility.[31] All provinces benefited from improved tax collection due to low inflation, and from overall gains in tax bases. Yet, there was a redistributive component favoring the provinces that are net recipients in the common pool of

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Peronists held their first ever presidential primary election in 1988, and the two principal candidates were Antonio Cafiero from Buenos Aires Province and Carlos Menem from La Rioja. Menem said almost nothing about his program but promised the voters a return to the glory of the past. He also played on the anti-*porteño* animosity of the interior. Menem won the primary with huge majorities in the interior, especially in the western provinces, and in the outer belt of industrial suburbs around Buenos Aires, which had voted Peronist in 1983; Menem lost in the more developed provinces. In the general election, with the economy in shambles, the Radicals had no chance of winning. Therefore, the politicians of the interior who had kept Menem's candidacy alive in the early days of the campaign and the voters of the interior who voted for him in the primary assured that he would become president. (Sawers, 1996)

[31] The latter effect is common to all exchange rate-based stabilizations, in this case reinforced by the reappearance (after many years) of credit. See for instance Rebelo and Vegh (1995).

coparticipación. A very simple simulation of these effects (treating private sector and public sector as a unit) shows that the central provinces of Buenos Aires, Córdoba and Santa Fe (and the Capital City of Buenos Aires) were net losers, the province of Mendoza was around indifference, and all the other provinces were net winners.[32]

One of the main costs of the reforms was associated with the reduction in public employment and, more generally, with the increase in unemployment. Federal employment was cut by more than 81.000 agents in 1991-92. On top of that, there was an important privatization process, which included substantial restructuring and labor shedding. Estimates indicate that the total employment reduction associated with restructuring was of about 95.000 people (a 37% drop). This reduction in public employment (both in the central administration and in privatized public enterprises) was concentrated on the metropolitan region. We do not have the exact figures of the territorial distribution of the reduction of national public employment, but even under the assumption that the reduction was uniform across the territory, 74% would have taken place in the metropolitan region (Buenos Aires, Córdoba, Mendoza, Santa Fe, and the city of Buenos Aires), and 26% in the periphery. It is likely that the actual distribution of labor shedding was even more concentrated in the center.[33]

Focusing on the evolution of unemployment, Table 11 indicates that the increase in unemployment was concentrated on the metropolitan provinces.

Table 11
Unemployment

	Unemployment Rate		**Change**
Region	1989	1993	
Metropolitan	7.6%	10%	**2.4%**
Periphery	9.4%	9%	**-0.3%**

Regarding "hand-outs," the most salient were: (i) the subsistence and increase of "industrial promotion" schemes, (ii) the 1992 "Fondo de Desequilibrios Regionales" (Fund for Regional Imbalances), (iii) the asymmetric reduction of labor taxes, and (iv) the distribution of Contributions from the National Treasury (ATNs).

"Industrial promotion" is a very distortive and controversial system of tax exemptions for some industries in a number of peripheral provinces, dating originally from 1956. By 1987, its direct cost was estimated at 1.7% of GDP, and its indirect cost (including the deferred

[32] The simulation (available upon request) computes the net gain from change in VAT revenues received by the province minus change in VAT collection in the province, and adds to that different estimates for the Olivera-Tanzi gain. (It implicitly treats money taken from citizens of province *j*, and given to the government of province *j* as equivalent.)

[33] Even beyond labor shedding, other reform measures such as deregulation were also concentrated on national rather than subnational regulations. (See description of the degree of fulfillment of fiscal pacts in the next section).

payment of some other taxes during high inflation times) at 3% of GDP. The main beneficiaries are the provinces of Catamarca, San Luis, San Juan, La Rioja, and Tierra del Fuego. It is decided in each year's national budget. It has survived in spite of the fact that every year there is a heated discussion over its continuation (even in 2002!). President Menem extended the range of sectors beyond industry benefited by the regime.

In the negotiation of the 1992 Fiscal Pact (see next section), a fund to cover regional disequilibria was created, distributing money with criteria different from the Coparticipation Law. Its distribution is reflected in Table 12.

Table 12
Distribution of Funds from the 1992 "Fondo de Desequilibrios Regionales"

	U$S Millions	% Total		U$S Millions	% Total
Buenos Aires	0	0%	Mendoza	26	5%
Capital Federal	0	0%	Misiones	26	5%
Catamarca	26	5%	Neuquen	30	6%
Córdoba	6	1%	Rio Negro	30	6%
Corrientes	0	0%	Salta	30	6%
Chaco	0	0%	San Juan	26	5%
Chubut	36	7%	San Luis	26	5%
Entre Rios	23	4%	Santa Cruz	36	7%
Formosa	26	5%	Santa Fe	6	1%
Jujuy	26	5%	Santiago del Estero	26	5%
La Pampa	30	6%	Tierra del Fuego	36	7%
La Rioja	26	5%	Tucumán	26	5%

The Fiscal Pact of 1993 (explained in more detail in the next section) included reductions in the (national) employer payroll taxes, which would be reduced anywhere from 0 to 80%, depending on region and sector of production. That system was excessively complex and distortive (Schwartz and Liuksila, 1996, p. 413). In March 1995, the system was simplified, unifying tax rates across sectors, but maintaining a provincial differentiation based on "distance from the Capital City" (!). Furthermore, this was enacted by a presidential decree, reflecting the executive's discretion in the allocation of this handout. The resulting rates are presented in Table 13.

Table 13
Distribution of Employer Payroll Taxes after 1995 Modification

Province	Rate	Province	Rate
Capital Federal	27%	La Rioja	18%
Buenos Aires	26%	Tucumán	18%
Córdoba	23%	Corrientes	16%
La Pampa	22%	Chubut	15%
Santa Fe	22%	Jujuy	15%
Entre Rios	21%	Misiones	15%
Mendoza	21%	Salta	15%

Neuquen	20%	Tierra del Fuego	15%
Río Negro	20%	Chaco	14%
San Luis	20%	Formosa	14%
San Juan	19%	Santa Cruz	14%
Catamarca	18%	Santiago del Estero	14%

Source: Ministry of Labor

Finally, the discretionary transfer par excellence in the Argentine federal fiscal system are the ATNs, a fund of 1% of Coparticipation revenues which is distributed by the Ministry of the Interior, "to cover temporary fiscal imbalances in the provinces." Traditionally, it has been distributed in the most political of manners, independently of the fiscal situation of the province. In 1994, for instance, 20% of ATN money went to the small province of La Rioja, followed by 2.4% to San Luis and 2.3% to Santiago del Estero.

III. Evolution of the Federal Fiscal System in the 1990s and Attempts at Reforming It

The federal fiscal system in Argentina has been under attack for many years, by scholars, analysts, international organizations, participants (governors, national and provincial finance ministers), and the public. In this section we explore the most salient "institutional" moments in which the system has been modified. The analysis shows a mixed picture of some (partial) efficiency-enhancing reforms, the (partial) accommodation to changing circumstances, as well as a basic inability to strike the intertemporal agreements that would be necessary for the deep reform of the system.

We start the section by summarizing the main deficiencies of the system.

III.1. Major deficiencies of the federal fiscal system[34]

a) *High deficits, increasing indebtedness, and procyclical finances of provincial governments*. Argentine provinces have been running important budget deficits throughout the 1990's, constituting a key element of fiscal vulnerability of the Convertibility regime. Furthermore, provincial public spending has been highly procyclical.
b) *Bailout*s. In several instances, and through several different channels, the federal government undertook rescue operations to finance some provinces (Nicolini et al, 2000).
c) *Poor provincial tax collection and poor national tax collection*. Tax compliance at the provincial and national level is quite low by international standards. Both things, in turn, relate to the lack of incentives of provincial authorities to raise local taxes or to assist in the enforcement of national taxes. (See for instance, Gomez Sabaini and Gaggero 1997).
d) *Distortive national taxation*. The fact that some taxes are shared and others are not, induces a bias to national tax policies towards the non-shared taxes, which end up being inefficiently high. In the past, these taxes included trade taxes and the inflation tax. After the reforms of the 1990's, this applies to payroll taxes and more recently to a tax on financial transactions. (Unfortunately, trade taxes and the inflation tax have reappeared at the center of the political scene by the time of this writing. Interestingly, some provincial tax-sharing proposals after the abandonment of convertibility include clauses that amount to some for of sharing of the inflation tax).
e) *Very distortive provincial taxation*. More than 50% of provincial own revenues come from the "gross receipts" business turnover tax. It is a multi-stage sales tax with well-known problems: the accumulation of tax burden across the stages of production, leading to very high final effective rates for particular goods. It leads to potentially large

[34] This listing is taken from a consensus developed over a couple of years at a Forum on Fiscal Institutions convened by Fundación Gobierno y Sociedad (CEDI, Iaryczower and Tommasi, 1999). A more detailed diagnostic is provided in Tommasi, Saiegh and Sanguinetti (2001).

differences in effective rates across different types of final goods and even across producers of the same good (depending upon the individual producer's ability to vertically integrate.)

f) *Inefficiencies in the fiscal mix and difficulties for national fiscal adjustment*. Under conditions of fiscal stress, the national government is forced to adjust too much on the (national) spending side, given that any effort on the tax side automatically "looses" 50% into funds to the provinces, which tend to spend it.
g) *Inefficiencies in the provision of local public goods*. The federal system does not provide stable financing for critical goods provided by the provinces such as education.
h) *Insufficient capital spending by provinces*, increasingly financed by earmarked transfers from center.

III.2. Alternative approaches to explain why efficiency-enhancing reforms are not undertaken

As made clear above, there are severe inefficiencies in the Argentine federal fiscal system. A reform of the system that would morigerate several of those inefficiencies will certainly be welfare improving. In this section we attempt to understand why such efficiency-enhancing reforms have not taken place.

A strawmanized version of the economists' political economy analysis would state that reforms take place when reforming heroes prevail over the dark forces of political constraints (Tommasi and Velasco, 1996). Under such view, a non-reform should be explained on the basis of the veto power of those actors who benefit from the inefficient status quo. Even though useful for some purposes, such a view of the policy process has serious limitations.

First of all, there are very few reforming heroes around; most actors are self-interested, both in the economy, as well as in the polity. The proclaimed "heroes" (Harberger, 1993) are people who try to advance their careers; whether they act as heroes or not, will depend on the incentives that the political and professional environment provides to them. Second, the policy process is more continuous than the episodic notion implicit in the reform epic. Third, and most importantly, if the desired reforms are truly welfare enhancing, the key question is why does the political system not provide for the necessary political transactions that will allow the implementation of welfare improving measures accompanied by compensation to those (veto players) who stand to loose from the reforms. The answer to this question is *Transaction Cost Politics*, i.e., the political version of the Coase theorem.[35] The institutional environment for political transactions might not provide for the enforcement of the complex intertemporal trades necessary to enforce welfare-improving reforms. I argue below that the institutional environment in Argentina does not allow for the agreement and enforcement of the political trades necessary to instrument efficiency-enhancing reforms. Furthermore, this approach might help us understand not only the

[35] This concept originates in the work of North (1990) and Dixit (1996). Our use here is closer to the treatment in Spiller and Tommasi (2001).

failure to reform several deficiencies of fiscal federalism in Argentina, but also several other features of the evolution of the federal fiscal system.

The federal fiscal system is a dynamic creature, which regulates intergovernmental relations in the face of varying economic and political shocks. An ideal system would require the flexibility to adjust to changing circumstances -- such as technological changes (or fashions) that call for a reallocation of the assignment of fiscal responsibilities, or shocks from the international financial markets that call for fiscal adjustment. Unfortunately, the Argentine federal fiscal system has not had the required flexibility, and its rigidity has imposed very large welfare costs. Its rigidity, in turn, has developed as an attempt of the national and subnational governments to protect themselves from the possible opportunism of the other actors.

Over time, Argentine political authorities have attempted to reform the system in a more efficient way, but the implementation of (important aspects of) those agreements has failed, due to time consistency problems and due to the lack of adequate enforcement technologies. In the end, the rigidities derived of the inadequate institutional environment have lead to a situation in which the speed of markets and of social events has gone much faster than the capacity of the Argentine political system to respond, leading to the tremendous crisis that Argentina is undergoing at the time of this writing.

III.3. The inefficiencies of the system are the outcome of non-cooperative play in a federal fiscal game

We can interpret the evolution and performance of the federal fiscal system as the outcome of a non-cooperative game involving national and subnational authorities. As a first approximation I will treat that game as orthogonal to the agency problem between the citizens and their political representatives, as if the latter were perfect agents. That is, of course, not true, and I will raise a flag whenever that interaction needs to be made explicit.[36]

The features identified in III.1 are the outcome of non-cooperative play in the federal fiscal game, and of the rigidities that the players impose to the system in order to protect themselves from the opportunistic (non-cooperative) actions of each other. One typical example of subnational governments not internalizing the full effect of their actions are the cases in which they take a lax fiscal stance, in the expectation that they will be bailed out in the event of a fiscal crisis. This opportunistic behavior by subnational governments is often corresponded by opportunism on the part of the federal government, whose generosity at bailout time depends on the political alignment of the subnational government in question, or on the exchange of bailouts for favorable votes in the national Congress.

[36] In particular, it is important to note from the beginning that the national government is not a unified benevolent player, but rather an arena in which subnational interests interact with some "independent" federal interests in particular ways. (More on this later).

Another example of non-cooperative behavior affects the quality of the tax system. Since sometimes the shared taxes tend to be the more efficient ones, intergovernmental agreements tend to create a systemic incentive for the national government to increase inefficient taxes. (That is how Argentina has ended up with excessive social security taxes and excessive taxes on financial transactions).

Rigidities such as minimum revenue guarantees were gradually introduced in intergovernmental negotiations, as a way of insuring weak property rights in a weak institutional environment. Those rigidities turned out to be just too costly in the later part of the De La Rúa administration and were one contributing factor to the default and social explosion that ensued.

III.4. Why non-cooperative play?

The question is, then, why is it the case that the environment of intergovernmental relations in Argentina has been such that the equilibrium was a non-cooperative one? In order to answer that question, one needs to look into the general (abstract) determinants of cooperation in these types of games, and to map those abstract elements into the observable characteristics of Argentina's fiscal and political federal institutions. A listing of the determinants of the degree of cooperation -- taken from Spiller and Tommasi (2001) and Tommasi, Saiegh and Sanguinetti (2001) – includes: the payoffs of the stage game, the number of political actors with power over a given decision, the length of horizons (or patience) of key political actors, the intertemporal linkages among key political actors, the characteristics of the arenas where they undertake their exchanges, the timing and observability of moves, the availability of enforcement technologies, etc.

There is a two-way intertemporal interaction between the features of the federal fiscal system and cooperation in intergovernmental relations.[37] Features of fiscal federalism that arouse historically either by accident or by previous rounds of the game, then become determinants of the incentives to cooperate in later stages of the game. For instance, the large degree of vertical imbalance and the heavy dependency on central taxes has a reinforcing effect in providing poor incentives for developing strong local tax capacities, and is an obstacle to the enforcement of the commitment to decentralize tax responsibilities.

Key political variables are those that impinge upon the qualities of the arenas of intergovernmental decision making in fostering cooperation: one is intergovernmental relations per se (such as the Premiers' Conference in Australia), the other is the very structure of the federal government. The central government is a political arena with particular selection rules in which the representation of subnational interests interacts with some "purely national" interests. The purely national interests, in turn, include:

- on the positive side: the more encompassing national interest due to the broader electoral base of the president; and

[37] Fiscal and other economic features of the country play a role similar to the one plaid by market characteristics (elasticity, observability of price discounts, etc.) in oligopoly games in determining the possibility of enforcing cooperation. See for instance Green and Porter (1984).

- on the possibly negative side: the "spurious" national political interests – national officials want to be given the credit for certain actions, such as distributing welfare programs, and want to avoid the blame for things such as raising taxes or cutting teachers' wages.[38]

The exact incentives of subnational and "purely national" actors, as well as the exact rules of the game they play, will depend on the details of political institutions. These include: electoral mechanisms for different offices, legislative structure (number of chambers, etc.), legislative decision-making rules (including the legislative prerogatives of the executive; Carey and Shugart, 1998), the role of Courts, and the underlying distribution of economic, social and ethnic cleavages, as well as their mapping to political geography.

At one extreme, one can find cases where the central government is totally free from "the infiltration of subnational interests." More generally, one needs to identify the configuration of "national" political institutions that are more or less prone to fall into the politically motivated bailouts that distort incentives in decentralized fiscal structures.

III.5. The institutional environment of the Argentine federal game

The environment for intergovernmental transactions in Argentina has not been the most appropriate; the allocation of policy jurisdictions has evolved in a peculiar way throughout the twentieth century, while intergovernmental agreements have not been backed up by the institutions necessary for overseeing their enforcement. Given Argentina's political and economic instability since the 1930's (including numerous military "interruptions" and high and volatile inflation), political actors have tended to adopt a particularly myopic perspective. National and subnational governments have not invested in building intergovernmental institutions, and they have attempted to protect their quite vulnerable property rights instead of collaborating with one another.

This historical legacy has deeply affected the revenue-sharing system. Changes in bargaining power of collections of political actors have reflected in shifts in the system of transfers. For instance, when power was concentrated in the national government (mostly during military regimes) the changes shifted the distribution of taxes towards retention at the national level. Conversely, with the return to democracy, the once-again elected governors managed to get a larger share transferred to the provinces. These modifications in favor of the subnational governments as a whole were, in general, accompanied by an element of interprovincial redistribution, depending on coalitional politics at the time (Saiegh and Tommasi, 1998).

There have been mutually reinforcing interactions arising from intergovernmental relations and the country's overall incapacity to implement efficient intertemporal exchanges (Spiller and Tommasi, 2001). The combination of lack of legislative incentives, the disproportionate power held by provincial leaders in national policymaking, and the ability of the national executive to act opportunistically has deeply affected intergovernmental relations.

[38] This is one of the points in which we depart from the assumption of orthogonality between problems of intergovernmental cooperation and principal-agent problems between citizens and politicians.

Intergovernmental bargaining

Argentina is a case where "executive federalism" is prevalent, that is, the president and governors play a predominant role in intergovernmental relations. Yet, deals struck between national and subnational executives can easily be altered at either the legislative or the implementation stage. This is compounded by the fact that the governors' influence in national policymaking gives them enough political clout to be able to secure occasional legislative benefits at the expense of the national executive or other subnational units. On the other hand, during the implementation stage, the president can easily unravel agreements reached or ratified in the national legislature. Thus, these agreements are often reached outside the national legislature, and they tend to incorporate very rigid rules in order to prevent their modification.

Several features of the Argentine political system explain why the environment is not adequate for efficient political transactions among jurisdictions.

Weak national legislators, powerful governors

The national legislature could potentially serve to foster beneficial intercommunity agreements. The U.S. Congress is often depicted as an institution where intertemporal political agreements are secured. As Weingast and Marshall (1998) note, its internal organization and institutionalization facilitate the achievement of complex intertemporal agreements among its members. Jones et al (2001) show that this is not the case for the Argentine Congress. Legislators are short-lived, and they do not have the incentives to develop strong congressional institutions.

Jones et al (2001b) trace those incentives to the electoral system, in particular to the methods of intra-party candidate selection, and to the incentives they generate for local party leaders and for individual politicians. As a result of this, Argentine governors have a disproportionate amount of power in national politics, and they are continuously involved in national policymaking.[39] This impinges upon intergovernmental relations, by inducing a peculiar criss-crossing of national and "properly federal" issues.

A weak "horizontal" separation of powers

The last point indicates that congressional representatives are not key actors in the Argentine polity, neither for intergovernmental relations, nor for anything else, and that sub-national leaders exert disproportionate influence through Congress. Under those circumstances, one would want to focus on the arenas in which those relevant long-term players undertake their interactions. In turns out that, not only are congressmen not the key

[39] This fact is particularly evident in the many fiscal pacts signed (1990, 1992, 1993, 1999, 2000, 2002), in which, among other things, provincial governors promised to influence national legislators from their provinces (and their party) to vote for specific laws that were, at each time, important to the national executive.

players, but neither is the National Congress the (main) arena used by the relevant players to hammer their agreements, since the weak "horizontal" separation of powers does not prevent the national government from reneging on legislative agreements.

The weak horizontal separation of powers is due in part to some constitutional capacities and practices (including executive decree powers), to budget practices that give the executive ample discretion in the implementation of the budget, to the (historical) political alignment of Supreme Courts to the President, and to the lack of a strong, independent and professional bureaucracy.[40] All of these features contribute to the poor institutional environment for the enforcement of interjurisdictional deals.

Weakly institutionalized intergovernmental relations and their consequences

National legislators are not the key long-term players in intergovernmental relations, nor is the National Congress the arena in which the real players (the Governors and the National executive) strike the key bargains. This begs the question of which is, then, the arena for intergovernmental agreements, and which are the enforcement properties of that arena. The truth is that intergovernmental relations in Argentina have been carried out in very different ways, mostly on an ad-hoc basis and in multiple and superimposed political arenas.

Informal mechanisms have dominated, but formal intergovernmental agreements have also been used. Good examples of the latter are the "Federal Fiscal Pacts" that we analyze below. Also in 1994, important aspects related to fiscal intergovernmental relations were included in Argentina's revised constitution, establishing that A new Coparticipation law, "on the basis of agreements between the central government and the provinces," had to be drafted before the end of 1996. (The law has not been passed yet, although each new fiscal pact includes a promise that a new law will be passed "before the end of the year.")

However, besides these formal instances of negotiation, intergovernmental relations have been often conducted in a much more informal way. The lack of institutionalization of the mechanisms through which intergovernmental relations have been handled had serious effects on the nature of policy making in the federal fiscal realm. On the one hand, these arenas did not provide enough institutional "stickiness", making changes in the allocation of policy jurisdictions and in the allocation of federal funds too volatile -- and more generally making the enforcement of agreements very deficient. On the other hand, in order to avoid such uncertainty and opportunism, allocations have at times been defined through very rigid mechanisms, that later become a painful straightjacket and oftentimes the source of further difficulties.

III.6. The evolution of the federal fiscal system. Background

[40] See Spiller and Tommasi (2001) for more details and references on each of these points.

The federal fiscal system, and in particular the tax sharing agreement has a long and complicated history in Argentina.[41] When democracy returned to the country in 1983, after many years of military interruptions, the system had already acquired some of its distinguishing features: a large fraction of spending was in the hand of the provinces (around 25%),[42] a large fraction of that spending was financed out of federal government monies (67%), that fraction was very heterogeneous across provinces, and the tax sharing system was each time more redistributive, but at the same time very convoluted (full of loopholes, etc.).

With the democratization process initiated in December of 1983, the newly elected governors sought a new co-participation regime. Negotiations began in 1984, but a new accord could not be reached, and the previous regime dating from 1973 expired. Consequently, 1985 was characterized by the absence of a legal regime for "coparticipating" tax revenues between the federal and provincial levels, and all transfers to the provinces were channeled under the very discretionary mechanism of *Aportes del Tesoro National* (ATNs, National Treasury Contributions). In practice, each province negotiated bilateral agreements with the federal government (Schwartz and Liuksila 1997).

During 1987, the provinces and the federal government sought the enactment of a more explicit norm, which was achieved in the 1988 law N° 23.548. In this law the provinces' share of tax revenue reached its historical peak. With respect to the distribution of those funds between provinces, instead of adopting any objective criteria to calculate each province's share, the law tended to validate the share that each province had obtained in the 1985-1987 period through a coefficient that constituted a "magic number."[43] Although the law established this Coparticipation regime for 1988, it was extended for many years. The main features of the 23.548 law prevailed until 1992.

The main episodes of what might have constituted "the reform of fiscal federalism in Argentina" were so-called Fiscal Pacts of 1992 and 1993, the Constitution of 1994, and the Fiscal Pacts of 1999 and 2000 -- those attempts and their implications are considered below. We devote more attention to the 92-93 attempts because given the time elapsed it is easier

[41] A longer view of the system is provided in Iaryczower, Saiegh and Tommasi (1999) and Eaton (forthcoming).

[42] Much higher than that if we focus on the more discretionary spending, after subtracting interest payments and pensions.

[43] The details of the negotiation of the 1988 law are provided in Saiegh and Tommasi (1998). The political context was the defeat at the midterm congressional elections of the governing Radical administration in the hands of Peronism. The national government was under IMF pressure to pass a tax reform to improve the fiscal situation, and the powerful Peronist governors (and their legislators) were able to exchange the passage of tax reform for a tax-sharing agreement which was more favorable to the provinces, and that included an important sacrifice of resources by the province of Buenos Aires, then in Radical hands. This last element constituted the background for a later special fund *"Fondo del Conurbano Bonaerense"* obtained by the province, which was the basis for the development of a clientelistic network (often utilized for political mobilization) by Eduardo Duhalde, Vice-president 1989-1991, Governor of Buenos Aires from 1991 to 1999, and President of Argentina at the time of writing this draft. Fondo del Conurbano consisted of a 10% deviation of the income tax (with a maximum of $650 million per year) to the Province of Buenos Aires for financing social programs in the poor suburbs surrounding the federal capital.

to assess their consequences in detail; and because to some extent they were more comprehensive (although less process-oriented) reform attempts.

III.7. The Fiscal Pacts of 1992 and 1993

Two of the most salient moments in the recent history of fiscal federalism in Argentina were the so-called Fiscal Pacts of 1992 and 1993. For brevity, an given their closeness in time, I will treat them jointly. To begin with, it is important to clarify several important contextual factors around the time of the pacts.

Background

The main background of the 92-93 pacts, and of some related measures,[44] was the success of the core of Menem's economic policies in the early nineties. In terms of their impact on intergovernmental relations, the main effect of the "market-oriented reforms" was to shift the net fiscal position of the national and provincial governments in a way that increased provincial total revenues, relatively decreased national total revenues, and increased national spending responsibilities.[45]

The increase in provincial total revenues came mostly from an increase in shared taxes and a "sympathetic" increase in provincial tax revenues (increase in base, etc.).[46] The increase in shared taxes was due to a reverse Olivera-Tanzi effect after stabilization, as well as to changes in the structure of taxes. The new structure of taxes was characterized by a large increase in VAT (due to increased rates and base) and income taxes, and by a decrease in trade taxes due to economic liberalization.[47] The drop in relative national revenues was due

[44] Such as the transfer of some Education and Health responsibilities to the provinces, described in more detail in section IV.

[45] These factors tend to be ignored in some papers (mostly from political scientists) which in interpreting the evolution of fiscal federalism in the 1990s, speak of a process of "fiscal recentralization," ignoring these environmental changes that did require some shift of resources towards the center. Those papers, which include Faletti (2001), Haggard and Webb (2001), O'Neill (2001), Remmer and Wibbels (2000), and Eaton (forthcoming), present some valuable political theorizing, but without due attention to these environmental "economic" factors.

[46] That is because the main provincial tax is the sales turnover tax which, in spite of being very inefficient, benefits substantially from economic growth and from low inflation.

[47] During Argentina's ISI times, special tax treatments were the name of the (political) game (Eaton, 1997). Over the years these efforts resulted in narrow tax bases, differentiated rate structures, and significant tax evasion. According to the World Bank (1993), at the end of 1987 virtually all investment activity was subsidized through the tax system. One of the main components of Menem's reform effort was a tax reform (briefly summarized in table 6) attempting to: broaden tax base, flattening tax rates, and improving tax collection, in a marked shift from the sectoral particularism that had characterized Argentina's previous tax structures. In terms of political strategizing, the national executive did play a quite skillful strategy of sequencing tax reform and renegotiation of tax sharing in such a way that it first obtained approval of tax base broadening, then gradually increased rates, and only then renegotiated tax sharing. "Menem faced the political reality that *simultaneously* reducing the provincial share in tax revenues while asking legislators to pass tax reforms would run the risk of complicating support for tax reform among national legislators elected in provincial districts." (Eaton, 1997, p. 108).

to this decrease in its exclusive trade taxes, as well as to the loss of seigniorage from reduced inflation. Table 14 gives a sense of the quantitative significance or these changes.[48]

<Table 14>

Inflation was reduced from 4923% in 1989 and 1343% in 1990 to 84% in 1991, 17% in 1992, 7.45% in 1993 and 3.9% in 1994. This was accompanied by a reduction in inflation tax revenues from $26.421 (74% of National Government revenues from legislated taxes) in 1989 and $13.052 (40%) in 1990 to $2.536 (7%) in 1991, and zero from 1992 onwards.

On the side of spending responsibilities, other than the aforementioned transfer of some education and health services which is described in more detail in section IV, the main change was induced by the social security reform. The social security reform consisted of a series of measures, all of which increased the short-term fiscal burden of the national government. The main component of the reform was giving the option of staying in the public pay-as-you-go system or moving to one of private accounts. Given the nature of the transition, most senior workers stayed in the public system, while the younger workers moved to the private one, increasing the short-term fiscal burden of servicing pension obligations. It was originally estimated that the burden would be of the order of 2% of GDP, and that it will dwindle in about ten years. This factor was a crucial component of the negotiations of the Fiscal Pacts.[49]

In terms of the political and legal background of the pacts, during 1992, the distribution of federal taxes between the federal government and the provinces was affected by a series of laws and decrees aimed at providing funds to increase social security payments. The provinces reached the point of initiating legal action in the Supreme Court. Indeed, a clause in the first Fiscal Pact stated that those provinces that had initiated legal action against the National government (in reference to those decrees) had to cancel the processes under way.

Objectives

As already stated, the Federal Fiscal Pacts of 1992 and 1993 were not simple exercises in "reforming the federal fiscal system" in the "heroic" approach to reform. They were a manifestation of rather complex political exchanges that included: some efficiency-enhancing reforms (some achieved, some not achieved), some attempt at solving economic urgencies of the moment, attempts to adjust some allocations to changing circumstances, and some clever (and at times opportunistic) political maneuvering.

Among the "worthy" objectives pursued by the federal government we might include:

[48] The table does not capture the reinforcing composition effect from the fact that Olivera-Tanzi used to affect shared taxes but not trade taxes. Furthermore, in the old times there was not only gaming from tax-payers, but also from the national government, further delaying the transfer of (depreciating) shared taxes.
[49] Another contextual factor that deserves mention was the fact that the federal government had successfully rescheduled its external debt and was deepening its first generation reforms through further privatization.

- An attempt to push for fiscal retrenchment at the provincial level. As table 15 shows and as it was described in section II, the provincial level did not accompany the fiscal retrenchment of the central government.[50]
- An attempt to push for the reform of some very inefficient provincial taxes. The federal government was seeking from provinces to substitute the turnover tax by a consumption tax in order to reduce the cascading nature of the provincial turnover tax, to eliminate the highly distortionary provincial stamp tax, and to eliminate provincial labor, financial and energy taxes.[51]
- privatization of some provincial public utilities and public provincial banks.

<Table 15>

Content and political exchanges

The 1992 Pact, the so-called "Federal Pact" was signed August 1992 (ratified by Federal Law 24.130). It diverted 15 percent of Coparticipation funds to help pay for reform of the national social security system. In return, the government established a guaranteed floor on Coparticipation payments.[52]

To reach this pact, the President used other transfers as well as the reform itself to put together a coalition that spanned both houses: Buenos Aires province for its weight in the chamber of deputies and the low-population provinces for their weight in the Senate. A new *Fondo Conurbano* helped secure the support of legislators from Buenos Aires. For the small provinces, the new arrangement promised Coparticipation revenues, plus discretionary transfers that, in a few cases, were very high (related to the explanation in section II).

Regarding the second fiscal pact, in exchange for the "worthy" requests listed above, the Federal Government agreed to increase minimum co-participated transfers, postpone, and possibly forego, certain provincial debt obligations, and take over responsibility for funding

[50] Unfortunately, the federal government was not totally consistent with its own retrenchment effort later in the game, especially in the events surrounding the reelection efforts of President Menem.

[51] Minister Cavallo was very adamant in achieving the elimination of the very inefficient provincial tax on financial transactions. Interestingly, the same minister in his 2001 reincarnation reinstated a tax on financial transactions in the context of economic emergency, as an exclusive national (!) tax. The current government is still debating with the provinces over the distribution of that "emergency" inefficient tax that, as it is often the case with emergency measures in Argentina, is likely to become a permanent feature of the fiscal landscape. (By the May 2002 rewriting of this paper, yet another Fiscal Pact has been signed. Among other things, it makes 30% of the proceeds of that tax shared with the provinces. In spite of the fact that the Pact established the automaticity of this sharing, it has not been instrumented yet.)

[52] The Minister of Economics' initial objective was to agree on a fixed monthly transfer of $720 million – equal to what the provinces had received in December of 1992 plus an additional $100 million. The extra 100 million were to cover the newly decentralized education expenditures. Whatever money remained after the transfers was to be used to finance the pension system. Though provincial governors rejected this initial proposal, the final agreement was somewhere in between and the main items of Cavallo's proposal were maintained, i.e., a fixed monthly amount and the possibility to use part of the resources collected to fund the pension system. The 1993 Fiscal Pact raised the minimum monthly floor to $740 million.

provincial social security systems. In the context of the Fiscal Pact, the Federal Government had the obligation to accept the transfer of provincial social security systems, and harmonize contributions and pensions with the newly approved national social security system. Additionally, the Federal Government would support the privatization of public enterprises, and reduce the role of provincial banks through privatization of management and ownership.

The Pacts and their fulfillment

Tables 16 and 17 reflect the main components of the pact and the degree to which they have been fulfilled.

Table 16
1992 Fiscal Pact

	Commitment	Degree of fulfillment / accomplishment
a.	15% of the total co-participation (prior to all distribution) was assigned to finance the Pensions System and the DGI.	Total
b.	The Federal Government guaranteed a monthly transfer of 725 million pesos to the provinces.	Total
c.	A monthly fund of 43.8 million pesos ("Fondo de Desequilibrios Regionales") was established, in order to finance regional imbalances. This fund was distributed between provinces without regard of the secondary distribution stated in Law 23.548.	Total
d.	The Federal governments would automatically transfer resources from the FONAVI (National Housing Fund), FEDEI (Federal Electricity Development Fund) and the Fondo Vial Federal (Federal Roads Fund).[53]	Total
e.	Provinces would claim their legislatures to sanction balanced budgets, i.e., they would need either to control for the existence of the resources assigned to expenditures or reduce expenditures.	Nil
f.	Both the Federal Government and the provinces committed themselves not to increase their expenditures more than 10% above the 1992 current expenditure.	Only City of BA, Corrientes, Chaco, Entre Rios and Salta have fulfilled this commitment.

<Table 17: The 1993 Fiscal Pact >

[53] These funds were supported by a law and had their own distributional pattern, different from that of the Coparticipation Law.

Table 17 shows that the degree of fulfillment is very uneven across provinces and across reforms, with some key reforms (such as the replacement of the turnover tax) failing altogether. The following description by Schwartz and Liuksila is particularly telling:

> "Tax reform was clearly the centerpiece of the second fiscal pact. Provinces adhering to the pact committed themselves to eliminating stamp taxes on checking accounts, taxes on the transfer of fuel, gas and electricity and, most important, phasing out the provincial turnover tax. [....]
>
> Initially, the provinces were slow to join this second pact, largely because of the revenue implications of the tax reforms, particularly the initial stipulation to abolish the provincial turnover tax before June 1995. While the provinces were free to replace the turnover tax with other taxes, many have not yet done so. [....]
>
> Overall, there is no easy short-term alternative for replacing the provincial turnover tax. [....]
>
> Other alternatives for improving provincial revenue would be beneficial in the long run, but would not yield short-term results. [...] Similarly, improving real state taxation would require substantial initial efforts, including, for example, improving property mapping and property registries; providing better and more consistent application of valuation techniques; improving the exchange of information between local tax offices, property registries, ...
>
> The announcement in December 1993 that federal payroll taxes levied on employers would be reduced, depending on region and sector, in those provinces participating in the second pact, increased pressure on provincial governments to join. By May 1994, all but one provincial legislature had ratified the second fiscal pact, and most had taken at least some initial steps toward implementation. Also the provinces were given a minimum revenue guarantee and some other guaranteed fixed payments that provided a floor of federal transfers equivalent to about 4.5% of GDP annually.
>
> The second fiscal pact clearly shows the 'horse-trading' that is involved in implementing structural reforms of the system of fiscal federalism. [....], but came at the expense of making payroll taxes an explicit instrument of regional and sectoral policies, and contributed to the growing social security deficit."(1997: 408-412)"

This example illustrates the inability to make intertemporal trades that have the nature of investments, i.e., up-front costs and a later stream of benefits that could be appropriated. It shows that the extant federal governance structure of Argentina cannot support such trades.

All in all, the 92-93 pacts left a mixed landscape; including some successes like the privatization of some provincial banks, and some failures such as the non-reform of provincial tax systems. Clearly, the basic incentives and fundamental governance of the underlying federal fiscal game were not altered. That is reflected in the later reform attempts, such as the one in the 1994 Constitution, to which we now turn.

III.8. The Reform of the Tax-Sharing Regime in the Constitution of 1994

When president Menem was ending his first term, his interest in reelection –in those days not permitted by the Constitution- moved him to promote the reform of the Constitution. As a key step towards the reform, Menem made a pact with former president Alfonsín, who in exchange for his party's support requested several constitutional changes, all of which tended to reform the political system in the direction of parliamentarism. Their agreement was known as the "Pacto de Olivos" and they expected Congress to agree upon their proposal without further changes.

However, when the agreement was made public, several provincial leaders envisioned the opportunity to imprint the procedures to establish and reform the federal fiscal regime in the Constitution. They made their support in Congress conditional to the inclusion of this subject among those to be reformed. Menem and Alfonsín were compelled to accept these terms.

Given Menem's political ambitions, provincial leaders were in a position to negotiate some fiscal benefits. As explained above the late '80s and '90s were years in which several changes were introduced into the federal fiscal regime, and provincial leaders were well aware of the uncertainties they faced. The opportunity to negotiate an agreement which would be engraved in the Constitution –protecting them against future acts of opportunism from the federal government- could not be neglected. The "Pacto de Olivos" had to be endorsed in Congress where small provinces have considerable strength. The following table shows party composition in both chambers at the time of the approval of the bill. It shows that Menem did not confront strong opposition from other parties. However, members of the PJ in the different provinces were not willing to act under party discipline and preferred to stand out for the interests of their provinces.

Table 18
Distribution of Seats in Both Chambers
at the time of Constitutional Reform

Political Party	Senate 1992-95		Deputies 1993-95	
	No.	%	No.	%
Unión Cívica Radical	**10**	**21**	**84**	**33**
Partido Justicialista	**29**	**60**	**127**	**49**
Others	**9**	**19**	**46**	**18**
Total	48	100	257	100

The final constitutional text with regards to federal fiscal arrangements was the outcome of complex negotiations among the federal government (the president and national ministers) and the provinces (provincial governors and provincial party leaders in general). The alliances among these actors varied throughout the process, changing according to the issues at stake and the positions adopted by their districts in these issues. Therefore, the text agreed upon reflects these actor's opportunism under given constraints and the ways in which they attempted to protect themselves (and their districts) from future fortuities. In general terms, the provinces were able to establish a procedure that would in principle protect them from federal government's unilateral influence. It is interesting to note that provinces initially tried to get actual sharing coefficients to get written into the Constitution, but the national executive was able to convince them to replace that by procedural mechanisms with regards to the future sharing agreement.[54]

[54] At a more dissagregated level, one could also say that the procedures decided upon benefited the small provinces more than large –rich-- provinces such as Buenos Aires.

The negotiations at the constitutional convention as well as the final text (summarized below) are very clear illustrations of *transaction cost politics* at work:

(a) *A "Ley Convenio" based on understandings between the Nation and the provinces will establish systems of Coparticipation in taxes. The automatic delivery of funds is guaranteed.*

A *Ley Convenio* is a special procedure that requires that after being enacted by Congress, the law must be authorized by each provincial legislature before acquiring validity. This clause results from actor's distrust of each other, originated in past failures to honor agreements, or attempts to openly violate them. Due to their belief that if anything were left unchecked someone's interest might be endangered, they agreed on a procedure that requires several instances of approval. The conditions put forth to accept the agreement are so demanding that it would be rare to see such an agreement come to life, as illustrated by the failure to produce a law by the time of this writing.

(b) All taxes collected by the national government (other than foreign trade taxes) should be coparticipated.

This is to avoid the opportunistic creation of non-shared taxes.

(c) The distribution between the Nation and the rest of the districts –and among these districts- shall be carried out in direct conformity with the capacities, services and functions performed by the jurisdiction, in compliance with objective distribution criteria. This distribution must be based on principles of equity and solidarity prioritizing the achievement of similar levels of development, of living standards and equal opportunities throughout the national territory.

This looks like a protection imposed by provinces to guarantee certain levels of resources, given the differences with the federal government and among themselves in terms of capacities, services and functions performed by each jurisdiction. Provinces tried to protect themselves from arbitrary changes in the percentages they were entitled to receive from tax collection, a fear clearly resulting from the lack of criterion backing those percentages.

(d) The Ley Convenio is to be originated in the Senate and shall be enacted with the absolute majority of all the members of each House.

This procedure should be interpreted as a warranty to provinces in general that actors such as Buenos Aires (due to its numerical superiority in the House) or the federal government (an actor with sufficient resources as to buy support) would not be able to get away with a reform of the federal fiscal regime that was not supported by most of the provinces. The key to understanding this rule lays in the selection of the Senate as the chamber where the bill should be originated (therefore avoiding the numerical advantage of some provinces in

the House), and the requirement of absolute majority of all members in each house, which leans towards the same goal.

(e) It may not be unilaterally amended nor regulated, and must be approved by the provinces.

The explicit mention of unilateral actions, is a clear demonstration of the general concerns of the provinces, precisely in the direction emphasized in our framework. The ability of the national executive to undertake unilateral actions has been behind the inability to enforce the political transactions necessary to build a more efficient system.

(f) No transferal of competence, services or functions may be done without the corresponding reallocation of funds approved by a law from Congress and by the relevant province or the City of Buenos Aires, as required in each case.

This clause intends to protect the provinces against opportunistic actions by the national government. Their caution is a response to previous experiences with decentralization of public services, in which the National government not always transferred adequate funding alongside responsibilities. (See section IV for the case of education decentralization).

(g) *A Federal Fiscal Entity ("organism") shall be in charge of controlling the implementation of what is presented in this subsection, in accordance to what the above-mentioned law shall establish, guaranteeing the representation of all provinces and of the City of Buenos Aires in its composition.*

The requirement that a federal fiscal institution be created to control the implementation of decisions is a clear sign that the federal government –the "default" actor in charge of the implementation- is not a beneficiary of the provinces' trust. Along with all the other mechanisms set forth to ensure that they would not be tricked into loses when designing the regime, they established that whatever was decided could be misinterpreted –or bluntly ignored- by the federal government during the ongoing implementation phase. To prevent such course of events, the implementation is to be supervised by an organism in which all of the districts will be represented. This is a clear illustration of the importance of governance in a context of incomplete contracting.[55]

All the highlighted points reflect very clearly, the transaction-cost-politics nature of the problem. The very constitutional status of the issue is a reflection of its importance and of the fear of opportunism by some actors. Furthermore, all the important clauses represent the actors' attempt at protecting themselves (by procedural means, by forbidding certain actions, by adding veto gates) against opportunistic behavior. These procedures, while

[55] We have developed proposals of reform of fiscal federalism in Argentina that, from this incomplete contracting perspective, put most of the weight on the adequate design of this federal fiscal institution. See Iaryczower, Sanguinetti and Tommasi (2000) and Saiegh and Tommasi (2000).

giving some assurances to the parties involved, have at the same time decreased the likelihood that any change could occur.

III.9. The saga continues: no Law, still playing the old game, more Pacts, and the crisis of 2001/2002

The first thing to notice with regards to the evolution of the federal fiscal system after the 1994 Constitution, is the fact that the constitutional mandate of passing a new law (originally by the end of 1996) has not been fulfilled yet. There were always one or several projects on the table, but none has mustered enough support (not even within the Executive), so as to get serious political attention.

Argentina has been signing agreements with the IMF throughout the period, promising "to pass a Coparticipation Law, " but systematically failing to do so. Beyond some autistic tendencies in the IMF and in the Argentine national bureaucracy,[56] this reflects on some deeper issues. On the one hand, the complex procedural constraints imposed by the Constitution, do not facilitate the passage of a new law, what interacts with the ("transaction cost politics") intrinsic complexity of the problem of passage of a "definitive" regime. Furthermore, the usual agenda setter in these things is the national executive, and it was not obvious that it was in its best interest to move to a regime that, if well done, would restraint some of its own unilateral moves.[57]

Ex post, it is obvious that the fiscal path of Argentina was a far cry from what would have been necessary to avoid a terrible crisis like the one it is living today.[58] Both a more relaxed fiscal stance in the second Menem administration, and the dynamics of provincial finances put the country in a risky path that, when interacted with several negative shocks, plus the wild fluctuations in international market conditions and sentiment, precipitated the crisis. During the 1993-1998 period, when the Argentine economy was generally performing well, and the Argentine government was receiving substantial non-recurring revenues from privatization and enjoyed other temporary fiscal benefits, the public sector debt over GDP nevertheless rose by 12 percentage points. This clearly was not an adequately disciplined or sustainable fiscal policy.

Table 19 summarizes the behavior of provincial, national and consolidated finances from 1993 to 2001. It is clear that, especially at the provincial level, there was high growth of spending during the good years after the Tequila shock, and that the adjustment to the

[56] The latter, in turn is explained by some endogenous features of the Argentine bureaucracy, not totally independent of the federal fiscal/political mess, explored in more detail in Spiller and Tommasi (2001) and Bambaci, Spiller and Tommasi (2001).

[57] Here we are emphasizing the short-term self-interest of the political actors running the executive at a given point in time.

[58] This is not the place for a complete analysis of all the determinants of the Argentine crisis. It suffices to say, for our current purposes, that a tighter fiscal position throughout the second half of the 1990s would have been desirable (or essential, according to some accounts).

difficult times starting in 1999 was far too delayed.[59] From 1997 to 1999, primary expenditure increased almost 20% at the provincial level and 14% at the national level.

<Table 19>

The less than perfect fiscal discipline by national and provincial authorities is the consequence of the same old political game being plaid, in spite of the fact that some of its explicit channels have been closed by the convertibility regime, and by some further measures. This lead to an overly enthusiastic assessment of the overall fiscal sustainability of Argentina by international organizations such as the World Bank and the International Monetary Fund, who were fairly bullish about some accomplishments such as the privatization of several provincial banks and by the approval of a Fiscal Responsibility Law in 1999.[60]

The perverse behavior of public finances was in large measure linked to the 1999 presidential campaign. Early in the game, president Menem attempted a blatant move to run for a third term, a move that in spite of its obvious lack of constitutionality, lead to a relaxation of the national fiscal stance in order to gain support. Even worst than that, the other contender for the Peronist candidacy was governor of Buenos Aires Eduardo Duhalde. First in fighting Menem's reelection bid, and then in fighting the interparty presidential competition as the Peronist candidate, Duhalde made generous use of the largest budget in the country, that of the province of Buenos Aires. Given the importance of the province, and the federal fiscal linkages emphasized in this paper, those actions had dire consequences for Argentina.

Buenos Aires accounts for 30% of GDP, 30% of total provincial spending, 31% of personnel expenditure and 23% of total provincial debt by 2000. By the third quarter of 2001 (shortly before the Argentine implosion), Buenos Aires' deficit represented 57% of the consolidated provincial deficit. Its deficit had a markedly different behavior from 1991 to 1997, when it was less than 8% of total spending, and since 1998, when it represents more than 13% of provincial spending. (See Figure 5). Total spending in Buenos Aires grew 30% between 1995 and 2001, much higher than the 10% increase in the other provinces, and the 15% increase in national spending (Figure 6). This lead to fiscal disequilibria of 19% in 1999, 18% in 2000, and 20% in 2001, and to an increase in its debt stock of 69% in the 1997-99 period. Provincial public employment rose from 320 thousands in 1995 to 405 thousands in 1999, with the largest increase (17%) occurring from 1998 to 1999. Personnel expenditures rose 49% in the 1996-99 period.

<Figure 5>
<Figure 6>

[59] Of course, in a normal country in normal times, you would not want fiscal retrenchment in a recession. Yet Argentina is not a normal country in normal times, but a country suffering from (well-deserved!) deep credibility problems, forcing the need for contractionary fiscal moves after having lost the opportunity of fiscal savings during the good times.

[60] See Braun and Tommasi (2002) for a more detailed critique of some of those assessments.

In spite of all these efforts, Duhalde lost the 1999 presidential election to Fernando de la Rúa, the candidate of an alliance of the traditional Union Civica Radical with Frepaso (a recent federation of center-left parties). Duhalde was replaced in the province by the Peronist candidate Carlos Ruckauf,[61] who did not do much to improve the fiscal situation. The impending default of the Province was one of the main concerns of the National Ministry of the Economy throughout 2001. In a sense, there was a perverse political war of attrition to see who (the radical National authorities or the peronist provincial authorities) was blamed by the imminent financial disaster.

In April 2001, the province of Buenos Aires and the Federal Government signed a bilateral agreement to improve the provincial fiscal situation. The agreement established a nominal deficit ceiling, a primary spending cut, and the Federal government's commitment to provide financial support. The former, in the finest Argentine tradition, was not fulfilled by the province, but the latter was used in November 2001 when the Central Bank gave a $65 million rediscount to the Provincial Bank of Buenos Aires (one of the surviving dinosaurs) to avoid the provincial default ("*cesación de pagos*"). The Banco Provincia also received a Central Bank waiver on the liquidity requirements on public deposits, as well as some additional tinkering with bank regulation to make its asset portfolio look better. (All of these happened after the convenient removal of the previous Central Bank president, and his replacement by somebody more "understanding.")

All of this, other than reflecting on the weakness of Argentine institutions, is also a perverse "Buenos Aires" revenge after all the redistribution away from the province in the previous decades. Unfortunately, instead of a more rational limitation on the redistributiveness of the system, we have these perverse dynamic interactions between the fiscal realm and the political realm. The late 1990s saw the two bigger fiscal players of the country involved in a spending binge, under the hope that it would be another political player the one to pay the bill.

Another connection between the Argentine disaster and fiscal federalism can be traced to the 1999 and 2000 fiscal pacts and their final effect. These pacts were signed right after the presidential election and shortly after the incoming administration took office, respectively.

The turn of the century found Argentina trying to overcome the harsh recession that began in the middle of 1998, mainly a result of the Brazilian and Russian crises, intensified by the Brazilian devaluation. As soon as the results of the presidential election were known, the future Economics Minister (José Luis Machinea) announced that the budget projected for 2000 needed serious changes, mainly because the rate of growth for the coming year would

[61] Ruckauf, who was vice-president of Menem's second term, was "promoted" from Governor of Buenos Aires to Foreign Minister in the Duhalde national government which eventually followed (on January 1st, 2002) the anticipated resignation of De la Rúa. It seems pretty evident that Ruckauf was moved out of the province of Buenos Aires so that the very likely impending financial disaster (or alternatively the very high political cost of the huge adjustment necessary) does not explode in his (loyal) hands.

be lower than that declared by the Menem Administration. This was a difficult task since opposition (Peronist) governors, who controlled a large chunk of the Congressional vote, denied their support. In order to carry out budgetary changes that would permit to comply with the deficit limits allowed by previous agreements with the IMF (and reflected in the 1999 "Fiscal Convertibility Law"), the incoming administration decided to bargain a new fiscal pact.[62] This agreement was attained in December 1999, four days before the De la Rúa administration came into office.

The central government committed to transfer a fixed amount to the provinces, independently of the revenues collected. The new administration envisioned that through an increase in income and sale taxes ("*impuestazo*"), the additional amounts needed to neutralize the fiscal deficit would be collected. The central government also committed to implement a plan of financial assistance and financial reform (FFDP) to allow the provinces to afford their 2000 needs[63]. The provinces committed "to pass Solvency and Fiscal Responsibility laws" and to fulfill the terms of the FFDP if they chose to adhere to that. The degree of fulfillment is summarized in the next table.

Table 20
Fiscal Pact 1999

Commitment	Degree of fulfillment / accomplishment
a. The Federal Government fixed a monthly transfer of 1350 millions of pesos to the provinces.	Total until the 2001 disaster.
b. Both the Federal and the provincials' governments commit their selves to sanction the new Coparticipation Law (required by the 1994 Constitution) during year 2000.	Nil
c. The provincial governments commit to pass both Solvency and Fiscal Responsibility Laws in their provinces reflecting the aim of the Federal Fiscal Responsibility Law.	14 provinces had passed this kind of law. Many of those provincial laws have not been fulfilled afterwards.[64]

[62] This was not the first time in Argentine history that the National government is, under IMF pressure, forced to sign an agreement with the provinces that leads to further costs down the road. For some previous episodes (in particular the 1988 Tax-Sharing Law), see Saiegh and Tommasi (1998). This reinforces a point that I have been making in this and related papers (see for instance Braun and Tommasi, 2002), international organizations should understand better the political economies of the countries in which they operate.

[63] The latter was called *Fondo Fiduciario para el Desarrollo Provincial* (FFDP), with the usual political euphemism of using the word "development" for what are in principle financial adjustment programs.

[64] See the details in Braun and Tommasi (2002).

d. Implementation of the FFDP program	Mixed
e. Tax harmonization in all levels of government[65]	Nil
f. The federal government commits to finance provincial pension system deficits gradually if the province permits a federal audit.	There was some assistance from the Central Government to the province of Córdoba and Santa Fé

After taking office, the De la Rúa administration was characterized by a rather quick political deterioration, including the resignation of the (Frepaso) Vice-President Carlos Alvarez. In that context, the government needed an additional fiscal pact in order to pass a consistent budget for 2001. The bargaining dynamics were similar to what we have studied so far in the paper: executive under foreign pressure for "consistency", opportunism by some provinces, some topical issues included alongside quasi-structural reforms, some efficiency-enhancing paragraphs here and there (on budgeting practices and fiscal transparency), etc. Governors complained loudly about the unfulfillment of the previous pact (some provinces complained about other provinces not fulfilling it). They committed (once more!) to pass a Coparticipation Law; provincial governments gained some more room to administer the few remaining national social programs (of limited use to solve the deep social problems of the country, but of high political leverage given the clientelistic use of focalization). The next table shows the main compromises and their fulfillment.

Table 21
Fiscal Pact 2000

Commitment	Degree of fulfillment / accomplishment
a. The Federal Government fixed a monthly transfer of 1364 millions of pesos to the provinces for year 2001 and 2002, and guarantee a monthly transfer of 1400 millions of pesos for year 2003, 1440 millions for 2004 and 1480 millions for 2005.	The later bargaining over this point was a compounding factor in the 2001 disaster. (See details in text below).
b. The provinces and the federal government commit to not increase the primary spending	Both levels of government increased primary expenditure the first semester of 2001.
c. The provinces pledged to sanction pluriannual budgets	Partial. Solvency and Fiscal Responsibility Laws establish this kind of budget formulation.

[65] Interestingly, this later pacts call for the fulfillment of clauses of the 1992 and 1993 pacts yet unfulfilled. This reflects on the inability of the system to enforce agreements.

d. Transparency and wide diffusion of the fiscal and financial accounts.	Partial (Nil in some provinces)
e. Implementation of the Fiscal and Social National Identification System..	Partial
f. Federal Agreement on Tax harmonization within 120 days.	Nil
g. Budget increase for social and employment programs for 2001.[66]	Was assigned in the Budget, but was underexecuted.
h. Federal Agreement on Modernization of the State (within 120 days)	Nil
i. All governments commit to sanction a new Coparticipation Law in year 2001.	Nil

The most important clause in practice was the establishment of a fixed amount to be transferred to the provinces. The following depiction (of both pacts), from Gonzalez, Rosenblath and Webb (2001), is useful:

One major component of the Federal Agreement was that during the year 2000, the provinces would receive a fixed amount in automatic transfers.[67] This provided the provinces with predictability in income, but the amount was also designed to allow the federal government to keep a larger share of incremental revenues expected both from an economic recovery and an increase in federal tax pressure. The calculation of the monthly fixed amount of $1.350 billion during 2000 was roughly based on the average of the previous two years.

The Agreement also established that during 2001 the provinces would begin to receive an average of the three most recent years' legal amounts (i.e., an average of what the provinces would have received under existing fixed percentages established in the general Coparticipation and tax-sharing laws). In this way, the idea of moving towards a moving average of recent years' percentage shares was put in place. However, in addition, the provinces were offered a minimum guaranty for 2001 that was set at a level 1 percent higher than the fixed amounts of 2000.

....[D]ebt-restructuring deals were offered to smaller provinces, and the federal government promised that they would facilitate larger provinces' debt restructuring via private banks and the multilateral development banks. Plus, they would finance part of provincial employee pension systems' deficits if reforms were made to make the systems consistent with the national system. (Many smaller provinces had already passed their pension systems to the federal government; however, this feature was attractive to the larger provinces that still have their pension systems.)

[66] This increase has to be distributed among provinces 50 percent proportionally and 50 percent according to 23.548 Coparticipation Law proportions.

[67] Virtually all automatic transfers were included – both the general revenue-sharing pool and tax-sharing arrangements. This represented a *de facto* simplification of the labyrinth of automatic transfers described above.

One year later, this agreement was followed by a more comprehensive *Compromiso Federal por El Crecimiento y la Disciplina Fiscal*, signed in November 2000 by all provincial Governors, except the Governor of Santa Cruz, a small province in the south. This agreement included a number of clauses for provincial reforms in the area of state modernization, budgeting and the transparency of fiscal accounts. In terms of stabilizing transfers, this new agreement established a timetable for switching permanently to the moving average concept. However, as described below, there would still be guaranteed minimum amounts over transition period.

For 2001 and 2002, the provinces would receive a fixed monthly amount equal to $1.364 billion. This figure was the guaranteed minimum for 2001 that had been stated in the previous 1999 *Compromiso* (where the actual amount was to be an average of three most recent years). Now it would be both a floor and ceiling for both 2001 and 2002. The amount itself implies an increase of $14 million, or about 1 percent, over the amount received during 2000.

From 2003-2005, the provinces would start to receive a moving average of the three most recent years shared revenue amounts. In other words, it would be an average of what they would have received according to the old laws during the three most recent years. In case this moving average were to coincide with recessionary or low growth years, a guaranteed minimum amount is set: $1.4 billion per month in 2003, $1.44 billion in 2004 and $1.480 billion in 2005. These minimum amounts represent approximately 2.6 to 2.8 percent increase per year in nominal terms.

Note that it is not clear what the federal government would do with the expected savings from the lower transfers. A fiscal stabilization fund that would lock up the savings so that they could be used later during recessions is not explicitly established by this *Compromiso*, although there is general language stating that this fund would be established in due course. Depending upon what growth rates one assumes, over the five year period, the provinces would lose anywhere from $1.5 to $7 billion in transfers that they would have otherwise received.[68]

Any major recessions over the period would have implied that the provinces could break even or come out ahead. As it turned out, the floor did not strongly favor the provinces during the first half of 2001. In addition, the federal government created a new financial transactions tax with the revenues proceeding exclusively to the federal treasury. However, during the second half of the year, the fixed transfers would have implied significantly more resources than otherwise would have been the case. For 2001, as a whole, the provinces were to receive about $2.8 billion (about 1.1 percent of GDP) in transfers beyond what they would have received without the guarantee. This contributed to substantial fiscal, political and social stress during the latter part of the year. Ultimately, the federal government was not able to transfer the full guarantee and arrears accumulated.

The bickering over the unfulfillment of this clause was an important fact in the political dynamics leading to the demise of the De la Rúa Government and the ensuing Argentine default. The procrastination in provincial governments signing a new agreement was a key factor in demolishing Argentine credibility in the eyes of international markets (The Economist, November 17th, 2001).

At the beginning of the second semester of 2001, the national government was unable to transfer to the provinces all the resources established in the 2000 Pact. Provincial governments took several steps attempting to enforce the Pact: a) the Senate, by governors request, passed a law that established that the recently imposed tax on financial transactions

[68] See World Bank, *Provincial Finances Update IV*, 2001 (www.bancomundial.org.ar).

has to be coparticipated to the provinces;[69] b) the UCR governors, backed by some PJ governors, presented a bill declaring the "intangibility" of coparticipated revenues; and c) the governors made a formal claim to the Supreme Court in order to enforce the fulfillment of the federal pacts. This process finished with a new addenda to the 2000 pact that allowed the federal government to cover the coparticipated revenue shortfalls using LECOP[70] up to 40% of total transfers fixed in the Pact. Also the provinces and the federal government agreed to establish a new way to finance provincial fiscal distress through LECOP (up to one payroll).

The shortfall in coparticipated revenues and in own resources, plus the inability to get voluntary financing throughout 2001, lead some provinces to issue low denomination provincial debt (*bonos provinciales*). A few provinces had this kind of instrument *before* 2001, but several provinces issued new bonds in 2001 for approximately 8% of their spending, and have continued to issue in the first semester of 2002 by approximately 20% of their spending. The bonds usually do not pay interest and seem generally accepted as substitutes for pesos in transactions within the boundaries of the provinces.

This *bonos*, that have covered the deep fall in resources avoiding difficult (in some cases almost impossible) spending cuts, are appropriating the right of seignorage of the central government. In the new dynamics after convertibility, where seignorage is likely to become a non-trivial fraction of revenues, this also creates perverse dynamic incentives. Many opportunistic provincial actors are planning to issue *bonos* in anticipation of this revival of inflationary finance.

As shown in table 21 and in figure 7, the economic recession fostered the issue of new provincial bonds. In 9 months their stock rose from 543 millions (6% of money circulation) to 4816 millions of pesos (29% of circulation). This was due mostly to the huge bond issue by Buenos Aires (1672 millions in late 2001 and early 2002) that now represent nearly 35% of total provincial bonds plus national LECOPs.

Table 22
Stock of Provincial *Bonos*

Province	Bond	Stock (Millions of pesos)	Ratio Stock of *Bonos* to Provincial Own Revenue

[69] With the economic recession getting worse in the second semester of 2001, the fiscal situation of national and provincial governments deteriorated sharply. The central government (with Cavallo already on board) attempted to morigerate that fiscal drain by re-instating the very inefficient tax on financial transactions that had been eliminated in the 1993 Pact. This time, though, it was instated as an exclusive national tax, that could be deduced partially from VAT (which is coparticipated), stealing resources from both the provinces and the social security system. Notice that, even though previous laws (and the Constitution with regards to the future regime) established that any new taxes have to be shared, the 2000 Pact had (in practice) replaced that rule by the guaranteed amounts, independently of tax level and structure.

[70] LECOP (Letras de Cancelación de Obligaciones Provinciales) are low denomination debt certificates that the federal government issues to pay Coparticipation and to lend to provincial governments.

		Before 2001	2001	2002	Total	
Buenos Aires	Patacon (A and B)	0	972	700	1672	41%
Catamarca	Bono Publico	25	0	0	25	65%
Córdoba	LECOR	0	200	250	450	49%
Corrientes	Cecacor	200	0	0	200	236%
Chaco	Quebracho	0	50	0	50	54%
Entre Rios	Federal	0	49	99	148	57%
Formosa	Bocanfor	0	50	0	50	200%
La Rioja	Bocade	0	5	0	5	21%
Mendoza	Petrom	0	0	178	178	50%
Tucumán	Bocade	36	62	40	138	76%
Total Provincial Bonds		261	1388	1267	2916	48%
Federal Government	LECOP	0	1900	0	1900	
Total Bonds		261	3288	1938	4816	

<Figure 7 here>

The probability of repayment of these bonds varies across provinces. For instance, the Corrientes and Formosa bond stocks double provincial own revenues and represent 63% and 53% of money circulation in each one respectively.

To close this section, it might be helpful to come back to the connection between national politics and the federal game. President de la Rúa was thrown from government in part due to the incapacity of his administration to govern. This in turn had to do with idiosyncratic characteristics of the coalition that took him to power, but also to the role plaid by peronist provincial governors and their puppets in Congress. At a more micro level, the street riots and manifestations that marked the departure of de la Rúa were in part spontaneous mobilizations of the middle classes after their bank savings were expropriated, but largely due to the mobilization of violent protests by the peronist machinery of the province of Buenos Aires. After 3 presidents in a week, finally an agreement was reached in Congress to place the boss of that machinery, Eduardo Duhalde, in the seat of President. It has become patently clear in the last few months that the real power in Argentina resides in provincial governors. Their struggles for the crumbles of Argentina and for the presidential succession are also marking the limits for the current government. Perhaps the only positive aspect of what we are seeing these days is that some relevant actors like the IMF have finally understood the underlying political game, and are dealing directly with the provinces in an attempt to build some more sustainable form of fiscal compromise.

IV. Federalism and social sector reform in Argentina. The Case of Education

Over the last decade or so, decentralization of public services, especially in the social sectors, has become one of the new tenets of the "Washington-sponsored" reform agenda faced by developing countries.[71] Argentina has not been immune to these new winds. Out of a mix of conviction, foreign pressure, political opportunism, and shortsighted fiscal moves, Argentina has decentralized large part of its social policy over the last decade or so. By 1999 provinces spent 96% of overall education spending, 70% of overall health spending, and 62% of spending on social development (anti-poverty, food programs, etc)

Even though some of the postulated benefits of decentralization might be at work, the implementation of reforms and, specially the quality of policy making and delivery in the social sectors, has been tainted by several of the characteristics of fiscal and political federalism in Argentina highlighted throughout this paper. In this section we provide a sketchy narrative of some of those interactions in the Education sector.

IV.1. Background

The 1853 Constitution established that primary education was a responsibility of the provinces. This was mostly a recognition that, in fact, schools have been exclusively supported by local efforts since independence in 1810. This was more the consequence of a lack of effective national government than any strong provincial assertion.

Resource scarcities and a growing population created the need for some national support. Isolated remittal of resources was made in 1857 and 1867. In 1871 a Law of Subsidies was sanctioned, establishing that the national government would provide resources to fund building of schools, materials and teacher salaries. In 1905 the so-called Lainez Law (named after senator Manuel Lainez) allowed the creation of national schools in the provinces that so requested. Even though this law was heavily criticized and interpreted as a "failure of education federalism," in practice provinces made use of it, and a parallel system of national and provincial schools developed. National schools paid better salaries (and did so in time!), so that teachers preferred to work for the National government.

Between 1956 and 1976 there were several unsuccessful or partial attempts at transferring the national primary schools to the provinces. In 1978, mostly for fiscal considerations, the

[71] See Acuña and Tommasi (1999) and references there.

(1976-83) military dictatorship appealed to article 5 of the Constitution to decentralize primary schools.[72] So that the Constitution, and appeals to "true federalism" were used to unload 6564 establishments and 897.400 pupils onto the provinces (that did not object about the transfer per se, but to the abruptness of the procedure, and to the lack of accompanying funds).

The same argument of "real federalism" served for a new adjustment of public accounts in 1992, this time focusing on secondary education, which I describe in the next subsection. The provincial "burden" for school finance has grown progressively over time, as depicted in Table 23.

Table 23: Distribution of Public Sector Expenditures in Education

Year	Contribution to total budget (as %)	
	Federal	Provincial
1961-65	57.8	42.2
1966-70	60.2	39.8
1971-75	58.4	41.6
1976-80	48.9	51.1
1981-83	43.1	56.9
1984-88	34.9	65.1
1989-91	32.4	67.6
1992-94	19.7	80.3

IV.2. Education Decentralization and Fiscal Federalism in the 1990s

In December 1991 the Menem administration passed a law that decentralized the management and finance of secondary education from the federal to the provincial levels.[73] In 1993 a "Federal Education Law" was sanctioned. These laws altered the traditional role of the central government from provider of schooling services to "helmsman" in education policies (Argentina – Ministry of Education, 1999).

This process was largely contested by provinces that interpreted decentralization not as an opportunity for greater local autonomy, but as an attempt of the federal government to abandon its financial responsibilities in the education sector (Benveniste, 1999). The transfer of the responsibility for schooling from the national to the provincial levels, although publicly spoused by local governments as a reaffirmation of federalist principles, was

[72] It is a sad paradox that a military dictatorship that violated the most sacred aspects of the Constitution (human rights and division of powers) showed such respect for the letter of the Constitution with regards to the vertical allocation of responsibilities for primary education.

[73] It is interesting to notice that, *in an appendix to that law*, hospitals and other social services were also transferred. This process implied the transfer of 1905 schools with 112.000 teachers and 14.200 non-academic employees, servicing around a million students; as well as 20 health clinics with 9.200 employees; and 22 family/childhood institutes employing 1.700 agents. (The bundling of the two sectors in one law reflects an underlying fiscal drive over sectoral considerations).

privately rejected by some out of a concern for federal fiscal and political abandonment (Rhoten, 1999). Hanson (1994) reports that "the transfer of the secondary schools was a surprise move. The first notification that the attempt would be made came when the national budget was produced and distributed. The budget had deleted its historic financial support for secondary education. The outcry was so intense that the central government was almost obliged to delay the transfer while it developed a justification, held public debate and passed a law."

The bargaining process over education decentralization started, then, in the 1992 national budget law submitted to Congress in 1991. From there the negotiations went intergovernmental with a very active role of governors and of the national Economics Ministry. The national and provincial education ministries only entered center stage later on, in the discussion over the implementation of the federal education law that complemented the decentralization law.

Even though there have been recommendations of the Federal Education Council stressing the pedagogical advantages of decentralization, the true motor in the actual process was the pressure from the National Finance Ministry (from 1991 Minister Cavallo).[74] The transfer of educational services in the 1990s took place without any actual transfer of additional resources to the provinces (following the experience of 1978). It did happen in the context of the large increase in tax-sharing revenues after the Convertibility plan, described in the previous sections. Figure 8 (from Nicolini et al, 2001) illustrates this expansion in revenues.

<Figure 8>

The Ministry of the Economy insisted that the decentralization should be financed out of the large increase in coparticipated revenues that ensued the implementation of the convertibility plan. Based on the evidence presented by the ministry (including projections of future revenues), and on circumstantial political pressure, governors agreed that the transfer would, in principle, be financed with those "extra" Coparticipation resources as long as the national government would guarantee to cover the cost of services transferred in case those revenues were to fall below the monthly average of April-December 1991.

The mechanism finally used to "finance the transfer" was to define a "retained" amount of $711.2 millions (corresponding to the estimate of the cost of the transfer) subtracted from the secondary Coparticipation, and distributed to the recipient provinces as a function of the estimated cost of the services transferred (essentially payroll costs). This was, in fact, a redistribution of secondary Coparticipation towards the provinces receiving proportionally

[74] For instance one distinguished independent deputy, Federico Clerici, declared that "the main force behind this transfer has been the compromise to reduce federal government spending by $1200 millions." Deputy Dumon from the opposition UCR, stated: "We treated, within the *Congreso Pedagógico*, the issue of decentralization as a social concern, but we were confronted with big news: the decentralization we were instrumenting was not that of *Congreso Pedagógico*, but the one we had promised to the IMF in the 1990 letter of intent." (Repetto et al, 2001). There is additional evidence confirming the suggestion that the genesis of the actual process of education decentralization was related to memos exchanged between the executive and the IMF, hardly an institution specializing in education (Nores, 1999).

more teachers. The law also established that, if the increase in shared revenues with respect to a 1991 baseline was (in the aggregate of provinces), inferior to the cost of services transferred, the national government would guarantee that amount. Figure 8 also shows the evolution of the difference between the increase in tax revenues and the (stipulated) cost of services transferred.

After a brief debate in Congress, the law (24.049) transferring educational services was sanctioned in December 1991. This law constituted just the framework for the transfer process. It established that the details of the transferences would be established by agreements between the National Executive and each of the jurisdictions; where they will accord on any questions not considered in the law, adjusting to the particular circumstances of each jurisdiction. Hence, law 24049 constituted the beginning of a series of (bilateral) negotiations between the national government and the provincial governments that would conclude two years later, in December 1993, with the signing of the last agreement of transference between the national government and the governor of the province of Buenos Aires, Eduardo Duhalde. (The first agreement was signed with president's Menem province of La Rioja.) The following table summarizes some characteristics of the agreements.

<Table 24: Agreements of Transfer of National Educative Services to the Provinces. 1992-1993: Ordered by time of signing agreement.>

Thirteen provinces signed before November, 1992 (within a year of the sanction of the law), and 11 did it later. The province of Buenos Aires was the last one to sign probably due to the importance of the transference; 33 % of all the transferred schools corresponded to the province of Buenos Aires. Probably the delay in signing allowed the province to negotiate additional funds for almost 91 millions of *pesos*. More generally, the provinces that signed later (Catamarca, Santa Fe, Corrientes and Formosa) were those who achieved the grant of funds for the improvement of public buildings.

IV. 3. Some Tentative Conclusions

- It is still too early to pass any definitive judgement on the overall impact of education decentralization, or where the political, fiscal and pedagogical dynamics surrounding it will lead us. There have been some encouraging signs in the reinvigoration and operation of the Federal Education Council, which has plaid an important role, at least in the implementation of pedagogical reforms. (Less so with regards to the proper funding of the system)

- Regarding the impact of decentralization on education outcomes, the only methodologically sound study I am aware of (Galiani and Schargrodsky , 2002) seems to find evidence that, on average, decentralization improved the performance of public school students in test scores. That study is not totally free of problems, though. The dependent variable is performance in public schools relative to private schools. Their finding might also be

consistent with decentralization worsening the performance of private schools.[75] Furthermore, as spelled out in more detail in Tommasi (2002), almost none of the theoretical arguments on the virtues of decentralizing a public service like education, seems to have real bite in the actual decentralization of education in Argentina. The main reason is that most of the arguments that define more precisely the channels by which "government is brought closer to the people," do not seem to apply to the size of Argentine provinces (which are more a historical accident of military and fiscal technologies two centuries ago than "optimal school districts").[76]

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Also, there are discussions regarding the impact of education decentralization on the achievement of equity objectives. There have been traditional asymmetries in the quality of public education across provinces, and it might be the case that decentralization might have increased those asymmetries. Overall, the fate of decentralization in each jurisdiction has been deeply impacted by social conditions, as well as their political relations to the national government. In poor and isolated localities education decentralization has not increased financial autonomy from federal authorities. On the contrary, the lack of technical and financial resources has maintained the dependence on the central government. Provincial governments are circumscribed to instituting the curricular plans handed down from the national Ministry or implementing compensatory programs that are federally funded.[77] Fiscal difficulties in several provinces led to violent demonstrations, which even caused the central government to intervene in one province to restore order (World Bank, 1995). In more developed localities, provincial governments have taken education decentralization as an opportunity to detach themselves from the sphere of control of the central state. (Benveniste, 1999, Repetto 2000, Winkler 2001)

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As stated, the overall experience of education decentralization in Argentina requires further analysis, both in terms of substantive impact, as well as in terms of the process of its implementation. We take a few paragraphs to reflect here on the latter: on the marks that such process left on the experiment, and on the peculiar elements of the Argentine polity that affected it.

The very fact that education decentralization was in large part driven by fiscal-federal opportunism of the central government, is a reflection of the inability of the Argentine federal system to adjust in efficient ways. Ideally, reforms such as decentralization should be carried out in response to technological or democratic advantages of decentralized provision, and money should follow function (and not viceversa!). As insistently pointed out

[75] Private schools educate 25 percent of total students in Argentina. Of these schools, 25 percent receive no subsidy whatsoever, 45 percent receive a subsidy that covers 100 percent of their costs, and the remaining 30 percent receive partial subsidies.

[76] This perhaps carries a message with respect to the interactions of IFI's "flavor of the month" buzzword reforms, with the particulars of the polities at the receiving end.

[77] Furthermore, the compensatory assistance from the central government has been an easy prey in later fiscal adjustments, over politically more sticky monies, such as those spent on university education.

throughout this paper, the Argentine polity is a far cry from that benevolent (or Coasean) model.[78]

What actually happened in the decentralization of education in Argentina ("use the excess Coparticipation revenues from improved regular tax revenues, and I guarantee you a floor") would have been roughly consistent with the idealized decentralization "transaction" only under very specific circumstances. That would have been a "fair" deal only insofar as we assume that the spending needs in all other dimensions of provincial public finances will be constant, or there is an agreement that an important shift in composition is desired.[79]

With respect to the "revenue guarantee", it turns out that given the good performance of the economy in the years after decentralization, coparticipated revenues were always above the estimated cost of the transfer (as reflected in figure 8), so that the guarantee was not binding. In the later part of the 1990s, revenues plummeted, and the national government was unable to fulfill the aggregate transfer guarantee that in 1999/2000 superceded this arrangement.

Furthermore, it is quite likely that at the level of individual provinces "the extra funds" were not actually sufficient to cover the cost of the transferred services even in years prior to the later crisis, specially if we take into account the increase in coverage and in the potential population. Some estimates by the Federal Tax Commission (CFI) for 1999 indicate that the total cost of the decentralized services, plus the cost of implementing other aspects of the later Federal Education Law are several orders of magnitude above the original "guaranteed" estimates. Nonetheless, sitting governors might have been more interested in the short term funding they obtained through the negotiated agreements (Table 24) than in the medium to long term sustainability of the exercise.

As stated, the overall set of education reforms included an important role for the National government, among other things in providing compensatory programs (in the more needy areas) and infrastructure programs. These programs were substantially reduced in later fiscal adjustments. (Nicolini et al, 2001, pp. 79-80 and Appendix Tables).

- The episode also reflects on other features of the Argentine polity, in particular of the functioning of political institutions and policymaking in Argentina, and on its implications.

[78] In terms of federal spending in education, the decentralization process led to a net spending reduction of $400 million. This corresponded (roughly) to a reduction of $800 million in basic education and an increase of $400 hundred in other items, especially university education. Funding for the politicized and ineffective National Public Universities is a hot ticket in budget politics, since the parties, especially UCR, use the universities as a temporary employment agency for their activists, and as a platform for political co-optation.
[79] It is worth noting that since the City of Buenos Aires at the time was receiving a fixed sum of Copartipation taxes, this implied that the city, which became "independent" in 1995, received additional functions without additional funding.

The curious and sometimes uncoordinated actions of the Economics and the Education Ministry reflect on some generic characteristics of Argentine bureaucracy that lead to poor coordination and poor interdepartmental cooperation even within administrations. This reflects on some more general characteristics of the Argentine bureaucracy and of the Argentine policy making process, where transient technical bureaucracies do not tend to develop interdepartmental cooperation norms, and coordination is not solved via ex ante agreements in broader arenas such as Congress (Bambaci, Spiller and Tommasi, 2001).

In spite of the "decentralization of education" several actors continue to operate nationally. A telling example occurred in 1999, when teachers' unions, with strong support from other sectors of society staged a permanent camp in front of the *National* Congress demanding increases in teachers' wages (which are, *de jure*, a provincial responsibility). Interestingly, some preliminary survey work indicates that citizens are not well aware who is responsible for what. Furthermore, *de facto* citizens might be right in assigning final responsibility to the National government, once one takes into consideration the overall workings of the federal fiscal system. And even in that specific example, the National government did convalidate those beliefs by establishing a special tax on cars to subsidize those wage increases.

In general, the overall experiment shows the crisscrossing patterns of national and provincial politics that we have been emphasizing in this paper. One feedback of education reform onto fiscal federalism is provided by the fact that after decentralization, the budgetary flexibility of provincial governments has been reduced, as schooling expenses now require a large fraction of provincial budgets. This has implications for the future possibilities of fiscal adjustment.

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