

Making Decentralization Work in Latin America and the Caribbean

A Background Paper For the Sub-national Development Strategy

Inter-American Development Bank

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Sustainable Development Department

Foreword

The rapid decentralization of political and fiscal decisions occurring in Latin America and the Caribbean and the growing role of the Inter-American Development Bank in assisting this process prompted the Board of Executive Directors to adopt a Subnational Development Strategy to guide Bank action in this sector. The Sustainable Development Department published the strategy document in its Sector Policy and Strategy Series of publications (Nº SOC-124 of May 2001).

As part of the strategy preparation process, the Department undertook several technical studies covering key areas of concern. Topics researched included: the extent of decentralization in the region, the new tasks and challenges faced by subnational governments, intergovernmental relationships, the democratic governance and institutional capacity of these governments, and the issues concerning lending to subnational governments. These studies provided valuable insight to the team drafting the strategy by further delving into the technical aspects of the topics touched upon by the strategy. SDS considers this information very useful for the Regional Operations Departments responsible for the implementation of the strategy. Further, the information gathered can be of value for government officials in borrowing member countries engaged in the formulation and implementation of decentralization policy. Based on these considerations, SDS decided to publish the background studies for the Subnational Development Strategy in the present format that synthesizes the findings of the different technical studies in eight chapters.

It is hoped that this publication will help Bank and government officials in dealing with the complex development issues faced by subnational governments and by central governments who have the task of transferring resources and responsibilities to these territorial entities.

Mayra Buvinic
Chief
Social Development Division

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1.

Introduction and Summary

The paper provides information and analysis in support of the Bank's subnational development strategy (GN-2026). The strategy will guide future Bank operations in support of decentralization to address the complex issues countries are facing in their efforts to promote the socio-economic development in subnational territories.

Chapter 2 provides an overview of the decentralization process in Latin America and the Caribbean and sets the stage for an analysis of the key issues that need to be addressed by the Bank when supporting the decentralization process in the region.

Chapter 3 discusses the challenges confronted by subnational governments. The development of subnational governments is key to improving well-being.

The strategy recommends that the Bank assist countries to create the conditions necessary to reach these goals. That is, subnational governments should be capable of taking over expanded responsibilities in the provision of services and infrastructures and become active players in the promotion of economic development in their jurisdictions. This approach requires a change in the way the Bank approaches lending for subnational development moving away from merely financing the expansion of capacity and good financial management and focusing attention on the system of incentives built into the different structures that determine subnational government outcomes:

1. The structure of intergovernmental relations.
2. The system of governance.
3. The institutional capacity of subnational governments.

4. The mechanisms for financing subnational entities.

The goal for Bank involvement in decentralization is to establish subnational governments capable of providing for themselves the institutional and financial resources needed to discharge their responsibilities

Other chapters in this paper support the objectives and recommendations related to the four areas identified. Chapter 4 focuses on the structure of intergovernmental relations and concludes that a well-designed structure provides subnational governments with incentives to efficiently allocate resources to the most socially profitable uses. Consequently, it recommends that the Bank assist countries to establish subnational governments with:

1. Clearly defined responsibilities.
2. Sufficient resources to discharge their functions.
3. Hard budget constraints that force decision-makers to fully assume responsibility for the trade-offs involved in collecting and allocating a limited pool of resources.

It is further recommended that to foster the efficient allocation of resources at the subnational level, the Bank should stress the need for a close correspondence between those who benefit and those who pay for government programs and services to ensure that the different constituencies are aware of the costs of their choices. The use of transfers, co-participation in centrally collected taxes, and other forms of higher tier financing of subnational governments needs to be guided by the objective of putting in place

incentives for local decision-makers to adopt fiscally sound decisions.

Chapter 5 discusses the governance issues involved in decentralization. It recommends that the Bank stress the importance of well-functioning mechanisms of citizen representation and oversight so that elected subnational officials can be effectively held accountable and the management of local affairs can be made transparent. Attainment of these governance objectives—essential conditions for democratic oversight—is a necessary condition for good fiscal management and accountability at the subnational governmental level. To this end, the Bank will also contribute to strengthening central government functions related to setting performance standards, performing evaluations and ensuring the transparency of subnational governments' operations.

Chapter 6 concentrates on the institutional aspects of decentralization and concludes that the Bank should emphasize the need for subnational governments to have sufficient institutional capacity and resources to discharge their responsibilities at socially acceptable levels of performance. Whenever necessary, Bank-sponsored programs should include reforms and institutional development components to support the development of the organizational structure, administrative systems and human resource policies of subnational governments of different size. Emphasis should be placed on strengthening the civil service career, thereby providing incentives for continuity and the professional development of subnational civil servants.

Chapter 7 discusses the variety of issues related to financing subnational governments and recommends that the Bank stress the paramount importance of sufficient sources of financing for ensuing good subnational government performance. Own sources of revenue should constitute the principal source of financing for subnational governments, using fee for services rendered where possible. Otherwise, to the extent possible the services should be financed from taxes borne by local residents. When subnational services are associated with national or regional priorities, high tier government transfers are efficient. Transfers should not substitute for own revenues, and should be in forms that do not distort local expenditure preferences. For borrowing to be an efficient source of financing for subnational governments, regulations and capital markets, combined with a sound structure of inter-governmental relations, should impose on them a hard credit discipline. Therefore, the Bank will stress the need for linking subnational development programs to programs aimed at developing capital markets and their regulatory framework.

When appropriate, the Bank will incorporate the necessary conditionality in subnational development loans and will provide the required technical cooperation and policy advice to foster a hard credit discipline for subnational governments. Finally, chapter 8 discusses the implications of these proposals for Bank operations in support of decentralization including a revision of the potential role that the lending and non-lending products offered by the Bank can play in pursuing the objectives identified in the preceding chapters.

2.

The Decentralization of Government: A Sustained Trend in Latin America and the Caribbean

WHAT IS HAPPENING? DEMOCRATIZATION AND DECENTRALIZATION

Democratic Decentralization

One of the most remarkable features of the recent history of Latin America and the Caribbean has been the decentralization of political and fiscal decisions. The devolution of responsibilities to subnational entities of government has proceeded at a fast pace in the last decades. The process has run in parallel with the democratization of government, dramatically changing the way local affairs are run in the region.

The number of IDB borrowing member states with democratically elected central governments increased from 13 in the mid-1980s to all 26 in the late 1990s. Democratization also has taken place in subnational governments. Elected officials run municipal governments in 23 countries (up from only 6 two decades ago), in most of them (17) mayors are elected by direct vote while in the rest they are nominated by an elected council (IDB 1997a).

Subnational governments not only are becoming more democratic; they are also playing a larger role in the management of local affairs. In less than 15 years the average share of public expenditures managed by subnational governments rose from 8 percent to almost 15 percent. However, there are significant variations among countries in the degree of decentralization. While Argentina, Brazil and Colombia are highly decentralized (with over 40 percent of total government expenditures managed by subnationals) others are still highly centralized. For instance in Costa Rica, Dominican Republic, and Panama subnational governments manage less than 5 percent of total government expenditures. Others have not decentralized at all. In

Barbados and The Bahamas the central government remains in charge of all expenditures (see Table 2.1). There is still much room for expanding decentralization considering that in industrialized countries 35 percent of government expenditures are in the hands of local authorities (IDB 1997a). In sum, as stated by Bird (2000) decentralization is not only in the air; it is already on the ground and influencing policy outcomes throughout the continent in a major way.

Motivation

The motivations of the decentralization process in Latin America and the Caribbean are many and do not always fully coincide with the propositions that support decentralization as a mechanism to better allocate and use public resources.

The often-quoted advantages of decentralization include allocative efficiency; that is, the potential for attaining a better match between the set of goods and services offered by the government and the preferences of the population. Decentralization is also reputed to foster greater levels of engagement and ownership by the community on local development programs. In functioning democracies, it should also result in greater accountability and better governance as decisions are adopted closer to the community's scrutiny. The expectation is that the great variation of needs and preferences observable in different parts of the countries will be better served by decentralized systems of decision-making than by centralization (IDB 1998). These advantages, significant for the allocation of resources, are not present in the discharge of the governments' stabilization and redistribution functions that are better executed in a centralized manner. Not surprising, they have remained largely centralized.

Table 2.1. Countries and Level of Decentralization

Focus of Decentralization	Level of Decentralization (Subnational Public Expenditures as a percent of total)		
	More than 20%	Between 10 and 20%	Less than 10%
Intermediate Level (states or provinces)	Argentina (49.3) Brazil (45.6) Mexico (25.4) Venezuela (19.6)	Peru (10.5)	
Local Level (municipalities)	Colombia (39.0) Bolivia (26.7)	Uruguay (14.2) Chile (13.6) Honduras (12.3) Guatemala (10.3)	Ecuador (7.5) Trinidad and Tobago (7.2) Paraguay (6.2) El Salvador (6.0) Nicaragua (5.2) Panama (3.2) Dominican Rep. (2.9) Costa Rica (2.3) Barbados (0.0) Bahamas (0.0)

Source: IDB 1997a

The downsides of decentralization are also significant and fuel a strong counter current that has tempered the decentralization drive in many countries. Opponents point to the fact that autonomy of decision does not by itself guarantee improvements in public services. Service provision may even worsen for certain groups if the local political elite captures the decision-making process or if the distribution of resources does not balance the delivery capacity among subnational jurisdictions. Although these outcomes are mostly the result of faulty intergovernmental relationships that do not allow the full benefits of decentralization to bloom, they provide arguments to the centralization lobby usually nested around finance ministries and those concerned with macroeconomic stability and fiscal discipline.

Specific motivations driving decentralization vary among countries. There are cases where the process is driven by the desire of strapped central governments to transfer the responsibility to pay for local services to lower tiers of government in the hope that local governments may be able to mobilize community resources or raise additional revenue. In other instances, decentralization is driven by the need to diffuse politi-

cal pressure exercised on the central government by communities calling for greater participation in decision-making. These motivations rarely support efficient decentralization processes and often lead to partial transfers of responsibilities (thus generating overlapping jurisdictions) and the allocation of insufficient resources to subnational governments. There are also governments that genuinely try to improve the provision of certain services through decentralization. However, this motivation still may lead to deficient intergovernmental relationships as central governments find it easier to transfer the responsibilities but not the resources decision-making autonomy required to properly perform them. Decentralization often clashes with dated legislation framing intergovernmental relations, further hampering the process.

Level of Decentralization and Type of Government

The influence of the system of government on decentralization is not conclusive to explain the degree of decentralization attained in a country. In principle, federal systems of government would grant more autonomy to subnational levels of government than unitary systems, the lat-

ter leaning toward the exercise of greater degrees of central control. Actual autonomy though, seems to be determined more by the political circumstances and size of the countries involved than by the system of government.

Argentina, Brazil, Mexico and Venezuela are all federal republics. However, the autonomy enjoyed by subnational governments in each of them is very different. At one end of the scale, the large political and fiscal autonomy of the Argentine provinces is noteworthy. They have their own constitutions and legislative bodies that regulate many aspects of local political and economic life (including the responsibilities and resources assigned to municipalities). They receive block transfers from the central government (*coparticipaciones federales*) that they can allocate with autonomy. At the other end are the Venezuelan states that have but nominal responsibilities and manage a small proportion of public resources. Similarly, decentralization also varies significantly in countries with unitary systems of government. For example, decentralization is much greater in Colombia, a unitary state, than in Mexico, which has a federal government system. A decade-long, sustained political commitment to decentralize responsibilities and resources has made Colombia one of the most decentralized countries in Latin America. In Mexico, however, the central government has retained many of the responsibilities and resources that could have been handled by states and municipalities. Measuring decentralization as the percentage of total public expenditures managed by subnational governments, Argentina, Brazil and Colombia are the most decentralized countries of the Region (40 percent or more), followed by Bolivia, Mexico and Venezuela (between 20 and 30 percent) (see Table 2.1). This is a good mix of federal and unitary states. Differences also exist in the focus of decentralization. There are countries that transferred responsibility and resources to intermediate levels of government, while others have done it directly to the municipal level, often to the detriment of the intermediate level. Argentina and Brazil have emphasized devolution to the intermediate level (provinces and states respectively) and through them, they transfer resources and responsibilities to municipalities. Peru has

strengthened the provincial level of government at the expense of the municipal level, while Bolivia and Colombia have done the opposite, transferring resources and responsibilities mostly to municipalities.

The decentralization processes currently taking place in Latin America and the Caribbean seldom addresses explicitly the underlying system of incentives driving the behavior of the different actors in the process: the central government, the various subnational governments, national and local politicians, government officials, the local community and the private sector. It is increasingly evident that these incentives determine the outcome of decentralization and their reform should play a major role in any decentralization process. Failure to address the system of incentives makes the resulting structure of intergovernmental relationships incapable of fully realizing the potential benefits offered by decentralization. This is a major theme of this document that will be discussed in following sections.

WHAT IS BEING AFFECTED? LOCAL GOVERNMENTS AND THE ASSIGNMENT OF RESPONSIBILITY

Assignment of Responsibility

A key aspect of decentralization is the assignment of responsibility among different levels of government. History and the system of government have a significant influence on this. Certain functions have belonged to the subnational level of government since colonial times (for example, the control of markets, abattoirs or cemeteries has always been a municipal responsibility). Other functions have been transferred from the central or intermediate levels of government as a result of decentralization programs. The net result of this process is that, to date, the distribution of responsibility among the different levels of government is only partially optimal. While some functions are allocated according to the subsidiarity principle (i.e., decisions should be made at the lowest possible level of government), many are being shared by different levels of government with a logic that can only be ex-

plained by the history of the decentralization process.

The complexity of the issue prevents its full analysis within the scope of this paper.¹ (It involves a variety of factors, including the distribution of responsibility for allocating resources and choosing a delivery structure, as well as responsibility for the execution and supervision of delivery.) A review of one of these aspects (the distribution of responsibility for 24 functions in 18 countries), indicates that the greater the decentralization the larger the number of functions whose execution is shared among levels of government (see Table 2.2). Not surprisingly, in countries in which the subnational level of government is responsible for less than 10 percent of total public expenditure (Table 2.1), the division of functions is fairly clear: the central government is responsible for providing most services. In these cases, municipalities are mainly concerned with traditional functions such as maintaining roads and regulating markets, abattoirs and cemeteries. In countries with greater decentralization of expenditures (between 10 percent and 20 percent controlled by subnational governments), national and subnational governments share responsibility for a number of functions. These are typically centered on social services, including primary and secondary health care and education, and subsidized housing. The involvement of intermediate levels of government in the provision of services is only significant in the most decentralized countries of the region (Brazil, Argentina, Colombia and Mexico). Most often, they share responsibility with the national and municipal levels.

Allocation of Resources

A lesser degree of devolution of responsibility is apparent in the allocation of resources among the different levels of government. Frequently, central governments retain decision-making powers in the allocation of resources for services

but assign their provision to lower levels of government. In many countries, decentralization refers to a delegation of responsibility for service provision that places subnational governments in the role of agents of the central government for the execution of certain functions. Proper decentralization involves devolution. Devolution implies that the authority to decide what services will be provided is transferred to subnational governments together with responsibility for implementation. A disturbing trend is that, in the more decentralized countries, there are a number of services for which decisions about the allocation of resources are shared among the different levels of government (often all three levels). The ambiguities that this situation produces may be a source of inefficiency in the allocation of resources that negates some of the benefits of decentralization.

Sharing execution responsibilities among the various levels of government may be efficient in certain circumstances and a waste of resources in others. When the overlap in responsibilities results from a legitimate need to support weak subnational governments, as is the case in primary and secondary education, sharing responsibilities for providing the service may be efficient. When the overlap results from an incomplete transfer of responsibility and duplicates efforts, it is wasteful and may lead to an under-supply of services. Programs whose aim is to optimize the decentralization process must assess this aspect carefully. The rationale for assigning responsibilities for making decisions and allocating resources, as well as the structure of delivery, execution and supervision, must be evaluated in each particular case in order to enact the appropriate reforms. What matters is not so much that each expenditure function is clearly assigned to one level of government or another, but rather that all those involved understand clearly who is responsible for carrying out which tasks.

¹ The IPES (IDB 1997a) contains data concerning the distribution of responsibility the amount of resources allocated to the function, decisions on the delivery structure, execution and supervision of its delivery for 20 services in 18 countries.

Table 2.2 Assignment of Responsibility for the Provision of Services in Selected Countries

Level	Activity	Country																		
		ARG	BRA	COL	BOL	MEX	VEN	URY	CHL	HND	PER	GTM	ECU	TTO	PRY	SLV	PAN	DOM	CRI	
National	Utilities/regulation	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Airports/ports/railways	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Police	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Welfare services	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Regional highways	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Secondary and tertiary health care	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Primary health care	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Tertiary education	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Secondary education	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Primary education	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Public transportation	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Social housing	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Urban planning	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Public hygiene	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Potable water	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Sewerage	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Waste management	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Drainage	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Markets	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Abattoirs	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Cemeteries	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Street maintenance	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Street lighting	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
	Traffic control	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	
Local	Parks and recreation	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N	

Does not include traditional national functions like foreign affairs, defense, national highways. Functions are ordered from those most local at the bottom to those more national at the top. Countries are ordered according to decreasing level of decentralization from left to right on the basis of the data on Table 1.1. Source: IDB 1997 and Nickson 1995

■ Sole responsibility of the level of government

■ Shared responsibility of more than one level of government

Level of government N = National I = Intermediate, State, Province, Regional L = Local

WHERE IS HAPPENING? SUBNATIONAL GOVERNMENT, POPULATION AND URBANIZATION

Decentralization and Size

A recent study identified a strong relationship between size and decentralization. Measuring size in terms of population, territory and GNP, it was found that the greater the size, the greater the decentralization (IDB 1997a). The region's largest countries (Brazil, Argentina, Colombia, Mexico), show greater degrees of decentralization than smaller countries in terms of territory, demographics or economic size. Extreme cases of this relationship are the very small countries of the Caribbean where there is no decentralization at all. For instance, all public expenditures in Barbados and The Bahamas are the responsibility of the central government.

One of the basic characteristics of a subnational government is a clearly defined jurisdiction. Therefore, the apportioning of the territory among these entities becomes a significant factor in the analysis. History, geography and the regional economic development determine how territories have been apportioned for internal governance. Territorial jurisdictions established in colonial times have survived the hazards of independence and different economic and political development cycles and define subnational territories to this day. The boundaries of most Brazilian states and Argentine provinces that were established during the colonial era persist to this day (to some degree because of inertia and parochial interests). Only a handful of countries have undertaken methodical revisions of their territorial subdivision that changed subnational boundaries significantly.

Population size has a definitive impact on a country's political subdivisions regardless of whether the government is federal or unitary. Except for a few odd cases (Peru, which has more municipalities than Colombia even though it has a smaller population, or the Dominican Republic with a larger population but fewer municipalities than Honduras and Paraguay) the

larger the country the larger the number of subnational governments (see Table 2.3).

Types of Subnational Governments

The Latin American subnational government landscape is complex. The more than 100 states and provinces (also known as departments or regions) and 14,000 municipalities that exist in the region comprise a vast and varied set. Some states have very large populations (the state of Bahia has over 30 million inhabitants and the province of Buenos Aires has more inhabitants than most Latin American and Caribbean countries). Others are the economic powerhouses of their countries (the state of São Paulo accounts for over 50 percent of the industrial output of Brazil). There are also small and poor states that command fewer resources than a medium-sized municipality.

The great majority of the municipalities listed in Table 2.3 are small and many are very small. As Figure 2.1 shows, 90 percent of the municipalities have less than 50,000 inhabitants and more than 30 percent have less than 5,000 inhabitants. Still, the average size of municipalities in Latin America and the Caribbean is relatively large compared with the European countries. Table 2.3 shows that, excluding Jamaica and Uruguay, the average population of municipalities is 36,000 compared with 12,000 in the European Union countries (Dexia 1997). In other words, the average Latin American municipality must provide services to three times as many people than their homologous institution in Europe.

In terms of the size of the population served by municipal governments it is worth distinguishing four groups. The first group comprises the very small municipalities (with less than 10,000 inhabitants). These account for 53 percent of the total number of municipalities but serve only a small portion of the population (8 percent), which is mostly rural and lives scattered throughout the territory in small hamlets. Small size (usually accompanied by a lack of human and financial resources and low population density) poses a significant challenge to the efficient provision of services (see figure 2.1).

Table 2.3. Number of Subnational Governments, Selected Countries

Country	Population (000s)	Federal		Unitary		Average size Mun.
		States	Municip.	Depart*	Municip.	
Brazil	174,825	26	5,001			35,000
Mexico	102,410	32	2,397			42,700
Colombia	37,822			23	1,026	36,900
Argentina	36,648	23	1,922			19,000
Peru	25,082			12	1,818	14,300
Venezuela	24,170	22	333			72,600
Chile	15,311			13	341	44,900
Ecuador	12,646			21	205	61,700
Guatemala	12,222			22	330	37,000
Bolivia	8,329			9	311	26,800
Dominican Republic	8,495			28	153	55,500
Honduras	6,485			19	291	22,300
Paraguay	5,613			17	213	26,400
Nicaragua	5,169			15	143	36,100
Costa Rica	3,798			7	81	46,900
Panama	2,856			9	68	42,000
Uruguay	3,274				19	172,300
Jamaica	2,543				14	181,642
Guyana	883				6	147,200
Suriname	447				10	44,700
Subtotal		103	9,653	195	5,029	
Total number of municipalities			14,682			

* Departments otherwise known as provinces or regions

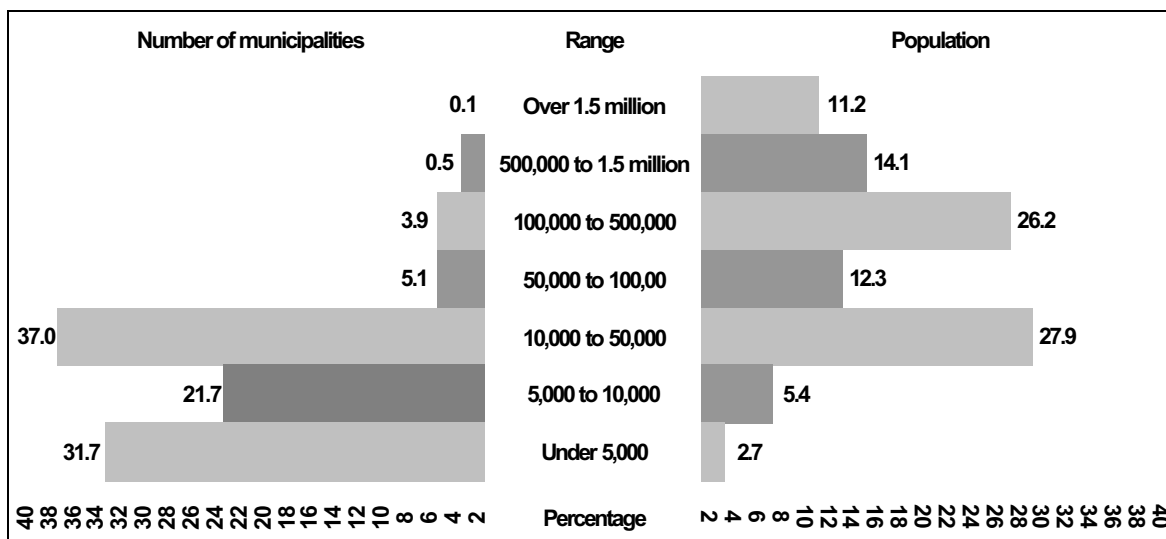
The second group includes municipalities in the 10,000 to 100,000 population range. These make up 42 percent of the municipalities and provide services to 40 percent of the population. The local governments in this group face complex institutional problems. A significant portion of the population of these municipalities is scattered in rural areas (although a portion live in urban areas). Except for particular circumstances (for instance, municipalities that receive royalties from the exploitation of natural resources), their capacity to provide services is hampered by lack of institutional and financial resources.

The third group comprises municipalities with populations between 100,000 and 1.5 million. Although relatively few in number (just over 600 in the sample analyzed, or less than 4.5 percent of total), they are very significant, providing services to 40 percent of the population, which is mostly urban. Most municipalities with more than 100,000 people are in fact medium-

sized cities that play significant roles in their regional economies.

Large metropolitan areas make the fourth group and represent a special case in local government. There are four mega cities (cities with more than 10 million inhabitants) in the region: São Paulo (17.8 million), Mexico City (16.4), Buenos Aires (11.4) and Rio de Janeiro (10.2). Three other metropolitan areas are home to more than 5 million inhabitants, they are: Lima (8.4), Bogota (6.3) and Santiago de Chile (5.4). Nine large cities are in the 3 million population range. The later group includes Belo Horizonte (4.4), Pôrto Alegre (3.8), Recife (3.5), Guadalajara (3.4), Salvador de Bahia (3.2), Caracas (3.1), Fortaleza (3.1), Monterrey (3.1), and Santo Domingo (3.0). In most cases, the built-up area of these cities extends well beyond the administrative boundaries of the core municipalities, encompassing the jurisdiction of several local governments, and their economic and functional influence extends even beyond their territories.

Figure 2.1. Number of Municipalities and Population (in percentages)



The last group involves the states and provinces of federal countries and makes a varied lot. The just over 100 subnational governments of this type have diverse functions and fiscal and budgetary autonomy. They range from the fairly autonomous Argentinean provinces and Brazilian states to the limited Venezuelan states. Some are larger than many countries; they have sizable resources and generate a large percentage of national output. Others are small, commanding fewer resources than a middle-sized municipality

The differences in size among subnational governments reflect enormous differences in institutional capacity. There are municipalities like São Paulo, Buenos Aires and Mexico City whose institutional capacities are greater than those of many small countries and allow for sophisticated financial management. However, some small municipalities often do not have permanent staff and, least of all, the services of a professional accountant. Their financial capacities also show staggering differences. The per capita revenue of the Government of the City of Buenos Aires is over US\$1,000 per year while many municipalities have to do with less than US\$5 per year in own-source revenue.

URBANIZATION AND THE CONCENTRATION OF POPULATION AND ECONOMIC ACTIVITIES

Over 75 percent of the population of Latin America and the Caribbean live in urban areas, making it one of the most urbanized regions in the world. The great majority of this urban population lives cities with 100,000 residents and over. Therefore, municipalities servicing large and medium-sized cities are a critical component of local government inasmuch as their capacity to provide services affects large populations. This becomes even more important because medium-sized cities are growing faster than any other urban areas in the region.

The metropolitan regions pose a particularly complex problem for local governments, which increases with size (see Habitat, 1996). As Table 2.4 shows, this is an issue of growing significance since the number of urban agglomerations with more than 1 million residents grew from 21 in 1975 to 47 in 1999 housing a total population that more than doubled in that period from just under 70 million to more than 150 million. As urban areas expand and begin to extend over several local jurisdictions, authority and responsibilities for the provision of services

Table 2.4 Urbanization Trends 1950-2000
(Population in thousands)

	1950	1950-1975	1975	1975-2000	2000
Total population	179,050		319,893		523,875
Increase in total population		140,843		203,982	
Urban population	74,484		196,094		401,287
Increase in urban population		121,610		205,193	
Urban population as % of total	41.6%		61.3%		76.6%
Agglomerations of over 1 million					
Population			69,534		153,995
Number			21		47

Source: HABITAT 1996

weaken and overlap.² Often other levels of government complicate matters attempting to solve the problems created by territorial fragmentation. Examples of the problems created by metropolitan growth include the imbalances between the demand for services felt by core municipalities and the resources available to provide them. (These demands often originate from commuters living in outlying communities who do not contribute to the tax base of the core municipality.) The increasing complexity of managing the transportation and environmental problems of these agglomerations is another example. These problems often surpass the capacity of any single municipality, forcing state or central government intervention and the emergence of a plethora of semi-autonomous organizations created to provide services in a unified manner.

Territorial Imbalances

The disparity in the distribution of Latin America's population and the region's urban concentration are rooted in economic trends that favor the concentration of economic activities. Disparities in absolute and per capita output among different regions are significant throughout Latin

² For example, Authority in the Buenos Aires is split between the city government (which has provincial status) and 19 other municipalities situated in another province. Similarly, 32 independent municipalities have responsibility in Santiago, Chile.

America. Per capita GDP in Argentina's richer provinces (or the richest states in Mexico or Brazil), for example, can be up to four times higher than in the poorer regions. This serves as a population magnet to these areas and their urban centers. Projections of the economically active urban population of Mexico indicate that it will double by 2025 (from 26.8 million in 1995 to 54.3 million in 2005). In contrast, the economically active rural population is only expected to grow by 18% in the same period (from 8.5 million to 10.1 million).

The concentration of economic activity in large metropolitan areas and medium size cities generates agglomeration economies that favor productivity. However, it also creates shortages of infrastructure and environmental damage whose solution requires huge investments. In rural areas, the out migration of the population and the sector concentration of productive activities (which are usually limited to a few extractive or natural resources based activities) make productive diversification difficult and render local economies extremely vulnerable to market fluctuations.

These regional imbalances waste the local potential for economic expansion; create migratory and social tensions among territories, uneven wealth distribution, and the perpetuation of huge disparities among the regions. Further, regional imbalances have strong impacts on subnational governments affecting their resource base and institutional capacity. Subnational governments

in rich regions may command more resources to maintain the infrastructure and services required for economic growth and development. In contrast, the subnational governments of poor regions may face a vicious cycle where the lack of financial and institutional resources hampers local economic development.

Cultural Diversity

Local cultural differences are another ingredient of the challenges (and often opportunities) of effective decentralization. Ethnicity, history, and geography combine to produce a varied mosaic of cultural differences among communities. Although these differences may pose a challenge to old-fashioned policies that aimed for the unification of the modes and structures of local government, they are a great asset for effective decentralization. Cultural differences are the foundations on which social capital is constructed. They present an opportunity to build diverse local communities whose forms of organization respond to share cultural traits. For instance, taking advantage of cultural traits can increase the effectiveness of the provision of services in communities with a strong tradition of cooperation, or facilitate local democracy in communities with long traditions of community councils. Cultural diversity can also be a destructive force for local cohesion, as is the case where ethnic or cultural clashes remain unresolved. Perfecting local democracy can go a long way in reducing these conflicts and turning cultural diversity into a positive factor for local identity.

WHO IS IN CONTROL? THE MANAGEMENT OF DECENTRALIZATION

The institutional setting within which subnational governments function in most developing countries falls into one of three categories: (i) the overcontrolled local public sector, (ii) the undercontrolled local public sector, and (iii) the perversely regulated local public sector (World Bank, 1995a).

The first of these situations seems most common in developing countries. Central governments sometimes control all the details of local gov-

ernment—who they hire, what they pay, where and when the buses run, etc.—and leave little or no freedom of action for local initiative. In addition, central governments often finance local services directly or earmark the resources they transfer to local governments to such an extent that local finance is as effectively restricted as if they did exercise direct control. These arrangements (microcontrol) generally produce weak and incapable local governments. While less common, the opposite problem (under control) is also apparent in several countries as a result of inappropriate decentralization strategies. Under control resulted in fiscal imbalances (excessive borrowing and inefficient service provision). Finally, all too frequently local governments receive perverse signals from central governments in a number of ways. If, for example, the amount of transfers a government receives depends upon the size of its budget deficit, incentives are clearly perverse. As another example, national funding is often available for infrastructure investment at no cost, but no funds are available for operation and maintenance. This creates a perverse preference for new investment and rewards localities for not maintaining existing facilities (which they would have to do out of their own funds) in order to strengthen their apparent need for new ones (for which the central government will pay).

Even when the incentives facing local government are wrong-headed, local efforts and policies may sometimes make a real difference. In Brazil, for example, some cities are well run and provide services efficiently, while others, apparently similar in character and resources, are badly run and poorly equipped. In Colombia, some departments provide better health services than others with similar resources. Almost everywhere, some local governments do better than others. The reason may be simply historical circumstance (for one reason or another an area started to do something well some time ago, and it continues to do so) or it may be because of a caring and charismatic local leader or some other chance circumstance. Whatever the cause, such experiences emphasize two important points. First, even in the perverse situation in which many local governments are placed by inappropriate central policies, there is usually

some scope for local initiative. Second, such local initiatives may make a real difference in the lives of local residents. Indeed, an important aspect of making decentralization effective and efficient in any country is both to make it easier for such “good examples” to occur by giving subnational governments some room for maneuver, and through facilitating an adequate flow of information, to make it easier to emulate such successes elsewhere.

**IDB REACTION:
NEW APPROACH TO DOING BUSINESS**

Overview of Bank Lending to Subnational Governments

The Bank has been an active supporter of decentralization in Latin America and the Caribbean. Bank loans have traditionally supported investment in most sectors for which subnational governments are responsible. In addition, lending has focused on strengthening subnational governments and supporting national or state municipal development institutions. More recently, through its private sector window, the Bank has expanded the scope of its support to decentralization by providing loans to private companies that have acquired municipal serv-

ices. In its forty years of operations, the Bank has lent more than US\$17 billion (in 1992 US\$) in more than 240 projects that directly benefit subnational governments. This figure represents 14 percent of the total resources lent by the Bank during this period and almost 10 percent of all the loans approved (see Table 2.5).

Bank operations for municipal development, integrated urban development and urban transportation have covered investments in almost all areas of responsibility of subnational governments. These include water supply and sewerage, waste disposal, urban and rural roads, traffic management and public transportation, education and health infrastructure, markets, passenger and cargo terminals, rural and urban electrification, abattoirs, burial grounds, environmental protection and recreational parks. The number of municipal development operations has grown steadily in recent years. Stand-alone operations in the sanitation, infrastructure, environment, education and health sectors also benefited subnational governments, mostly by financing state and provincial investment programs. In terms of number of projects and total loans, the sanitation and infrastructure sectors are important, particularly in Brazil where borrowing by states have been significant.

Table 2.5 Bank Lending for Local Governments 1961-1998
(1992 US\$ million)

Type of Operation	Sector	Amount	No
Urban development operations benefiting local governments	Municipal Development	2,668.5	32
	Integrated Urban Development	1,335.2	14
	Urban Transportation	707.0	6
Sector operations benefiting local governments	Sanitation	8,881.0	160
	Infrastructure	1,952.6	20
	Urban Environment	1,512.1	12
	Education	165.1	2
	Health	155.1	1
Total		17,376.6	247

Phases of Bank Lending

Bank lending in support of subnational development has evolved considerably. Bank operations have adapted their objectives, eligible investments and execution mechanisms in response to the expanded responsibilities and growing autonomy granted to subnational governments. However, the share of Bank municipal lending to finance the expansion of infrastructure and services has remained relatively stable over the years. It still accounts for the largest proportion of project funds. Changes in Bank thinking and investment in support of decentralization parallels shifts in the role of subnational governments in service delivery and socioeconomic development. In the last decade, central governments have decentralized many functions, such as the provision of social services. For subnational governments, these new responsibilities have been added to existing ones since they have not relinquished responsibility for traditional tasks like street lighting, garbage collection and maintenance of open spaces. Consequently, Bank operations expanded the variety of eligible infrastructure and service activities and adjusted the execution mechanisms to fit the needs of the new subnational responsibilities.

Similar shifts are noticeable in the structure of Bank loans. Early loans were granted to the central government, which acted as borrower, executor and guarantor, even when part or all of the activities may have been executed by public enterprises or agencies of other levels of government. Later, Bank operations allowed for decentralized execution by subnational governments, but the central government continued as borrower and guarantor. Due to legal and constitutional restrictions, there are countries in the region where the central government has been unable or unwilling to guarantee the provision of counterpart funds or subnational government compliance with their contractual performance covenants. In these cases, the Bank has allowed a partial guarantee from the sovereign covering only the repayment of the principal, interest and charges, with the local government assuming other elements of the guarantee.

First Phase: Expanding Capacity. The initial Bank approach to subnational lending focused on expanding the capacity of local governments to provide infrastructures and services to a growing urban population. A key concern of this generation of projects was the efficient allocation of investment resources and the proper operation and maintenance of the infrastructure. Bank loans thus emphasized project preparation and appraisal, devoting the bulk of institutional development resources to improving the execution of project-related activities. Bank conditionally focused on cost recovery to cover operation and maintenance and later, part of the capital investment. The Bank also promoted national intermediary institutions to on-lend resources to subnational governments. With central government guarantees, the Bank supported municipal development banks and state or provincial municipal development funds to on-lend or transfer Bank funds to states or municipalities.

Second Phase: Building Financial Capacity. In response to deepening political and functional decentralization in the region, the Bank provided support to a second generation of municipal development programs that promote reforms to the intermediation mechanisms and the structure of intergovernmental relationships in an attempt to improve the fiscal situation of subnational governments. Key objectives for these projects included (i) ensuring reliable sources of revenue for subnational governments to effectively discharge their expanding duties, (ii) sustaining the financial buoyancy of subnational governments, and (iii) strengthening the financial capacity to plan and finance investments and to mount efficient cost recovery mechanisms. Still, the bulk of the resources provided by the Bank were destined to investments to expand capacity. Innovation in financial intermediation was a parallel objective. The Bank supported a variety of institutional arrangements including second-tier financial institutions rediscounting loans by private banks and the refinement of government sponsored municipal funds to prepare them for issuing debt instruments in the local capital markets.

The Future: Restructuring Intergovernmental Relations. In the meantime, the decentralization wave sweeping the region has increased the complexity of the development problem posed by subnational governments. In many countries municipalities are now responsible for providing key services for the low-income population (like health and education), while many others are assuming new regulatory roles for privatized services. Moreover, subnational governments are assuming more active roles in promoting local economic growth and favorable business conditions. As table 2.6 shows, the Bank pipeline contains a significant number of projects that benefit state and provincial governments. Based on the recent experiences of loans to the provinces of Buenos Aires and Mendoza in Argentina, these operations focus on the reforms required by these governments to fit in the system of intergovernmental relations. These operations are an addition to traditional municipal development loans, which play a significant role in the pipeline. To assist local government develop, Bank operations will have to give priority to institutional capacity. This means that the Bank must address topics as varied as reforming the structure of intergovernmental relations, strengthening local fiscal management, and the quality of community involvement in local decision-making. These topics will assume an even

more critical role in the Bank effort to assist subnational governments to become efficient and democratic providers of services. Noteworthy is the number of sector operations that directly benefit subnational governments. The strategic approach adopted by the Bank concerning its support to local government has a direct impact on these operations.

The Institutional Component of Bank Projects

A review of the municipal development projects in execution and recently completed (Verdisco 1998) shows that although institutional development concerns are being incorporated into Bank operations, what has been done is still insufficient. Projects executed in the 1980s typically devoted around 2 percent of their resources to institutional development activities and, as noted earlier, they were mostly targeted to the enhancement of the executing agency's capacity to identify, evaluate and execute investment projects. Projects under execution in the 1990s typically devote around 8 percent of their resources to institutional development activities that encompass a wider set of concerns, including fiscal management, budgeting and investment planning in addition to the traditional project oriented institutional support of the past.

Table 2.6 Bank Pipeline 1999-2001
(in US\$ millions)

Type of Operation	Sector	Amount	No
Operations with subnational governments	Municipal Development	2,059	23
	State and provincial development	1,340	8
Sector operations benefiting local governments	Sanitation	2,737	17
	Infrastructure	1,952.6	20
	Urban Environment	77	2
	Education	150	1
Total		8,315.6	71

Responding to IDB-8 mandates, Bank operations in support of decentralization are now concerned with a wider array of social services and focus on institutional developments to ensure the sustainability of subnational governments in the emerging structure of intergovernmental relations and new responsibilities. In order to respond to and complement on-going changes in the roles of subnational governments, the design and execution mechanisms of Bank operations is more process oriented and flexible than in the past.

However, implementation of the institutional components is frequently far from efficient because the need to strengthen institutions that are simultaneously the target of institutional development and essential for the execution of Bank operations creates certain ambiguities. Only a handful of Bank loans contain institutional conditionality to discriminate among beneficiaries on the basis of their institutional capacity prior to disbursing Bank investment funds. Institutions are slow to change; reform is not automatic, nor does it occur in a linear fashion. As a result, the scope and reach of the reforms often fall victim to institutional inertia. Despite innovation in delivery mechanisms, service provision may, in practice, still replicate the top-down modes of the *status quo ante* well into the execution of Bank sponsored reforms. Such inertia conflicts with the timetables and disbursement schedules laid out in Bank loans. Delays in implementation, nor surprisingly, thus arise.

Delays in implementation in municipal projects under execution are consistently traced to weakness in institutional capacities.

Similarly, projects rated as unsatisfactory in their execution status or as unlikely to achieve their development objectives all appear to have institutional problems. These weaknesses parallel those found in the overall portfolio where almost 90 percent of projects with unsatisfactory performance cite institutional capacities as principal reasons for difficulties in implementation (IDB 1997b).

This problem is only partially solved in Bank operations that rely on "executing units," (agencies especially created to execute Bank projects), which commonly operate under different rules than the rest of the civil service. These are more of a *Band-Aid* approach to institutional problems than a permanent institutional solution. Institutional strengthening activities required to execute the increasingly complex Bank operations must be address *ex-ante* or in a more comprehensive manner.

Encouraging trends are emerging from recent loans. They give subnational governments a larger role in project implementation than that assigned to them in the past and consequently, provide more attention to their institutional strengthening. Furthermore, they are linking more closely institutional strengthening activities at the local level with the reforms introduced in the fiscal and legal framework of the decentralization process. Most operations approved in the late 1990s complement wider processes of institutional reform launched by the countries.

3.

New Responsibilities, New Opportunities: Emerging Challenges to Subnational Institutional Capacity

The transfer of responsibilities to subnational governments is a complex undertaking. It is further complicated by the assignment of new tasks to states and municipalities, in addition to their traditional responsibilities of supplying infrastructure and local services. Some of these new tasks emerge from the need to respond to economic globalization (for example, the promotion of economic development). Others, like the provision of services to the poor, are the result of the reassignment of responsibilities among levels of governments. Yet others emerge from the privatization of the provision of infrastructure and services that force local governments to assume supervisory roles for privatized services. These new responsibilities are taxing the institutional and financial capacities of subnational governments. The proper integration of these new functions into the subnational government structure is perhaps the single most demanding challenge faced by the countries of Latin America and the Caribbean in their decentralization efforts. It requires not only an expansion of capacity to take over the new functions but a profound reshaping of the way subnational governments are financed and managed. This chapter discusses the characteristics of the challenge posed by the new responsibilities as a frame of reference for discussion of the reforms required in intergovernmental relations, governance, institutional capacity and subnational financing.

Local Economic Development

The most important determinant of the well-being of the population is the strength of the local economy and its ability to provide jobs and raise government revenue. International experiences suggest that there are a host of factors under the purview of local governments that play a key role in the development of small and medium enterprises and overall economic devel-

opment. The proper management of these factors by subnational governments is becoming a key factor in shaping the competitiveness of the local economies.

The Impact of Globalization

Rapid economic globalization is not only affecting the economy as whole, but is having differential impacts within countries. Local factors, which are strongly affected by territorial constraints, remain imperfect but global markets of goods and services have become highly developed. Global markets of goods and services involve large numbers of suppliers and consumers interacting in increasingly efficient and competitive markets. However, Latin American factor markets (like financial and labor markets) do not exhibit the levels of efficiency that characterize industrialized countries. They are often constrained by the dynamics of the domestic economy, at the national, subnational and local levels, which has a negative impact on the system's overall competitiveness.

This imbalance between global markets and local factor markets has a significant impact on small and medium enterprises. These firms have more problems than large enterprises in reaching productive factors that are mostly supplied in main cities or international markets. Small and medium enterprises in out-of-the-way regions are in a weaker competitive position to access key inputs such as sophisticated financial products or highly qualified labor than larger enterprises that thanks to their scale and resources can reach metropolitan and international markets.

Given present trends, traditional economic growth factors (natural resources endowment, capital, technology, and labor) explain only part of the growth of any given economy. The rest

depends on the local factors that determine the competitiveness of the local enterprises. Territorially determined factors like the social capital embedded in local networks of entrepreneurs, the quality of the labor force, and the quality of local infrastructure, affect the costs of production and play a significant role in determining the success and vigor of the local economy.

Local Competitiveness and Growth

Local economic development efforts are geared to attracting new investments in a broad business base (small, medium and large enterprises) capable of generating stable growth in local employment and income. These include investment to expand capacity in local industries or to develop new local industries and attract new investment. To this end, three basic factors need to be considered:

1. *The Use of Endogenous Capabilities and Assets for Development.* They depend on the territory's development capacity (location, resource endowment) and the population's entrepreneurial and managerial skills. Their mobilization requires identifying and taking advantage of business opportunities in emerging and external markets for local products and improvements in the quality of the labor force.
2. *The Generation of External Economies within the Local Territory.* The public and private provision of business services that generate or enhance the type of economies of agglomeration that are typical in industrial concentrations but are usually lacking in less industrialized areas.
3. *The Reduction of Business Transaction Costs.* The cost of doing business differs among territories depending on factors such as: local governance, red tape, the rule of law, institutional efficiency, the articulation of civil society institutions, and the level of trust among economic actors. The social capital of a community and its level of productive integration in local clusters also affect the competitiveness and ease with which firms can reach global market.

The Role of Subnational Governments

Several of these factors fall under the purview of subnational governments, making this level of government a significant player in promoting local economic development. This means that subnational governments should enact economic development policies, a task that opens up an opportunity to establish productive partnerships with the private sector. Small and medium size enterprises (SMEs) are a natural focus for economic development policies. As the largest source of formal employment in urban areas, they are significant actors in employment generation strategies. Furthermore, they are also important in rural areas, representing the most effective way of promoting local economic diversification.

Local factors influencing local economic development include both tangible (all kinds of infrastructures) and intangibles (efficient local labor markets, financial and nonfinancial services, support for technological innovations, entrepreneurial culture). Some of these factors are sensitive to subnational government policies, while others are more sensitive to the activities of the private sector. This makes private-public partnerships an effective mechanism to promote local economic development. The most dynamic subnational governments in the region are already working in partnership with private sector organizations. Through an equitable distribution of responsibilities (social gains and costs between the public and private partners) they actively promote competitive local factor markets. Success stories are more obvious in the more decentralized countries, reflecting the benefits of decentralizing policies such as labor training, dissemination of technology, business development services, and small and medium size enterprise development. The advantage of subnational governments rests on their greater capacity to identify the needs of local enterprises. However, the transfer of these responsibilities to subnational governments requires a corresponding increase of their technical and managerial capacities and stable sources of financing that allow long-term planning and sustained interventions.

Local Economic Development Strategies

Subnational governments can promote new investments by creating a favorable environment for putting unused or underutilized local resources into full production, or by improving local competitiveness for new direct investment. Subnational governments have long been aware of the importance of good quality local infrastructure to attract and retain economic activities. Reliable and cheap supplies of energy, water and communication services are central to the productivity of firms, as is a good and uncongested road system. Consequently, governments have long endeavored to ensure the provision of good infrastructure in their territories and, more recently, of good residential services. Subnational policies and regulations also determine a wide variety of factors influencing the efficiency of firms. These factors range from labor training to the regulation of natural resources including the operation of real state markets.

New factors, also within the purview of subnational governments, are gaining in importance as determinants of local economic growth. These include fostering the availability of services in the local economy and the cooperation of individual enterprises for acquiring economies of scale in the provision of certain goods and services. Local governments can encourage the diversification of local service providers by facilitating the creation of new enterprises, fostering the entrepreneurial culture and supporting coordination among enterprises in areas such as the promotion of local goods in international markets. Local development agencies can also have an impact on local economic development by promoting increased flexibility in local labor markets. Training labor on the basis of the needs of local producers has long been an area of local concern and action. More recently, local institutions are experimenting with labor pools (*bolsas de trabajo*) to match skilled workers to available jobs. Another effective public/private partnership is that of allowing the local private sector to participate in the provision of public services.

Local/Regional Development Agencies

The institutional setting is critical for the development of effective public-private partnerships to promote local economic development. Subnational governments, the business community and civil society organizations (particularly universities, chambers of commerce and entrepreneurial organizations) come together in this setting to discuss economic development goals, prepare strategic plans, and design and implement programs and projects. The more decentralized the structure of the political and institutional system, the easier it is to create discussion and negotiation forums between subnational governments and local civil society.

An effective approach to establishing a suitable institutional setting is the creation of local/regional development agencies. The international experience, including some cases in Latin America, indicates that there is no unique model for a regional/local development agency. Differences reflect different responsibilities and intervention approaches. Some operate as think tanks, specializing in the research and analysis of the local economy's growth potential. Others work as forums for the discussion of the long-term role of the local economy. Yet other agencies focus on designing strategic development plans that establish an outline for achieving local economic and human development goals in their area of influence. Still others are more concerned with operational planning and the design and implementation of development programs in specific fields such as infrastructure, tourism, technology, the creation of SME clusters, financing innovative projects, international marketing of local products and enterprises, attracting foreign investors and the like.

Financing for these jointly owned (public/private) agencies depends on the kind of activity that they perform and their beneficiaries. Partial public financing would make sense if the agency's activities generate direct returns (paid for by the beneficiaries), increase the subnational government's tax revenues or have measurable beneficial impact on the local economy. For example, a unit that specializes in reducing red tape (single window or one-stop-shop), can

cover its expenses by charging processing fees (although it will also generate indirect benefits to the local government through the simplification of bureaucratic procedures). In any event, success cases indicate that the regional/local development agencies should be managed under private sector criteria and follow demand driven programs.

The source of public funding for local economic development should be consistent with sound fiscal discipline. Investment promotion must not require tax exemptions or other types of fiscal concessions (a traditional resort of local politicians). The objective is not subsidized economic development but the growth of dynamic, competitive and self-sustaining enterprises. New enterprises must be tax contributors, not consumers of local resources. It is important to support the efforts of small businesses in this endeavor. Their entry into the formal economy, as well as their growth and consolidation are the basis of their contribution to the creation of new jobs and wealth. As they grow and prosper, these small businesses can become taxpayers assisting local government to continue with the process. Local governments need to be cautious of not imposing an excessive tax burden on micro, small and medium enterprises to avoid driving them underground.

The diversity of institutional models and responsibilities of local/regional agencies is also a function of the areas in which they operate, their political and administrative structure and the priorities established by stakeholders. The term "local" can refer to various geographic areas. It can be used to represent a regional area (state, province or department) or a municipal jurisdiction. Further, differences exist at the municipal (urban) level between large metropolitan cities, middle-size cities and their immediate area of influence; and small rural cities. Each one of these jurisdictions plays a different and variable role in national economic development.

Subnational Involvement in Local Economic Development

The states and provinces of large decentralized countries such as Argentina and Brazil already

have a considerable tradition of promoting economic development through long established ministries of development, industry, economy or promotion. This is a more recent development in Mexico, where the states of Jalisco, Chihuahua and Baja California are involved in promoting local development. Local governments in other countries, such as Venezuela, Chile or Colombia are less involved in promoting local development.

The availability of a good communication infrastructure, attractive living conditions (access to cultural activities, entertainment and educational institutions), and the variety and quality of the specialized services available from the local diversified economy attracts the command and control activities of the large enterprises to large metropolitan areas (Sassen 1998). Two prime examples are São Paulo and Buenos Aires, whose combined GDP exceeds that of four Andean countries (World Bank 1999). These cities attract all types of enterprises and are engines of economic growth for the nation as a whole. Yet, appropriate management of local factors like congestion, pollution, and the quality of housing are essential to maintaining their economic dynamism. The size and complexity of these problems is a mayor challenge that only recently has started to be addressed.

The impact of local factors in boosting economic development is evident in the increasing economic importance of medium size cities. Their population is growing at a faster rate than any other component of the urban structure in most Latin American and Caribbean countries. Moreover, their economies are playing a growing role in national economic development. To a great extent, this reflects the fact that these cities offer most of the advantages of larger cities (good infrastructure, diversified services, and a well-trained labor force) without the problems normally associated with metropolitan areas (congestion, poor environmental quality, high cost of land).

Local factors not only affect the development of medium size cities but also that of all types of settlements. For example, rural growth and productivity are influenced by local factors that fall

under the control of local governments. These include the availability of feeder roads as well as the efficient management of water resources and local environmental impacts. Rural areas are excellent niche markets where SMEs can start-up and grow thanks to the availability of idle local resources. In exchange, SMEs benefit local economies through their impact on economic diversification and vigor.

PROVISION OF SERVICES TO THE POOR

The Rationale for Subnational Participation

Differing community preferences and resources lead to spatially differentiated patterns of consumption of public goods and services. Subnational governments can increase the general well being by better adjusting the use of public resources to local preferences and capacities. They are in a better position to understand the varying needs and preferences of the local population and thus have advantages in the provision of goods and services that generate spatially defined benefits whose delivery can be tailored to the preferences of different communities. Accordingly, traditional local functions have always included responsibility for items such as local infrastructure (including parks, community centers and sports facilities), transportation and land use planning, and the delivery of public services like garbage collection, street cleaning, public lighting.

By taking advantage of their capacity to tailor services to community needs and preferences, subnational governments are also in a good position to take responsibility for public services whose centralized national provision presents intrinsic diseconomies of scale, lack of flexibility and administrative inefficiency. This is the case of social services, such as social assistance, which are very specific and must be targeted. The same is often also true of those whose provision involves the management of a multiplicity of small units, like education and health. (Marcel 1993). Note must be made of the fact that decentralization of services delivery does not necessarily mean that the subnational level of government is the most efficient provider. There are

cases where efficient delivery calls for the transfer of resources and decision-making powers to even more decentralized structures like school boards or individual hospitals.

Areas of Subnational Government Action

Social Service Provision. Second generation reforms affecting health and education are taking advantage of the potential benefits of decentralization and enhancing the role of subnational governments and other local organizations in the allocation of resources and the provision of services. A similar trend is apparent in the execution of emergency programs such as social investment funds.

Access to Land. In the absence of sustainable mechanisms to allow low-income households access to housing through the formal sector, self-help and staged (progressive) housing construction is the strategy of choice for these households. The viability of this strategy rests on the access to suitable land. More often than not, subdivision and land use regulations hamper access to land by the poor, requiring infrastructure standards and lot sizes that put the land out of their reach. Management of land development is a traditional activity of local governments that has significant impacts on the housing status of the poor. Subnational governments can facilitate access to land by low-income families by amending regulations governing the subdivision of land.

Settlement Upgrading. Traditionally, subnational governments provide urban infrastructures that are critical for the health and well being of the population. These include water supply, sewerage or wastewater control and treatment, drainage and garbage collection. Making these services available to the poor is one of the most powerful tools to improve the living conditions of disadvantaged members of the community. Municipalities (often with central government encouragement and help) have embarked in settlement upgrading programs that provide services that weak public utilities have been unable to provide. These programs target substandard settlements that originated from land invasions or illegal subdivisions and provide, in addition

to sanitation, secure land tenure and community infrastructure.

Transportation Services. The management of urban public transportation also offers local governments an opportunity to assist the poor. By regulation or incentives, local governments can direct transportation services to low-income neighborhoods, thus improving the poor's access to jobs and urban services.

Challenges of Service Provision

Health and education services provide for the basic needs of the population and supply an essential service to the economy, a healthy and educated labor force. The latter offers the best hope the poor have to escape poverty. However, the provision of these services is plagued with difficulties and has yielded less than satisfactory results given the resources expended. The most critical difficulties facing delivery systems are monitoring performance, ensuring equity and addressing distortions in the allocation of resources (IDB 1996a).

Most problems can be traced to the government's inability to run centralized and standardized delivery systems in an efficient way. In most countries, centralized and hierarchical structures give operational decision-making power to officials that are distant from service providers and who lack the necessary information and direct contact with beneficiaries to improve delivery. Standardization prevents providers from adjusting services to local circumstances and needs. Most services systems are trapped in a vicious circle in which low pay is used as an excuse for absenteeism and low efficiency while poor performance is used as an excuse to limit discretion and autonomy for providers. These systems are considered to be unresponsive to changes in demand, incapable of achieving an efficient input mix, slow to innovate and ineffective at motivating improved performance. This leads to weak performance and the discrediting of the system.

Experience indicates that services can be better supplied locally by fostering competition. Most countries could be better served through central

funding of services to address externalities and inequities. By the same token, multiple services providers can lead to reduced costs, improved quality and a better response to changing needs and innovations. Service providers can include subnational entities or autonomous enterprises in addition to the private for-profit and nonprofit organizations. The critical feature is giving clients the option to choose among providers and make the public resources follow them to their chosen providers.

The way in which social services are financed affects the structure of incentives. It is important to ensure that financing for services responds closely to the demand for services. For example, schools can be funded on the basis of the number of students attending, and health services financing can be made a function of the number of people kept healthy rather than the number of employees. In other words, public delivery systems should be budgeted on the basis of output, not inputs. Capitation grants, discussed in Chapter 4, are one mechanism that can serve this purpose well. In systems undergoing this transition, attention must be given to complementary actions to assure that outcomes are properly measured and rewarded.

Subnational Impact

Decentralization of the delivery of social services to subnational entities will not improve the provision of services, in and of itself. Such improvements require the assignment of responsibilities to different levels of government and providers in ways that creates incentives for making efficient decisions. Proposals must also be justified on the basis of economies of scale and scope, efficiency gains from coordination and the breaking of delivery units among relatively homogeneous client groups. In other words, in order to improve services, some functions must be decentralized while others are centralized.

The education sector provides a good example. The central government may, for example, appropriately set national standards for graduates and teachers, and may also establish the basic curriculum. It can promote research on

pedagogical techniques and learning; reward innovations in teacher training and disseminate findings and teaching tools. In turn, regional governments may develop their own policy goals (for instance, with respect to school facilities) and deploy appropriate regulatory instruments in an attempt to achieve them. Local governments or independent school boards may be responsible for actually paying teachers and maintaining facilities. And, of course, local schools deliver educational services which as experience suggests, produce better outcomes if they have a substantial degree of budgetary autonomy and managerial authority to respond to teachers, parents, the local community and information regarding performance and cost.

As governments face institutional difficulties in the delivery of services, nongovernmental organizations (NGOs) and, to a lesser extent community based organizations (CBOs), have stepped in to provide services to low-income households. These initiatives have encompassed a large variety of mostly isolated projects that profess to rely on popular participation. Although sometimes successful in alleviating poverty at the community level, these initiatives are not immune to the institutional limitations in which local governments operate. For instances, they rarely are able to undertake long-term planning and development activities to effectively benefit the target population, nor are they capable of generating programs of sufficient scale to tackle the problem effectively. NGOs and CBOs can play a significant role in strategies to alleviate and eliminate poverty provided that their activities are framed in an integrated long-term plan whose formulation and financing is best carried out by the subnational government.

Regulating Privately Provided Infrastructures and Services

Local governments are important providers of services to firms and households. These services are intrinsic in their management of key economic infrastructures and services that are essential to ensure the quality of life and protect the environment. They include, for example, water and sanitation, wastewater and solid waste

management and the regulation of protected areas. To increase efficiency and promote cost recovery, local governments are increasingly transferring responsibility for the provision of a wide variety of services to private providers under many different modalities. Examples range from the small town council giving private entrepreneurs the concession to manage the local market, to the large metropolitan municipality privatizing the municipal water and sewerage company. The privatization drive also encompasses outsourcing the provision of services, like the operation of the land cadastre. Although widely different in the amount of resources involved, once completed, the types of transactions described face local governments with a similar problem, that of regulating service provision.

The Challenge of Decentralization

The development of an adequate regulatory framework for the private provision of services is a new area of concern where subnational governments need to develop capacity. To fully tap the potential of privatization, subnational governments need to develop privatization strategies. These strategies will indicate the most efficient privatization schemes under the local circumstances. Further, local governments need to develop institutional capacity to outsource services, sell or lease assets, award concessions and supervise contracts or build infrastructures under innovative financial and operational arrangements. The efficient provision of the services that cannot be privatized also requires institutional developments to ensure the appropriate separation of functions and finances between services and to run efficient cost recovery schemes. Local governments must also be equipped to solve equity issues arising from the privatization of services by means of clearly defined and well-funded social programs that do not jeopardize the financial foundations of service provision.

The complexity of the problem varies significantly among different types of local governments. What in a small rural community entails establishing and operating a cooperative to run the potable water service, in a large metropolitan

area may involve a complex international transaction to award a concession for the delivery of water and sewerage services. The complexity of the problem is also large when the city turns to the private sector to expand service capacity through innovative finance schemes like build, operate and transfer (BOT). States and provinces face similar complex problems, for instance when dealing with the concession of the regional road network.

There is ample opportunity for local governments to engage civil society organizations (OCS). Private nonprofit corporations, cooperatives and professional associations are already playing a role in providing health, education and social services with private and public funding. They can be contractors to local governments in providing these services, a role that can be particularly significant in small rural municipalities where for-profit providers may find it difficult to operate. Taking advantage of this opportunity means that local governments must develop the capacity to contract and supervise the services of this varied group of social actors. Furthermore, local governments must develop a strict payment discipline since these organizations rarely have the financial capacity to deal with delays (a common means by which local governments obtain credit from suppliers).

Traditional Responsibilities, Renewed Challenges

Traditionally, subnational governments, particularly municipalities, have taken responsibility for the provision of important community services. This includes, for instance, environmental functions such as land use regulation, building codes and drainage works. Municipalities often take responsibility for a variety of functions that range from fire and hazardous materials safety and control, to safeguarding public health, ensuring the safety of public events and regulating commerce and the professions. Local jurisdictions are also responsible for the administration of justice in areas such as neighborhood relations and maintaining archives and registries (property, marriage, birth, and death). Although great variation exists among different types of municipalities, some of these

activities are still performed according to their original intent and objectives (such as, for example, responsibility for operating traffic courts and adjudicating neighbor disputes). Other activities are a form of control and regulation on behalf of the common good that is rarely exercised, but for which municipalities still collect revenue. These include the issuance of licenses to carry out commercial activities or practice professions. Others are carried out in a perfunctory manner, like the maintenance of archives and records and the control of land use and building regulations.

Most large and medium sized municipalities should have sufficient institutional capacity to properly discharge these functions. In these cases, shortcomings in service provision relate more to organizational and operational deficiencies than to structural problems. Institutional strengthening programs should be able to take care of these problems provided that sufficient priority is given to them. Unfortunately, most of the attention of institutional development usually goes to financial and budgetary management to the detriment of these activities. However, their importance can be easily understood. A few examples illustrate the point.

The regulation of commerce to safeguard public health involves the licensing and supervision of establishments selling food and drugs, and requires periodic site visits by specialized personnel. With the exception of the better organized municipalities, most municipalities find this a difficult task and their failure to properly carry out their duties can give rise to potential threats to the community. Lacking the knowledge and information to protect themselves, consumers are unable to mitigate their exposure to these risks. The same is true of land use regulations and building codes supervision. Compliance with land use regulations is important to avoid construction on dangerous sites such as flood plains or landslide prone areas). Building codes ensure the structural safety of buildings (a critical issue in earthquake and hurricane prone areas) and their installations (electricity and natural gas). As with public health, this involves the licensing and inspection of buildings by specialized personnel, a task that is beyond the fi-

nancial and administrative capacity of many municipalities. Consumers do not have the knowledge and access to the required information to protect themselves. The cost of not performing these duties (or doing so inadequately) is the heavy casualties sustained when natural disasters occur. These casualties are, to a great extent, avoidable.

The hidden costs of not performing functions that are less conspicuous but nonetheless important are obvious in the case of municipal archives. Municipalities inherited the functions of the *cabildos* or *ayuntamientos*, which were the backbone of local administration in colonial times. These local authorities had responsibility for civil and criminal justice as well as the administration of their jurisdictions. They maintained these functions after independence and most still perform them. Documents from colonial and republican administrations are valuable records of the history and culture of the communities. However, they are poorly stored and kept in municipal (or provincial) archives and are being lost at alarming rates. Some of these archives, like those of Santa Marta (Colombia), Lima (Peru), La Paz (Bolivia), Buenos Aires (Argentina) are invaluable and need to be preserved. The loss of these documents may have no obvious significance for the day-to-day concerns of local administration, but it does affect the preservation of the community's historic and cultural heritage. On a more practical vein, municipal archives often provide essential information for updating land cadastres or settling commercial disputes.

WHAT IS REQUIRED? CHALLENGES FACING DECENTRALIZATION

The decentralization process in Latin America and the Caribbean will not result in more effective government unless deficiencies in the legislation and practices that govern intergovernmental relationships are addressed and resolved. The solution to these challenges depends greatly on the particular circumstances of each local jurisdiction, from small and scattered populations to the region's mega cities. This section

outlines these challenges and provides a framework for organizing the discussion that follows.

It appears useful, therefore, to separate subnational governments according to size and institutional capacity because each group faces unique challenges and requires different solutions. In addition, states and provinces under federal systems of government often face unique fiscal and governance problems that are necessary reflected in the problems faced by the municipalities under their jurisdiction. The grouping of subnational governments in functional associations often creates economies of scale for service provision or to access capital markets. In other cases, associations are needed to cope with problems that cut across the administrative boundaries, for instance, the association of municipalities within a metropolitan area.

Intergovernmental Relationships

Most legal frameworks that define the responsibilities and resources of local governments fail to properly match the devolution of responsibility with the allocation of resources and to provide appropriate incentives to foster efficient and fiscally responsible responses from local governments. The mismatch takes the form of poorly defined responsibilities, improperly designed fiscal policies or lack of clarity in intergovernmental transfer systems. The regulatory environment in which local governments discharge their responsibilities requires development to allow higher levels of government to efficiently regulate local borrowing, resource allocation and the provision of services.

Governance

There are more than 15,000 local governments in Latin America and the Caribbean. Although reforms are necessary to improve institutional capacity in all local governments, implementation mechanisms may vary significantly depending on the circumstances. The rules governing democracy in subnational government affect the accountability of elected officials and their inclination to respond to the demands of their constituencies. Community involvement in decision-making is another central factor deter-

mining the capacity of oversight that can be exercised by the constituencies and their capacity to get their views taken into consideration in day-to-day decision-making. Governments have a critical role in establishing legal and institutional mechanisms to ensure transparency in local government administration, an essential condition for democratic oversight and capital markets involvement in local financing.

Lending to Subnational Governments

There are compelling reasons for subnational governments borrowing to finance investments in infrastructure and in other areas of capacity building. The IDB's principal contribution to decentralization is lending to subnational governments.

However, borrowing creates opportunities for wasteful and inefficient resource allocation if not carefully regulated. Unfortunately, most of the time intergovernmental relations do not provide sufficient oversight and create opportunities for subnational governments to shift financial responsibility to other government entities. There are still few sources of capital for subnational governments and their capacity to acquire debt varies widely. Tapping the full potential of this source of financing requires significant improvements in subnational financial and institutional capacity and the development of long-term debt instruments in the local capital markets.

4. Setting the Incentives Right: Intergovernmental Relationships

Decentralization can mean a number of things depending on the perspective adopted. It can be understood as the process of dividing functional responsibilities and resources among different levels of government (fiscal approach), as the apportioning of decision-making power among different constituencies (political approach), or as an efficient way of providing services (organizational approach). In fact, decentralization comprises all of the above, making it difficult to conceptualize it in operational terms. According to Burki et al. (1999), a useful way of understanding decentralization is as "...a management reorganization of the public sector, in which the rules of hierarchical bureaucracy are replaced by a much more limited set of constraints on the behavior of subnational political actors." This notion focuses attention on the changes in rules that are required to promote a movement from a centralized to a decentralized system of allocating resources and deciding on its use to provide services to the population. That is to say, moving away from a system where policy is set at the top and executed by decreasing levels of a hierarchy ruled by administrative procedures and executed by agents motivated by the desire of internal advancement within the hierarchy. The movement is toward a system where local decisionmakers are motivated by their relationship with the constituencies whose opinion determines whether or not they hold on to power.

From this perspective, two sets of rules are of importance: (i) the rules defining the assignment of responsibilities and resources among the different tiers of governments, and (ii) those that regulate elections, the exercise of power by elected representatives and public involvement in making decisions. This chapter discusses the former, while the next chapter will discuss the latter.

Five questions must be answered when discussing intergovernmental relationships among different tiers of government:

1. Who does what? The question of expenditure assignment.
2. Who levies which taxes? The question of revenue assignment.
3. How is the (virtually inevitable) resulting imbalance between the revenues and expenditures of subnational governments resolved? The question of vertical imbalance.
4. To what extent should fiscal institutions attempt to adjust for the differences in needs and capacities between different governmental units at the same level of government? The question of horizontal imbalance, or equalization.
5. Can subnational governments borrow, and under what conditions? The question of subnational borrowing autonomy.

Ideally, these questions should be approached in the specific circumstances of each country, taking into account both the political constraints (such as the strength of different regions and groups in political decisions) and economic constraints (such as the development of financial markets) facing policymakers.

The resolution of these issues hinges on the design of the system of intergovernmental relationships for which, in turn, certain general rules can be established. The actual solution should provide the actors with the incentives to make full use of local financing capacity, attain the greatest possible level of efficiency in providing services and achieve a balanced set of local and national objectives.

WHO DOES WHAT? THE ASSIGNMENT OF EXPENDITURES

How government functions should be divided among levels of government is a complicated matter, to which each country has its own unique solution. The main point that needs to be stressed is that, from an economic perspective, the most important question about expenditures is not *who* does what but rather *what* is done and *how* well it is done. The details of expenditure assignment are less important than the clarity of that assignment, how it is determined and implemented, and how expenditures are managed at all levels of government.

The basic rule of efficient expenditure assignment is often taken to be to assign each function to the lowest level of government consistent with its efficient performance (the subsidiarity principle). As long as there are local variations in tastes and costs, the argument goes, there are efficiency gains from carrying out public sector activities in as decentralized a fashion as possible. From this perspective, services should only be provided centrally if: i) there are no differences in demands for the service in different localities; ii) there are substantial "spillovers" between jurisdictions that cannot be handled in some other way; or iii) the additional costs of local administration are sufficiently high to outweigh its advantages.

Under this approach, apart from the important issue of distribution, almost all public services (other than national defense, foreign policy, and surprisingly few others) should, in principle, be delivered at the local level. Thus, what services are provided, to whom, and in what quantity and quality is decided at the local level and local taxpayers foot the bill. The problem with this approach to expenditure assignment is that there are no guarantees that the services assigned to any particular level of government will be matched by adequate revenue instruments assigned to that same level. To the contrary, a fundamental imbalance in the vertical assignment of expenditures and revenues (and hence an apparent need for intergovernmental fiscal transfers to close the budgetary gap) exists in virtually every country.

The essential economic role of local government is to provide to local residents those public services for which they are willing to pay. Local governments are (or at least should be) accountable to local residents to the extent that those residents finance local government activities. Such accountability is the public sector equivalent of the bottom line in the private sector. Three conditions need to be satisfied to achieve accountability in subnational finance:

1. Subnational governments should, whenever possible, charge for the services they provide.
2. Where charging is impracticable, subnational governments should finance services from taxes borne by local residents (except to the extent that the services are associated with national priorities and the central government is willing to pay for them).
3. Where the central government does pay via transfers, subnational governments should be accountable to the central government at least to some extent.

To apply these rules, an essential first step is to establish clearly the lines of responsibility and accountability. But *clarity* of assignment, in terms of specifying exactly what services each governmental agency is responsible for delivering, is only part of the story. Clarity must be matched by *accountability* (in terms of political democracy and transparency of operation) as well as by *authority* (in terms of the ability to manage expenditures and to determine revenues, within limits).

It is important to understand that clarity as to whom is responsible for what does not preclude the involvement of several public sector actors in the provision of any particular service. In many spheres of public sector activity (for example in education), a broad range of territorially differentiated jurisdictions may have critical roles to play. Much of the relevant policy and regulatory framework regarding education, as well as much of the financing, may come from higher levels of government, while the actual service delivery may take place below the level of the local government. Three or more levels of

government may thus all appropriately play important roles in delivering educational services. In these circumstances, it may not be very meaningful to consider education to be "assigned" to the local level. What matters is not so much that each expenditure function is clearly assigned to one level of government or another, but that it is clear to all who exactly is responsible for doing precisely what.

The joint provision of public services by several layers of government calls attention to the problem of coordination. Although lack of coordination may be a problem (as it often implies wasted resources and inefficient service provision), it should be recalled that the coordinated, centralized solution sometimes does not deliver the goods. Or at least, it does not deliver the right goods in the right quantities to the right people. "Letting 1000 flowers bloom" in the form of relatively uncoordinated decentralized public sector suppliers striving to meet clearly specified and publicly accountable mandates may provide a more promising laboratory for the development of new and better public sector services than any conceivable centralized alternative (Oates, 1998). The answer, thus, is not abandoning decentralization, but rather designing intergovernmental fiscal relations in such a way that real coordination problems are minimized. Another part of the answer is, of course, to continue working at the difficult task of establishing better coordinating institutions. Significant progress toward resolving coordination problems can be made by establishing hard budget constraints for all relevant decisionmakers (which is not trivial), and making the operation of the system as transparent as possible.

WHO LEVIES WHICH TAXES? THE ASSIGNMENT OF REVENUE

Principles of Local Financing

The "correct" revenue assignment in a multi-level government structure is by no means clear in principle. There are two fundamental problems. First, the central government can inherently collect most taxes more efficiently than subnational governments. Second, the potential tax bases that can be reached by the latter vary

widely from jurisdiction to jurisdiction. The first of these problems gives rise to vertical imbalance; the second produces horizontal imbalance. While vertical imbalance could potentially be solved by allowing variable surcharges on central taxes (a solution that, with few exceptions, has not been taken advantage of in Latin America), the second problem—horizontal imbalance—would be accentuated by more decentralized revenues. This problem increases the importance of good transfer design, at least in countries in which such disparities are of policy concern.

The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. The only "good" local taxes are said to be those that are easy to administer locally, are imposed solely (or mainly) on local residents, and do not raise problems of "harmonization" or "competition" between subnational governments or between subnational and national governments.³ The only major revenue sources usually seen as passing these stringent tests are property taxes and taxes on vehicles, but not much else other than user fees. Since this conclusion fits in well with the reluctance of most central governments to provide subnational governments access to more lucrative sales or income taxes, it is not surprising that it has become conventional wisdom. Subnational governments almost everywhere are thus urged to make more use of these revenue sources, and criticized when they do not exploit them adequately.

Although there is much to be said for a better use of these revenue sources, heavy reliance on property taxes at the local level may lead to some problems. First, property taxes are in fact costly and difficult to administer well, and these problems are greatly exacerbated as the tax burden increases. In addition, the high visibility of this tax, which makes it appealing, as it fosters accountability, also creates political resistance to increases, limiting its revenue potential. Due to

³ The classic tax assignment arguments are set out in Musgrave (1983). Recent restatements may be found in Oates (1998) and McLure (1999a). For a review of this literature, see Bird (1999a).

these political constraints, property tax increases often end up affecting primarily those nonresidential properties that most lend themselves to tax exporting. This undercuts one of the principal arguments for local use of this tax base.

Second, and perhaps more important, even a well-administered local property tax cannot finance major social expenditures (education, health, social assistance) except perhaps in the richest communities. As far as it is desirable for governments to finance from their own revenues the services they provide, local governments financed by property taxes are either confined to providing local services (street cleaning, refuse removal, etc.), or are heavily dependent on transfers from higher levels of government.

Third, the problem of the insufficiency of conventional subnational revenue sources becomes more severe in the case of larger countries with important intermediate levels of government, which generally play a major role in financing social expenditures. Even if *local* governments can finance local services through property taxes and user fees on residents, *regional* governments as a rule cannot. Given the move toward decentralization in Latin America, and the fact that subnational governments are becoming increasingly responsible for social services, the appropriate revenue structure for subnational governments should be reexamined.

The characteristics of an ideal subnational tax may include the following:

1. The tax base should be relatively immobile, to allow local authorities some leeway in varying rates without losing most of their tax base.
2. The tax yield should be adequate to meet local needs and sufficiently buoyant over time (that is, it should expand at least as fast as expenditures).
3. The tax yield should be relatively stable and predictable over time.
4. It should not be possible to export much, if any, of the tax burden to nonresidents.
5. The tax base should be visible, to ensure accountability.

In addition, taxpayers should perceive that the tax is reasonably fair. Finally, it should be relatively easy to administer efficiently and effectively.⁴

International experience suggests that subnational governments carrying out important expenditure functions are more likely to do so responsibly the more they are responsible for raising the revenues they spend. While there will always remain an important role for intergovernmental transfers, especially in countries with wide regional economic disparities, there seems to be no reason, in principle, why wealthier regions (including metropolitan areas) should not be able to raise and spend most of their budgets themselves. It is very important that subnational governments have some significant degree of freedom to alter the level and composition of their revenues. Without this freedom, local autonomy and local accountability are not meaningful concepts. In particular, subnational governments should be able to set tax *rates* (albeit perhaps within limits). However, this condition is seldom satisfied in developing countries. In Latin America in particular, such rate flexibility is essential if local governments are to be adequately responsive to local needs and decisions, while remaining politically accountable to their citizens (see IDB, 1997a).

A potential danger in permitting local governments even limited freedom to tax is that they will not utilize fully all the revenue sources open to them, thus allowing the level and quality of public services to deteriorate. If intergovernmental fiscal structures are properly designed, this should not be a real problem. If the service in question is one of national importance or one in which there is a strong national interest in maintaining standards, it should presumably be funded (and the extent to which it is achieved, monitored) by the central government. If it is not

⁴ Obviously, not every level of government will agree that all these objectives are equally desirable. For example, while central governments should be concerned about limiting the scope for tax exporting, and fostering visibility of the tax to ensure accountability, such attributes are unlikely to be appealing for local governments.

a matter of national interest, why should the central government be concerned? Of course, this argument assumes that the central government has both adequate information and a predetermined transfer system, as discussed below.

If local electors do not like what their local government does, or does not do, they can try to change the elected officials at the next election. The freedom to make mistakes, and to bear the consequences of one's mistakes, is an important component of local autonomy in any country. Indeed, unless local governments are given some degree of freedom with respect to local revenues, including the freedom to make mistakes (for which they are accountable to their citizens), the development of responsible and responsive local government is likely to remain an unattainable mirage. Of course, if the conditions of effective democracy and adequate information are not satisfied, or if those who fail to collect local taxes or to spend revenues efficiently are bailed out by discretionary transfers, the elected officials may not be changed but rather be re-elected for their success in obtaining a larger share of other people's money. Countries that, for whatever reason, fail to set up an appropriate intergovernmental fiscal structure are likely to have more problems in managing decentralization and less satisfactory policy outcomes.

A more potent danger may be that local governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. Although limited local taxation of business may be warranted on "benefit" grounds, it may be desirable to limit local government access to taxes that, in many instances, fall mainly on nonresidents. This includes most natural resource levies, pre-retail stage sales taxes and, to some extent, nonresidential real property taxes. One way to deal with this problem may be to establish a uniform set of tax bases for local governments (perhaps different for different categories such as big cities, small towns and rural areas), with a limited amount of rate flexibility permitted to provide room for local effort while restraining unproductive competition and unwarranted exploitation.

In sum, the approach taken here to subnational taxation is based on three simple principles. First, more attention should be paid to matching expenditure and revenue needs at different levels of government. Second, more effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. Third, subnational taxes should not unduly distort the allocation of resources.

Attention can be now turned to two distinct and important problems in subnational taxation. The first is how to finance regional governments, a problem of significance in larger and especially federal countries, but by no means confined to those countries. The second problem, found everywhere, is how to finance "local services" more narrowly understood.

Financing Regional Governments

The most immediately important subnational revenue issue facing larger countries in Latin America is probably to develop a satisfactory revenue base for regional governments, that is, one for which those governments are politically responsible. While in most countries more can be done in the form of regional excise taxes (especially on vehicles and fuels), if regional governments have significant expenditure responsibilities, there are really only two financing possibilities: through a surcharge on the Personal Income Tax (PIT) or a surcharge on the Value Added Tax (VAT). If a country wants its local governments to be both large spenders and less dependent on grants, experience suggests that it must provide them with access to national tax bases. Piggybacking through surcharges seems to be the only viable way to do this while retaining an important element of political accountability (Bird, 1999).

The possibility of local income tax surcharges now seems to be broadly accepted. Unfortunately, as Shome (1999) has recently emphasized, few Latin American countries have sufficiently robust central income taxes to offer much hope that subnational governments will soon be able to derive much revenue from this source. A

potentially more promising alternative for sub-national revenues may thus turn out to be a surcharge on the VAT. Such a tax already exists and works well in Canada. Its implementation now seems feasible even in countries with less well-developed tax administrations. At least in the larger Latin American countries with federal features, such as Brazil, Argentina, or Mexico, this path seems to be open and it should be explored further. Turning to local taxes, apart from user charges there seem to be only two major possibilities, a revised, and revived property tax and an improved form of local business taxation.

User Charges. Since many services provided by local government clearly benefit identifiable persons (or businesses, or properties) the failure to levy user charges where they are applicable not only results in government spending that is higher than it should be, but also in a mix of government spending that does not reflect the real needs of society as determined by citizens, rather than bureaucrats. At least three types of local user charges, broadly defined, exist almost everywhere: service fees, public prices, and specific benefit charges.

Service fees include such items as license fees (marriage, business, dog, vehicle) and various small charges levied by local governments for performing specific services (registering this or providing a copy of that) for identifiable individuals (or businesses). In effect, such fees constitute cost reimbursement from the private to the public sector. Charging people for something they are required by law to do may not always be sensible (for example, if the benefit of, say, registration is general and the cost is specific) but on the whole there is seldom much harm, or much revenue, in recovering the cost of providing the service in question.

In contrast, *public prices* refer to the revenues received by local governments from the sale of private goods and services such as water (other than the cost-reimbursement just described). All sales of locally provided services to identifiable private agents (from public utility charges to admission charges to recreation facilities) fall under this general heading. In principle, such

prices should be set at the competitive private level, with no tax or subsidy element included unless doing so is the most efficient way of achieving public policy goals (and even then it is best if the tax-subsidy element is accounted for separately).

A third category of charge revenue may be called *specific benefit taxes*. Such revenues are distinct from service fees and public prices because they do not arise from the provision or sale of a specific good or service to an identifiable private agent. Unlike prices that are voluntarily paid, taxes represent compulsory contributions to local revenues. Nonetheless, specific benefit taxes are (at least in theory) related in some way to benefits received by the taxpayer (in contrast to such general benefit taxes as fuel taxes levied on road users as a class or local general business or property taxes viewed as a price paid for local collective goods). Examples abound in local finance: special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary property taxes related to the provision of sewers or street lighting, development exactions and charges, delineation levies, and so on. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property (its area, its frontage, its location).

Unfortunately, it is not easy to “get the prices right” and charge correctly. Most of the fees and charges that now exist in most countries are clearly defective. Water rates, for example, are frequently applied as fixed charges independent of the volume of water consumed. Consequently, the marginal cost of consumption is zero, leading to over-consumption of water and over-investment in water capacity. Even when water consumption is metered but declining block rates are used, prices are less than marginal cost for large water consumers, thus favoring those with large lawns and backyard swimming pools. The fact that sewer charges are usually prorated on the amount of the water bill only compounds this pricing error (see Bird, 1999b; Bird and Miller, 1989; Bird and Tsiopoulos, 1997).

Distance from the source of supply, for example, should matter in setting an appropriate user fee, as

should the time of year when there are seasonal peaks in demand. The uniform pricing approach almost never makes economic sense (although it may sometimes be warranted when administration and enforcement costs are taken into account). Generally, user fees should correspond to the marginal costs of providing service to each consumer. A connection (or admission) fee should be charged to cover capital or fixed costs. Such a two-part pricing policy is a more efficient pricing instrument than a user fee set at the level of average total cost. On the whole, municipal governments should be encouraged to adopt an appropriate fee for services approach to program delivery wherever possible. Many municipal waste management facilities and parking lots, for example, are seriously underpriced in most countries.

Quite apart from the failure to set the “right” prices, the main failure in most countries is that prices are far too low, and indeed often zero. One reason less use is made of such charges than seems warranted in most countries is that they are often thought to produce adverse distributional effects. User charges are perceived to hurt low-income people when a service that was previously provided free of charge to everyone now costs everyone who uses it the same amount. Nonetheless, those concerned about helping the poor are generally mistaken in opposing pricing: providing the wrong public services inefficiently is no way to improve income distribution. Moreover, it is often far from clear who benefits from a “zero-price” policy. Upper-income households frequently benefit disproportionately from the consumption of free, or low-cost, public services.⁵

Although distributional concerns may often be exaggerated, they are nonetheless real and must be explicitly considered in developing a user charge policy. Moreover, it is by no means always easy in reality either to be precise as to when, and to what extent, charges are appropriate on efficiency

grounds. Or, if they are appropriate, it is not easy to establish how such prices should be set. Subnational governments should impose user charges whenever feasible. But no one should think that to do so is either technically or politically a trivial problem.

The Property Tax. Almost without exception, much can and should be done to strengthen the deficient property taxes now in place in most Latin American countries. The tax should be simplified and applied uniformly. Cadastral maps should be updated and valuations made more consistent and current. Improved use should be made of flows of information from property registries, local building license authorities, public utilities, etc. In addition, from a revenue perspective, more attention should generally be paid to improving collection and enforcement rather than to the technically more costly (and less immediately productive in terms of revenue) mapping and surveying.

While the property tax is a useful and necessary source of local revenue, it is important to stress that, in most countries, it cannot easily provide sufficient resources to finance a significant expansion of local public services. In the most advanced countries, local property taxes can seldom yield enough to finance local services. In developing countries, despite substantial efforts and considerable foreign assistance, property taxes seldom account for more than 20 percent of local current revenues (Bird and Slack, 1991). The problems stem from the high visibility of the tax, which makes it politically unattractive, and from difficulties associated with tax administration, especially in countries with endemic inflation.

Regarding the visibility problem, the property tax generally has to be paid directly by taxpayers in periodic lump sum payments. This makes taxpayers more aware of the size of their tax bill, which adds to the accountability and responsibility of governments, but it also greatly increases the sensitivity of taxpayers to even nominal increases in taxes. In addition, since the base of this tax does not, as a rule, increase automatically over time, the need to maintain real revenues when price levels rise requires in-

⁵ Flat-rate water charges, for example, favor households with large lawns, swimming pools, and multiple vehicles to wash and not the poor (Bird and Miller, 1989).

creased tax rates. These periodic rate increases exacerbate the resistance of taxpayers to the property tax, making it politically unattractive.

Other problems result from property tax administration. As a rule, property is supposed to be assessed on the basis of its market value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Even in countries with well-developed property tax systems, discrepancies arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons (Bird and Slack, 1993). Since taxpayers can easily compare their property taxes with those of similar properties in their neighborhood, such discrepancies lead both to specific assessment appeals and to general pressure for tax relief.

The temptation to indulge in politically painless but economically inefficient "tax exporting" suggests that some constraints should be placed on local taxation of nonresidential property. As discussed below, some local business taxes may be justified on benefit (efficiency) grounds, but in principle they should always be strictly constrained in order to preclude localities from attempting to shift the costs of services to outsiders.

Other policy reforms are also needed to turn the property tax into a responsive instrument of local fiscal policy. First and most importantly local governments must be allowed to set their own tax rates. Few countries currently give local governments much freedom in this respect. Secondly, the tax base must be maintained adequately. In countries with much inflation, some form of index adjustment may be advisable. Sometimes, national assessing agencies must be provided direct financial incentives to keep the tax base up to date. Finally, procedural reforms are often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base. None of these steps is easy, but countries that want to have local governments that are both responsive and responsible must follow this hard road. There are no short cuts to successful local property taxation.

Local Business Taxes. Another critical problem in many countries is to replace all or some of the various subnational taxes on business with less distortionary taxation. While the ability to distort markets through taxes must be restrained (for example, by establishing a uniform national base for local business taxation, with a minimum and maximum rate⁶) there is an economic (benefit) case for some regional and local taxation of business. Indeed, in many countries, given the political resistance to residential property taxes, local business taxes have sometimes been the only way in which local governments have been able to expand revenues in response to perceived local needs.

Unfortunately, most forms of local and regional business taxes in developing countries (corporate income taxes, trade taxes, business taxes, differentially heavy nonresidential property taxes, and even so-called 'retail' sales taxes) may introduce serious economic distortions in a variety of ways. One way to reduce such problems is through a so-called "Business Value Tax" (BVT) in essence, a relatively low rate flat tax levied on an income-type value-added base. In contrast to the regional VAT surcharge, the BVT is aimed primarily at improving the allocative efficiency of subnational revenue systems. This line of action may offer a potentially promising alternative to the proliferation of increasing, and increasingly distorting, subnational business taxes.

CLOSING THE GAP: DEALING WITH VERTICAL AND HORIZONTAL IMBALANCES

Regardless of the revenue sources made available to local governments, transfers from central to local governments will undoubtedly remain

⁶ A minimum rate is needed to prevent distorting "tax competition" (with richer jurisdictions -- those with larger tax bases -- lowering rates to attract still more tax base). A maximum rate is needed to prevent equally distorting "tax exporting" (as when jurisdictions in which breweries or gas distribution pipelines are located impose especially heavy taxes on such facilities in the expectation that the taxes will ultimately be paid by persons not resident in the jurisdiction).

an important feature of the public finances of many countries. Transfer are necessary if services must be provided by local governments that do not have the fiscal capacity to finance them at levels considered adequate. They are also needed if there are externalities associated with the services in question, or if it is important to address differences in needs among regions. Thus, a well-designed system of intergovernmental transfers is an essential component of any decentralization strategy, which together with a properly designed subnational tax base provide incentives for "fiscal responsibility" at the local level. Unless made accountable, public sector decisionmakers are unlikely to make effective and efficient resource allocation decisions.

The previous section stressed the fact that subnational governments carrying out important expenditure functions are more likely to do so responsibly when they are also responsible for raising the necessary revenues. When spending "other people's money," local governments (and their constituents) are unlikely to face local pressure to spend this money efficiently. As important as limiting vertical fiscal imbalance may be, however, it is even more important to impose accountability *at the margin*. Even if, due to differences across jurisdictions, some local governments are 90 percent dependent on central transfers, it is in principle still possible for them to be fully accountable, as long as the amount of the transfer is predetermined, that is, cannot be altered as a result of action by the recipient. A well-designed formula-based transfer along these lines will ensure that at the margin, local actions to raise or lower local revenues or expenditures will directly affect outcomes, which is what is needed to ensure political accountability.

Basic Principles in the Design of Intergovernmental Fiscal Transfers

Experience suggests that no simple, uniform pattern of transfers will be suitable for all circumstances. Among other things, transfers reflect closely the nature of a country's political system. As a result, their inherently political nature must be taken into account. What is most

critical about intergovernmental transfers, however, is not who gives them, or who gets them, or their design details, but rather their effects on policy objectives. As with user charges, the idea is to "get the prices right" in the public sector—or, to put it another way, to impose a hard budget constraint on all actors involved. Three aspects of intergovernmental fiscal transfers need attention: the size of the "distributable pool," the basis for distributing transfers, and conditionality.

Determining the Distributable Pool. There are three ways of distributing funds through intergovernmental fiscal transfers, variants of which can be found throughout the world. Funds can be distributed as a fixed share of central government revenues or on some other "macro" basis, for example, as a percentage of GDP. They can be distributed on an ad hoc basis, that is, in the same way as any other budgetary expenditure. And finally, they can be distributed on a "formula-driven" basis, that is, as a proportion of specific local expenditures to be reimbursed by the central government or in relation to some general characteristics of the recipient jurisdictions.

Defining the total distributable pool in an ad hoc fashion creates a number of problems. First, recipient governments need transfers to be stable and predictable, in order to be able to budget properly. Ad hoc transfers are neither stable nor predictable. Second, this system is not conducive to hard budget constraints. Central governments will be constantly subject to political pressures from powerful regional lobbies in order to increase the size of the transfers. This problem becomes even more serious when the distributive formula is discretionary as well.⁷

Systems that establish transfers as a fixed percentage of central taxes (or current revenues) provide some degree of stability for local gov-

⁷ This last concern may be misplaced in countries where the central government is very powerful vis-à-vis the subnational governments. An example of this is Peru, a country where transfers are almost completely discretionary. However, the problems for the recipient governments in terms of lack of stability and predictability obviously remain.

ernments as well as flexibility for the central government. Sharing specific national taxes is less desirable than sharing all national taxes because it leads central governments over time to tend to increase more those taxes that they do not have to share. This option, however, has some problems as well. First, it makes it more difficult for the central government to make adjustments during periods when this is necessary, in particular in countries where transfers are a significant share of revenues. For example, if a fiscal deficit prompts the central government to increase taxes, part of the increased revenues go to subnational governments, who then can increase expenditures. Second, this approach may provide insufficient stability for subnational income when national taxes are very sensitive to external shocks (such as a fall in export prices) or to the business cycle. As a result, subnational financing of such vital human capital development services as education and health may suffer. It may therefore be desirable either to base the total amount transferred on a more stable macro measure, such as a GDP moving average, or finance such services separately through a system of capitation grants.

The Distributive Formula. Discretionary or negotiated transfers are clearly undesirable. Sound transfer systems should distribute funds among recipient jurisdictions on the basis of a formula. These transfers provide the central government a lot of flexibility to direct resources to the jurisdictions with the greatest needs. But, for the same reason, unless the central government is very strong vis-à-vis the subnational governments, these transfers are more likely to result in soft budget constraints for the subnational governments, and thus do not provide adequate incentives for fiscal responsibility. This view is based on the belief that, under discretion, transfers will tend to be allocated to those jurisdictions that are facing financial difficulties or are running a deficit. This can very easily give rise to a moral hazard whereby subnational governments spend beyond their means because they know that they will receive supplementary transfers from the central government. Alternatively, transfers could be allocated for political reasons, which would not be efficient either. In addition discretion regarding the allocation of transfers

will result in transfers that are very unstable and unpredictable for the subnational governments

The essential ingredients of most formulas for general transfer programs (as opposed to "matching grants" which are intended to finance narrowly defined projects and activities) are needs and capacity. Needs may be sometimes roughly but adequately proxied by some combination of population and the type or category of municipality. A more difficult, but conceptually critical, problem is to include some measure of the capacity of local governments to raise resources, given the revenue authority at their disposal. One way to structure a good transfer system, for example, might be to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a (centrally) predetermined level of services. Because capacity-based transfers are, in principle, based on measures of potential revenue-raising capacity (not on actual revenues), this approach does not create disincentives to fiscal effort. Differentials in needs and in the cost of providing services (for example in rural or less densely populated areas) may be taken into account, but caution is necessary in this respect. It is easy to turn a simple, transparent formula into one that is obscure and easily manipulated by introducing too many refinements into its definition.

Conditionality. Once the total amount to be distributed has been decided and the basic distribution formula determined, the key remaining question is whether the transfer should be made conditional on the provision of certain services at specified levels. Two quite different approaches may be taken. On one hand, to the extent that the primary objective of transfers is to ensure that all regions have adequate resources to provide such services at acceptable minimum standards, simple lump-sum transfers, with no conditionality other than the usual requirements for financial auditing, are called for (Shah, 1994). In this "federalist" approach, it is assumed that the fact that the funds flow to locally-responsible political bodies will ensure sufficient accountability and that it is neither necessary nor desirable for the central government to attempt to interfere with, or influence, local expenditure choices.

On the other hand, if the central government is using local governments as agents in executing national policies (for instance to provide primary education at a specified level throughout the country), then it is sensible to make the transfer conditional upon the funds being spent for the desired purposes (Bird, 1993). Since money is fungible, even transfers based solely on need do nothing to ensure that the recipient governments will in fact use the funds as the central government might wish unless receipt is conditioned on performance and compliance is monitored in some way. Thus, in these cases, monitoring of performance is a key element of design. As a general rule, in the circumstances of most developing countries some conditionality seems desirable, particularly when local governments provide important national services such as education and health.

Fiscal Capacity and Fiscal Effort

Some measure of fiscal capacity is an essential element in the design of intergovernmental transfers. Different jurisdictions have different revenue-raising abilities and will varying resource needs from the central government in order to provide similar levels of public services. Transfers based on measures of potential revenue raising capacity (not on actual revenue) they do not create disincentives to fiscal effort. Unfortunately, measures of fiscal capacity are not easy to construct. A rough approximation may be attempted using estimates of regional GDP per capita or some other macroeconomic index, although these indices tend to be very imperfect measures of fiscal capacity.

However, it may not be advisable to include measures of fiscal effort in the distributive formula. Fiscal effort can be understood conceptually as the ratio of actual taxes collected to "potential" taxes estimated on the basis of some standard measure of fiscal capacity and some standard (e.g. national average) tax rate. Though it may seem appealing to reward fiscal effort, in particular given the "fiscal laziness" sometimes observed at the subnational government level, doing so entails some problems. First, the measurement of fiscal effort is more complex than usually assumed. If, for instance, tax bases are

sensitive to tax rates, then the usual measures overestimate capacity in low tax rate areas (and hence underestimate the effort needed to increase tax rates) because the base will decline if the rate is increased. Moreover, given the limited flexibility most local governments in developing countries have to alter their revenues through their own actions, it is far from clear to what extent it is meaningful to interpret the behavior of revenues as reflecting their "effort." In addition, including actual tax rates in the formula may undesirably open it to manipulation by recipient governments if actual rates set by a particular jurisdiction can affect the size of the transfer it receives.

Transfers and Poverty

In many countries, transfers are designed to redistribute resources among jurisdictions. In Argentina, for example, poorer provinces tend to receive more support from the central government, though it is not the very poorest that gain the most. Per capita transfers to the poorest provinces of Argentina (Chaco, Formosa and Santiago del Estero) are only slightly higher than the average, while other relatively wealthier provinces (such as Catamarca) received almost double the average per capita transfer (Porto and Sanguinetti, 1993). But even if transfers were effectively directed to the poorest jurisdictions, there is no guarantee that they would reach the poorest individuals in those jurisdictions. In addition, many poor families live in the richer regions. For example, in Chile, more than half of the persons whose incomes fall below the poverty line live in the wealthiest regions (the Metropolitan Region of Santiago, Valparaiso and Libertador Bernardo O'Higgins). Regional transfers are inherently inefficient in reaching these poor families. In principle, the greater the weight that the central government places upon the equitable delivery of essential services to specific groups of poor citizens, the less the weight that can be given to the autonomy of local governments in the sense of leaving them free to spend as they see fit. If a principal aim of central policy is to deliver "basic needs" to the poor, either the central government should do it itself, or it will have to develop an elaborate and detailed (and probably not very effective) monitoring

system to ensure that local governments perform their role as agents of central policy efficiently and equitably. Decentralization, properly carried out, may have many virtues, but doing exactly what the central government wants in terms of income redistribution is not likely to be one of them. This point may be especially relevant to those concerned with alleviating the poverty of groups not favored by local power structures.

International experience suggests that those who would decentralize successfully, while at the same time focusing on poverty-alleviating policies, should be wary of unnecessarily complicating intergovernmental finance (Bird and Rodriguez, 1999). In all countries, fiscal relations between governments are inevitably complex and usually unsatisfactory in some respects to all parties concerned. If the central government wants to accomplish a specific goal (such as delivering specific services to specific (poor) households), it should do so without further complicating intergovernmental finance. Many of the complications, and complaints, characterizing intergovernmental fiscal issues in most countries result from overloading the system with tasks for which it is ill-equipped, such as targeted poverty alleviation. Whenever feasible, direct transfers to the poor (e.g. through some variant of vouchers) are better than indirect transfers to localities (even poor localities) that are intended primarily to help poor households.

If, for some reason, such key poverty-related services as education and health must be provided through decentralized governments, very careful attention has to be paid to three key issues. First, getting the prices facing service providers right (e.g. via a well-designed system of grants). Second, setting up an information and inspection system sufficient to ensure that the desired services are delivered to the target groups. Third, devising some system (e.g. a national "fail-safe" provision) for dealing with those who are not in compliance without punishing those who comply. These are not easy tasks.

MACROECONOMIC IMPACTS: TRANSFERS, BORROWING AND DEFICITS

An interesting aspect of the recent move to decentralize public sector activities in many countries has been the revival of an old worry, that decentralization might have a negative impact on macroeconomic performance. In part, these concerns are based on fears that, left to their own devices, subnational governments would act in a fiscally irresponsible way. Of particular policy concern in many countries has been the alleged need to develop new and more stringent controls over subnational borrowing. There are several channels through which decentralization could potentially result in macroeconomic problems, such as increased spending or deficits: i) whenever transfers of resources to subnational governments are increased without transferring equivalent expenditure responsibilities; ii) when revenue sources are transferred to subnational governments and they fail to exert adequate effort at mobilizing resources (similarly, when transfers are increased and subnational governments reduce the efforts on the revenue sources they already control); iii) in countries with a high degree of decentralization, central governments responsible for macroeconomic management may not have enough room to maneuver if resources and responsibilities are concentrated at the subnational level; iv) when the central government fails to impose hard budget constraints on the subnational governments.

Transfers

When a national government transfers revenues to subnational governments, it should also as a rule transfer expenditure responsibilities that are roughly equivalent. If this is the case and in the absence of behavioral reactions, subnational expenditures should increase by exactly the same amount as subnational revenues. Revenues available for expenditure at the national level decline and those available at the subnational level rise by the same amount, as do subnational expenditures. However, in several recent moves toward decentralization in Latin America, revenues have been transferred without the corresponding responsibilities. Sometimes, increases

in transfers have been mandated by a new constitution. While it is possible that these increased transfers could reflect the fact that resources available to subnational governments were insufficient to carry out their tasks, in several cases the increase in resources has led to increased general government spending and central government deficits.

Transferring expenditure responsibilities together with additional resources does not eliminate the potential for macroeconomic impacts, however. These will depend on two things: the behavior of central government spending in response to the transfers, and the effect on subnational government "own" revenues. Regarding the first issue, on occasions central governments have been very slow to let go of the transferred responsibilities, and have not reduced their own expenditures proportionately. This obviously results in a duplication of activities, lack of clarity and accountability regarding who is responsible for what, and increased expenditures and deficits. Recent experience in Colombia illustrates this behavior by the central government. This problem, however, is more likely to be temporary (until the central government adjusts to the new situation) than permanent.

Subnational revenues may decline as a result of increased transfers (a phenomenon known as "fiscal laziness," "decrease in fiscal effort," or "substitution effect" of transfers), they may remain the same as in the absence of transfers ("flypaper effect"), or they may actually increase local own revenues ("stimulative effect" of grants). On the whole, the evidence suggesting a decrease in local effort is far from overwhelming (Burki, et. al. 1999). This suggests that most macroeconomic problems arising as a result of increased transfers are either due to the spending behavior of the central government, or to improper design of intergovernmental relations (such as transferring resources without corresponding responsibilities), rather than to irresponsible behavior by the subnational governments.

In any event, even the most irresponsible local politicians can cause macroeconomic problems only when their actions are in some way vali-

dated by either the central bank (monetizing subnational deficits) or the central government (bailing out subnational governments). Decentralization may certainly complicate macroeconomic management, but it does not shift responsibility for it out of the hands of the central government.

Since macroeconomic stabilization is, for the most part, a national government task, it is important that the national government have full control over all the instruments of policy it needs to carry out this task properly.⁸ In a few very decentralized countries in Latin America, such as Argentina and Brazil, subnational governments are responsible for almost half of total expenditures and, once transfers are taken into account, command a substantial portion of government revenues as well. This raises valid concerns that, when fiscal adjustment is necessary, it will be more difficult for the central government to control expenditures. At the same time, increases in taxes may not be as productive a form of adjustment since, given the importance of tax sharing arrangements, part of the increased revenues have to be transferred to the subnational governments, which in turn may increase their expenditures as a result of the windfall.

But perhaps the main concerns with decentralization, from a macroeconomic perspective, relate to subnational government borrowing.

Subnational Borrowing

The rules regarding borrowing by subnational governments in Latin America vary considerably from country to country. While some countries, such as Chile or Venezuela, restrict subnational government borrowing almost completely, others, such as Argentina and Brazil, allow a high

⁸ There is some scope, however, for subnational governments to carry out some stabilization responsibilities. They can, for example, smooth out the cycle by using stabilization funds. Most of the US states have "rainy day" funds precisely for this purpose, and some subnational governments in Argentina have recently adopted this type of funds, in the context of loan programs financed by the IDB.

degree of subnational borrowing autonomy.⁹ These last two countries have also experienced notable substantial subnational deficits and debt (Dillinger and Webb, 1999). The association between autonomy and bad performance is not coincidental; under certain circumstances, borrowing autonomy can lead to soft budget constraints for the subnational governments. At the heart of the issue is a problem of commitment. It is often very difficult for central governments to commit not to bail out state and local governments when they are in financial trouble. Absent the ability of central governments to commit, borrowing autonomy may well result in irresponsible fiscal behavior on the part of the subnational governments. This behavior is nothing more than an optimal response to incentives when the perception of a bailout exists.

There are several reasons why the central government may find it hard to commit to a no bailout rule. First, if a jurisdiction is in financial trouble, the central government may resort to a bailout to ensure the welfare of the affected population or avoid negative externalities on other jurisdictions in the absence. This last factor has been crucial in the rescue of state banks in the larger Brazilian states. Failure to do so could have resulted in widespread bank runs.

This discussion helps to identify some of the characteristics of intergovernmental relations that may exacerbate the difficulties central governments face when trying to impose hard budget constraints. First, it will be more difficult for the subnational governments to get themselves out of financial trouble if they have no control over their revenues. Limited flexibility to increase their own resources (either because of high vertical imbalance or because they cannot affect the tax base and tax rates) will make necessary adjustments more painful in the absence of bailouts, and thus will make a bailout more likely. Similar considerations apply to the expenditure side. If the subnational government

does not have flexibility to cut expenditures (perhaps because they receive a large proportion of revenues via conditional transfers), undertaking adjustments on their own will be more difficult, if not impossible.

Discretionary transfers are another potential source of bailouts, since they provide an easy way for central governments to extend bailouts and an easy way for subnational governments to request them. The less transparent the transfer system, the more damaging discretionary transfers can be. The degree of borrowing autonomy of subnational governments also plays an obvious role in determining bailouts. Lack of autonomy to borrow does not eliminate bailouts, but reduces the scope to situations such as accumulation of debts to suppliers and workers. Preliminary results from a seven-country study on the determinants of subnational government bailouts in Latin America, conducted by the IDB, are consistent with this conclusion.¹⁰

A clear case can be made for extending at least some capacity to borrow to state and local governments. As public finance textbooks note, in terms of both allocative efficiency and intergenerational equity it often makes sense to finance long-lived investment projects, especially those that will increase productive capacity, by borrowing rather than relying solely upon either current public savings or transfers. For this reason, restricting subnational borrowing, at least for investment purposes, entails important costs. Other reasons for borrowing are less defensible. In some cases, for example, local officials have reaped the political benefits of expenditure financed by borrowing, while leaving the political pain of debt service to their successors. Such practices entail an externality and raise a major issue of accountability.

Borrowing with the expectation of a central government bailout involves an externality as well. State and local governments will borrow beyond what is socially optimal if they think they can shift part of the cost of repayment onto others outside the jurisdiction. Moreover, when the risk

⁹ See IADB, 1997, for a country-by-country index of subnational borrowing autonomy. Brazil has moved toward more restrictive conditions as part of the debt renegotiations between the states and the central government.

¹⁰The study includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay.

of bailouts exists, markets are clearly not an adequate disciplining device. If lenders expect the central government to bailout local governments, they will accommodate the borrowers more readily than would otherwise have been the case. In these cases, constraints on subnational government borrowing may be the right policy.¹¹

Imposing strict borrowing limits may pose some difficulties, however. First, it may not be easy to do in the case of federal countries, where the central government's ability to impose intergovernmental fiscal relations is more limited, at least in some countries. Second, central limits to subnational borrowing may have a perverse effect. If loans that fall within subnational borrowing limits are perceived by lenders as having the central government's seal of approval, they in effect carry an implicit guarantee of central government backing. As a result, lenders may not scrutinize the fiscal situation of potential borrowers as closely as they might otherwise. The same concern exists when transfers are used as guarantees, affecting the lender's assessment of risk, undermining the impact that such assessment has on the fiscal discipline of subnational governments.

As the previous paragraphs make clear, when it comes to subnational government borrowing, there is "good" borrowing as well as "bad." In principle, it is as important to facilitate the former as to block the latter. Indeed, facilitating the access of subnational governments to borrowing can, under the right conditions, help over time in developing some degree of market discipline. On these grounds allowing subnational access to capital markets, if done right, should in the long run strengthen rather than weaken fiscal discipline. Of course, the central government's refusal to engage in further bailouts of subnational governments must be credible.

While emergency central support may sometimes be unavoidable to resolve debt problems,

¹¹ See Ter-Minassian (1995) for a description of different types of arrangements regarding subnational government borrowing and their effectiveness.

it should carry the obligation to introduce and make effective any necessary reforms under the supervision of a review board. The loss of political autonomy in the event of a bailout may reduce moral hazard behavior on the part of subnational government politicians. Given that formal bankruptcy proceedings are impossible in the public sector, reducing this moral hazard depends at least upon the institution of a credible review/control system for resolving debt. More generally, to ensure accountability, all subnational borrowing should be reported immediately and in a transparent fashion both so that no governments can shift hidden debts onto the next administration and so that both local voters and the central government can understand clearly what is going on. Inappropriate borrowing by subnational governments should be viewed not so much as a "problem" of decentralization but as a symptom of more basic underlying inadequacies with the intergovernmental fiscal system in general. Once that system is cleaned up the institutional problems that may give rise to unsustainable subnational borrowing may largely be solved.

However, some ex-ante limits on subnational borrowing may be warranted. Borrowing should be permitted only for investment purposes (which may be difficult to enforce in the absence of strictly segregated capital budgets), since the only good case for local borrowing is to finance capital investment.¹² A case could also be made for requiring prior approval from the central government for foreign borrowing. Finally, given the extreme dependence of some subnational governments on central transfers and the expectation of central government bailouts, there may be a case for ex-ante administrative controls on borrowing, such as requiring prior central approval or limiting debt service to a certain proportion of current revenues.

¹² Of course, some arrangements may have to be made to permit "in-period" borrowing to smooth out cash flows over the budgetary year.

5.

Local Democracy at Work

CHAPTER SUMMARY

The sources of the relevant incentives for good subnational government performance are wide-ranging. The structure of inter-governmental fiscal relations and the rules establishing the division of functional responsibilities present a pivotal set of incentives, which to some degree circumscribe the rest. Underneath this broader umbrella, but not less significant, are the incentives that stem from the more specific regulatory frameworks and standards established by the central or regional governments to govern the delivery of services. However, decentralization not only implies changes in the rules defining the assignment of resources and responsibilities among different levels of government, but also a change in the rules governing the relationship between elected officials and their constituencies. For the benefits of decentralization to be fully realized a profound democratization of local government must take place.

This chapter focuses on democratic institutions and practices that shape the incentives on subnational public officials to govern responsibly, effectively and in accordance with the preferences of their constituents. The subsequent chapter focuses on the problem of how to build the organizational and managerial capacity of subnational governments to respond to the challenges presented by the new responsibilities and increased citizen demands for better quality services.

LOCAL DEMOCRACY AT WORK

Strengthening Incentives for Improved Government Performance and Increased Responsiveness

In theory local democracy is expected to enhance the degree to which the mix of goods and services provided by governments matches that

preferred by citizens. But, “bringing the government closer to the people” does not necessarily mean that the government will be more responsive to “the people” or that “the people” will manifest themselves in a more visible form before governmental officials and make their preferences and demands clearly known. Given the hard realities that it is costly for citizens to participate in politics and acquire political knowledge and that, as a consequence, day-to-day politics tends to be the work of professional full-time politicians, it is equally possible that local governments may be run by, and in the interests of, a narrow group of wealthy, politically connected, and/or well-educated elite. Or, it may be that political parties, centralized in the hands of national or regional political patrons (or bosses) dominate local governments, with little sensitivity to the needs and preferences of the majority of the citizens.

The potential problem of representation and accountability at the local level is reflected in and aggravated by the disenchantment with democratic politics evident in many countries. Opinion polls point to the low esteem in which politicians and political parties are held. They are blamed for corruption, abuse of authority, and the failure to respond adequately to public needs. Whether decentralization leads to more democracy and better government depends critically on the structure of local political institutions. These institutions generate the incentives that shape the extent to which elected and non-elected government decisionmakers carry out their duties transparently, responsibly, and in a manner that responds to citizen needs and preferences. Important institution-related incentives fall under five main categories that are discussed below.

The first is the extent to which elections serve to communicate citizens’ preferences over local policy issues and their approval or disapproval

of public officials' performance in office. The second incentive relates to the extent to which subnational councils or legislative bodies have the capacity to assimilate and aggregate the full range of citizen and group preferences and to act as a counter-weight to the executive (mayoral) branch to ensure that it does not abuse its authority or does not ignore citizen concerns. In the third place is the extent to which formal institutions exist in which citizens and nongovernmental organizations (NGOs) have real opportunities to air their complaints, articulate their preferences (for instances in respect to capital investment projects), and receive and provide information and advice. Fourth is the degree to which the government is required, because of central government regulatory regimes or national and local laws, to regularly provide reliable information about such matters as legislation enacted, the level and functional distribution of expenditures and revenue collection, and comparative unit costs for public services and other performance-related evaluations. The last institution-related incentive is the extent to which a fair and independent media and a relatively rich network of civic organizations exist.¹³

Electoral Systems and Representative Institutions

The rules governing the election and removal of local officials provide the basis for making them accountable to their constituencies. As such, they are an important part of the system of incentives that promote efficient behavior in local governments. Within their sphere of influence, electoral systems play as important a role as the rules assigning tax revenues and authority to borrow, to induce elected officials to manage public accounts responsibly and to supervise the effectiveness of local bureaucracies. Election

¹³ As Putnam (1993) and others have argued, the propensity of citizens to participate in politics and to associate together in civic organizations is affected by culture and other historical factors. At the same time, however, it is likely that this propensity is affected by the perceived efficacy and costs of civic engagement, which are influenced by more malleable factors, including the nature of political institutions (Hirschman, 1970; Cohen and Rogers, 1992).

rules that are set up correctly can go a long way toward making possible the fulfillment of the two theoretical benefits of decentralization; namely, enhanced citizen involvement in governmental affairs and an improved match between the goods and services delivered and those desired by citizens. But, while it may be true that a closer connection with government activity can mobilize citizen interest, it is also certain that a faulty political system (for instance, one that does not provide opportunities for real citizen influence or that restricts electoral choice) can quickly generate cynicism and disengagement.

When do elections work as a mechanism to communicate citizen preferences? When do they allow citizens to effectively register their approval or disapproval of local government conduct? Given the complexity of most policy issues; lack of citizen interest, knowledge or time; the absence of complete or objective information; and their relative infrequency, elections cannot be expected to perform these functions perfectly. As a result, there must be additional avenues through which citizens can express their preferences and involve themselves in the political process. Despite their inherent limitations, however, elections are obviously a vital element of democracy. The characteristics of the electoral system and other aspects of the formal structure of subnational government shape their effectiveness.

Direct Election of Mayors. As reflected in its widespread adoption across Latin America, the *direct election of mayors* and governors appears to be an indispensable step in enhancing democratic accountability at the subnational level. Table 5.1 shows that after the electoral reforms of the 1980s and 1990s most countries elect mayors directly. The only exceptions are Costa Rica, Honduras, and Peru. In Peru the candidate heading the winning party list for council membership is automatically selected mayor. In the other two cases the mayor is indirectly elected by the councilors from among themselves. In Chile the council candidate with the most votes becomes the mayor unless the winning candidate fails to obtain more than 35 percent of the vote. If that happens, the newly elected city council

members select the mayor from among themselves.

Length of the Mayor's Term and Reelection. Another set of electoral rules affecting accountability at the local level is the length of the mayor's term of office and whether he/she can be reelected. If terms are three years or less, municipal governments are less likely to be able to establish a track record of performance for which they can claim exclusive responsibility. Further, they are less likely to assume the risks of reforms that entail short-term costs but have the potential to bring significant future benefits. In addition, under these circumstances a significant share of the mayor's term of office is first spent learning on the job and then, in the third year, becoming involved in the election campaign of their successors (Nickson, 1995).

At the same time, the possibility of reelection gives mayors clout to carry out their programs, encourages them to be responsive to citizen concerns, provides a greater incentive to risk some political capital for the sake of bringing about improvements, and permits greater continuity in municipal policy programs and administrative staffing. Short terms of office and the impossibility of reelection tend to create a "revolving door" for staff and devalues training and technical expertise. This is a common problem. In five countries (Colombia, Guatemala, Mexico, Peru, and Venezuela) mayoral terms are relatively short and in seven countries no immediate reelection is permitted.

Election of Council Members. Electoral accountability at the local level is also affected by the manner in which city council members are elected. One issue is whether council members are elected from narrower geographical districts (wards or neighborhoods) or at-large districts taking in the entire municipality. Other things being equal, election from at-large districts restricts territorial representation at the municipal level and limits the ability of citizens to hold council members individually accountable. Ward or neighborhood-based participation could be expected to encourage higher levels of citizen participation since involvement is more likely to bring tangible results and also to open politics to

more people by making it less costly to run for office. Throughout most of Latin America, however, council members are elected from at-large districts. The only exceptions are Panama (where the "first past the post" or "plurality system" based on sub-municipal electoral wards is practiced) and some English-speaking Caribbean countries.

Timing of Elections and Ballot Structure. The utility of elections as a mechanism for signaling local citizen policy preferences and for holding individual council members and mayors accountable for their actions in office is further undermined when local elections are held concurrently with elections at the national level, when electors are unable to split their vote between different governmental offices, and when voters are forced to choose between party lists and cannot express their preference among individual candidates in the same or different parties. Especially when the latter two rules are followed, the coincidence of elections at different levels of government tends to reduce the importance of local issues in contests between parties and/or individuals at the local level. As a consequence, the effectiveness of elections in indicating citizen preferences in respect to local issues and in signaling approval or disapproval of the conduct of local officials in office is diminished. In addition, concurrent elections means that the selection of party candidates for municipal office is often determined by the electoral support they can mobilize for the party's national politicians rather than by the personal capabilities of the candidates and their fitness for local government office (Nickson 1995). Though electoral reforms have separated local from national elections in some countries, they remain concurrent in almost half of the countries of Latin America.

At the same time, the scope for electoral choice and the possibility of holding politicians individually accountable would appear to be undermined when voting is by blocked party lists, where voters must vote a straight party line and cannot divide their votes between candidates of different parties. In many of the cases where such a system is in place, the lists are also closed.

Table 5.1 Elections and Citizen Participation at the Subnational Level

	Executive										Legislative				Local Elections Coincide with National		Other forms of participation	
	Intermediate			Local			Intermediate				Local		Local Elections Coincide with National		Other forms of participation			
	Elective position	Direct election	Immediate reelection	Elective position	Direct election	Immediate reelection	Mayoral Term Length	Electoral System	Immediate reelection	Electoral System	Immediate reelection	Electoral System	Immediate reelection	Local Elections Coincide with National	Are there any?	By popular initiative		
Argentina	yes	no	yes	yes	yes	4	PR	yes	PR	yes	PR	yes	yes	Yes	yes			
Bahamas			yes	yes	yes				PL	yes		yes	no					
Bolivia	no	n/a	n/a	no	yes	5	Mix	yes		yes		yes	no	no	n/a			
Brazil	yes	yes	no	yes	no	5	PR	no	PR	yes	PR	yes	yes (state)	yes	yes			
Chile	no	n/a	n/a	yes ¹	yes	4	N/A	yes	N/A	N/A	PR	yes	no	yes (local)	yes (local)			
Colombia	yes	yes	no	yes	no	3	PR	no	PR	yes	PR	no	no	yes	yes			
Costa Rica			yes ²	no	yes ²					yes	PR	yes	yes					
Ecuador	yes	yes	yes	yes	no	4	PR	no	PR	yes	PR	yes	no	no	n/a			
El Salvador			yes	yes	yes					yes	PR	yes	yes					
Guatemala			yes	yes	yes	2 ³				yes	PR	yes	yes					
Honduras			yes	no	yes	4				yes	PR	yes	yes					
Mexico	yes	yes	no	yes	no	3	Mix	no		no	PL	no	no	no	n/a			
Nicaragua			yes	yes	no					yes	PR	yes	yes					
Panama			yes	yes	no	5	N/A	no	N/A	N/A	PR	yes	yes	no	n/a			
Paraguay	yes	yes	no	yes	no		PL	yes	PL	yes	PL	yes	no	no	n/a			
Peru	yes	yes	yes	no	yes	3	PR	yes	PR	yes	PR	yes	no	yes	yes			
Rep.Dom	no	n/a	n/a	yes	yes		N/A	yes	N/A	N/A	PR	yes	no	no	n/a			
Uruguay	yes	yes	yes				PR	yes	PR	yes		yes	yes	yes	yes			
Venezuela	yes	yes	yes	yes	yes	3	Mix	yes	Mix	yes	Mix	yes	no	yes	yes			

Shaded areas indicate that the level of government does not exist.

¹In Chile the city council and mayoral candidate with the most votes becomes mayor unless no candidate receives 35% of the vote or more. In this case the newly elected council members from among themselves select the mayor.

² In Costa Rica mayors are elected by municipal council members who in turn are elected by popular vote.

³ Guatemala City has a four year term of office

That is, voters can choose only between competing party lists, and the party ranks its own candidates, thus determining who will sit on the council at different levels of total voting support. These practices prevent electors from expressing their support for council members who appear to be particularly devoted and responsive and from penalizing those who are lazy or unresponsive. It also encourages politicians to be accountable mainly to the party apparatus rather than to the electorate and limits the potential pool of candidates. As a result, certain groups, such as women and indigenous peoples may be underrepresented. The limits on electoral choice entailed by closed and blocked party lists may be partly responsible for the fact that women occupy only about 4 percent of mayoral offices and about 10 percent of municipal council seats (FLACSO, 1995).¹⁴ Voting by blocked and/or closed party lists also tends to limit the independence of the electoral mandate of councilors and thus undermines the capacity of the councils to oversee and counterbalance the power of the local executive branch (Peterson 1997).

In most Latin American countries councilors are elected by party lists, which are usually closed and blocked. The main exceptions are the English-speaking Caribbean countries, Panama, Brazil, and Chile. In Brazil and Chile voters choose a single candidate instead of a list of candidates from an at-large district. In Panama councilors are elected one by one from sub-municipal wards in a "first past the post system."

Powers of Municipal Councils. Though importantly shaped by these attributes of the electoral system, the capacity of municipal councils to have an effect on policy-making, to monitor the mayor's office, and to represent citizens between elections is also influenced by the level of their resources (salaries and expertise of council members, availability of technical advisors, etc), their size, and the formal legislative powers

¹⁴ Within systems in which parties control which candidates have opportunities to be elected, one way of enforcing a greater proportionality in gender representation in political offices is through quota laws, described below in the text (Htun, 1998).

vested in them by the constitution. In most cases, councils in Latin America tend to be very weak. Though the mayor generally is required to submit key financial decisions to the council for approval, the council lacks the ability or, in some cases, the legal power to compel changes in the details. The council is left with the role of ratifying or refusing to ratify legislation and enacting internal administrative regulations. In some cases, however, the mayor can even override council opposition to executive actions. (Nickson, 1995; Peterson, 1997). Thus, organizational and legal weakness impedes the ability of the councils to be more effective in channeling feedback from the public to elected or appointed decisionmakers, in resolving diverse social preferences into a coherent set of policy and spending programs, and in overseeing the executive.

Referenda, Citizen Initiatives, and Recall Elections. A partial remedy for the bluntness of periodic elections as an instrument of political accountability can be found in the introduction of other electoral mechanisms, such as referenda (on such issues as taxation and borrowing, for example), citizen initiatives, and recall elections. Referenda are potentially valuable for local democracy since they give citizens a chance to directly decide matters of great importance to them and lend greater legitimacy to key governmental decisions. Initiatives allow citizens to force action on issues where special interests lobbying or weak grassroots links keep politicians from being fully responsive to majority preferences. Recall elections provide an additional incentive for elected politicians to pay attention to voters between elections, thus providing added incentives for them to act as representatives rather than as delegates of citizens.

COMMUNITY PARTICIPATION AND CIVIL SOCIETY ORGANIZATIONS: ADDITIONAL MECHANISMS FOR ENHANCING DEMOCRATIC ACCOUNTABILITY

In addition to these more traditional electoral mechanisms of representation and accountability, other forums, rules, and government-citizen partnerships have been utilized in advanced de-

mocracies, and increasingly in Latin American countries, to enhance communication flows between the municipal government and citizens, and to expand opportunities for citizen participation and involvement in government.

While electoral participation is to a great extent an individual activity, more continual forms of citizen involvement usually require a higher degree of organization. There are a host of non-government organizations (NGOs), community based organizations (CBOs) and other civil society organizations (CSOs) like neighborhood associations, trade associations, church groups and sports clubs, whose activities are of great importance for local development. Their involvement covers a wide range of activities. Some are key actors in promoting community involvement in local decision-making and have a significant impact on local governance. Others collaborate with local governments in the provision of services through philanthropic activities targeted to specific population groups. Yet others function as contractors for the execution of local development programs. They vary significantly in size, institutional capacity, and in the scope of their interests and support base. For instance, some are international or national organizations and others have a local character.

The expansion of the scope and capacity of civil society organizations and their role in development can increase the accountability of government to citizens, enhance the degree of citizen ownership in development projects (and, therefore, their viability and effectiveness), and promote greater efficiency in the allocation of public resources.

National and subnational governments can play a role in promoting the development of civil society organizations, by granting them legal status, by providing indirect forms of financial support (such as giving nonprofit organizations tax exempt status), and by incorporating opportunities for the participation and the collaboration of civil society organizations into the design of programs and decision processes. International financial institutions, foreign governments, and external NGOs also can provide important support, both through direct financial

assistance and by promoting their participation and formal partnership in state-sponsored projects.

Forums such as community advisory boards, regulatory commissions, open town meetings, public hearings, citizen complaint centers (offices of citizen assistance), and judicial and legal proceedings provide opportunities for citizens and civil society organizations to articulate their preferences, air their grievances, and influence policy and investment decisions beyond Election Day. Several interesting examples of mechanisms for formalizing community participation in local agenda-setting exercises have begun to emerge in a few countries in the region. Some examples are the local *Mesas de Concertación* in Colombia, solidarity groups at the municipal level in Mexico, *Organizaciones Territoriales de Base y Comités de Vigilancia* formed under the Popular Participation Law in Bolivia, participatory budgeting in Porto Alegre (Brazil), and municipal government partnership with community groups in La Florida (Chile).

Such forums hold great promise but their potential has thus far been underexploited in Latin America. Though in several countries town meetings have been written into national law, their role is limited when citizens and groups draw up project proposals without adequate information about project costs and budgetary constraints (or they are not compelled to consider such information) or when they are not given a formal place in the decision-making process. In the open town hall meetings in countries like El Salvador and Honduras, for example, community groups' impact on decision-making is limited by the fact that, lacking access to cost or budget information, they are unable to truly participate in setting investment priorities (Peterson, 1997). Nevertheless, when citizens' demands are expressed in such a forum it raises the chances that their interests will be taken into account.

Bolivia's Popular Participation Law, the partnership of the municipal government of La Florida (Chile) with community groups, and the "Participatory Budget" in Porto Alegre (Brazil) are each cases in which citizen participation entails

real decision-making power in respect to capital investment planning and public works spending (Peterson 1997). In these cases, community groups must face the realities of resource constraints and compare the costs of alternative project proposals. In addition, given the trade-off between leaving decisions to the executive or to a more automatic mechanism, they have a strong incentive to build consensus behind a common set of objectives. Participatory mechanisms of this kind can significantly increase efficiencies in respect to resource allocation and productivity and can promote the development of neighborhood-based organizations and greater degrees of civic engagement and empowerment. This has further implications in terms of subnational government accountability and efficiency.

Citizen and community participation has also been enhanced in the United States and some Latin American countries by means of requirements regarding meetings of public boards (e.g. school boards), planning and zoning commissions, and/or legislative councils. Specifically, these meetings must be open to public attendance and participation. In addition, provisions have to be made for public comments on major rulings or decisions. Such participation can be quite important in ensuring that public services, investment planning, and government decisions are responsive to citizens and public officials are accountable.

Productive and effective participation requires accurate and comprehensive information not only about the budget but other matters as well. Thus, citizen involvement in matters like investment planning or zoning decisions is enhanced when citizens are guaranteed in law full access to the findings of review panels, to government records, to company data (such as on pollutants emitted, taxes paid, etc.) and to other relevant information.

Aside from knowledge of costs and resource constraints and access to a wide array of information, the broadening and deepening of citizen representation requires that the participation of different socioeconomic and ethnic groups directly in the democratic process or through membership in community groups be propor-

tionate to their presence in the population. In addition, the profile of public office holders should mirror to the greatest extent possible the nation's underlying sociocultural diversity. Unfortunately, evidence suggests that the participation of women and marginalized groups in many cases has not been sufficient for their interests to be adequately represented. For instance, while women appear to be relatively well represented among those who attend local assemblies and meetings, their participation as members or leaders of local organizations and decision-making bodies has remained low.

The broadening of representation can be advanced, on the one hand, through the establishment and/or strengthening of agencies or councils that advocate for the particular minority or under-represented group. Such agencies or councils can advocate for the modification of laws and public policies or collaborate in the design of sector programs aimed at enhancing the group's conditions and opportunities. For instance local institutions or offices that focus on women's issues have been established in Argentina (in 20 of 24 provinces), Chile (in 129 of 341 municipalities), Colombia (in 12 municipalities), Venezuela (100 institutions at different levels of government coordinated by a national Council) and in Paraguay (Htun, 1998).

On the other hand, some steps toward increasing the effective participation of women have also been made through "pool-enlarging" strategies that attempt to increase the number of women who are qualified and able to compete for leadership positions, and quota laws that enforce given thresholds of representation for women in party electoral slates. "Pool-enlarging" strategies have included university scholarships, leadership and professional training programs, and initiatives to increase campaign funds for women candidates. The movement toward quotas, though highly debated, is gaining momentum. To date, laws at the national level requiring that between 20 percent and 40 percent of candidacies be reserved for women have been passed in Argentina, Bolivia, Brazil, Costa Rica, the Dominican Republic, Ecuador, Panama, and Peru (Htun, 1998). Quota laws are also being enacted at the subnational level. For example, 22 of Ar-

gentina's 24 provinces have adopted quota rules for state legislature and municipal councils. Similarly, three Mexican states have also done so.

Accountability and Intergovernmental Relations

As has been emphasized throughout, if decentralization is to work properly, those charged with providing local services must be accountable both to those who pay for such services and to those who benefit from them. Local political accountability will not work effectively unless the division of responsibilities between different levels of government is clear (and well-enforced and respected). It also requires that local officials have sufficient authority to perform the roles assigned to them and bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. Otherwise, local citizens will not know who to blame for poor performance and will not face realistic trade-offs between their public spending needs and desires and the associated costs in terms of taxation (Dillinger, 1994).

But, given that many types of local government actions have a consequence not only for local citizens but also for the nation as a whole, to some degree local governments must be held accountable not only "downwards" to their constituents but also "upwards" to the central government. Central regulation of local decisions is clearly warranted in the case of those functions that have consequences for the nation as a whole (such as monetary and fiscal policy). Central regulation is also appropriate with regard to functions that are viewed to have implications for core national values or objectives, such as reducing poverty. In these cases the central government may delegate much of the responsibility for the delivery of the particular service to local governments but maintain some regulatory authority. By contrast, central regulation is difficult to justify when the impact of local government behavior is mostly localized and regulation requires detailed knowledge of local conditions and priorities.

Of course, in many cases the choice between reliance on central regulation and systems of local accountability is not clear-cut and is often a source of conflict between different jurisdictions. Once the important issue of the lines of authority is settled, however, the two forms of accountability can complement each other. For instance, in the context of an on-going process of decentralization, central government oversight may enhance local political accountability by enforcing compliance with certain performance standards and providing needed information. Such information can allow for more efficient client/customer choices (in semi-privatized service delivery systems) and can boost the capacity of citizens to participate effectively and hold local officials accountable. Unless local publics are made aware of what is done, how well it is done, how much it costs, and who paid for it, no local constituency for effective government can be created.

A clear need for central regulation also exists when, in the typical case, the central government absorbs a considerable share of the responsibility for financing the provision of a given public service in the form of transfers. As stressed in Chapter 4, effective decentralization depends on the establishment of an appropriate regulatory framework that clearly delineates the various responsibilities of each jurisdictional level in respect to each type of service. Otherwise the subnational authorities can use the transfers designated to fund a particular service for other purposes, knowing that the central government will come in to fill the gap.

Given the usual need for transfers to fund services that are administered at the subnational level, it is especially necessary for the central government to develop its regulatory capacity. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized or that transferred funds are being spent appropriately and efficiently. Therefore, an essential element of the hard budget constraint needed to promote efficient local decisions is adequate central enforcement capacity in the form of credible information gathering and

evaluation. The "carrot" of central financial support of local efforts must, in the end, be accompanied by the "stick" of some degree of withdrawn support if performance is inadequate. Moreover, a credible stick requires both some standards of adequacy and some way of knowing to what extent performance measures up.

Unfortunately, the lack of an appropriate central government structure to monitor and support local governments is a common problem. Most central authorities do not have a very good understanding of either the existing situation of their local governments or of the likely effects of any proposed changes in local finance. Most need much more regular and detailed financial data on local governments than they usually possess. Key conditions for improving monitoring include:

1. The existence of uniform financial reporting and budgeting systems and an appropriate agency—preferably with a certain degree of political separation from the central government—for collecting and processing data in a timely fashion.
2. Central government support for developing and maintaining an appropriate reporting system, and for training and supporting local government officials.

3. Formal reporting and evaluation systems adapted to the needs of the public to whom subnational governments are accountable.

Regardless of the form that decentralization takes, an important institutional problem remains; namely, how to ensure that the relevant central government agencies have adequate incentives and the ability to monitor and regulate subnational activity, and that subnational governments have sufficient incentives to provide the necessary information. Some incentives for compliance with demands for information may be created by making timely submission of such reports a condition for receiving fiscal transfers. Transparency with regard to government functions is essential to strengthen the effectiveness of intergovernmental accountability mechanisms and to provide citizens a factual basis for evaluating the impact of public policies and the effectiveness of incumbent governments and politicians.

But, organizational and managerial capacity must also be developed at the subnational government level if entities at this level are going to be able to successfully face the challenges presented by their expanded responsibilities and the increased political pressures to carry them out effectively. This important dimension of decentralization is the topic of the next chapter.

6.

Strengthening the Capacity of Subnational Governmental Organizations to Respond to the New Incentives

CHAPTER SUMMARY

The lack of adequate institutional capacity at the subnational level is one of the most important obstacles for the effective decentralization of government. Particularly challenging in small rural municipalities, this problem also affects local governments facing the mounting poverty problems concentrated in the metropolitan areas of the region. The high rotation of personnel and the hiring and promotion of staff on political rather than merit grounds compound inadequate organizational and operational structures in weakening institutional capacity in subnational governments of all types. Simultaneous and coordinated changes are required in key management areas, including policy making and strategic planning and evaluation systems to raise institutional performance to levels compatible with the efficient administration of the expanding responsibilities entrusted to subnational governments. Of utmost importance for promoting efficiency in these public agencies is that the diverse management systems must generate incentives that lead individuals to work in harmony and with reasonable competence and effort. These incentives match reforms of the intergovernmental relations and governance systems described in previous chapters in promoting efficient and democratic subnational governments.

CAN LOCAL INSTITUTIONAL PERFORMANCE BE IMPROVED? BUILDING LOCAL CAPACITY

Local democracy, when working properly, should result in a heightened demand for better quality and more efficiently and equitably targeted governmental services and public investments. But, such “external” incentives, while critical for spurring necessary reforms and improving communications between citizens and

subnational governments, will not automatically result in improved governmental performance. Rather, a second set of “internal” incentives must also be overhauled in order for subnational governments to be able to meet the challenges posed by their new responsibilities and by heightened citizen demands. Efforts to better harmonize and strengthen key public management systems (including those related to the design of policies and strategic planning, budget implementation and revenue collection, personnel, information storage and flow, and control and evaluation) are also necessary to ensure that the potential benefits of decentralization materialize. In fact, if insufficient efforts are devoted to building the institutional capacity of subnational governments, then the resulting imbalance between citizen demands and governmental performance could erode the legitimacy of the decentralization process, further complicate the task of institutional reform, and possibly weaken democracy itself.

Some authors have expressed concern about the possible dangers of decentralization (Prud'homme, 1995), particularly those arising from the poor quality of local administration in most developing countries. Concerns about the supposed incompetence or deficient capacity of local governments have slowed the process of decentralization. Local administrations are viewed as being filled with deficiently qualified and under-motivated staff, to be plagued by excessive turnover of professional staff, and to lack any capacity for strategic planning or effective management. These deficiencies in turn are viewed to result from widespread practices of clientelism in which public employment is treated more as an instrument for doling out political favors than as a valuable resource for carrying out the government's responsibilities. While there is often good reason for such concerns, it should be emphasized that subnational

officials respond to the incentives with which they are faced. If those incentives discourage initiative and reward inefficiency and even corruption, it should not be surprising to find corrupt and inefficient local governments. Experience has shown that with the appropriate democratic as well as “internal” incentives in place it is possible even for local governments in relatively underdeveloped regions to significantly enhance their capacity in a relatively short period of time (Fiszbein, 1997).

Building the capacity of subnational governments to carry out their new and often more complex responsibilities requires a comprehensive approach in which most public management systems are upgraded and integrated in a more harmonious fashion. Deficiencies or misalignments in the capacities of local governments (considered as a whole or in terms of individual organizations or agencies) will undermine their performance and their responsiveness to citizen demands and social needs. Deficiencies may affect many activities including policy design and strategic planning, budget management and revenue collection, human resources and information management, control and performance evaluation, just to name a few. The present chapter outlines proposals for improving institutional capacity in subnational governments. The first three sections focus on the key management systems: personnel, budget, and control and evaluation. The fourth section discusses reform strategies relevant to the different types of services commonly managed by local and regional governments.

Human Resource Management for Local Development

A basic approach to the institutional weaknesses of subnational governments puts the blame on the deficient training and poor motivation of the administration. However, these problems, while in many cases real, are but one component in a mosaic of dysfunctional traits that have a more complex origin related to deficiencies of a broad set of management system.

Nevertheless, the deficient performance of staff is, in most cases, at least partially rooted in per-

sonnel rules and practices. In this area there are numerous potential causes, including hiring systems that fail to guarantee that individuals will be selected on the basis of merit and will have the appropriate training for the position being filled. The widespread practice of clientelism that often substitutes merit and qualification-based hiring in part originates in deficient legislation but also in the absence of judicial and management mechanisms to enforce compliance with existing laws. Conversely, in the lower and middle positions in the local bureaucratic hierarchy there is often excessive security, which creates strong disincentives to good performance (Nickson, 1995). By contrast, there is a high level of discretion and relative insecurity with regard to professional level positions, especially those that are most susceptible to political pressures and corruption. High professional staff mobility, which also results from pay scales which are consistently below those of the private sector (or even other parts of the public sector), is one of the most important deficiencies of local public management that have a negative impact on the continuity of policy. The generally low salaries and low social status of local government employment, along with the politicized nature of appointments and instability at higher ranks, impedes the development of a more talented, appropriately trained, and stable work force.

Incentives for good performance are also limited by the absence of a career system. When mechanisms of internal promotion exist they tend to be applied arbitrarily and usually fail to take into consideration pertinent criteria, such as past performance and skills of the incumbents. Aside from the lack of a merit system, career structure, and adequate pay scale, motivation is also undermined in many cases by the absence of sufficient mechanisms to evaluate performance and the weakness or infrequent application of disciplinary regimes.

Deficiencies in the personnel system are generally compounded by deficiencies in the broader management structure. For instance, the weakness of planning and policy-making makes it difficult to develop personnel policies. Deficiencies in strategic planning often exist side-by-side

with weaknesses in personnel management. As a consequence, often the roster of job positions is not rationally connected with the direction in which the agency is headed, and the skills and functions needed for each position are poorly specified. It is common for clientelist pressures to thrive in this personnel policy and strategic management vacuum, expanding the workforce well beyond the needs or budget capabilities of local governments.

There is a generalized absence of qualified training institutions in the region. When they do exist, training programs are often not geared to the skills required and/or not linked closely with the strategic plan of the organization. Training methodologies also need to be changed, with less emphasis on classroom teaching and more on problem solving, on-the-job, and hands-on approaches. The potential of distance education also needs to be tapped to train local governments staff in isolated areas. The demand-oriented approach to service provision and its financing through the sale of services to municipalities makes Brazil's Institute of Municipal Administration (IBAM) a source of good practices.

BUDGET MANAGEMENT FOR LOCAL DEVELOPMENT

Managing Revenue Collection

The difficulties that subnational governments face in raising own revenues only in part originates in the intergovernmental restrictions discussed in Chapter 4; namely, their lack of discretion in the selection of tax bases and rates. These difficulties are compounded by weaknesses in revenue collection procedures and the deficient capacity of functional units in charge of tax administration (IDB 1998). Progress in revenue assignments, particularly locally administered taxes and user fees, must be accompanied by a significant improvement in local capacity to manage tax rolls and collection systems.

Legislative Framework. Municipal tax codes and small-yielding levies, which are difficult to administer, do little to improve tax management. In

some cases, municipal tax legislation is not compatible with national or intermediate government legislation for instance, in the definition of certain tax bases.

Institutional Setup for Revenue Management. The functional makeup of municipal revenue bureaus and units makes it difficult for these governments to collect taxes efficiently. For one thing, few have compliance monitoring and audit units or plans, and very few do tax inspections and audits and in general exercise their enforcement authority. Likewise, many municipalities have no master tax roll and collection systems, such as current-account systems that can furnish aggregated data on the tax liability of each taxpayer. Further collection of property taxes, the single largest source of local revenue for many local governments, is seriously hampered by out-of-date property rolls and by the fact that property data are often spread among various record offices. For instance, real estate property transactions are registered with different offices than those that track property valuation for tax purposes. In addition, a different level of government often handles registration. The frequent lack of communication among these units makes it difficult for subnational governments to update tax rolls to keep track of the commercial value and current ownership of properties.

It is frequent to find municipalities with no integrated information systems for financial management that would expedite budget management, efficiently track municipal spending and make it compatible with revenues. The financial management modules in place for budgeting, accounting, cash management, and procurement and contracting are not usually integrated. A large number of municipalities, even those in the most advanced countries in the region, have budget systems that are incompatible with systems used by other levels of government. For instance, budget classifications are usually not grounded in technical criteria, making it difficult to compare accounting and financial information across municipalities. A similar problem emerges from the lack of uniformity between municipal and central government public investment systems. The cases in which financial

management systems are directly linked with tax administration systems are rare.

Asymmetry of Institution-Building Needs. The institutional problems outlined vary in magnitude and frequency from one subnational government to the other. Moreover, although the problems described are common to a vast majority of local fiscal institutions, not every subnational government in every country faces the same problems. Even in the presence of similar institutional constraints, it is important to consider that while problems may be similar, solutions should not necessarily be the same. The objective of creating efficient tax units in every municipality, for example, should not be pursued across the board, without considering at least two factors: environment and size. If the proper legislation and political support exists, it might be equally or more efficient to piggyback certain tax services (such as collection and auditing) on those of larger municipalities or even national tax agencies. Solutions should always be customized in order to avoid the inefficient standardization of approaches.

Fiscal capacity building at the subnational level may proceed as incremental programs addressing one or more specific problem areas for defined groups or as integrated institution building efforts in a target set of subnationals. The choice of one approach or the other is dictated mostly by the situation of the target government, including the quality of the legal and institutional environment. There is the option to attempt massive institutional development programs to assist a whole cohort of subnational governments with solutions implemented in a serial manner. This option entails the development of a menu of products appropriate for a significant number of municipalities, such as information systems comprising standard tax and financial management modules and including the required training programs for their use. It is most suited for situations in which the legal and institutional environment for local government development has been reformed to enable a sufficient degree of autonomy and efficacy.

Capacity building programs for fiscal decentralization in general, and institutional development

for efficient fiscal management in particular, usually confront the dilemma of whether to undertake such activities prior to the completion of policy reforms or to wait until these have been completed. The question of what should go first, policy reform or institution building does not have a final answer. All depends on the circumstances, particularly on the depth of the reforms required. Except in the most trying circumstances, a comprehensive approach involving both policy and institutional strengthening activities is more likely to succeed inasmuch as these activities reinforce each other. As the reform of the legal and institutional framework frees local energies, institutional support activities allow the newly empowered local governments to stand up to the challenge.

Intergovernmental Support Systems. For a large cohort of subnational governments, the strengthening of local fiscal bureaus requires long-term support from fiscal agencies at higher levels of government. Areas where this collaboration is productive include:

1. Technical advice for upgrading of managerial and operational systems to make them compatible with national systems;
2. Provision of information to support auditing or supervisory functions;
3. Provision of revenue collection and auditing services, and
4. Training of local officials.

However, it is not always the case that central or state/provincial governments are able to provide such support. A weak national or provincial tax administration not only will lack the required technical resources to assist local governments, but also will likely complicate the work of local offices. Such programs, therefore, should prioritize efforts to strengthen technical capacity at the national or intermediate level of government as a prerequisite for building such capacity at the local level.

A related issue emerges when local government systems and management practices are not fully compatible with those of the central or state/provincial governments. This situation calls for harmonization of critical areas like data re-

porting (cash versus accrual basis) or budgetary classification.

Managing Public Expenditures

Sources of Funds and Autonomy of Decision Making. No matter where subnational governments get their funds, they are unlikely ever to have enough resources to do all they or their citizens want and expect. A critical element in successful local government is to ensure that scarce public funds are managed efficiently and used effectively. This is an essential component of local capacity building.

Financial honesty and political accountability require properly established and implemented budgeting and financial procedures. They also require comprehensive, comparable, verifiable, and public budgeting, financial reporting, and auditing. It is equally important, however, to ensure that budgeted resources are applied as efficiently and effectively as possible to achieve desired public outcomes. Adequate and appropriate procedural norms are important in any financial system. But substantive outcomes are what really matter and budgeting and financial procedures are, in the end, simply the accounting manifestation of public policy. Proper public expenditure management must adequately control the total level of revenue and expenditure, appropriately allocate public resources among sectors and programs, and ensure that governmental institutions operate as efficiently as possible (World Bank, 1998). It seems particularly critical that subnational governments have sufficient authority to manage their revenues and expenditures.

As discussed in detail in Chapter 4, it is important to ensure that the correct incentives exist on the revenue side. Specifically, subnational governments must have access to some significant revenue sources for which they are economically and politically responsible. On the expenditure side, the earmarking of substantial parts of inter-governmental transfers for local infrastructure investment has characterized much of the recent experience with decentralization in many Latin American countries. For example this feature is found in Argentina, Brazil, Colombia, Chile,

Ecuador, Guatemala, and Venezuela. Presumably motivated in part by the desire to prevent local governments from "wasting" transfers on expanding local payrolls, such earmarking has had the paradoxical effect in some cases of exacerbating local fiscal problems. Although not fully effective,¹⁵ the result has usually been to increase capital spending to some extent, while making the already difficult problem of financing operations and maintenance even more difficult. Such earmarking has relatively little to be said in its favor: it distorts local preferences, exacerbates perverse incentives already found in the local finance system, and often connects revenue sources with expenditures in totally illogical ways. Moreover, excessive earmarking (and the related process of "mandating" subnational governments to spend in accordance with central preferences rather than their own) significantly reduces the scope for subnational governments to allocate expenditures according to the needs and preferences of local citizens and in a cost-effective manner.

Planning and Budgeting. As with good fiscal practice anywhere, good subnational budgeting should take place within the framework of a medium-term expenditure framework (MTEF). This is required to ensure the proper financing of investment projects and to reduce the scope for short-term political manipulation of budgets (for example, to expand pre-election public employment in an unsustainable fashion).¹⁶

An essential first step in this direction is to put sound budgetary and financial procedures into place, especially in the more important subnational governments, such as states and large cities. Subnational budgets must be comprehen-

¹⁵ Since money is fungible, there is usually some substitution of transfers for own-source revenues.

¹⁶ Of course, unless there is an adequate MTEF at the central level, it may be difficult to require one locally. On the other hand, given the growing importance of local governments in many countries, it is increasingly difficult to have an adequate MTEF at the central level in any case without explicitly incorporating aggregate local revenues and expenditures into the budgeting and planning exercise.

sive, accurate, periodic, authoritative, timely, and transparent. The budget law must be uniform and clear, and it must be enforced. Moreover, expenditures must be subject to external audit to ensure that the law is followed. All this would seem to require a strong central hand to ensure that the rules are in place, and complied with. For example, the central government should establish a "framework" budget law and require adequate external audit (such as by a private sector firm).¹⁷

A strong budgeting and financial system along these lines will satisfy two essential requirements of good government. First, it will establish the basis for financial control. Second, it will provide reasonably accurate, uniform, and timely financial information. But, by itself, even the best financial procedures can do nothing to ensure that scarce public resources, even if properly spent and accounted for according to law, have been spent in the best possible way or as efficiently as possible. Nor, as some countries have seen in recent years, does even the best enforced budgetary procedures ensure that aggregate fiscal discipline will be adequately maintained. To attain favorable outcomes in these respects, additional important fiscal institutions need to be put in place.

For example, the MTEF can encourage *fiscal* discipline by providing an essential baseline for measuring and monitoring the budgetary impact of policy changes. Similarly, fiscal discipline requires predetermined intergovernmental transfers that are not subject to political renegotiation during the budgetary year. Moreover, as discussed in Chapter 4, subnational governments must not be able to depend on central government bailouts when they have made unwise financial decisions (such as unsustainable borrowing or expenditure increases).

Ensuring Efficient Management. Similar institutional safeguards should be in place to ensure allocative and operational efficiency within af-

fordable fiscal limits. *Allocative efficiency* requires that managers at all levels receive adequate and accurate information on the effectiveness and social outcomes of the programs for which they are responsible. Such signals can derive from the revenues produced by properly designed user charges and/or through participatory interaction with clients at both the budgetary and implementation stages. Moreover, they must have strong incentives to respond to these signals. For example, by facing a predetermined spending limit, which can be altered only if they can "sell" more services than their client groups are willing to pay for.

Operational efficiency may best be achieved in most cases by allowing line managers (like the school managers mentioned earlier) significant discretion, within budgetary cash limits. Such discretion allow managers to reallocate funds among inputs or perhaps even across budgetary periods, subject to the attainment of predefined operational (performance) goals as well as compliance with appropriate internal and external financial control and audit systems. Emphasis is thus shifted from input controls (hiring a given number of persons at a given wage or renting a given amount of office space) to output controls (providing health care of a determined quality to a given number of persons within a specified time period or issuing a given number of marriage licenses).

Shifting the emphasis in public finance from inputs to outputs in this way is an essential step for improving policy outcomes at any level of government. It carries with it some risks and it is by no means fully clear how best this shift can be accomplished in the difficult circumstances faced by most countries of the region.¹⁸ Nonetheless, there is already considerable experience in Latin America with such techniques as client surveys, participatory budgeting (notably in some Brazilian cities), performance budgeting, and user financing (Burki, 1999). The path to

¹⁷ It should *not*, however, require subnational budgets to be subject to prior approval, or the whole point of decentralization is lost.

¹⁸ For example, there must still be full accountability by clearly identifiable decisionmakers with respect to all expenditure decisions to reduce the possibility of fraud.

success is by no means clearly marked. But at last some clarity exist about the directions in which countries should begin to move in terms of expenditure management if their leaders are seriously interested in making life better for their populations.

Control and Evaluation Management Systems for Local Development

The strengthening of control and evaluation mechanisms entails granting subnational governments the capacity to monitor their own activities, to learn from past experience, and change direction. Such mechanisms enable the government to supervise and audit the resources that are employed (INPUTS), its degree of compliance with rules, norms and procedures, and results obtained (OUTPUTS), as well as the consequences of these results or their final impact (OUTCOMES). Following are a few potential mechanisms to bring about improvement, given the considerable weakness of control and evaluation systems in most subnational governments.

One approach might be to build "sunset" provisions into transfer programs; that is, make transfers to local institutions subject to renewal in a specified number of years provided they pass some form of independent evaluation of their performance. Another approach might be to use centrally supported access to capital markets for infrastructure finance not only as a screening device to reject obviously flawed projects but also as an evaluation system to build up "ratings" of local capacity and effort. Yet another approach might be to assemble and publicize reliable comparative information on subnational government performance. Finally, most democratic federal countries have developed specialized institutions that serve, on the one hand, to partially integrate the fiscal decisions of governments at different levels and, on the other, to provide the informed public with some useful and trustworthy (nonpartisan) information on what both levels of government are doing, separately and together.

Developing such institutional "infrastructure" is neither a quick nor a cheap undertaking, but it is

an essential one if countries want to decentralize important public sector activities without losing touch with what is going on in these parts of the public sector. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized. Much more informed and open discussion of these matters than is common in most countries is needed. Regular publication of relevant data is essential. However, the system cannot rely solely on one of the interested parties (the central government) to carry out all the analysis that is needed for informed public discussion in any country in which intergovernmental financial issues are important. In countries in which the role of local government is important, consideration might therefore be given to establishing a nongovernmental institution focusing on local government problems.

Some central governments are learning through experience to carry out this essential information and monitoring activity more adequately in their own interests (for example, to avoid excessive subnational borrowing and hence potentially undesirable macroeconomic pressure). In no country, however, has any central government yet admitted that full disclosure (transparent accountability) should apply also to its own actions as they affect intergovernmental fiscal relations. Decentralization is a two-way street, and the central governments need to more fervently assume their pivotal role in this complex process. As Breton (1996) has demonstrated, for the potential benefits of increased governmental competition to be realized, governments at all levels must become more transparently comparable and hence accountable for their actions.

The main conclusion one can draw from international experience with specialized "decentralization institutions" is that each country takes its own approach. Nonetheless, experience around the world suggests that several different roles might be envisaged for a body concerned with intergovernmental finance issues. Depending upon what is politically desired and feasible, some of these roles may, or may not, be combined in the same institution.

One possible role might be to serve as a link between the political and executive branches in the center and the regional (and perhaps local) governments. A special institution does this by:

1. providing a nonpartisan forum within which various relevant actors may get to know one another in a nonconfrontational setting;
2. providing a common informational basis to all parties that will (one may hope) be trusted by all parties; or, finally,
3. training, both formally and informally, a cadre of experts in local service provision, fiscal and financial areas that may, over time, spread over the country, thus improving the trust in (2) and the basis for (1).

Whether the "forum" role (which would appear to require that members largely be selected on political criteria) is really compatible with the other two objectives is not clear, however. In the circumstances of many countries one of the most important needs is for a cadre of fiscal and policy analysts to be trained at all levels of government. They should be trained not only in the mechanics of analysis but in working together, from their different perspectives, towards the common goal of making the complex political and administrative system work.

Other ways in which an intergovernmental agency might, if desired, serve a formal political role are the following:

1. making annual or periodic reports on "the state of the federation"
2. determining, or reporting on, the appropriate basis for grants;
3. providing "federalism impact statements" indicating clearly the impact on subnational governments of central actions; or
4. working with central banks and departments of finance in developing comparable public finance data (for example, on borrowing).

A body whose main formal role was educational rather than political could achieve the substantive content of each of these tasks as well or better. For example, a common accounting framework could be developed and utilized for monitoring the fiscal performance of all levels of

subnational government. Such reports, which would be relevant to both the central government and to citizens in general, might be more credible if the agency did not have a formal "reporting" role to the central government, and its output was accepted as the work of competent and politically neutral analysts. Similarly, an intergovernmental fiscal body might play a very useful role by monitoring and reporting on the impacts of possibly intrusive central government policies on subnational governments. Again, its work on such matters might be more credible if it were not seen as one of the players in the political game but more as an outside, but very well informed and trustworthy referee.

For any decentralized system to work well in a democratic setting, people need to understand not only what is going on but also the real possibilities and constraints facing governments at all levels. An appropriate intergovernmental agency might serve as a central analytical focus, both supplying trustworthy information to all actors and, importantly, helping to create the informed public that is needed for the political system to cope with the great strains and many challenges facing it in most countries today. How "political" such a body might be, or what its optimal structure might be, is something to be determined in the context of each country.

Specific Reform Strategies for the Types of Services Typically Managed by Local and Regional Governments

A strategy for improving the institutional capacity of regional and local governments should start with a specific diagnosis of institutional performance in those areas that are considered to be critical. From there, attention should be focused on identifying the more specific causes of deficient performance and determining the objectives of the reform effort, in light of the conflicting interests in play and the available resources. Notwithstanding the need for specific diagnosis to support proposals for specific situations, existing knowledge in the fields of organization theory, management science, and public policy analysis, and the accumulated experience of the Bank and other multilateral institutions, makes it possible to suggest some orienting

guidelines for the improvement of performance tailored to the particular nature of the governmental function and the public intervention in consideration. These guidelines should be considered as initial hypotheses to be considered in the specific diagnostic analyses of particular cases mentioned above.

The universe of government interventions can be classified into the following basic types:

1. Representation and defense of local interests outside local area
2. Policy-making
3. Establishing norms and regulations
4. Application and enforcement of laws and regulations
5. Provision of public goods and services (in nonmarket conditions)
6. Provision of public goods and services in market or quasi-market conditions

Table 6.1 shows the type of intervention that corresponds to each function or set of local-regional public activities. The details of this table differ from country to country depending on their institutional capacity and the extent to which they can mobilize resources for the provision of goods and services and social welfare. The classification presented here assigns each type of activity to types of intervention that are most pertinent from a management perspective.

In what follows we present guidelines to improve performance in the public interventions that are most important in terms of their weight in the activities carried out by local governments.¹⁹

Provision of Goods and Services under Nonmarket Conditions

The provision of public services like education and health are complex public interventions. The

¹⁹ To see a discussion of the other types of public interventions and for a more in-depth analysis see Losada and Payne (1999) *Documento de orientaciones para programas y proyectos de reforma del Estado*.

nature of the activity requires that careful attention be given to training the professionals in charge of delivering a service that requires that they enjoy substantial freedoms to adequately perform their jobs. The personnel systems, therefore, cannot aim to tightly regulate the behavior of individuals in their execution of the job (i.e. teachers should have a great deal of discretion to teach a given curriculum in the way they think is best).²⁰ For this type of activity the professional organization model (also called the professional bureaucracy) is particularly valid. In reforming institutional mechanisms for the delivery of these services, emphasis should be placed on personnel policies for the professional providers of the public service (e.g. doctors, teachers, social workers). Particular attention should be given to the processes of hiring, training and retraining, socialization in the values of the profession and of public service, promotion of the professional career (avoiding the flight toward management careers), and in evaluation and payment scales.²¹

To improve efficiency in service delivery, it is important to maintain relatively flat organizations with few levels of management and avoid creating hierarchical and power-oriented cultures. The loss of professional discretion should be avoided and an organization design with broad job classes (with few levels of vertical specialization) should be maintained. Bureaucratization and excessive rule making should be avoided to the greatest extent possible. Investment in training should be targeted at professional employees, rather than at the middle level or at the administrative assistant level, as long as these are critical to sustain good performance.

²⁰ Mintzberg, 1979. Cap. 12

²¹ For specific thoughts on health care see Moore, 1996. That study makes a distinction between public health and prevention activities, for which a traditional bureaucratic model is most appropriate, and the provision of therapeutic medical services, for which a professional bureaucratic model is most appropriate. See pages 16 to 21.

Table 6.1. Forms of Interview and Local Governments Activities

FORM OF INTERVENTION	Representation and defense of local interests	Policy-making	Making laws and regulations	Application and Enforcement of Laws and Regulations	Provision of public goods and services in non-market conditions	Provision of public services in market or quasi-market conditions
TYPES OF LOCAL GOVT. ACTIVITIES						
<i>Economic Activities</i>						
Local economic development						
City marketing and attraction of foreign investment						
Creation of economic infrastructure (e.g. convention centers, industrial parks)						
Management of markets and distribution facilities						
<i>Urban Planning Activities</i>						
Territory planning, land use						
Territory management: urban plans						
Public works						
Neighborhood recovery						
Environmental programs						
Maintaining public property						
<i>Infrastructure and Urban Service Activities</i>						
Management of water runoff, sewage						
Public transportation						
Management of waste and street cleaning						
Maintaining urban real estate, parks, public lighting, parks						
Management of cemeteries						
<i>Social Activities</i>						
Provision of education services						
Cultural, sporting and other activities						
Provision of social services (families, elderly, youth)						
Public health maintenance and health services						
<i>Governmental Activities</i>						
Collection of taxes, user fees						
Management of basic information						
Management of registries						
Police and security						
Justice admin. and peace justice						
Detention centers, prisons						
<i>Institutional Activities</i>						
External representation and defense of city						
Citizen participation and articulation of conflicting interests						
Creation of a consensual vision of goals/plans/projects of city.						

When the local or regional government decides to guarantee or regulate rather than to directly manage the delivery of a particular good or service, the mixed management model is likely to be most appropriate. This model entails that subnational governments will have to assume the task of elaborating the legal framework and the rules of the game that should govern the delivery of the service and monitor and enforce compliance with these rules and provide the necessary financing.²²

Provision of Public Services in a Market or Quasi-market Environment: The Divisional Model

Subnational governments are responsible for services such as water, gas, and electricity. Given that these goods and services are in large part excludable and do not show significant externalities, there are no compelling reasons to keep them in the hands of the public sector, at least when a market can be established that ensures competition and adherence to a given set of standards. As a result, they are being privatized. In these cases, the only relevant function that remains in the hands of the government is the regulation of private providers, a function performed sometimes at the national level, others at the subnational level (mostly states and provinces). A different approach to reform is desirable for the services that remain in the public sector.

Different market mechanisms are needed for this type of public intervention. For example, demand and supply changes are required to lower costs and improve quality of service. Supply-side reforms may include the breaking up of monopolies, promoting the entrance of new competitors, promoting public-private competition, and creating markets or quasi markets. Demand-side reforms entail giving consumers or users of public services the power to choose among suppliers, creating co-payments/vouchers schemes, and improving the availability of in-

²² For the specific reform recommendations associated with this model see Losada, Payne (1999, cap. 3).

formation about costs. When market or quasi-market mechanisms are used, the public entities should be managed in a business-like manner. In practice, these activities are commonly carried out through a public stock company or an entity with a high level of autonomy relative to the executive (semi-autonomous organizations, state agencies etc). The challenge for subnational governments is managing the provision of services through autonomous or semi-autonomous units over which they do not have direct control. This public management model is made up of four elements,²³ each of which indicates areas for improving performance.²⁴

Grouping Functions According to the Provision of Goods and Services. The first area that requires attention is the criteria used to determine the functions and services that should be included in the new unit or division. The agencies or units should assume responsibility for all of the functions necessary for the production of a public good or service or final output. The reach of the agency cannot be limited to one function or one part of the process; it must be able to generate by itself an identifiable and measurable product or service. The idea of a tangible and homogeneous output is key to the grouping of functions and is a prerequisite of the other elements of the agency model (the business as well as the divisional variant).

Separation of Policy and Management Responsibilities. The policy responsibility entails establishment of a mission, objectives, performance indicators, and control of results according to objectives and targets for the agency or business.

²³ Details may vary; however, all four elements are essential to ensure the internal cohesion of the model.

²⁴ The divisional model is a specific variant of agency theory. The principal-agent relationship in this case is based on the existence of highly specifiable outputs and/or the possibility of introducing competitive mechanisms. These means of control are possible because there is no imbalance between principal and agent in negotiations *ex ante* (e.g. information is available to the principal), and because it is also possible to carry out an *ex post* control based on results without needing to control the process.

Management responsibilities should be assigned to professional directors whose earnings are tied to performance. The agency model depends heavily upon the professionalization of the public administrator or director function (otherwise its implementation can be highly counterproductive).

Management Autonomy. The third area of attention is the level of autonomy granted to the new division. Agencies should be designed with considerable autonomy. It can be considered a limited decentralization, predicated upon a more effective and efficient fulfillment of its mission. The degree of decentralization and management autonomy will depend upon the outputs. The powers that are subject to transferal include management of the agency's operations (its structures and internal procedures), management of its human and financial resources, and management of support services (purchases, information technology, etc.). Functions that are required for establishing the agency's policies and those that are essential for maintaining the broad integrity of the institution should never be transferred. These functions include the development of strategies and allocation of resources; rule making; the design of accountability systems based on results; decisions concerning strategic investments; the naming and renewal of directors; and the definition of the strategies of information systems.

Control Based on Results. The last area of attention is the design of the control system. While bureaucratic structures base control on hierarchical supervision and the uniform imposition of procedural rules, control in the business or agency model is based on a comparison of the results obtained with the targets set previously in management plans. Control entails two areas of action: (i) the supervision of the agency's compliance with the basic rules of the game in the framework within which it exercises its management autonomy and (ii) regular checks on results indicators (quantitative and qualitative) which allows the identification of deviations and determines the need for corrective action. For accountability mechanisms to be efficient a central unit specialized in the oversight and control of the operations of the businesses/agencies is required.

Summary of the Elements for Improving Local Institutional Performance

The problems affecting local public administrations in Latin America are significant, however things may not be as bad as they seem. Central governments have not performed well in delivering services. The devolution of authority and the onset of electoral accountability mechanisms for subnational governments have been quite recent in most cases. Therefore, it should not be surprising that the process of building capacity would take some time. The devolution of functional responsibilities has frequently been driven by political expediency and, in many occasions, resulted in the establishment of a broader intergovernmental framework that produces disincentives for improved performance. Thus, the initial slowness of local governments to respond to the new challenges is due to the distorted incentives arising from poorly specified and separated responsibilities, inadequate regulatory frameworks, and/or imbalances between expenditure responsibilities and available resources.

Creating incentives for improved local government performance depends not only on the establishment of a more rational and clearly specified framework of intergovernmental relations and more effective institutions for citizen participation and representation, but also on more effective and finely tuned public management systems. Patronage-based personnel systems need to be transformed into ones that take labor needs, individual merit, and incentives for good performance fully into account. However, to create a capable public administration staffed by adequately trained, well-motivated, and properly directed individuals, requires reforms not only of personnel norms and procedures, but simultaneous and coordinated changes in other public management areas, including policy-making and strategic planning and evaluation systems. In order for public agencies to perform efficiently—that is, to adequately meet the objectives they are designed to achieve—the diverse management systems must generate incentives that lead the individuals within the organization to work in reasonable harmony and with reasonable competence and effort.

The effectiveness of local governments in managing revenues and expenditures is constrained by the limited discretion given them in selecting tax bases, in assigning tax rates, and, in choosing how to spend funds transferred from the central government. However, the problems stemming from the structure of intergovernmental fiscal relations are often exacerbated by the deficient local capacity to maintain and utilize reliable and up-to-date taxpayer data, to enforce fulfillment of tax obligations, to integrate information on the revenue side with that on the expenditure side, and to efficiently and accountably allocate public resources among sectors and programs. Transparency, reliability, and comparability in budgetary information are not only a prerequisite for efficient revenue collection and budget implementation, but also a key factor for promoting the accountability of the government to citizens via electoral and other participatory mechanisms.

Given the diversity of country conditions, the varied causes of deficient performance in specific areas of governmental activity, and diverse governmental priorities, it is not possible to develop a general approach to building institutional capacity at the local level. However, it is clear that the desired managerial systems and the nature of the incentives for promoting good performance vary according to the type of public intervention being addressed.

Given the complex, yet predictable nature of the governmental function of delivering public goods and services not readily amenable to market competition, it must be ensured that appropriate personnel policies are in place in respect to the professional providers of the public service and that a relatively non-hierarchical and non-bureaucratic authority structure exists. For goods and services that are amenable to market competition it is possible for the government to devolve responsibility for direct management to public stock companies or semi-autonomous or autonomous agencies. If the government is to effectively perform this task of indirect management it should ensure: i) that such agencies assume the responsibility for all of the functions necessary for the production of the public good or service or final output; ii) that while the management responsibilities associated with these core functions are fully devolved, the policy responsibilities are retained by the government; iii) that the degree of autonomy granted the directors of the agencies is tailored to the outputs being produced and the specific conditions for effectiveness and efficiency; and iv) that the government has sufficient capacity to supervise the agency's compliance with the basic rules of the game and to enforce necessary adjustments in the agency's performance.

7.

Lending to Subnational Governments: Developing a Hard Credit Discipline

CHAPTER SUMMARY

From the system of financing subnational activities emanates a significant part of the structure of incentives under which local decision-makers operate. As discussed in Chapter 4, established practices need thorough reforms to create the right set of incentives. Own sources of revenue need to be developed in synchrony with intergovernmental transfers so that the latter do not displace the former. The transfer mechanisms used establish another layer of incentives inasmuch as tied transfers may encourage the overprovision of certain services to the detriment of other community priorities. General budget transfers provide more room for the expression of local preferences and are preferable although they reduce the capacity of higher tiers of government to attain specific sector objectives. Borrowing by subnational governments is a powerful tool of financing, but poses potential problems when used where: (i) subnational governments are not subject to hard budget constraints, (ii) capital markets fail to impose a hard credit discipline, and (iii) officials are not fully accountable to their constituencies. Developing an efficient and equitable system of financing for subnational governments should be a priority for design and implementation of decentralization programs.

Support for a Hard Credit Discipline

Responding to the expanded functions entrusted to subnational governments, the largest and strongest states and municipalities are increasingly financing their investment programs with borrowing, mostly from national banks and financial institutions and lately in the capital markets. This trend creates an opportunity for private investment in local infrastructure, a major step in financing decentralization. However, this

option is limited to creditworthy subnational governments that are able to borrow.

A preliminary survey of the financial condition of subnational governments shows that few have the degree of creditworthiness needed to access domestic capital markets. In fact, the great majority of the municipalities lack the capacity to borrow. Their local economies do not support a large enough tax base or the wherewithal to recover cost from beneficiaries. Further, they do not have the institutional capacity to undertake the level of project planning, implementation and operation usually required by financial institutions. As a result, they are now and are likely to remain unable to borrow. They will rely mostly on transfers to finance capacity expansion plans. A number of poor and institutionally weak states and provinces face similar problems.

For subnational governments that have the ability to borrow, putting in place conditions that promote a hard credit discipline will effectively complement reformed intergovernmental relations and democratic governance in establishing the appropriate incentives. As the discussion in previous sections shows, even for these subnational governments, general financial management restructuring is needed before considering a major municipal capital markets access initiative. There are a handful of municipalities and states that can today access local or international capital markets. The limited experiences of Buenos Aires, Bogota, Rio de Janeiro or Sao Paulo indicates that these governments have obtained funds on good terms but also points to the narrow conditions under which private lenders were willing to lend. Events of the past year, including the defaults of several states, suggest that true market readiness might be even less attainable than originally thought.

There is an opportunity for expanding the role of private lenders in financing subnational infrastructure investments. Seizing this opportunity requires a concerted effort to prepare these borrowers to satisfy the creditworthiness conditions of lenders. This section proposes a framework to promote lending to subnational governments based on a gradual strategy. Under this approach, a technical assistance program to develop the different aspects that support creditworthiness from the perspective of private lenders would guide sub-sovereign governments. After achieving a reasonable degree of creditworthiness, subnational access to capital markets would then be assisted by a credit enhancement facility, which could take many forms. The analysis favors national level mechanisms jointly capitalized with national governments but involving a strong element of private sector management and decision-making. Guarantees for the facility would be tailored to each market, but should be partial in nature and focus on credit support and maturity extension. The program, whose characteristics will vary from country to country, must also focus on building sustainable local markets; that is, ensuring that there are a healthy number of issuers consistently accessing the market. Finally, because local finance often has direct political ramifications, the program must be coordinated with national governments, national development banks, and other multilateral development institutions operating in the country.

The Foundations of a Hard Credit Discipline

The Bank faces a significant challenge in aligning its lending operations to subnational governments with the general approach advanced in this paper that centers on generating the right incentives for subnational governments to behave in an economically efficient, fiscally responsible and transparent manner. The solution to this challenge lies in promoting a hard credit discipline on the actors involved, including local financial intermediaries, subnational governments and multilateral development banks. The proposal rests on the proposition that instilling creditworthy values and practices in the system will break the barriers that constrain financial opportunities for subnational governments.

The factors that give rise to a “hard credit culture” are those systemic elements that help to mitigate risk and generally encourage the repayment of debt on time and in full, and discourage delinquencies and defaults. As figure 6.1 demonstrates, these factors can be grouped into the following pillars that sustain a hard credit culture.

Improved intergovernmental relationships (as discussed in Chapter 4) generate the favorable environment for strengthening the financial capacity of subnational governments. Some of the key elements include the legal and policy framework that facilitates local borrowing, debt servicing, and revenue sourcing. Attention should be given to the development of a stable and predictable intergovernmental fiscal system that provides shared revenue and/or the capacity to raise own-source revenues that reasonably match the needs and responsibilities of local authorities. Unambiguous legislation and legal provisions regarding the authorization, treatment and use of subsovereign debt is a critical element in facilitating the development of a subsovereign financial market. Of particular importance is clear legal authorization for subnational governments to incur debt and pledge collateral to secure that debt. In addition, investors must be comfortable with the legal process that governs the enforcement of security claims. Furthermore, the legal ability to incur debt must be accompanied by a regulatory framework that encourages responsible use of debt. This might include regulatory limitations and enforcement measures on all forms of indebtedness for subnational governments, and possibly negative consequences for local borrowers in the event of nonpayment.

Local authorities must have the *institutional capacity* to fully execute the responsibilities that they are being assigned. As discussed in Chapter 6, consistent accounting, auditing, budgeting, tax administration, reporting mechanisms and internal controls for municipalities and municipal enterprises must be established, along with appropriate disclosure standards.

Increased private sector involvement in the financing and provision of subsovereign services

can create the incentives for these entities to build their financial capacity to source low-cost funds with adequate tenor in the private financial market. This is a significant challenge for local authorities that do not have the credit history and credit culture needed to secure the levels of funding necessary.

The development of local financial markets, particularly capital markets, including the supporting legal and regulatory infrastructure (such as rating agencies, underwriters, bond insurers) is the fourth pillar of a hard credit culture. Shallow local capital markets are a major obstacle to encouraging private financing of local entities to provide infrastructure. Mechanisms that enhance the creditworthiness of local entities should address both perspectives of the problem: limited financial capacity on the demand side and constrained market interest from financiers on the supply side. Capital markets often begin to develop in economies faced with increasing demand for local and regional infrastructure.

The overall hard credit culture framework described above sets the parameters for an efficient subsovereign financial system. In addition to these systemic factors, which can be used as a basis for assessing subsovereign risk, there are also transaction-specific factors that must be considered.

TRANSACTION-SPECIFIC RISK ASSESSMENT: EVALUATING CREDITWORTHINESS

Lenders and guarantors will need to focus on the identification of a set of borrower-specific credit risk evaluation factors. As shown in figure 6.2, in underwriting credit transactions, particularly for subsovereign projects, close and often complex interactions occur among the concepts of willingness to pay, ability to pay, and essential

ity. Together, these three factors are used to guide the assessment of subsovereign risk.

Willingness to Pay. This concept refers to the political will of borrowing entities to repay debt, including the ability to charge appropriately and receive payment for services provided. Among the measures of credit quality included in this concept are:

1. The strength of the overall legal and regulatory environment;
2. The strength of specific legal obligations to repay debt;
3. Expressions of political commitment by citizens and/or their legal representatives;
4. Demonstrations by decisionmakers of their political capacity to raise taxes or rates; and
5. The financial performance of the debtor during prior periods of political or economic stress.

Ability to Pay. Ability to pay assesses a borrower's actual capacity to repay debt. This concept summarizes a second cluster of basic credit quality indicators, including:

1. Measures of the social and economic base of borrowing jurisdictions;
2. The ability to levy and collect taxes and/or other revenues;
3. The financial and procedural ability to apply collected revenues to the payment of debt service now and in the future, as measured by the analysis of the structural flow of funds;
4. Assessments of management and governance;
5. Measures of the anticipated financial performance of borrowing jurisdictions; and
6. Reasonable projected demand and revenue estimates.

Figure 7.1 The Hard Credit Culture Framework

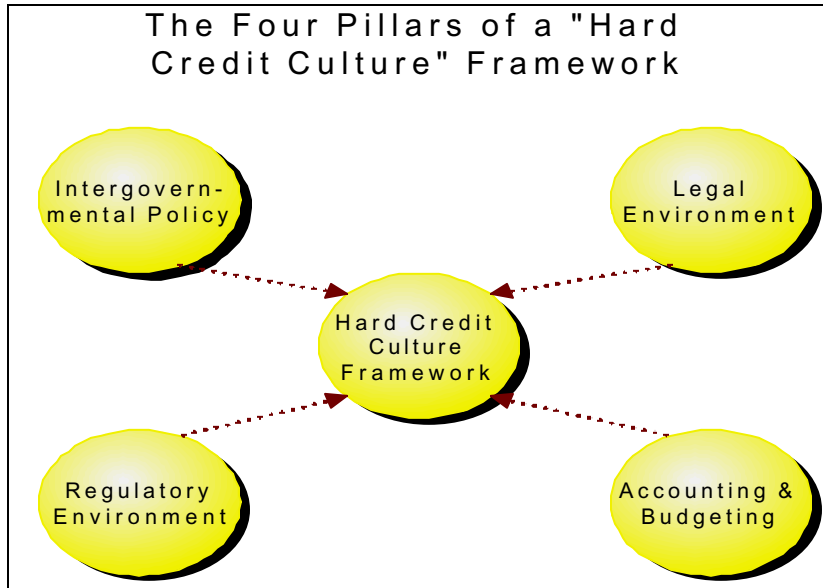
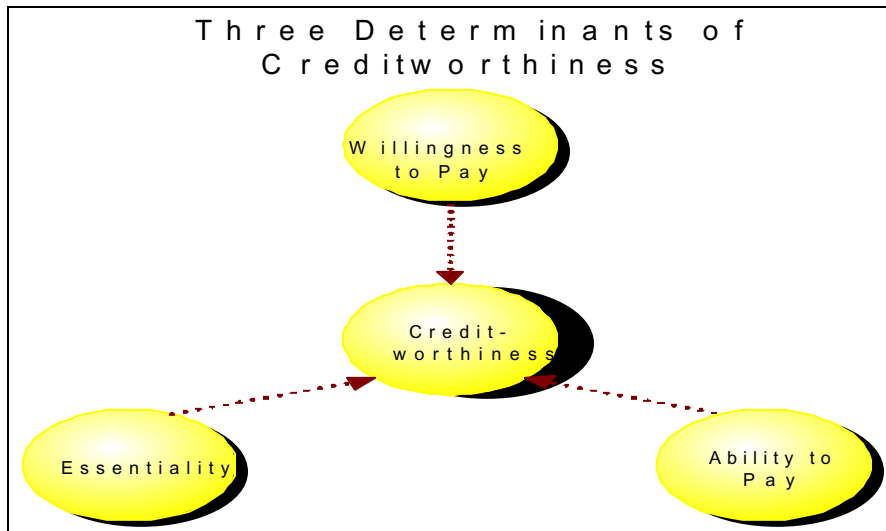


Figure 7.2 Determinants of Creditworthiness



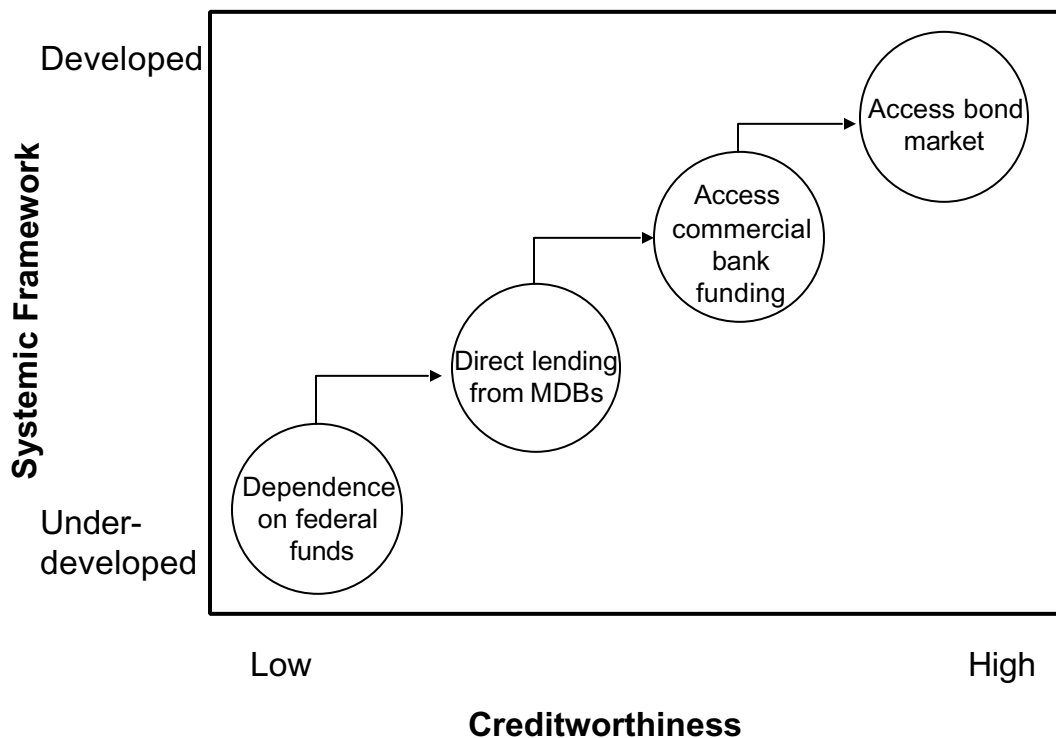
Essentiality. The concept of essentiality captures a third set of indicators concerning the priority that decisionmakers can be expected to place on specific public facilities or other assets. Indicators of essentiality include:

1. Close association with public health, as with basic water and sanitation facilities;
2. Basic educational or training value, as with elementary, secondary and other fundamental educational institutions or equipment;
3. Close association with public safety and the rule of law, as with police, fire, judicial and similar facilities and/or equipment; and/or,
4. Provision of utilities deemed fundamental by most citizens, a definition that in developed countries like the United States will include electricity, gas, solid waste, water, sanitation and even telecommunications, but which may vary somewhat in other countries.

Impact on Potential Sources of Funds

The assessment of subnational governments based on the framework described above determines the potential funding sources available to these entities. As figure 7.3 indicates, this depends on the relationship between the level of development and the degree of creditworthiness. The result is a stepped course that begins with complete dependence on central government funding and culminates with direct subnational access to bond markets. As national systemic frameworks become more developed and subnational governments become more and more creditworthy, they will enjoy access to a greater pool of credit. Borrowers will move from relatively limited and inflexible sources of credit to larger and more diverse funding sources. This will be maximized when subnational governments have the ability to consistently access private financing through commercial banks and bond issues in local capital markets.

Figure 7.3. Potential Sources of Financing for Subnational Governments



Credit enhancement can play an instrumental role in the development of subnational financial markets. In figure 6.3, credit enhancement can be employed to boost sub-sovereigns along the steps to cheaper, more efficient, and larger pools of funding. For issuers, credit enhancement has the potential to facilitate access to capital markets, broaden investor participation, and lower the cost of funds. For investors, credit enhancement serves to decrease the risk profile of the transaction by allocating risks (commercial, political, financial, etc.) to the party best suited to manage it.

In Latin America credit enhancement can be instrumental in introducing the more creditworthy subnational governments to the markets. It can form the basis of nascent domestic financial markets, while at the same time demonstrating the value of creditworthiness to other subnational governments. Examples of credit enhancement mechanisms that might be applicable to Latin American subnational governments include revenue intercept mechanisms; over-collateralization; guarantees; letters of credit; debt service reserve accounts; pooled-risk mechanisms; and bond insurance.

Not all of these credit enhancement mechanisms are consistent with providing decisionmakers with incentives to adopt fiscally responsible decisions. Transfer intercepts have been used as a short cut to provide security for subnational loans; however, this practice has serious drawbacks in the long term. Fundamentally, it reduces the incentives for private lenders to fully assess the risk posed by individual subnationals, thus weakening the borrowing discipline that the market can exercise. Committed to promote a hard credit discipline for subnational governments, the Bank does not advocate the use of the intercept when its use discourages lenders from assessing the full risk presented by subnational governments. For the intercept to bring to bear its potential benefits, it should be capped on the basis of a small proportion of own revenues and used only when subnational indebtedness is fully disclosed. There are other options that may achieve the same results without using the intercept, for instance the establishment of irrevoca-

ble trust funds by subnational governments to guarantee repayment of loans.

An Agenda to Support a Hard Credit Culture

The previous section of this chapter has outlined the prerequisites for development of a hard credit culture. This section provides four principles that make up a finance program that could be implemented in almost every Latin American country and is consistent with the Bank's larger development agenda

Focus on Creditworthiness and Self-Sustainability. At the core of a development agenda should be the emphasis on self-sustainability. In subnational finance this refers to an agenda to promote creditworthiness. This does not mean that all revenues must come from the locality, or that expenditures have to be drastically cut to meet an arbitrary budget. Rather, it implies that an operating budget should be rationally balanced between intergovernmental revenues and local taxes; that tax administration should be effective and efficient; that an investment budget should be financed with a reasonable issuance of debt, and also that user fees should be charged at appropriate levels.

Employ a Graduation Strategy. A vision for subnational finance should be that states and municipalities eventually graduate to self-sufficiency. The basic map is a path that leads from dependence on central government transfers to capital market access, with all progress based on creditworthiness. For the larger and financially more capable subnational governments, the Bank should steadily move from its current lending to government-owned financial intermediaries, to a second step focused on credit enhancement mechanisms to bridge the gap between subnational governments' existing debt issuance capacity and local capital markets. Initially, only a handful of states and local governments in each country would qualify for the credit enhancement vehicle, while most would be best served by direct lending coupled with technical assistance. Inevitably, some of the poorest subnational governments would remain

financially dependent on the national government for the foreseeable future.

Develop Private Sector Intermediaries. In addition to assisting localities with creditworthiness issues, the Bank program also needs to support the formation of private sector intermediaries that act as brokers, developers, feasibility consultants, and trustees. This does not mean that the Bank will fund these private sector agents, but rather that lending and credit enhancement mechanisms should not pre-empt and, in fact, should encourage these private sector participants.²⁵ A successful graduation strategy requires a system of private sector intermediaries with expertise in commercial banking, debt markets, or both.

Coordinate with Other Multilateral Financial Institutions and National Development Banks. Several multilateral financial institutions are pursuing a subsovereign finance agenda. Coordination between the institutions is important to avoid duplication of effort and/or contravening initiatives (see Chapter 8). In addition, current programs should be wary of activities that distort the market and do not promote creditworthiness. The current Bank approach to avoid subsidized lending and focus on market rate loans coupled with grants, point in the right direction. This creates a competitive environment where private sector banks can provide the loan and creates marketable loans for future securitization.

Close coordination with the various national development banks is also important. As the MFIs may be implementing a lending program with national development banks, they must be sensitive to the challenge of operating a subsovereign program outside of their customary

²⁵ Two examples are useful to consider. In Guatemala, INFOM does much of the feasibility analysis and also holds all of the credit information on cities. Consequently, no brokers exist to develop municipal transactions, and few feasibility consultants exist to allow commercial banks and institutional investors to assess the value of particular projects for which cities want to issue debt. In Mexico, no municipal debt bankers exist because BANOBRAS is a direct lender to states and cities. Consequently, almost no commercial lending exists for municipalities.

channel of distribution.²⁶ If possible, technical assistance initiatives should be designed and implemented in close concert with the development banks. Direct lending should operate as independently as possible.

A Three-Pronged Agenda

In light of these four reform principles, a three-pronged subsovereign program consisting of technical assistance, direct lending and credit enhancement is advisable.

The Technical Assistance Program

A core part of any financial reform program for subnational governments must be a comprehensive technical assistance program. Technical assistance programs and delivery mechanisms will have to be custom tailored for each country, but should be guided by a general framework.

Comprehensive Support to Budget and Finance Activities for Self-Sustainability. For states and municipalities with a history of lack of control over the major components of their budgets and finances, the first step is to implement a program to develop responsibility and accountability in all key parts of the planning, revenue and spending components of the local government administration. The goal should be a comprehensive reform that incorporates meeting benchmarks on an agreed upon continuum toward self-sufficiency. While it is likely that governments will take different approaches to implementation of technical assistance programs, the core areas for reform targeted by these programs should be consistent across all countries. The programs should consist of four main areas: revenues, expenditures, investments, liability management and political risk.

Revenues. In some countries, especially those where taxing authority is being devolved in tandem with expenditure responsibility, the most

²⁶ If the national development bank perceives these initiatives as threatening, the response may be to undercut the MFI direct lending or credit enhancement program with heavily subsidized funds and looser credit criteria, resulting in a defunct MFI program.

important area requiring technical assistance will be tax administration. Local independent authorities, such as water authorities, also need assistance in establishing efficient fee collection mechanisms to reduce under-investment. Efficiency improvements will lead to increased revenues without requiring new or higher user fees.

Expenditures. In a decentralizing system, the management of an increasing array of expenditures can be a fundamentally new activity for states and municipalities. The implementation of budgeting and control systems will be a major activity in these places.

Investment. The capital expenditure process will involve creating a medium-term plan based on a needs assessment for the state or city. Many of the current planning systems in place have only a vague relationship to the actual capital expenditure process. New systems will have to be implemented.

Liability Management. The main new local activity will be the management of the liability side of a government balance sheet and the development of a sustainable financial strategy.

Political Risk. It will be necessary to develop safeguards and institutional arrangements against interference for lenders rights due to political instability and constraints

Focus on Systemic Factors. The Bank will focus its assistance on strengthening the areas that make up the foundation of a hard credit discipline. In addition, the Bank will support the reforms required by the financial and management mechanisms to enhance subnational borrowing from capital markets. Some of the specific considerations include improved intergovernmental relationships, institutional capacity, increased private sector involvement and the development of local financial capacity.

Improved intergovernmental relationships will generate a favorable environment for strengthening of the financial capacity of subnational governments (see Chapter 4). Local authorities must have the necessary *institutional* capacity to

fully execute the responsibilities that they are being assigned. *Increased private sector involvement* in the financing and provision of local services can create incentives for subnational governments to strengthen their financial capacity to source low-cost funds with adequate terms in the private financial market. This is a significant challenge for local jurisdictions that do not have the credit history and credit culture needed to secure the levels of funding necessary. The foundations for accessing private funding are laid out by comprehensive support to budget and finance activities for self-sustainability already described. *The development of local financial markets*, particularly capital markets, is especially important. This includes the legal and regulatory infrastructure such as rating agencies, underwriters, and bond insurers. In this area, the recommendations of the Bank's *Capital Market* and *Financial Market Strategies* should be followed. Shallow local capital markets are a major obstacle to enhancing private financing for subnational government activity in infrastructure provision. Mechanisms that enhance the local entities' creditworthiness should address both perspectives of the problem: limited financial capacity on the demand side and constrained market interest from financiers on the supply side.

In addition to these systemic factors, which can be used as a basis for assessing subnational risk, there are also transaction-specific factors that must be considered. It is essential to create the conditions under which lenders and guarantors of subnational debt focus on borrower-specific credit risk evaluation factors (including willingness to pay, ability to pay, and the priority placed by the community on the investments to be financed) and undertake their own due diligence.

The Direct Lending Program

The direct lending program would take different forms in different countries in recognition of the varying levels of development. However, there are key elements that should form the core of the program, regardless of country of implementation.

Focus on Essential Infrastructure. Apart from being almost the only area of subnational financing for which borrowing is efficient, lending focused on essential infrastructure allows for relatively simple prioritization among projects by the community, and simple testing of the criteria of willingness to pay and ability to pay.

Conditionality Leading to Graduation. Conditionality should concentrate on graduating borrowers away from national municipal banks and multilateral support. Loan conditionality should include a commitment to adopt reform programs that will lead to self-sufficiency within several years and to graduation from development bank lending to the capital markets or bank loan market.

Bank Lending. The traditional lending program will aim at strengthening the financial autonomy of subnational governments as well as their capacity to access capital markets. It will be directed at fostering private sector participation in financing infrastructure and the expansion of services provided by subnational governments. Bank lending should also be used to strengthen institutional capacity to enhance the delivery of these services.

Lending with Sovereign Guarantee. All Bank loans to states, provinces and large municipalities have been provided with full guarantee from the sovereign. The Bank will continue this practice and no loans will be provided to subnational governments without the central government guarantee. There are no advantages to Bank lending without this guarantee. All of the Bank objectives concerning subnational development can be accomplished through operations with sovereign guarantee. Furthermore, under the faulty inter-governmental relationship structure that exists in the countries of the region, lending to subnationals without the guarantee may lead to moral hazard. The externalities involved in cases of subnational default on a loan with the Bank will lead a central government to provide a bail-out in order to prevent a default from affecting future access to Bank loans by other subnational governments. This amounts to an implicit guarantee on the part of the sovereign. Explicit, negotiated and well-priced guarantees are preferable and the Bank

will continue its current practice of requiring these guarantees.

The Role of Government-owned Financial Intermediaries. The Bank will consider financing municipal development funds and other government-owned and or managed financial intermediaries only as a temporary step to target market failure. This approach will be pursued when private markets are unwilling or unable to provide a particular service and these activities would not distort market functioning. These activities will also be justified when local capital markets are shallow and lack the institutions capable of lending to subnational governments. Bank operations will follow the *Financial Markets Strategy* that states that Bank operations with publicly owned and managed financial intermediaries must be based on an understanding of the incentives facing public banks and the comparative advantages they may hold vis-à-vis private banks. Their inherent corporate governance problems, including conflicts of interest, moral hazard and adverse selection, need to be addressed directly. Bank operations should work to eliminate these distortions supporting either their privatization or conversion into second tier banks for the period in which they are needed to facilitate the flow of long-term external funds to the private sector at market conditions. Bank operations in support of these institutions will include measures to prepare them for privatization at the earliest possible date.

The Credit Enhancement Program

Credit enhancement mechanisms are required whenever the undeveloped nature of local financial markets makes private investors unwilling and unable to accurately underwrite subnational credit risk. To address this market failure, governments may institute credit enhancement mechanisms to attract private investment and improve creditworthiness. Options include direct guarantees and structured finance techniques like reserve funds and over-collateralization. To avoid moral hazard the credit enhancement strategy needs to rest on credit criteria based on commercial terms, which involves identifying risks in advance, and ensuring that they are reasonably priced and that the structure of all agreements is negotiated in great detail.

Why Credit Enhancement? One of the most powerful tools that a multilateral institution can use is its ability to bring to bear various types of credit enhancements to attract private investment into subsovereign finance and to induce governments to adopt policies that increase creditworthiness. The Bank could develop a credit enhancement product to meet the needs of countries that have developed systemic frameworks and have achieved a basic level of creditworthiness. The objective of the credit enhancement product should be to facilitate subnational government access to the local capital or commercial bank markets. Credit enhancement is the application of some form of credit support to a loan or bond to improve its rating, lower its interest rate or extend its maturity. There are many mechanisms through which credit enhancement can be delivered: direct guarantees, structured finance techniques such as reserve funds, or over-collateralization. However, developing an overall credit enhancement strategy is probably more important than the specific mechanisms used to achieve it.

The starting point for discussing credit enhancement is to argue that it is not needed because the market should price the real risk of a debt issue. However, due to the undeveloped nature of local financial markets, private investors have been both unwilling and unable to accurately underwrite subsovereign credit risk. As a result, a number of national lending institutions have been created to address this market failure. However, most attempts on the part of governments or development agencies subsidize the credit risk and further distort the allocation of capital, creating various forms of disincentives for improved credit management on the part of the state or municipality. Although the foundation for any effective credit enhancement mechanism should be to effectively price the risk it is absorbing, the dominant situation in most Latin American countries is that in the near future there will be a gap between the level of creditworthiness of even the best localities and the investment grade requirements by institutional investors. The new mandatory pension funds are the natural source of long-term funding for municipal capital investment needs and are probably the only source large enough to

meet existing investment need. Therefore, credit enhancement that would stimulate private sector availability to discriminate among a wide range of potential borrowers is a logical transitional tool to link pension funds to municipalities.

The Moral Hazard Problem. The central problem of credit enhancement is moral hazard. Essentially, if investors rely on a guarantee, whether full or partial, lenders will adjust the quality of their due diligence to match the expected loss under the guarantee structure. This reduces the pressure faced by investors, and it shifts the responsibility for creditworthiness to the credit enhancer. If the credit enhancer is a government agency or wields strong political influence, it will be difficult for it to maintain commercially viable standards in the long run. A likely outcome is that the credit enhancer ends up lowering its standards, allowing localities to incur too much debt, and ends up having to be bailed out itself. The key to a successful credit enhancement strategy is to maintain the credit criteria on commercial terms. To identify risks in advance, it must ensure that they are reasonably priced and the structure of all agreements is negotiated in great detail.

Potential Forms of Credit Enhancement.

The definition of this product line is one part of implementing a credit enhancement or capital markets graduation strategy. There are eight important parameters for a credit enhancement facility that are defined below.

Direct Individual Guarantees vs. Funding Facility. The Bank can issue direct guarantees with a national government counterguarantee or it can capitalize a national or regional guarantee facility. Operating on a project-by-project basis, the assumption would have to be that only a few large projects could be completed each year, which negates a comprehensive market development strategy. Funding a facility is analogous to wholesaling a guarantee, which would require the approval of a uniform retail guarantee product. This approach would facilitate greater volume and deeper private sector involvement.

Individual Issues or Bond Bank. Credit enhancement could apply to each individual issue as it is sold into the market or could be operated through a conduit, such as an accumulation or bond bank that creates both greater diversity and volume.

Full Guarantees. The simplest form of credit enhancement is a full guarantee of timely payment of principal and interest. This is the easiest way to get an AAA-rated debt instrument using a financial guarantee. However, full guarantees works against the main objective of the development exercise that is to have investors make the market self-sustaining by enforcing on-going financial accountability on the part of localities. Given this policy goal, full guarantees are probably best left to those markets with the strongest basic debt markets, where commercial insurance vendors can offer a product that always has an uninsured alternative. In these markets, full guarantees can offer the issuer or the investor a higher degree of liquidity at a price that is more likely to result in sustainable risk management.

Partial Guarantees. Development banks have generally preferred to use partial guarantees, one for risk and one for credit. Adopted by the World Bank and the IDB in 1993, the implementation of the partial guarantee program has been problematic for a number of reasons. One is that it was intended for projects that would otherwise be unable to obtain financing on commercial terms. Another was that they require a government counterguarantee. Nevertheless, a product line of partial risk could play a catalytic role because it allows for the disaggregation and discrete identification of particular risk components of transactions as well as for appropriate risk allocation.

By Type of Risk (Partial Risk). Investors typically desire coverage of regulatory, political, and performance risks. Partial risk guarantees ensure payment in the case of default resulting from the nonperformance of contractual obligations undertaken by governments or their agencies in private sector projects. For example, the investor may be concerned about several specific risks in a municipal project. A water district may

have only just implemented a tariff reform and the investor may have concerns about a tariff roll back if political pressure on the district is strong. An investor may want assurances from the national government that the current levels of intergovernmental revenue will not change dramatically over the term of loan. Debt service payment may be dependent on a project completion, and the investor may want to be insulated from this risk.

By Maturity of Risk (Partial Credit). Partial credit guarantees cover all events of nonpayment for a designated part of a financing. These guarantees encourage extension of maturity by covering part of a financing typically the latter maturities. Partial credit guarantees extend the term and thus better match the liability with the economic life of the asset, thereby mitigating refinancing risk. A put to the credit enhancement facility is a useful product in this situation.

Hybrids – The EGAT Structure. Neither of the two products mentioned above gets at the fundamental level of credit risk of the municipality. To have partial risk coverage that affects the overall credit rating requires some form of hybrid coverage. An example is the recently completed structure used by the IBRD and the Government of Thailand for EGAT (the Energy Generating Authority of Thailand). In this transaction the IBRD insured the principal and the next interest payment due. If the government defaults on the interest payment, the IBRD pays the investor, and the government then has 60 days to cure the default in order to preserve the guarantee for the next interest payment. These types of guarantees can be extremely useful in raising the investor interest in municipal debt, while preserving the need to analyze fundamental credit risk.

Currency Hedge Products. Much discussion by states and large municipalities over the last few years has concerned international bond issues, in which case some sort of currency risk insurance would have great value. This may make sense in certain project finance transactions that earn foreign currency, but for local governments, whose revenues are generated in local currency, international bond issues present a high degree of

risk. Whether the Bank should offer a hedging product as part of the local credit enhancement package is a topic best considered after a local currency credit enhancement product has been implemented.

Credit enhancement may take many forms; however, certain forms are better suited to attain the development objectives described. For instance, guarantee facilities are to be preferred to direct individual guarantees that serve specific projects as the latter greatly increases transaction costs with limited benefits for development.

Wholesaling of guarantees through uniform products facilitate greater volume and deeper

private sector involvement. Bond banks can accumulate issues having greater impact through diversity and volume thus being more effective than individual issues.

Partial guarantees, one for risk and one for credit, are the form of choice of development banks and will be used whenever suitable, clearly indicating the specific events covered to avoid the Bank from assuming *de facto* risks for which it is not fit to handle. The clear identification of the specific events and risk covered also serves to correctly price the credit enhancement offered by the Bank.

8.

Assisting Subnational Governments: Instruments for Bank Support

KEY AREAS FOR BANK SUPPORT FOCUSING ON THE UNDERLYING INCENTIVE STRUCTURE

Decentralization in Latin American and the Caribbean is a well-established trend as many governments have demonstrated a strong resolution to devolve responsibilities and resources to subnational governments. The region's sustained democratization process is percolating from the national to the subnational level of government and provides the underpinning for the decentralization efforts. Many countries are perfecting the mechanisms that support local democracy providing communities with greater involvement in decision-making and oversight capacity.

Bank activity in support of subnational development should center on assisting countries to create the conditions under which subnational governments can take over expanded responsibilities in the promotion of economic development in their jurisdictions and in the provision of services and infrastructures to the population and economic activities. This requires a change in the way the Bank approaches lending for subnational development. Attention should shift from the current focus on financing the expansion of capacity and good financial management at the local level to address the system of incentives built into the different structures that determine subnational government outcomes in an integrated fashion. These are the structure of inter-governmental relations, the system of governance, the institutional capacity of subnational governments and the mechanisms for financing subnational entities.

The goal for Bank involvement is to contribute to the consolidation of subnational governments capable of obtaining the institutional and financial resources needed to discharge their responsibilities. This is a vast and complex undertaking

that requires coordinated long-term developments in the political, fiscal, institutional and financial arenas. Some of the required changes must take place simultaneously, thereby adding further complexity to the process. In facing this challenge the Bank can draw on its vast experience in municipal lending, and on knowledge and experience from a variety of other sources. The Bank can support governments in putting in place the required reforms through technical studies, policy advice and best practices, and will require, whenever necessary, that implementation of the reforms be made part of the conditionality of loans.

Pursuing the strategic focus proposed requires a shift in the emphasis in Bank lending for subnational development. The Bank should no longer lend just to expand municipal infrastructure but should also support solutions to the problems that distort the resource allocation process, or prompt fiscally irresponsible behaviors on the part of subnational governments. These issues lie at the core of the incapacity of subnational governments to provide services and maintain and operate infrastructures. Thus, current Bank practices in subnational lending will need to be expanded to address the core elements of the institutional framework resulting in unsatisfactory outcomes. Access to Bank programs is to be made conditional on firm commitments on the part of governments to undertake necessary reforms. Given the complexity of the issues involved and the encompassing nature of the reforms required, progress will take time. Bank support for subnational development should be structured accordingly, as a phased sequential program involving the coordinated use of the full array of Bank instruments

Conditions for Efficient Subnational Governance

The discussion in previous chapters indicates that the structure of incentives and the accountability of elected officials are critical to the functioning of subnational governments and for attaining the objectives of decentralization. The development and regulation of capital markets also play important roles in establishing the hard credit discipline required to make borrowing by subnational governments an efficient and equitable source of investment financing. These conclusions can be summarized as a set of conditions that must be met for decentralization to work.

1. Local democracies must work well and hold elected officials accountable for their decisions.
2. Transparency in transacting government business is essential for democratic oversight.
3. These conditions are the foundations of good fiscal management and accountability.
4. Subnational governments must have clearly defined responsibilities.
5. There must be a close correspondence between those who benefit and those who pay for government programs.
6. Subnational governments should face hard budget constraints.
7. Subnational governments must have the institutional capacity and resources to discharge their responsibilities at socially acceptable levels of performance.
8. Regulations and capital markets should impose a hard credit discipline on subnational government borrowing.

Helping the countries of Latin America and the Caribbean attain these conditions poses an ambitious development agenda for the Bank from which it cannot shy away. The mandates of the VIII Capital Replenishment see decentralization as an important step in improving social programs (IDB 1994, paragraph 2.12b). Further, the Report of the Working Group on the Institutional Strategy (IDB 1999, paragraph 3.51) identify decentralization as one of the important components of the modernization of the state

and an area where the Bank has a comparative advantage in providing support to borrowing countries. These priorities are reflected in the significant number of projects in the Bank pipeline that address issues of municipal development and reform of the state with a significant subnational focus.

Implications for Bank Support to Subnational Development

Supporting decentralization in Latin America and the Caribbean is a vast and complex undertaking. For the process to succeed, a complex set of developments in the fiscal, political and financial fronts need to take place. Some of the required changes must take place simultaneously, a condition that further complicates matters. In facing this challenge the Bank can draw on its vast experience in municipal lending, on the conclusions and recommendations of recent evaluations (IDB 1998), and on the knowledge and experience of a variety of international sources. However, even within its vast store of resources the Bank faces limitations. The limited set of instruments at its disposal and the small volume of lending relative to needs, force the Bank to select the areas of the decentralization process where the development impact of Bank intervention can be the largest.

Given the very large investment needs of subnational governments, the supply of funds to finance investments in infrastructures and services is clearly not an area where the Bank can have the greatest impact. Even using its full lending capacity to support decentralization for the years to come, the Bank would be able to supply only a small portion of the resources required to develop subnational institutions, provide services and expand social and economic infrastructure. To be effective, the Bank must focus attention where its resources can have a meaningful impact. This is where the proposed key areas for Bank involvement come into play. Focusing on creating the conditions for the countries to provide for themselves, in an efficient and equitable manner, the resources required by subnational governments to provide services and effectively manage local affairs involves an emphasis on the system of incentives that determines the per-

formance of subnational governments. The practical implications of the proposed strategic focus for Bank activities in support of subnational development are many.

Shifts in the Emphasis of Bank Lending

Pursuing the strategic focus proposed implies changes in the way the Bank engages in lending for subnational development. First, access to Bank programs would need to be made conditional to firm commitments on the part of governments to undertake the necessary reforms. These may be wide ranging, involving the structure of intergovernmental relations, subnational governance and its institutional setup as well as the regulatory and operational conditions for local capital markets to impose a hard credit discipline on subnational borrowing.

Second, given the interdependence that exists between the issues affecting subnational development, the Bank should avoid engaging in discrete projects that focus only on one aspect of the problem. The Bank should no longer lend only to expand municipal infrastructure and services leaving untouched the institutional issues that distort the resource allocation process or prompt fiscally irresponsible behavior on the part of elected officials. These issues lie at the core of the incapacity of subnational governments to provide services and maintain and operate infrastructures financed with Bank resources.

Third, Bank operations must engage all relevant central, state, and municipal entities that have an impact on the effectiveness of subnational governments. The institution building effort must also consider nongovernmental and civil society organizations that play a role in improving subnational governance.

Broadening the Themes Addressed by Bank Operations

The proposed strategic focus has implications for the scope of themes to be discussed with borrowing member countries while addressing subnational development issues. First, it leads the Bank to venture into the less traveled roads (at

least for multilateral development banks) of promoting reforms to the underlying incentive structure that determines the behavior of subnational governments. This requires the Bank to discuss with borrowing countries the system of intergovernmental relationships that determine whether or not the subnational governments face tight budget constraints or are face incentives that lead them to behave in a fiscally irresponsible manner. It also implies that the Bank should worry about the political system that determines the accountability of elected officials and the incentives they have to respond to their constituencies and behave in a fiscal and administrative responsible manner. Another area of concern is the legal and budgetary rules governing subnational government borrowing and the response of the local capital markets, factors determining whether or not governments and markets are imposing a hard credit discipline on subnational governments.

Second, the proposed approach places great emphasis on institutional development issues. The capacity of subnational governments to manage human and financial resources to respond to the needs and priorities of their communities becomes a central focus of development assistance. Few proven approaches exist to successfully venture into this complex field of work. Further complicating the matter is the fact that successful institutional development depends on changing human behavior, an endeavor that often requires long-term efforts. This may represent quite a challenge because countries often do not commit themselves to objectives or goals whose attainment calls for actions that go beyond the term of the administration in office. Further, traditional Bank lending instruments make fairly ineffective tools for supporting sustained long-term institutional development efforts. Loan appraisal and disbursement procedures work better in the case of discrete investments with clearly identified beneficiaries and benefits that accrue in the short term. For its part, institutional reform requires investing on a wide range of interrelated fronts with diffused constituencies and benefits accruing in the long term. Progress in an area that requires short-term sacrifices in search of long-term gains also requires strong and sustained political commit-

ment, usually in short supply in elected officials with short periods in office. Third, the strategic focus recommended in this document modifies the development role played by the investment resources provided by the Bank. From a simple vehicle to finance the expansion of infrastructure and services, investment resources become levers to induce the required institutional changes. This involves approaching lending with a different perspective. Investment money becomes a tool for promoting the structural reforms required to attain the regulatory and institutional environment leading to a self-standing process of subnational government development. The challenge is how to best use the leverage provided by this limited set of tools to induce the required changes in the system of intergovernmental relationships, the rules governing the activities of elected officials and the signals sent by capital markets to borrowing subnational governments. Under this perspective, the disbursement of Bank loans makes a secondary goal. Progress in project execution needs to be measured as a function of the institutional change accomplished rather than of the amount of resources lent.

Finally, the diversity of subnational governments that exist in the region poses an additional complexity to the attainment of the proposed strategic objective. Although the reforms to the system of incentives is a national responsibility, concrete measures and policies still need to be tailored to the circumstances of the different subnational governments. To the necessary diversification of rules, different approaches to institutional development must be added. While the institutional development of a large and resourceful state must be approached as a singular case, reaching the vast number of small municipalities will require national intermediation.

New Areas of Bank Development Assistance

Borrowing member countries require policy advice and best practice support to confront the complex challenge posed by subnational development. Country sector studies and subregional studies can be sponsored by the Bank to provide necessary inputs for policy dialogue and the design of country specific reform programs. The

Bank's project design and implementation will also benefit from a better knowledge of good practices in subnational development. The Bank is in a privileged position to identify and disseminate good practices in the fields relevant for the development of subnational governments.

Tailoring the Support Mechanisms

The complexity of the development agenda described is augmented by the diversity of subnational governments existing in the region and the variety of challenges they face in becoming efficient and equitable service providers. As discussed in Chapter 1, subnational government is a term that covers a wide range of institutions each with particular development needs. For the purposes of the present paper, five general types of subnational governments are worth considering.

States and provinces of federal countries sit at one extreme of the range of subnational authorities. There is a great variety in this second tier of government. Some states and provinces are larger than many Latin American countries while others are small and command fewer resources and institutional capacity than large municipalities.

Large cities and metropolitan areas vary greatly in size. Some are home to more than 10 million people, others have populations in the 4 to 6 million range and many have populations between 1.5 and 4 million. They are often managed by several subnational governments adding an additional layer of administrative complexity to the of managing infrastructures and services for such vast urban agglomerations.

Medium-size cities, with populations between 100,000 and 1.5 million, are numerous, play a significant role in the economy, and provide services to more than one third of the population of the region.

Medium-size municipalities with populations ranging between 10,000 and 100,000 inhabitants represent the largest single group of subnational governments, which also provide services to more than one third of the total population. Their

territories often contain a small city, several villages and significant rural populations.

Small municipalities with total populations of less than 10,000 are the largest subnational government group, yet they provide services to a very small percentage of the population.

This variety in type of subnational governments is compounded by the fact that some are rich while others are poor. Some have a strong local community spirit and some have none. Well-intentioned and trained people run many subnational governments, but incompetent and corrupt officials also do exist. Although the general rule is that the smaller the subnational government the weaker it is in institutional terms; there are well-run and efficient small municipalities and poorly managed large cities. This diversity in type of subnational government is seldom matched by an equally diverse set of management rules and policies to promote their development. One-size-fit-all legislation and policies abound, often impairing local development. Even though some subnational governments may manage to break out of the mold into which they have been put, most will not. Successful decentralization must recognize the diversity and heterogeneity of the universe of subnational governments allowing for an equally diverse and heterogeneous set of responses. At its best, such an approach can focus pragmatically on what may work, rather than on trying to force everyone into the same centrally determined box. Bank operations need to support the diversification of policies to match the variety of situations that exist in a given country. The diversification is also needed in the financial mechanisms used to lend Bank resources and to facilitate subnational access to local capital markets.

INSTRUMENTS FOR SUPPORTING SUBNATIONAL DEVELOPMENT

The Bank's Toolkit

The strategic focus proposed for supporting subnational development requires an integrated response by the Bank. The effectiveness of Bank interventions in promoting subnational devel-

opment will depend on its capacity to promote, in a coordinated fashion, the reforms required in a variety of fronts. These include, to name a few: the assignment of responsibility and resources among different tiers of government, rules governing transparency and accountability in subnational governments, developments in capital markets to expand lending to subnational governments, and comparable institutional development of the variety of entities that comprise the structure of subnational government in a country.

The above objective requires an integrated response by the Bank involving the coordinated use of all its available instruments: technical studies, policy advice, best practice research and dissemination, loans, and technical cooperation. Such level of coordination of actions is uncommon in the Bank. Further to fruitfully deploy a coordinated set of Bank instruments in support of subnational development, a broad agreement needs to be reached with the borrowing country that defines the objectives, instruments and sequencing of interventions and the Bank's role in supporting them. Only after such an agreement is reached will it be possible to identify the lending and nonlending products that the Bank can put at the disposal of the borrowing country to assist its subnational development efforts.

The coordination of Bank instruments in support of long-term country objectives in subnational development is taxing on Bank management. It involves guiding instruments as diverse as Bank sector studies and policy advice, loans to the government and subnational entities, loans to the private sector, technical cooperation and operations of the Multilateral Investment Fund so that they all work toward a common objective. Attainment of the above conditions has implications for most Bank activities, from programming to evaluation.

Programming

Policy Dialogue. The need for an integrated response on the part of the Bank places a significant toll on the programming of Bank activities in a given country. To incorporate the many dimensions of subnational development, pro-

programming exercises will have to be extended beyond the current sector-based and operation-focused approach of the country papers. The programming process should become a vehicle for an integrated discussion of the issues confronting subnational development in the country. In those countries placing a priority on Bank support to decentralization, programming exercises should lead to agreements on a long-term subnational development program. Inasmuch as this program guides national decision-making concerning decentralization, it constitutes a non-financial product of the Bank in support of the country. A second outcome of this exercise is a definition of the scope of the support (national, subnational levels), the topics to be addressed (intergovernmental relationships, governance, provision of services, and local economic development) and the sequencing of the Bank intervention.

Given the long-term nature of the interventions required to foster subnational development, the Bank's operational program will require a corresponding long-term perspective. This contrasts with the current three-year timeframe of programming exercises. When dealing with subnational development, Bank-country agreements will have to adopt a longer timeframe, even though the operational programs may be reviewed in three- to four-year intervals. One option is for the country and the Bank to agree on a multi-phased program engaging the key issues of subnational development with a sequence of interventions designed to accomplish well-defined objectives. This option is particularly taxing on the programming process and requires long-term commitments on the part of governments that are affected by frequent policy swings. The major advantage of this approach for the country is that it contributes to the stability of decentralization policies. For the Bank this approach allows individual operations to fit into a well-designed policy framework. This greatly facilitates the coordination of different Bank products benefiting the different sectors with an impact on decentralization. It also facilitates loan preparation, appraisal, negotiation and start up. The absence of a long-term view for the Bank's support to decentralization may reduce

effectiveness and make the loan design and negotiation process less certain.

Sector Work. A solid understanding of the issues confronted by decentralization is needed to support the proposed policy dialogue. In countries committed to decentralization and requiring Bank support, sector studies need to be completed in advance in order to support the policy dialogue. Useful country sector work includes technical studies, seminars and meetings with government officials to identify and promote policy reforms that foster the attainment of the government's decentralization objectives. Many topics need to be addressed. Reforms to revenue sharing mechanisms, to relevant local and national taxation, to the rules governing borrowing by subnational governments, powers, responsibilities and the legal framework for the management of local affairs, are but a short list of the themes that can be discussed and agreed at this stage. The sector work also helps to coordinate reforms promoted in subnational development programs with those planned or under execution in related sectors (like capital market promotion, tax reform and reform of the state) supported either by the Bank or other agencies.

Investment Lending

Lending with sovereign guarantees is the principal instrument available to the Bank to support reforms in subnational development policies. Traditional Bank operations finance the expansion of local services and infrastructure, and provide resources for institutional development activities. The strategic focus for Bank support to decentralization proposed in this document, calls for the diversification of Bank products offering to borrowing countries the whole array of instruments at the Bank's disposal. These include, sector reform loans for public utilities under the purview of subnational governments, reform of the state operations benefiting institutions central and subnational government institutions, institutional development and investment loans (multiphased or multiple works) to the nation, and states or provinces in federal states, reimbursable and nonreimbursable technical cooperation. MIF operations can support aspects of the reforms needed, in particular the

development of local capital markets and the enhancement of the regulatory framework for the privatization of municipal services.

The effective use of the instruments available to the Bank needs the agreed policy framework and multi-year program discussed previously. The defined objectives and goals implied in a clear policy framework allow the country and the Bank to select the most suitable combination and sequencing of Bank instruments for attaining the policy objectives.

The Scope and Content of Lending Operations

The scope and content of lending operations may vary significantly as a result of the differences in the issues faced and the capacity of the different types of subnational governments.

Large and resourceful states, provinces and municipalities may benefit from specific Bank loans guaranteed by the sovereign as it is currently done. Combining reforms, institutional development activities and investment financing, these loans are a suitable instrument to promote the development of subnational governments. However, loan preparation and assessment must address the intergovernmental relations and governance mechanisms framing the functioning of the subnational institutions. In a faulty framework, even the best-designed loan-supported program may end up just improving a grossly distorted and suboptimal system of subnational government.

Small and Weak Subnational Governments. At the other extreme, support to small, weak and mostly rural subnational governments may be best provided through centralized institutional support mechanisms and financed with well designed transfers. In this case, sector work and policy dialogue with the government should address the issues arising from the current subdivision of the territory, the size and buoyancy of subnational budgets, the assignment of responsibility among the different tiers of government and the capacity of the subnational governments to discharge these responsibilities. It is not enough to focus institution-building activities on the improvement of specific aspects of subnational governance like accounting and tariff

collection procedures. It needs to focus on the whole gamut of issues surrounding the delivery of critical services through dispersed and weak institutions.

Mid-sized Subnational Governments. These are the subnational governments that have benefited the most from municipal development loans executed through national intermediaries. The traditional municipal loans extended by the Bank that finance the expansion of services and infrastructure through multiple works programs are well suited to middle-sized subnational governments with sufficient institutional capacity. However, evaluations of dealings with less able subnational governments show disappointing results for the institutional development components. The reason for this lies in the fact that these operations have only occasionally addressed the system of incentives emerging from faulty intergovernmental relations and governance. This range of municipalities and states will benefit the most from greater decision-making autonomy and stability of resources, the expected outcomes of the reforms to the framework of intergovernmental relations and governance promoted in this document.

Large cities and metropolitan areas under the control of several subnational governments face complex coordination problems in the financing and delivery of services. The provision of sanitation, drainage and waste management services, public transportation, and pollution abatement, are but a handful of problems that can be resolved if the Bank promotes the appropriate institutional and financial mechanisms. These operations place emphasis on the governance structure. The establishment of efficient and democratic coordination mechanisms for the provision of services and the management of common affairs are the main development outcomes of these operations inasmuch as the volume of investment resources they require far exceed the lending capacity of the Bank.

Types of Lending Operations

In the array of Bank products, two types of operations stand out as particularly suited for promoting subnational development; namely, *pol-*

icity-driven investment loans and *multi-phase program loans*. The former place policy reforms at the center of its objectives, and the latter allow incorporating gradual policy reforms and institutional development to loan conditionality. Both mechanisms increase the capacity of the Bank to leverage investment resources to promote sector reforms and institutional development. In contrast, *time-slice* operations are less suited to the purposes at hand because they rely on well-structured institutional frameworks for the management of investment resources and delegate to the executing agency most operational decisions. Traditional *multiple-works* municipal loans lose much of their appeal when directed to the pursuit of the strategic focus proposed in this paper. Focusing on investment financing, this traditional Bank lending vehicle for expanding local services has a limited capacity to promote institutional development and none at all to act as a catalyst for policy reforms. Multiple works loans make effective instruments when the major objectives of the reforms are attained and the institutional setting for subnational development is on a strong footing.

The flexibility of *technical cooperation loans* and *reform of the state loans* makes them particularly well suited to support policy reforms and institutional development. *Learning and innovation loans* can also play a similar role at the early stages of implementation of a multi-phased program. They can be designed to finance the cost of administrative reforms and institutional re-engineering in addition to the technical studies and capacity building activities. Because they focus on institutional issues, these operations can play a critical role in the early stages of implementation of a multi-year Bank program and can be instrumental in preparing the groundwork for operations focusing on expanding local service capacity.

Development of a Window to Promote Innovation

Subnational governments are a source of innovations in service provision and institutional organization. This is a trend that can be supported by Bank operations provided that adjustments are made to the standard loan design and pro-

cedure procedures to suit the search and experimentation needs of innovation promotion. Municipal loans may include a new component to promote innovations, an “innovation-promotion window” to finance new approaches to service delivery. The window is useful because innovations cannot easily be accommodated in the investment expenditure category of municipal loans. Neither are they easily financed through the institutional development components that do not normally allow the financing of the capital investments often required to test innovations. The component could provide funds for institutional development and the initial capital investment required by projects that propose innovative approaches to service delivery at the local level. The resources of the window could be allocated through transparent and competitive procedures similar to those used to allocate research funds in science and technology programs. Funding may be partially nonrefundable because of the risks involved and the element of public good that innovations have when properly disseminated. Potential for replicating the innovations should rank high in the selection criteria and funds should be available to finance the dissemination process. Once tested, innovations can be mainstreamed and subject to standard procurement procedures.

Private Sector Lending

The Bank is using the private sector window to expand the volume of financing available to private investors in many areas of local responsibility that have been privatized. Examples include water treatment plants under private concession and urban toll roads. Justified on the principle of additionality (Bank involvement acts as a catalyst for private investment) the volume of resources that may be contributed by this line of lending is limited. In addition to supporting the privatization of local services, the most significant development impact of private sector lending in subnational development is to assist in creating the conditions for capital markets to take over subnational development financing. These characteristics make this lending window of limited significance for the implementation of the proposed strategy. Further, the institutional developments pursued by the sub-

national development strategy proposed are pre-conditions for the effective use of this line of financing. Thus, if support for reform is required from the Bank, it will have to come from other instruments.

The Multilateral Investment Fund

The MIF has supported two areas of concern for the subnational development strategy. One is the development of the institutional framework for the privatization of municipal infrastructure and services. The other is the establishment of institutional mechanisms for the promotion of subnational economic development. There is ample room for expanding these activities. Institutionally strong municipalities and states can benefit from the support provided by the MIF inasmuch as these activities are highly demanding on institutional resources. The support provided by the MIF to the development of national regulatory bodies concerned with privatized public utilities has a significant, albeit indirect, impact on subnational development. Similarly, the MIF provides support to the development of local capital markets.

Program Development Products

The Bank can also support the decentralization process, and the consequent development of subnational governments, with policy advice and good practice research and dissemination. The critical exchange of information, and the comparative analysis of experiences, can play a catalytic role in promoting more efficient decentralization efforts and perfecting ongoing experiences.

Products Generated in the Programming Process

The approach proposed to programming leads to two program development products. The technical studies completed as part of the recommended sector work and the program of interventions resulting from the policy dialogue. These are non-lending products that can promote decentralization and subnational development policies in borrowing countries. They will improve the understanding of the problems and

help sharpen the policies and reforms pursued by the governments. The operational program resulting from this process allows governments to coordinate activities and phase interventions, whether or not the Bank finances them.

Other Program Development Products

The Bank is in a privileged position to undertake studies covering a wide range of topics relevant for policy formulation and implementation. Studies on issues of regional interest (like the impact of central government bailouts on the fiscal discipline of subnational governments) or comparative studies of interest to specific groups of countries (like fiscal effort in federal countries) can make a significant contribution to the quality of policies and projects. Additionally, the Bank is also well positioned to identify and disseminate good practices in subnational development. These studies open the scope of solutions considered in subnational development programs and shorten the time required by innovations to take root.

THE INTEGRATED USE OF BANK INSTRUMENTS. EXAMPLES OF SUPPORT FOR EMERGING SUBNATIONAL CONCERNS

The coordinated use of the complex array of Bank instruments increases the advantage of providing assistance to subnational development efforts. Two examples illustrate the opportunities available through the proper coordination of instruments and also unveil the potential difficulties in achieving such coordination. However, since coordination affects the efficacy of Bank interventions in support of subnational development, the strategy advocates the coordinated use of Bank instruments whenever possible.

Local Economic Development

The Bank Group has several instruments at its disposal to assist subnational governments in fostering the economic development in their territories. These include *municipal development loans* that can finance improvements in infrastructure and local public services that are essential to the competitiveness of local firms.

Also pertinent are *reform of the state* programs to improve the efficiency of government and support the privatization and outsourcing of services. MIF-financed programs can support the strategic planning required to define a long-term program of joint private-public promotion of local economic development. Labor training programs can be designed to fit the partnership approach to training advocated by experts and adopted by the Bank.

The approach to be followed varies significantly depending on the context in which local economic development is attempted. Large metropolitan areas, by virtue of their complexity and size, will be interested mostly in expanding their competitive position as the location for high order command and control activities and the highly productive services supporting them. Their focus will be mostly on identifying a set of objectives shared by all stakeholders that provides political support to the investments required to improve the competitive position of the agglomeration. Strategic planning is thus a central initial activity followed by an investment program agreed with the private sector so that public investments are closely coordinated with private investments in new plant and services. Intermediate size cities offer the greatest potential for a productive partnership between the private sector and the subnational government to promote economic development. Such partnerships can be instrumental in promoting economic activities that reduce the cost of production to individual firms by allowing the outsourcing of services and production processes. Further, labor training programs can be set up in partnership with industry, improving their relevance for the local economy and ensuring the graduates are hired by local enterprises. More rural districts can also promote economic development by focusing on activities with high components of public good that cannot efficiently be undertaken individually by small and medium size production units. Examples of this type of activities are the acquisition and dissemination of new technology and the certification of the quality of local produce.

Regulating Privately Provided Infrastructures and Services

The Bank has gained much experience through municipal development loans in the traditional forms of infrastructure financing, including planning and evaluation of investments. More recently, it has acquired sizable experience advising and financing sector reforms in key areas of infrastructure provision (electricity, roads, energy, water and sanitation). The Bank assists not only in the consolidation of a new sector structure and regulatory framework, but also in preparing state-owned enterprises for privatization. Through its direct operations with the private sector it is enlarging its experience in innovative financing supporting a variety projects designed under different finance and construction structures (built-own-transfer, built-operate-transfer, etc.).

Considering this experience, the Bank is in a privileged position to expand its support for the privatization of local services and infrastructures. This can be stand-alone programs or a component of municipal development loans. The activities to be financed are those currently contemplated in sector reform programs assisting subnational governments to develop the institutional capabilities to take full advantage from privatization. This includes institutional strengthening for planning and executing privatization programs, expanding capacity to manage privatization contracts, funding for preparing government-owned enterprises for privatization, and infrastructure improvement and expansion to meet privatization criteria set by the national government.

Loan Execution Mechanisms and Government Sponsored Intermediaries

Traditionally, the Bank has turned to government-supported intermediaries to on-lend Bank resources to municipalities and provinces in multiple works investment loans. Municipal banks, first and second tier financial institutions and government agencies have been used to on-lend or transfer Bank resources to municipalities, states and provinces. These institutions face severe agency problems because they lack real

incentives to ensure the quality of the projects they finance. Bank loans often have allowed for the use of less than efficient mechanism for managing resources. Examples include the intercept of government transfers to secure repayment of loans and the use of interest rates that are out of line with those prevailing in local capital markets. This execution mechanism is justified on the absence of private institutions interested in or capable of working with subnational governments. The objective of operations that support decentralization must be to develop the hard credit discipline required for the resource allocation process to generate efficient outcomes. For this purposes, the central government plays a role in the prudent regulation of subnational debt issues and in ensuring that capital markets impose a hard credit discipline on subnational governments. However, government sponsored institutions will be needed in many countries as long as local capital markets lack the interest and capacity to lend to subnational governments.

The Bank will consider financing Municipal Development Funds and other government-owned and/or managed financial intermediaries only as a temporary step to target market failure. This approach will be pursued when private markets are unwilling or unable to provide a service and it can be proven that the activities would not distort market functioning. These activities will also be justified when local capital markets are shallow and lack the institutions capable of lending to subnational governments. Bank operations will follow the *Financial Markets Strategy* that states that Bank operations with publicly-owned and managed financial intermediaries must be based on an understanding of the incentives facing public banks and the comparative advantages they may hold vis-à-vis private banks. Their inherent corporate governance problems, including conflicts of interest, moral hazard and adverse selection, need to be addressed directly. Bank operations should work to eliminate these distortions supporting either their privatization or conversion into second tier banks for the period in which they are needed to facilitate the flow of long-term external funds to the private sector at market conditions. Bank operations in support of these institutions will

include measures to prepare them for privatization at the earliest possible date.

Execution of Institutional Development Components

Project financing and institutional development activities have few elements in common that justify execution by the same agency, yet many Bank-financed operations entrust execution of both components to the same institution, usually a government sponsored financial intermediary. This approach has worked to the detriment of institutional development. Financial intermediaries do not have the necessary ability or the structure to efficiently discharge institutional development functions like supporting project selection and preparation, and contracting training and institutional strengthening services. A clear separation of lending and institutional support functions is required in Bank operations that support of subnational development. Lenders should not be charged with the responsibility to ensure that the investment decisions made by subnational governments are realistic, a function better discharged by planning departments and elected officials. Furthermore, government effort to support institutional development at the local level can be better organized around institutions that allow the participation of subnational governments in their management and financing.

The national associations of subnational governments that have emerged and are acquiring increasing representation and institutional capacity are potential executors of Bank-financed institutional development activities. Variations exist among countries and this option may not be feasible everywhere. National associations of municipalities are members of international associations such as the International Union of Local Authorities (IULA) or the International Association of Capital Cities, benefiting from joint action. One example is the SERCADEL Program that promotes training and institutional development in several countries of the region.

Transparency and accountability in subnational government require information and analysis of subnational finances and institutional capabilities. This function can be better performed by

independent institutions that are financed jointly by the government and users. The design and start-up of these institutions' operations can be part of the execution mechanisms of Bank loans and their creation promoted whenever they make a suitable solution to the information problem. Bank operations also need to focus on the standardization of reporting procedures, a task that involves the national government and financial regulators. When necessary, these institutions must be incorporated into the execution mechanism of subnational development loans.

COORDINATION WITH OTHER DEVELOPMENT INSTITUTIONS

Other development institutions support the development of subnational governments in Latin America and the Caribbean. The Subnational Development Strategy seeks to coordinate activities with these institutions to avoid the duplication of efforts and take full advantage of the synergy created.

Multilateral Institutions

The World Bank is active in support of decentralization in Latin America and the Caribbean and has co-financed municipal and provincial development loans with the IDB in several countries. The most recent policy paper on the subject (World Bank 1999) acknowledges the growing importance of urban development and subnational government issues for attaining the socioeconomic development objectives of its borrowing countries and calls for a renewed assistance strategy. The aim of the renewed strategy is to promote sustainable cities and towns that improve the lives of the poor and promoting equity while contributing to the progress of the country as a whole. Based on the good performance shown by the urban development portfolio of the World Bank, the strategy aims at greater impact in supporting countries to tackle the urban transition process by focusing on cities. The objective is to promote the livability, competitiveness, good governance and bankability of cities. The building blocks of the strategy are support the formulation of national urban strategies and city development strategies as the

framework for planned intervention. Lending will focus on scaling-up services to the poor. Capacity building will focus on supporting intermediary networks for wholesaling the exchange of knowledge and expertise among subnational governments and other agencies involved in urban management and services delivery. These proposals are essentially compatible with the strategic focus proposed in this document since they recognize the need for longer-term commitments to sustain municipal policy and institutional reform. The World Bank works with specific cities in long-term partnerships to implement the strategy proposed.

The United Nations Center for Human Settlements (HABITAT) is active in municipal development in the region, concentrating on supporting efficient urban management. Apart from technical cooperation programs benefiting specific cities (La Paz/El Alto, Rio de Janeiro, Guayaquil) and national programs (resettlement in Guatemala, municipal support program of INURBE in Colombia) HABITAT has subregional and regional activities. These include the support to the Central American Center for Sustainable Development of Human Settlements, the Latin American and Caribbean Urban Management Program, the Urban Indicators Program and the Forum of Good Practices in urban management. All these activities are consistent with and complementary to the strategic approach proposed for the Bank in this paper.

The European Commission's URB-AL program aims to establish partnerships between cities of Europe and Latin America and the Caribbean to foster the exchange of experiences and develop themes of common interest in emerging urban issues such as drugs, conservation of historic areas, management and control of urbanization, urban mobility and the like. The URB-AL program is focused on specific cities and does not contradict the strategic focus proposed for the Bank, in specific instances it may reinforce it.

Bilateral Institutions

Several bilateral cooperation agencies are active in areas related to subnational development in the region; many have substantial programs.

USAID's Making Cities Work Program promotes effective city management by stimulating local economic growth, cost effective provision of urban services and environmental protection. The program supports projects in specific cities and, consistent with the proposed strategic focus for the Bank, emphasizes management issues for the sustainable provision of services, especially to the poor.

Germany's GTZ also actively supports municipal development in Latin America and the Caribbean. Based on a bottom-up approach, the focus of GTZ assistance is to facilitate community involvement in local affairs with a particular emphasis on the problems of the low-income households. The technical assistance provided by GTZ is complementary to financing provided by the KWA, focusing on the development of sustainable mechanisms for improving the living conditions of the poor.

The Swedish International Development Agency (SIDA) is active in low-income Latin American and Caribbean countries, mostly working with poor municipalities to improve the living conditions of the low-income population. The Canadian International Development Agency (CIDA) has provided assistance to municipalities in several countries with a particular emphasis on the English-speaking Caribbean.

Donor Coordination Forum

Responding to a proposal by USAID, the Bank hosted the creation of a Donor Coordination Forum with the involvement of the international cooperation agencies. The forum provides an opportunity to share information on technical approaches, policies and programs to avoid the duplication of activities or conflicting policies. The main instrument of the forum is a web site for the dissemination of information that is managed by a technical secretariat housed at the International City Management Association (ICMA). The forum expects to expand the topics covered in the web site to include information on best practices in technical cooperation for subnational development.

Corporate Impacts

Addressing the needs of subnational governments is a significant challenge for the Bank. The new focus for lending proposed in this paper will be more demanding of Bank resources than present activities because it emphasizes reforms to the framework of intergovernmental relations and governance, and the coordinated use of lending and program development instruments to attain country specific objectives.. A possibly larger challenge will be the proper coordination of Bank instruments to support decentralization in the countries where the Bank embarks on a subnational development program. Municipal development loans that finance the expansion of services and infrastructure and contain only limited sector objectives will no longer be sufficient. Loan operations framed under the proposed strategic approach will need to be coordinated with technical cooperation, and MIF and private sector operations to address, in addition to current concerns, the systemic issues surrounding intergovernmental relations and governance.

Execution of the proposed approach to subnational lending will expand the scope of counterpart agencies involved in loan preparation and negotiation, making the loan execution processes more complex and time consuming. Further, the Country Offices will have to assume more complex responsibilities in the supervision of policy driven and multiphased loans inasmuch as these operations require closer technical supervision.

Additional Transaction Costs

The Cost of Sector Work. To support the policy dialogue that should precede the adoption of a Country Sector Strategy, the Bank and the country will have to finance the required sector studies and consultation exercises. This will increase the burden on local specialists and policymakers as well as on the work program and budget of the Regional Operations Departments. Coordination of operations within the Bank Group is required if integrated interventions are sought. This poses programming problems, particularly if the coordinated use of OC and FSO

loans and TCs, PRI loans and guarantees, and MIF and IIC equity operations is desirable to accomplish the objectives agreed with a country. This is a difficult task in the best of circumstances.

Subregional Strategies. In certain instances, the Regional Operations Departments may find it useful to adopt subregional strategic approaches to better support decentralization. This is the case of Regional Operations Department II, which adopted an Operational Strategy on Subnational Finance and Development to guide policy dialogue with the countries (Henry et al., 1997).

Coordination of Bank Expertise. Given the many dimensions of decentralization, greater coordination among Operations Divisions will be required to properly conduct sector work. Bank expertise on decentralization is distributed among many divisions. The Regional Operations Departments will have to pool the expertise of specialists on municipal development from the Social Programs Divisions with that of specialists on capital markets and infrastructure economics from the Finance and Basic Infrastructure Divisions, and sanitation specialists from the Environment and Natural Resources Divisions. Expertise available in the Central Departments will also be necessary, particularly that of the Fiscal Division (INT/FIS) and the Research Department. The technical divisions of the Sustainable Development Department contribute strategic and policy advice and best practices research that play a significant role in identifying suitable solutions to sector problems.

In sum, to properly conduct sector work in a given country, a major collaborative effort is required among the operational units of the Bank. This has been a rare occurrence in the past; it thus requires a major Management commitment in the future. The importance of this collaborative managerial approach is underscored by the fact that the importance of the Bank for the borrowing countries in the future will increasingly rest on the knowledge it can contribute to the solution to development problems. With respect to subnational development problem, Bank knowledge is spread among

many operational units and needs to be coordinated.

Loan Processing. With sovereign guarantee, large municipalities, states and provinces can approach the Bank for direct operations and the volume of lending they require usually justifies Bank involvement. Taken to its limits, direct lending to this group of subnational governments greatly expands the number of potential clients and thus the administrative effort the Bank must engage in to respond to this demand. There is a natural limit to the number of operations that the Bank can process in a given year given existing budget and human resources constraints, thus limiting its capacity to deal directly with a large number of subnational governments. Furthermore, operations aimed at addressing the different issues involved in subnational development will require a significant expansion of or modifications to existing Bank operations. Loan preparation and assessment will have to be wider in scope and the negotiation of loan conditionality will be more complex. This will increase loan-processing times, long a source of friction with countries.

Loan Execution. The resulting operations are most likely going to be complex and, as a result, more difficult to execute and supervise. The operations that may emerge from the proposed focus for the Subnational Development Strategy most likely will involve policy-related tranching of investments. The correct evaluation of compliance with the conditionality of the tranches is a complex technical problem requiring vast sector knowledge and experience. Project Teams working on new operations will have to rely heavily on the reduced staff of specialists available in Headquarters, this will limit the support they will be able to provide the Country Offices during project execution.

Financing of Program Development Products

Focusing on the institutional development aspects of subnational governments will require the Bank Group to expand the range of program development products to support the soft aspects of the reforms. Financing sources will have to be identified to provide funding for activities like

technical cooperation for institutional development, policy dialogue, and good practice research and dissemination. Advances in program development products consume significant amounts of staff time and other resources. In addition to the shortage of qualified personnel, the Bank's lending approach will have to be modified to promote the development of program development products.

Evaluation

Program Evaluation. Evaluating the performance of Bank operations in support of subnational development under the strategic focus proposed in this document requires moving away from ex-post valuation methodologies to continuous feedback on the effectiveness of the operations. In project design, the Bank will utilize clear benchmarks and define specific expected results and will develop supervision and evaluation methodologies to assess the effectiveness of operations during execution to identify corrective action. The methodologies will include the use of, among other elements, quantitative indicators, questionnaires, public opinion surveys, and periodic evaluation meetings. The observance of these elements will improve the quality of collected evaluation data, facilitate the participation of beneficiaries in evaluation, and promote executors' self-evaluation, in addition to providing transparency to the evaluation process.

Evaluating the Implementation of the Proposed Approach to Bank Lending. The forces propelling

subnational development in the region are many and their interrelations very complex. The Bank is but one of many actors in the process. This prevents measuring the implementation of the approach proposed in this document on the basis of its impact on the development of subnational territories in any particular country, let alone the region as a whole. The best available option is to measure the impact of the strategy on the scope and nature of Bank operations in support of subnational development. To this end, the Bank may undertake a baseline study to assess the extent to which its projects in the last four years have included the key themes addressed in the strategy. The same study may be conducted after five years of implementation to assess whether the new crop of operations incorporated the themes and orientations provided for by the strategy. This methodology allows a measure of the influence of the strategy on Bank operations, a significant dimension of impact.

Policy Implications

Most of the interventions that may emerge from the strategy (multiple works loans, policy-based investment loans, technical cooperation, loans to the private sector, MIF supported investments) may be executed by the Bank Group within the framework of existing Operational Policies. Therefore, no new policies will have to be developed to execute the proposed strategic approach. It is also consistent with the existing strategies framing Bank activities in related areas; notably, the Public Utilities Policy and the Strategy for the Delivery of Social Services.

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