

**Municipal Taxes as Instruments
for Value Capture in Perú**

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Abstract:

This article describes the overall Peruvian policy on municipalities and their legal mechanisms for the recovery of local government investments (the Betterment Levy and the Special Assessment on Public Works). The Betterment Levy Program in the Municipality of Lima (1990-1993) is analyzed and it is concluded that the application of these instruments is viable, especially in lower income communities. There is more resistance among middle and upper income sectors.

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Introduction

In a context of continuous urbanization, the current incapacity of Peruvian municipalities to meet community demands is worrisome. This incapacity is due to financial weakness and the longstanding tradition for the central government to concentrate public resources and investment in its own hands in return for political loyalty. This tradition continues despite the opinion of specialists that it would be more efficient for municipalities to carry out local projects, which would favor greater local control and avoid duplication. Thus the challenge to municipalities is contingent on increased revenues. The betterment levy for the recovery of value increments resulting from works projects funded by public investment is one instrument that is contemplated for this purpose by current tax and legal codes.

Until 1993, the total or partial capture of investments was based on a land tax established in 1981 and regulated for implementation 1985 that was levied on benefits or value increments resulting from public works: the betterment levy. Today that tax is called the Special Public Works Tax (Contribución Especial de Obras Públicas).

Conceptually, such taxes fall into the category of value capture mechanisms, a group of practices (revenue mechanisms, negotiations among different actors) through which the State recovers from private land owners those land value increments produced as a result of public and community investment. In its broadest sense, this concept attributes the generation of value increments not only to works projects and administrative action by the local, regional, and central governments, but also to private entrepreneurial investment (in malls or shopping centers, for example) and to neighborhood or community action in demanding and obtaining services, social space for consumers and small retailers, etc. Likewise, streets and roads, potable water, electrification, provisions of the urban code such as authorizations for new land uses, densification, construction and operating permits, the establishment of commercial areas, urban beautification, etc., are measures that add additional value to land, producing a value increment that is expressed in the price of land when that land is transacted on the market. The defining characteristic would be that the value increment is produced by an actor other than the owner of the land that benefits or whose value is increased. In this sense, the value increment results from an investment or action of the community rather than the individual and should therefore be returned by some means to the community that has generated it (Brown and Smolka, 1997).

Although at first we were skeptical about finding any such mechanisms and believed that there would be little to report, in our research we found several practices that constituted value capture mechanisms ranging from a developed legal framework to a municipal program for the recovery of investments (Programa de Contribución de Mejoras de la Municipalidad de Lima). These mechanisms are little known by urban planners and local authorities, let alone by common citizens. Therefore it is uncommon to make the

appropriate association between investment in public works and its possible partial or total recovery.

The recovery of public investments and the capture of value increments have become better known in the context of decentralization processes in Latin America that strengthen the role of municipalities, processes that Peru has moved away from in recent years. This is important for a region of developing countries with a capitalist orientation where different socioeconomic classes have manifested resistance to the application of land property taxes in light of their historical-structural origins. (Doebele, 1997). In general, the most commonly used instruments have been, as in Peru, betterment levies. There are also been attempts, in Colombia, for example, to expand the concept with the use of additional mechanisms such as levies on value increments resulting from administrative actions (Furtado, 1997).

1. The Historical and Institutional Context

1.1. Background

The capture of property value increments in Peru is relatively recent, dating from Law Decree 184 of 1981, in the context of a municipal reform initiated the year before. Before that time, there were various other somewhat similar efforts that played a role in the configuration of what some sociologists call the “bureaucratic-rational State.”

This State configuration, the Peruvian republic having been constituted in 1821, is a twentieth century process. Significant steps along the way have included, in the 1930s, the formation of internal security forces to replace bands of men armed by local bosses to impose “order,” the establishment of a regulatory and administrative apparatus in the 1950s, and an effort in the 1980s, currently sidelined, to decentralize the State and strengthen the municipalities. Until the beginning of the 1960s, the State was controlled by the oligarchy, which developed centralist structures and privatized State functions to meet its own needs. Policy toward large land owners and urban developers was laissez faire and government regulatory action was limited to tepid planning efforts (zoning, construction regulations and development plans) and municipal mechanisms for regulating the urbanization of land. This laissez faire approach was morally justified by the liberal conception under which the private sector was granted the right to produce housing, and private property was not only respected but regarded as sacred. The municipalities were secondary bodies responsible to the Ministry of Government and Police. One sign of their weakness was that they continued to be regulated by an organic law dating back to 1892.

Revenue collection by the State was reorganized at the beginning of the 1960s. Law 13689 of September 7, 1961 (and later Law 13699) authorized provincial municipalities to receive, beginning in 1962, the revenue derived from urban and rural land taxes,

directing 50% of such revenues to the district municipalities.¹ In 1965 Law 15428 authorized provincial military municipalities to set, collect, and directly administer these taxes. Before that time, these responsibilities were assigned to a private entity called the Bank of Deposits and Consignments (Caja de Depósitos y Consignaciones), that provided a “service.” Supreme Decree 464-H of November 23, 1965, which set regulations regarding urban and rural land taxes, assigned the setting of taxes to the Technical Evaluation Organization of Peru (Cuerpo Técnico de Tasaciones del Perú) and to land owners through their own declarations of property value (Bulnes, 1967). In addition, the Bank of the Nation was established, and in 1968 other taxes were established on income, property, and motor vehicles. Municipal governments were further strengthened in 1963 with the democratic election of mayors, after five decades during which mayors had been appointed by the central government.

During the first administration of Fernando Belaunde in 1963-1968, some central government functions, including urban land management, land regularization, and the management of unused land, began to be transferred to the municipalities. This process was later limited and then reversed by the reformist military government of 1968-1980. While the military government ended domination by the oligarchy and made strides in combating urban speculation (through the Agrarian Reform Law 17716 of 1969, the expropriation laws of 1969-1970, and the tax on land property without buildings),² in the interests of keeping social control in its own hands it did not pursue further State decentralization. The military cut transfers to the municipalities and ended the democratic election of mayors, who were once again appointed by the Minister of the Interior.

1.2. Decentralization and municipal finances

The 1979 Constitution, produced by a constituent assembly elected during the final crisis of the military government, established that the Peruvian State was unitary, representative, and decentralized. Under this scheme, oriented to the regionalization of the country, the municipalities were defined as organs of local government with economic and administrative autonomy in their areas of competence (Article 252) and as the first instances of the future decentralized State.

Fernando Belaunde, newly elected president for 1980-1985, renewed his support to local governments, calling mayoral elections and gradually decentralizing responsibilities in areas including urban development and public transportation. He was also responsible for Law 051 in March 1981 and Law 23853 in 1984, the establishment of a new regime for the application of land taxes (Law 23552), and other measures. Likewise, Lima’s Mayor Eduardo Orrego (1981-1983) promoted the Metropolitan Investment Fund (Fondo de

¹ The political and administrative State is divided into the central, regional, and local or municipal governments. Only the central government issues laws. Municipal governments are in turn divided into provincial and district administrations, which have a tradition of competing for resources.

² This 1977 tax was imposed at extremely high rates on land properties without buildings and rates increased as time went on. In 1979 it was incorporated as Subsection 7 into Article 257 of the constitution, which is concerned with municipal properties and revenues.

Inversiones Metropolitanas - INVERMET), which had been established in 1979, for public works in the areas of street and road infrastructure and urban beautification.

Nevertheless, the central government continued to generate most public investment. In Metropolitan Lima, the capital and most important city in the country, the municipality was the source of only 4.7% of public investment, totaling 224,377 million Peruvian sols in 1981 and 1982 (Delgado, 1996: 50). Total municipal investment was so insignificant that it made no significant contribution to national development programs. Municipal tax revenues in 1981 and 1982 were respectively 28% and 36% of GDP. Municipal participation in the national budget was 3.9% and 4.3% in 1980 and 1981 respectively, far below that in other countries of the region such as Colombia (54%), Venezuela (41%), Ecuador (41%) and Bolivia (37%) (Delgado, 1995: 49-50). Municipal revenues were not even sufficient for current spending.

Instead, municipalities were dependent on government transfers, which in 1987 constituted 21.5% of total municipal revenues in the country; in 1979 they were 33.2%; and in 1980 they were 45%. Tax revenues increased under democracy in 1981 and 1982, and transfers were reduced to 16% and 23% respectively. Despite its “municipalist” discourse, the central government maintained control over public investment. In 1984 a body called Popular Cooperation, whose functions did not differ at all from those of local governments, received 128,767 million Peruvian sols while all the municipalities together received only about 30% of that amount (37,963 million sols). The central government provided 95.4% and the municipality only 4.7% of public investment in Metropolitan Lima. Political motivations gave rise to the use of Popular Cooperation to duplicate municipal functions and reserve largely to the central government the discretionary use of public resources as a means of denying such discretionary use to opposition mayors (Delgado, 1995: 53-54).

1.3. The Betterment Levy (Law Decree 184)

Law Decree 184 of June 12, 1984 established the Betterment Levy as a means of strengthening the financial condition of local governments, applicable to those properties with benefits attributable to public works projects. The law decree defined public sector entities other than public enterprises as active subjects of the tax. The passive subjects were property owners and those in possession of properties within areas benefiting from public works, with the exception of properties belonging to the government, to public institutions, to international organizations, to universities, and to churches. It established that the tax obligation was individual, payable in one installment, and proportional to the dimensions of the property and the benefit accruing thereto. However, the tax was not immediately applied because necessary regulatory language was only established in the context of a 1984-1985 tax reform.

1.3.1. Tax Reform (1984-1985)

The United Left coalition took power in Metropolitan Lima in 1984 and ruled until 1986 with Alfonso Barrantes as mayor. Taking advantage of the central government's tax

reforms favoring municipal finances, and using the tool of popular mobilization, the United Left was able to increase the resources of local governments and reduce their dependency on the central government. The 1984-1985 tax reform should be understood as part of a **municipal reform** that developed policies of neighborhood participation, the democratization of land use, the legalization of land tenancy, low income housing, and other measures.³

The Financing Law (24030) of 1985 entailed significant municipal tax reform. Its salient feature was the establishment of the Municipal Promotion Tax (Impuesto de Promoción Municipal - IPM) which was a municipal tax intended to replace the mechanism of transfers at the discretion of the central government. This was a means of consolidating the municipal autonomy put forward in legal texts. The IPM was made up of an additional percentage point added to the General Sales Tax (Impuesto General a las Ventas-IGV), known in other countries as the Value Added Tax (Impuesto al Valor Agregado-IVA) and imposed on all transactions of goods and services (another percentage point would be added in 1988). The justification for the IPM was that since commerce in goods and services takes place in cities, and the urban infrastructure is indispensable for those transactions, it is appropriate for part of the tax revenues generated through commerce to be returned to the city. Beginning in 1985, tax revenues increased significantly and transfers practically disappeared (Araoz, 1996: 92). As a result, municipalities could count on a proportion of the IPM for their revenue and not depend on the discretion of the central government to meet their budgetary needs, and local revenues as opposed to central government revenues grew by 8% in the 1986-1989 period. While due to its large proportion of the national population Lima received about 40% of these resources, the IPM was distributed to all the country's municipalities. At least 50% of the revenues it generated were used for investment purposes (Delgado, 1995: 93-94).

Tax reform also brought about a more efficient application of the property tax by raising rates and readjusting tranches. It extended the tax to parking facilities, limited tax exemptions to non-sports-related public events, defended the metropolitan use of a portion of tax revenues from real property transactions (the alcabala), established the rates at which the tax would be applied to land without any building construction,⁴ increased the tax on gasoline, and defined road tolls as municipal revenue (Delgado, 1995).

³ Some officials proposed novel forms of taxation on private development companies, which would have been able to pay the betterment levy on value increments resulting from public works in the form of land. With this property, a land bank would have been established for municipal housing projects. This proposal did not become law due to a lack of political will.

⁴ With time and in the context of spiraling inflation, the effect of the tax was distorted. It became confiscatory and paradoxically affected not speculators but small savers who had acquired property but lacked the resources to build housing. Article 53 of the Financing Law (24030) established two separate rates for the tax's application: one for natural and juridical persons engaging in the business of real estate and another for people not doing so.

1.3.2. Regulatory language governing the application of the Betterment Levy

Supreme Decree 021-85-EF was issued on January 28, 1985. It contained regulatory language for the application of the Betterment Levy and met all legal requirements for the application of this mechanism for the capture of value increments. The municipality of Lima had demanded this step due to the volume of public works within its boundaries and the necessity to recover their value, which would be channeled through the INVERMET investment fund. The Betterment Levy was ethically justified as a one-time assessment on land property, going beyond traditional property taxes, the object of which was to capture the portion of property value increments that were attributable to public works.

It was seen as a remedy for existing regressive taxation, and as an equitable and fair tax levied in proportion to benefits accruing to the property in a country where the greatest part of indirect taxation affected primarily low income sectors:

Because this tax was levied on property whose value was increased as the result of a public works project, it was redistributive in effect, taxing those who really benefit and doing so in proportion to their properties.” (Delgado, 1995: 84)

The regulatory language stipulates that the tax will be collected by the different levels of State administration (local, regional, and central) for any public works project that increases economic value or produces any other identifiable benefit with respect to individual properties that are located within its area of influence. Tax obligations are assessed in direct proportion to the economic benefits derived from each public works project. The revenues so generated will be appropriated to other public investments. Property owners in the area of influence have the right to information, coordination, and oversight of public works projects to be executed. Two regulatory bodies were also established: The Betterment Levy Council (Consejo de Contribución de Mejoras) and the Evaluation Board (Junta de Determinaciones). These bodies were to be operated according to guidelines set by decree within individual municipalities.

The regulatory language established several steps in the application of the tax:

- Identification by the Evaluation Board of the public works project or projects to which the tax will be applied, on the basis of analytical reports, feasibility studies, or projections of the proposed projects; analyses of estimated global benefits accruing to properties (value increments attributable to the project) and the outcome of the application or applications.

- Participation of project beneficiaries and potential taxpayers, who will assemble and elect delegates and alternates to represent property owners and participate in all stages throughout the process of determining the assessment.

- The production of a technical report on the Betterment Levy produced under the responsibility of the Evaluation Board, which would contain a technical economic analysis of the project and its total cost, a proposal for defining the area of influence, a map of the proposed area of influence, including the public works project and the local area cadastre, a socioeconomic report, a financing proposal, and a preliminary identification of individual taxpayers.
- The approval by resolution of the Betterment Levy Council of the affected area, of the financing plan, and a specific list of taxpayers.
- The specification by the Evaluation Board of individual levies, pay-by dates, forms and terms of payment, collections, and reporting to public registries for the recording of information with respect to individuals.

1.3.3. Effective application

Despite the efforts mentioned above, the tax was not actually applied by any government body between 1985 and 1989. Technical difficulties such as the complexity of calculating tax assessments are often cited as an explanation, but in reality this is explained by the scant political interest in implementation on the part of municipal and regional authorities. (Delgado, 1995) In the case of the United Left's municipal administration, there was significant public investment (130 km of new paved roads in low-income areas and 120 km of rehabilitated roads) financed by the World Bank through INVERMET, but the cost of this investment was not recovered. The political will did not exist to apply the Betterment Levy for fear of resistance from low-income sectors, which were the primary beneficiaries, especially because Mayor Alfonso Barrantes was a candidate for reelection. During the following city administration of Jorge Del Castillo of APRA in 1987-1989 there was a training course for officials to implement the tax but even then it was not applied until the 1990-1993 administration.

2. Illustrative Description: The Betterment Levy Program, 1990-1993

In general the effective utilization of the Betterment Levy up to 1993 was quite poor; its proceeds constituted only twenty-five percent of municipal revenues (Araoz, 1996). Still, a program on the levy had been developed in 1990 under the administration of Ricardo Belmont. In May 1990, after a training course, eight professionals were selected to move into the Program on the Betterment Levy of the Municipality of Metropolitan Lima, defined as a "deconcentrated" or semi-independent body (*órgano desconcentrado*) with economic and administrative autonomy, established through municipal Decree 081. The purpose of the program was to recover investments made through INVERMET or any other municipal agency in different districts of Metropolitan Lima (Gamarra, 1998).

The Program was first applied with reference to street paving in the settlement (*pueblo joven*) of Leoncio Prado in the Rímac district, and later covered a total of thirty public works projects executed by INVERMET. The projects covered included road interchanges, streets and roads, public lighting, and the connection of housing units to

potable water and sewer systems. Among the salient aspects of the program were the following:

Technical and socio-economic analysis

The complex technical and socio-economic analysis of the work projects included information on their characteristics and magnitude, the technological alternatives, the criteria of the executing agency, the project budget, and the verification that all project costs had been included. It also included the proposed delimitation of the benefiting area taking into consideration the characteristics of the project and the type of area where it was executed, the type of benefit that it generated, and the characteristics of the benefiting properties considering their current and future uses. A socio-economic report analyzed potential taxpayers' ability to pay proposed assessments in order to propose a feasible payment regime with regard to scheduling. A proposal considering these criteria was distributed among land owners. Within the benefiting area, specific properties were evaluated on the basis of frontage, areas and zones, degrees of benefit, etc. Once these requirements were met a resolution of the municipal council determined the modality of payment. Partial payments were established for periods of up to three years.

Successful experiences: low income sectors

The Program successfully applied the tax in low-income settlements, which reached agreements for its payment. The amount paid depended on the dimensions and type of benefit enjoyed by the property and by the taxpayer's ability to pay. Cost recovery varied from 20% to 50% of the total cost of the public works project, depending on the socioeconomic characteristics of the payers (artisans and professionals paid more than retailers). The Program was applied to public works projects including paving in the districts of Rímac, El Agustino, El Cercado, Los Olivos, Puente Piedra, and Ancón; and electrification in Santa María del Mar.

Unsuccessful experiences: upper-middle sectors

Contrary to what might be expected, the Program's efforts to apply the tax in areas of upper-middle population sectors were unsuccessful. The Monterrico and Puente Quiñonez road interchanges, located in the districts of Surco and San Borja, were the metropolitan road projects that were most costly to the municipality of Lima. When the Monterrico Program began to be applied, the beneficiaries put up strong resistance, arguing that the benefits were enjoyed on a metropolitan, inter-district scale. This was only partially true, since they were also beneficiaries and in fact had requested that these investments be made. Important politicians and officials living in the area began to exert pressure, including on the mayor of Lima himself, who also lived nearby. Under pressure due to the upcoming reelection campaign, the mayor canceled the bidding process not only on contracts for the Monterrico interchange, but for two others as well, and halted the projects (as was also the case with the project for the Plaza Dos de Mayo). One of the other projects was the Quiñonez bridge in San Borja and the other was the bridge between San Juan de Lurigancho and El Agustino, two low-income areas where there

was more willingness to pay the tax. Years later, the national Comptroller General intervened in the case for unrelated reasons and determined that the tax had not been applied. As a result, he initiated legal action against the man who was mayor at the time of the events.

Implicit and explicit practices

One lesson of the Program was to reveal the development of implicit practices. Legally speaking, the Betterment Levy was a tax payment due as a result of a public works project. In reality, however, municipal authorities negotiated with the low income population before public works projects were executed. The municipality communicated with low income neighborhoods characterized by a certain level of consolidation, informing them of the fact that street and service improvements were feasible on the condition that beneficiaries return a part of the investment in proportion to the benefit accruing to each property. This proposal was then accepted, and even when the Program was discontinued as a result of a political decision by the mayor, there were several applications pending from neighborhood organizations that wanted to participate in the Program, which they saw as a way to facilitate the urban consolidation of their neighborhoods. Where the Program was applied, neighborhood organizations participated voluntarily by supplying basic data on lots, data that was otherwise difficult to obtain due to the absence of cadastral information.

3. The Current Situation

The current municipal tax framework was defined in Legislative Decree 776 of December 28, 1993, applied in 1994. Under this framework, the Betterment Levy was repealed and the Special Public Works Tax was established as a modified vehicle for the capture of value increments. To better understand the current situation one must consider the general framework of government policy, particularly with regard to public spending.

3.1. Policy on public spending

Under President Alberto Fujimori (1990-2000) the central government applied neoliberal economic measures, but unlike other countries in the region such as Bolivia, Colombia, and Brazil, it promoted the recentralization of the State, which curbed the process of municipal reform begun in 1980. Unwavering support for private enterprise and the free market as the driving force for development eliminated obstacles to entrepreneurial and market activities. With regard to urban land management, it limited the applicability of the law of land expropriation by eliminating any consideration of social use and included only public necessity as a criterion for expropriation. It also suspended geographical limits on urban land uses intended to protect the ecological environment on the urban periphery.

Politically, halting the decentralization of the State reinforced the role of the central government, which recovered powers that had been ceded to the municipalities since

1981.5 Central government discretionality in the use of public resources was maintained. In 1998, budget appropriations in the public sector were concentrated in central government agencies, especially in the Ministry of the Presidency (20%), while the participation of the municipalities continued to be weak (3.7%).

Based on available information, in 1992 the greater part of fiscal resources (88.5%), and most spending (89.5%), both capital and current, were concentrated in the central government. In 1993 the central government's current revenues represented 11% of GDP and tax revenues were 9.5% of GDP, while local governments had increased their current revenues to 1.47% of GDP (having been 0.17% in 1984). This was due to the increased tax collection by the National Tax Administration (Superintendencia Nacional de Administración Tributaria - SUNAT) which collects most revenues from local governments through the Municipal Promotion Tax (Impuesto de Promoción Municipal - IPM) (Araoz, 1996).

In any case, municipal revenues are limited, impeding their provision of local goods and services. This contrasts with the spending capacity of central government agencies such as the Social Compensation and Development Fund (Fondo de Compensación y Desarrollo Social - FONCODES) and the National Housing Fund (Fondo Nacional de la Vivienda - FONAVI), which together supplied more than 28% of resources for gross capital formation and 69% of resources for bodies that execute local infrastructural projects (Araoz, 1996: 101). This results in opportunism in local infrastructural development by the central government, which exercises its discretion in appropriating public resources and directs them toward areas where the governing group receives less electoral support (Graham and Kane, 1998).

In 1993, total public sector gross capital formation was US\$ 1,306 million, only 10.9% of which corresponded to local governments (either district and provincial). Central government agencies that financed local infrastructural projects came to represent more than 41% of the total (to which must be added investment by the "deconcentrated" or semi-independent, semi-autonomous agencies of local administration). Thus, nearly half of all gross capital formation in 1993 was directed to local projects executed or financed by central government bodies without the participation of local governments (Araoz, 1996).

⁵ For example the regularization of land tenancy (L.D. 803 of 1996); the power to authorize urbanization (transferred to district municipalities and to the Commission for the Formalization of Informal Property (*Comisión de Formalización de la Propiedad Informal* – COFOPRI) under Law 26678 of November 20, 1997); and the power to regulate the management of vacant properties, assigned to provincial municipalities through the Organic Law of 1984.

3.2. The Municipal Compensation Fund (Fondo de Compensación Municipal - FCM)

Legislative Decree 776 stated that “the rationalization of the municipal tax system, in order to simplify the administration of the taxes that constitute local government revenues and to maximize their collection, is a matter of national interest.” Beginning in 1994, the decree established the tax revenues for municipalities consisting of a group of municipal taxes (the property tax, the alcabala tax on real property transactions, and taxes on vehicular property, lotteries, gambling, and non-sports-related public events), of assessments (a special assessment on public works), fees (for public services or adjudications, administrative services, business licenses, vehicle parking, and others) and national taxes established for the benefit of municipalities but collected by the central government (the IPM, the tax on gasoline, customs revenues, and a tax on recreational boats). This legislative decree simplified the tax system by reducing the number of municipal taxes from about 15 to only six.⁶

The most important aspect of Legislative Decree 776 is that it assigns resources to the Municipal Compensation Fund (Fondo de Compensación Municipal - FCM), established by the 1993 constitution,⁷ those being the resources generated by the IPM and the gasoline tax. It also stipulates that the distribution of the FCM will be determined by a supreme decree issued by the Council of Ministers, making this a mechanism for the transfer of resources from the central government, although it appears in the books as direct municipal revenue. The FCM accords great importance to the capital expenditures of the municipalities, appropriating 80% of its resources for that purpose and 20% of its resources for operational expenditures. The decree also stipulates that the percentage allocated to provincial municipalities should not exceed 20%.

According to scholars (Delgado, 1995; Araoz, 1996; Graham and Kane, 1998), the distribution of the FCM represents a decreased municipal capacity to collect taxes, to make spending decisions (which makes it into a government transfer) and within local governments, a transfer of resources from provincial to district authorities. During the implementation of the decree the only adversely affected party has been the Lima Provincial Council (the municipality of Lima) and its INVERMET program, where the percentage of resources from revenue collection fell from 35% to 20% in 1993-1994 (Araoz, 1996). This is because appropriations from the FCM are now determined by the

⁶ Among the taxes that were eliminated was the tax on property without building construction. This was considered a form of double taxation since there was already a general land tax. Delgado (1995) asserts that this was not a case of double taxation, which in tax theory refers to the repeated imposition of a tax on the same person or the same thing, whereas in this situation properties were taxed on the basis of meeting two separate conditions: 1) being located in an urban area; and 2) having no building construction present on at least 2/3 of their area. The tax basis for this tax was not the same as that for the land tax, ergo it was not a case of double taxation.

⁷ In April 1992 President Fujimori carried out a “self coup” (*auto golpe*) and dissolved parliament, which had had an opposition majority. As part of the later transition to the rule of law, a Constituent Assembly was elected and produced a new constitution in 1993.

Council of Ministers. The advances of municipal reform were curbed in that way and the discretionality of the central government was strengthened.

While public spending is concentrated in the hands of the central government, in 1993 seventy percent of total municipal spending was allocated to operational expenses. Thus it is difficult for local governments to improve local infrastructure independent of the central government. While the overall resources of district municipalities have increased as a result of FCM distributions, there are underlying perverse mechanisms. Since the criterion for the appropriation of funds is poverty (established through social indicators such as the rate of infant mortality), small municipalities in the rural interior are allocated more resources but lack technical and administrative personnel to manage capital spending, while only 20% can be used for current or operational spending. At times this leads to the appropriation of more funds to operational purposes or to the execution of public works that do not contribute to development plans, which are in any case usually nonexistent. But the worst aspect is that since poverty is a source of resources there is little incentive for local development, which would paradoxically mean a loss of resources to other communities.

3.3. Instruments for taxing property and land value

In this context, the order of the FCM to direct 80% to capital spending makes it necessary for local governments to improve their internal tax collection in order to meet their needs for current spending. As a result they have improved their collection mechanisms for taxes on the real property basis, at least in the most populated and most powerful urban districts. Legislative Decree 776 contemplates several taxes relating to property and land value (see Box 1).

The municipal property tax is the most productive of these taxes, particularly in large and powerful urban municipalities. In 1993 this tax represented 8.6% of total current revenues in the municipalities as a whole, which is significant if one considers that the Municipal Promotion Tax (Impuesto de Promoción Municipal - IPM) provided 10.6% and the tax on real property transactions (the *alcabala*) only 1.7% (Araoz, 1996). The largest beneficiary is the district municipality where the property is located,⁸ as it is collected annually and payable quarterly. It represents a substantial contribution to current municipal revenues, so services are contracted to monitor and identify all new construction projects and additions to existing buildings and thereby maximize tax revenues. Revenues from this tax are less substantial in other areas where the presence of consolidated housing is limited and the housing that is present is less valuable, where cadastral data is not available, and where processes for the legalization of land and property are not fully established.

⁸ In contrast, it is much less significant for provincial municipalities such as Lima. In the first quarter of 1998 the property tax represented only 12.3% of internal revenue compared to the 24.7% represented by the vehicle tax, 29.3% by judgments and 33.9% by fines and other revenue sources. *El Comercio*, April 12, 1998.

While legally 5% of the property tax should be budgeted for use by the cadastre, few municipalities comply (Allers, 1997). This is possible due to the weak oversight of municipal budgeting. According to Law 26199, this oversight is the specific responsibility of the Comptroller General (Contraloría General de la República) rather than the central government. In reality, oversight by Comptroller General's office is ineffective and often consists of merely archiving the annual reports of municipalities (Araoz, 1996).

In 1993, the tax on real property transactions (the alcabala) represented only 1.7% of current municipal revenues, but it has been modified by Legislative Decree 776. Whereas it was previously collected by provincial municipalities, it is now collected by district municipalities. While 50% of revenues from this fund should be transferred to the provincial municipalities where there is a Municipal Investment Fund (which is true only in Lima and its INVERMET), this requirement is not met due to lack of oversight.

Revenue from land taxes and the tax on real property transactions cover the operating costs of municipal administration. Since these are taxes whose collection does not correspond to the provision of any particular good or service, these resources revert to a "unitary fund" that is used to pay the political and administrative bureaucracy, in keeping with the idea that since 80% of FCM transfers are to be used for capital expenses, district and provincial municipalities make use of local taxes such as land taxes to cover current expenditures. There is no relationship whatsoever between the payment of these taxes and investment in public works. Capital investments rely on FCM resources, which are actually transfers from the central government and in principal could be based on programs intended to recover resulting value increments (such as the Special Assessment), but this is not contemplated in the initiatives of the local governments, of the central government, or of the Comptroller.

BOX 1: PROPERTY AND LAND VALUE TAXATION

A. The tax on land

The basis of the land tax is the value of land property. It is billed and collected by district municipalities. Individual tax bases are calculated with the use of two tables: the Tax Values of Land Property (Valores Arancelarios de Terrenos) and the Official Unitary Values of Buildings (Valores Unitarios Oficiales de Edificación) that are approved each year by the Ministry of Transportation and Housing on the basis of data provided by the National Valuation Council (Consejo Nacional de Tasaciones - CONATA).* The taxes are calculated by applying the following progressive cumulative scale to the tax basis, where one Tax Unit or TU (Unidad Impositiva Tributaria – UIT) = 2,600 Peruvian sols or US\$ 963 as of January 1, 1998.

Declared value of property	Tax Rate
Up to 15 TUs	0.2%
More than 15 TUs and up to 60 TUs	0.6%
More than 60 TUs	1.0%

According to Law 776, when housing improvements exceed the value of 5 TUs (US\$ 4,815) the property value should be updated in order to readjust tax payments. Five percent of the yield on the tax should be appropriated exclusively to the development and maintenance of the District Cadastre and to the administration of the tax itself in order to strengthen its application and improve collections. For the latter purpose, 3/1,000 (.003) of the tax yield is transferred to CONATA.

Properties belonging to the following institutions are exempt: municipal, provincial, central, and foreign governments; hospitals, religious entities, fire departments, mining concessions, campesino communities, universities and schools.

B. The tax on real property transactions known as the *alcabala***

The *alcabala* taxes those transfers of urban and rural real property that are either without cost, for consideration, or with property rights reserved until payment is complete. In effect, the tax is applied to transfers including donations, exchanges, and sales where the property continues to belong to the seller until payment is complete. The taxable basis is the declared value of the property during the period in which the transfer takes place, adjusted in keeping with the wholesale price index for Metropolitan Lima as determined by National Institute of Statistics and Informatics (Instituto Nacional de Estadística e Informática - INEI). The tax rate is 3% of the tax basis, payable in full by the buyer. The rate was previously 6% but it was reduced through L.D. 303 of 1985 in order to reduce pressure and incentivize private investment. It is now collected by district municipalities but in keeping with Organic Law of Municipalities 23853 of 1984 it was previously collected by provincial municipalities. According to Delgado (1995), collection by district municipalities is deeply flawed since each district municipality retains the revenues it collects, preventing their redistribution within the city from the richest to the poorest areas, thus violating the principle of redistributive justice.

The first 25 TUs of real property value (US\$ 24, 075) are not subject to this tax. This amount is subtracted from the price of the property, and properties worth less than this amount are not subject to the tax. The first sale of a given property by a construction company is also exempt. The district municipalities, which administer the tax, must transfer 50% of collections to the Municipal Investment Fund of the provincial municipality, if there is one.

* CONATA is a decentralized public institution within the Transport, Communication, Housing, and Construction Sector that is responsible for establishing the value of urban and rural real properties throughout the country in order to assist the work of local and central governments and the community in general. It is also responsible for determining the tax basis for the Tax on Land Property Values.

** The word *alcabala* is a Peruvianism whose etymological origin refers to a tax of up to 6% applied during the colonial period to artisanal and agricultural products.

3.4. The Special Assessment on Public Works

This assessment replaces the Betterment Levy eliminated by L.D. 776. As a mechanism for the capture of property value increments, the Special Assessment on Public Works is also based on the principle of recovering public investment by taxing the benefits accruing to land property as a result of municipal public works projects. Nevertheless, it differs in some respects from the earlier assessment. For one thing, it limits the active subject to the municipality (it is not applied to the central or regional governments) since it is defined within the municipal tax framework, and we are not aware of similar legislation referring to the other levels of government mentioned. Secondly, it requires the previous agreement of the population, which under the earlier legislation was not a prerequisite.

Law 776 stipulates that the assessment should be calculated considering the value increment resulting from the municipal work project. Under no circumstances should revenues from the assessment be used for any purpose other than covering the cost of the investment or a percentage thereof, as determined by the municipal council. Municipalities must establish rules guaranteeing the technical quality of the process by which the cost of public works projects is arrived at and the process by which the public is informed of those costs, and insuring public participation in these processes. As has been indicated, the collection of the assessment must take place only if the municipality has communicated the approximate cost of the project to its beneficiaries before contracting and executing the work.

According to Araoz (1996), the law has weaknesses in not defining the length of time before the project when it must be announced to the community, in the fact that such communication with the community does not necessarily mean acceptance if the community is not interested and does not wish to finance the project, and in the vague description of the value to be determined (the value increment accruing to the property that is benefited). Counter-intuitively, the law is praised for stipulating that the assessment may not be greater than the cost of the public works project, and that it may not be used for any other purpose, suggesting that something similar should also apply to fees. While the above mentioned weaknesses are real, legal traditions demonstrate that these aspects may be better dealt with in subsequent regulatory language. While the law stipulates that district and/or provincial municipalities should produce these regulations, however, they have not done so up to this time. This may be due to ignorance of the law, lack of interest, or the fact that the limited possibility for municipal investment and a dependence on transfers have reduced the municipalities' interest in producing regulatory language, i.e. the lack of resources with which to make investments and dependence on the central government would disincentivize any effort to develop mechanisms for recovering such resources.

In this sense, and the lack of regulations is an indicator, there has been virtually no effective utilization of the new assessment. Urban Development officials who have attempted to implement the new assessment, such as those in the Municipality of Trujillo, have found it difficult to obtain the required agreement of the population, which instead

expects the municipality and especially the central government to provide public works at no cost. In addition, municipal authorities know very little about the mechanism.

4. Obstacles to the Capture of Value Increments

4.1. Sociopolitical and economic obstacles

The primary obstacle to implementing mechanisms for capturing value increments is political, not only due to the highly centralized nature of the State, but also to the lack of political will on the part of municipal authorities, who are loathe to risk their popularity and position themselves disadvantageously for reelection.

In economic and financial terms the primary obstacle is that before seeking mechanisms to recover an investment one must first have access to resources to actually carry it out. The Metropolitan Municipality of Lima, which has moved forward with a program for the recovery of investments, has been the primary beneficiary of new legal and tax regulations that provide the central government with a degree of discretionality in public spending. This is legally contradictory in the sense that by the terms of Organic Law municipalities are responsible for the execution of local public services, while it is not they who in reality carry them out.

The central government's constant involvement in municipal public finances and its lack of coordination with its decentralized bodies (FONCODES, FONAVI) produce a structural weakness in those municipal finances. This weakness results from a lack of capacity for municipal self-financing and from municipal dependence on transfers, and from conflicting authority with the central government and the duplication of functions by the latter. These factors discourage efficient municipal management. (It pays to be poor and receive more resources as a consequence.)

These interrelated elements have perverse effects on the way that urban development is promoted in local areas. Not only do local governments fail to address the issue of urban development (which paradoxically is a function that has not reverted to the central government), but they also fail to adequately organize or coordinate infrastructural projects assigned to the localities. One example is FONAVI, which truly represents a distorted use of resources. In providing electrical and sanitation service on the informal periphery of municipalities, FONAVI effectively legitimizes unplanned land invasions and "individuals find that their properties are revalued without their having incurred any cost whatsoever other than having presented an application, and the property rights of municipalities over areas of possible urban expansion are limited." (Araoz, 1996: 103)

Under these circumstances, municipalities do not assume any commitment to recover costs nor to fulfill any of the service or maintenance requirements of this "system," if it can be called that. This affects the behavior of the community. Since no association is established between local taxation and local services, the community has an incentive to avoid paying taxes. In addition, accustomed as the community is to the paternalism of the central government no matter who holds office any given moment, they expect the central

government to offer local services and to pay for their ongoing operation and maintenance. These factors present major difficulties for the municipal recovery of public investments.

4.2. Technical and administrative obstacles

In light of the above, technical and administrative obstacles are secondary. Nevertheless, they should be elucidated in order to reach a comprehensive understanding of the situation.

4.2.1. Difficulties in determining the beneficiaries and degree of valorization

It is difficult to estimate total land value increments resulting from community and public investment in projects with metropolitan and inter-district effects such as large road projects, interchanges, overpasses, etc. Determining the gradient of beneficiaries is complicated, and it is difficult to convince beneficiaries to pay for the project. It is less difficult to determine the benefit to an individual property through valuations and market research. In any case, the table of values established by CONATA does not fully reflect the commercial value of properties because:

Property valuations are based on official tables of building unit values. A depreciation table is applied to the initial value of the building according to its primary structural material and its age and condition. Other factors that in reality affect the value of the property are not taken into consideration, for example the building's location, the characteristics of the neighborhood, the availability of public transportation, and proximity to shopping areas. The value of the land is defined in keeping with a basic tax map issued annually by the Valuation Council (*Consejo de Tasación*). These values have no relation to real or commercial values." (Allers, 1997)

4.2.2. The lack of human resources and administrative infrastructure

Local governments lack personnel qualified to manage their responsibilities related to taxation. In addition, it is difficult to coordinate urban planning and tax collection activities within the municipal administrative structure. Within that structure, there is an Urban Development Office with planning responsibilities and an office of revenue collection. These two offices are completely isolated from each other, especially since the former is accorded low priority. The presence of Urban Development Offices (Oficinas de Desarrollo Urbano - ODU) is not stable. Forty one percent of the ODUs were just being set up or restructured in Lima in 1993; six percent of the offices had not yet been approved; and 53% were approved but only in terms of their internal organization (Miranda, et al, 1996). The ODUs are bureaucratic entities dealing with the construction of urban infrastructure and regulating building construction, handling such aspects as construction licenses. Their primary function is oversight in the sense that they are restricted to issuing warnings and sanctions for code violations. It is hard to imagine the

development of value capture mechanisms as a function of these offices in the absence of a number of changes. One alternative would be the use of Special Programs, but that option should be evaluated with respect to the operating capacity of each municipality.

4.2.3. The incomplete cadastral information system

The experience of administering the Betterment Levy demonstrates the need for a modern and efficient cadastral registry. The cadastral system is relatively new and still precarious (see Box 2). Municipal authorities do not understand its usefulness as an instrument for the collection of taxes, assessments, levies, and fees. As a result, the 5% of land tax revenues stipulated by law are not appropriated for its improvement (Allers, 1997). This negatively affects the technical infrastructure for measuring and evaluating property value increments. One third of the municipalities that had fully established or improved their cadastres did not even use them in the urban management processes. All of this is in addition to the weakness of the Urban Development Offices, which are also responsible for developing the cadastre, conducting the physical inventory of real properties, and applying the resulting information to collecting revenue and producing development plans.

It must also be taken into account that those districts where low income population sectors are concentrated, those that also require more infrastructural development, are also the places where informal and illegal methods of accessing land and housing are most frequently practiced (A little over 55% of housing units in Lima are in this category). It is in these areas that the development of cadastres is hampered by the historical slowness in regularizing land tenancy and formalization. This presents an obstacle to the integration of this population and their properties as a basis for tax collection (property taxes, the alcabala) and for assessments. The Commission for the Formalization of Informal Property (Comisión de Formalización de la Propiedad Informal - COFOPRI) estimates that 70% of the rural and urban properties in the country are unregistered.

BOX 2: THE HISTORY AND REALITY OF THE CADASTRAL SYSTEM

The cadastral information system was established in 1985 within the framework of municipal reform. The system records and classifies all public and private real properties, urban infrastructure and “urban furniture” such as benches, streetlamps, etc. This information is systematically organized using variables such as physical, legal, fiscal, and economic characteristics (Ferreyros, 1997). The cadastre is a basic technical instrument for estimating and applying land taxes, for observing and measuring increases in the value of land and building properties, and for providing the technical estimates required for levying assessments.

In 1985, Bylaw #008 of the Municipality of Lima tasked the cadastre with responsibilities for improving urban planning, oversight, and tax collection. It established the Comprehensive Municipal Cadastre (Empresa Municipal de Catastro Integral), which

was transformed in 1989 into the Cadastral Institute of Lima (Instituto Catastral de Lima - ICL), and initiated an aggressive program to publicize and apply the cadastre. Preliminary cadastral surveys were produced with assistance from the French government, and the district municipalities committed themselves to organize their respective cadastral offices. By 1989 a third of the district municipalities in Lima were in the process of conducting cadastral surveys and 12% had completed them (Miranda, 1996). In the same year the central government stressed the importance of the cadastre and determined that district municipalities should appropriate 5% of land tax revenues to the development and maintenance of the Office of the Cadastre, but few municipalities complied (Allers, 1997). In 1990 the new municipal administration of Lima deemphasized the cadastre, and in 1993 many of the district municipalities that had begun the process had not completed it or had simply abandoned it.

Table 1

Cadastral surveys in the district municipalities of Metropolitan Lima, 1993

Municipalities	with	cadastral	surveys
			84.4
%			Complete
25.0%			
Partial			50.0
%			
Initial			
9.4%			
No		cadastre	15.6
%			
TOTAL			100.0%

Source: Miranda, et al, 1996.

In 1993 cadastres were complete in only 25% of district municipalities (especially those in higher income areas). In the country as a whole, the cadastral system is even weaker. Out of 1,793 districts, only 5% report having a cadastre in place and the remaining 95% have not even begun. In the 27 largest and most developed cities of the country, 76% of the districts report having an urban cadastre and the remaining 24% have not even begun the process of its establishment (Ferreyros, 1997). In some places such as Cuzco, the municipalities have sought to compensate for their technical and administrative weaknesses by requesting help from nongovernmental organizations (Estrada, 1995).

4.3. Cultural-Juridical

4.3.1. Cultural

The weak culture of taxation, associated with political clientalism, is an obstacle to the recovery of public investment. Although common sense might suggest otherwise, it is the middle and upper classes who are most reticent to pay taxes and apply political leverage to avoid doing so. In contrast, low-income sectors lacking streets and services are more willing to comply with tax laws. In general there is a tendency to consider private property sacrosanct, an idea that naturally extends to the appropriation of benefits stemming from the ownership of property. Thus investments in public works projects continue to go unrecovered. This is counterproductive to the process of constituting citizenship understood as the recognition of rights and responsibilities with regard to the State.

4.3.2 Juridical - taxation

The current juridical and tax framework (L.D. 776) makes it difficult to strengthen municipal finances. Municipalities are not authorized to establish new taxes or to set rates, and are not even authorized to establish the taxable bases of certain local taxes. All of this limits their ability to collect revenues effectively. Nonetheless, mechanisms for the capture of value increments provide the legal conditions for the application of the Special Tax on Public Works (Contribución Especial de Obras Públicas) and it is a failing of local governments if they do not establish and approve regulations for its application.

5. General Conclusions

Beyond the most general considerations (the incomplete formation of the modern State and its correlate, the citizenry) I have addressed the technical problem presented by the taxation of land value increments resulting from public investment. The application of value capture instruments forms part of a legal tradition initiated in 1981 and follows on a program of implementation in Lima from 1990 to 1993. For fundamentally political reasons (the central government's discretion with regard to public spending and a lack of political will on the part of local authorities) this tradition lacks continuity and despite the existence of a legal framework for value capture, investment in public works projects continues to go unrecovered.

This explains the continued existence of untaxed property valorization that also increases the operating costs of local governments. Property value increments such as those produced by the construction of malls or shopping centers such as the Plaza San Miguel or by the Program for the Recovery of the Historical Center of the Municipality of Lima (Plaza San Martín, for example), provide no return to the municipality, while the municipality must nonetheless assume responsibility for the resulting externalities (environmental degradation, increased traffic and garbage, etc).

Urban public policy in general is not managed in an integrated fashion to confront the problems of urban growth. The appropriation and distribution of urban land, public

works, land value increments, and taxation are all separate processes. The land market, public policy on infrastructure, local planning, and the tax framework are managed separately and are the responsibility of numerous actors with conflicting responsibilities such as the private sector, community entities, and the local and central governments. Policy is fragmented and problems are treated as separate and unrelated. This situation will continue as long as the political elite persists in its anachronic centralization of the State. The option for decentralization follows the principle of subsidiarity, according to which each State function should revert to the lowest level of government consistent with efficient performance. Thus the central government should provide public goods and services only in those cases where demand is undifferentiated; externalities are inter-jurisdictional; and the additional costs of local administration are greater than any potential benefits (Araoz, 1996: 37). With regard to local management, instruments for the capture of land value increments resulting from public investment should be integrated into a broader land management policy.

There is a clear consensus among academics that L.D. 776 fails in the sense that its (non-explicit) political objectives negatively affect the autonomy of local governments and it undermines the functioning of those (such as the metropolitan councils) that are expected because of their size to delineate methods for the recovery of investments. Without resources there are no public works, and without public works it is difficult to imagine value capture. The distribution of resources to small municipalities, to those that perversely benefit from continuing to be poor in order to continue receiving discretionary transfers, does not signal the way forward.

The ethical argument for value capture has not been developed or communicated by local governments. Taxing the benefits transferred to properties as a result of public works should be a guiding principle of redistributive justice. This issue should not be stated in pragmatic terms, i.e. that the citizenry should finance public works (which calls into question the role of the State and the justification for tax collection) but rather that those who benefit from a public works project when the market value of their land increases should pay their debt to the community.

This implies going beyond certain traditions of political clientalism and unrecovered investment. The need to produce regulatory language for the application of the betterment levy could be one way to communicate with governmental and non-governmental bodies as well as the public about value capture instruments and to develop their ethical components. In legal terms, these mechanisms must be broadened to include public works projects carried out by the regional and central governments.

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