

Subnational Development Strategy

Inter American Development Bank

Sustainable Development Department

Social Programs Division

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Executive Summary

BACKGROUND

The countries of Latin America and the Caribbean (LAC) are rising to the challenges of promoting social and economic development in an increasingly global economy. In their quest for accelerating the socioeconomic development process, they place great hope in capturing the development opportunities of their subnational territories. They foresee dynamic subnational economies able to provide employment opportunities and services to the population. To this end, they seek to improve government services and infrastructure and make subnational governments more attuned to the needs of local economies and better able to work with local entrepreneurs and civil society organizations in enhancing the competitiveness and promoting the growth of local economies. The bet on subnational governments as active actors to promote an equitable development process in LAC is also significant. Devolution of resources and decision-making power to subnational governments is expected to result in greater allocative efficiency in the provision of public services that are essential for the well-being of the population and also critical for attaining greater equity, both among different groups of society and different parts of the territory. The process is proceeding at a fast pace in LAC although differences exist among countries. While some countries have made significant progress in transferring responsibilities and resources to subnational governments, others are only beginning to discuss the issue. However, a common feature in all countries is that the regulatory and fiscal framework under which the process is taking place is highly imperfect, and often subnational institutional capacity to discharge the new responsibilities is not up to par. Reforms are required to attain the objectives set by governments.

The Bank can play a significant role in supporting these reforms through its lending and technical cooperation activities. Bank lending in support of subnational development represents a sizable portion of the Bank's portfolio totaling US\$17.4 billion (in 1992 dollars) or 13 percent of the total lending

by the Bank in its forty years of operations. Demand for Bank support has kept growing steadily. Average municipal lending measured in constant dollars has tripled in the last twenty years, from US\$104 million per year in the 1980s to US\$298 million per year in the 1990s. Demand for Bank assistance in this sphere of development is high as indicated by the 71 projects in the Bank's 1999-2001 pipeline (amounting to US\$8.3 billion in loans).

OBJECTIVES

The Bank will assist countries interested in pursuing subnational development programs to finance investments and implement the reforms and institutional strengthening activities that they consider necessary to turn subnational governments into efficient and democratic institutions capable of obtaining the institutional and financial resources needed to discharge their expanding responsibilities. This is a vast and complex undertaking that requires coordinated developments in the political, fiscal, institutional and financial arenas. The Bank will focus attention on the system of incentives built into the different structures that determine subnational government outcomes: (a) the structure of intergovernmental relations, (b) the system of governance, (c) the institutional capacity of subnational governments and, (e) the mechanisms for financing subnational entities. The Bank will assist governments through technical studies, policy advice and best practices, and will finance eligible expenditures required for implementation of the needed reforms. Objectives to be pursued within the specific circumstances of each country fall into the categories of intergovernmental relationships, governance, institutional capacity and financing. One of the Bank's objectives is to achieve a structure of *intergovernmental relationships* that provides subnational governments with incentives to efficiently allocate resources to the most socially profitable uses. This requires that subnational governments have clearly defined responsibilities and sufficient resources to discharge their assigned functions. In

addition, they must face hard budget constraints that force decision-makers to assume full responsibility for the trade-offs involved in collecting and allocating a limited pool of resources. To foster the efficient allocation of resources at the subnational level, the Bank will emphasize the need to achieve a close correspondence between those who benefit and those who pay for government programs and services to ensure that constituents 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 need to be guided by the objective of putting in place incentives for local decision makers to adopt fiscally sound decisions.

Concerning the *governance* structure, the Bank will stress the importance of well-functioning mechanisms of citizen representation and oversight so that elected subnational officials can be held accountable effectively and the management of local affairs can be made transparent. Attainment of these objectives is a necessary condition for good fiscal management and accountability at the subnational governmental level. The Bank will also contribute to strengthening of central government functions related to setting performance standards, performing evaluations and ensuring the transparency of subnational governments' operations.

The Bank will 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 projects will include reform and institutional development components to support the development of the organizational structure, administrative systems and human resources policies of subnational governments of different sizes.

Emphasis will be placed on strengthening the civil service career, thereby providing incentives for continuity and the professional development of subnational civil servants.

The Bank will stress the paramount importance of sufficient *financing* for ensuring good subnational government performance. To this end, the Bank will assist governments in structuring subnational finances according to sound technical principles. Own sources of revenue should be the principal source of financing for subnational governments, charging fees for services rendered where possible. Otherwise 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 can be used to alleviate vertical and horizontal imbalances; however, they must not substitute for own revenues and should be in forms that do not distort local expenditure preferences. To bring fiscal discipline to subnational governments, subnational borrowing requires a regulatory framework for debt management as well as financial market based mechanisms (private or publicly placed) that are well priced and liquid. These mechanisms must also foster risk differentiation across subnationals and enforcement of capital market rules.

INTEGRALITY OF BANK SUPPORT

To fully achieve the objective of placing the subnational development process on a self-sustained path, the Bank will seek to provide as integrated a response as possible when approaching subnational development issues with borrowing member countries. Given the complexity of the issues to be addressed, the resulting lending program may involve a sequence of interventions to tackle the critical issues.

I. Introduction

THE NEED FOR A BANK STRATEGY

Concerned with enhancing the well-being of the population, most governments in Latin America and the Caribbean place great hope in capturing the development opportunities of their subnational territories. They foresee subnational economies capable of providing increased employment opportunities and services to the population. To this end, they seek to improve government services and infrastructure and make subnational governments more attuned to the needs of the local economy and better able to work with local entrepreneurs and civil society organizations to enhance competitiveness and promote economic growth. The expectation on subnational governments to promote an equitable development process in LAC is also significant. Devolution of resources and decision-making powers are expected to result in the more efficient provision of public services. Central governments expect to achieve greater allocative efficiency by attaining a better match between the set of goods and services offered by the government and the preferences of the population. The expectation is that the great variation of needs and preferences observable across subnational territories will be better served by local decision-making systems than by centralized mechanisms. It is also hoped that it will foster greater levels of community engagement in, and ownership of local development programs resulting in higher accountability and better governance as decisions are adopted closer to the community's scrutiny.

Change is occurring at a fast pace in Latin America and the Caribbean, transforming the functions, resource base and governance structure of a larger number of subnational governments and decentralized entities that differ in size, resources and institutional capacity. These include: states and provinces of federal countries (some of them larger than many

countries of the region); intermediate levels of governments in unitary states (regions or departments); municipalities of varied sizes and institutional capacity; consortia of municipalities in charge of complex metropolitan regions and, more recently, indigenous territories with varying degrees of responsibility. There are also decentralized government agencies (for instance, development corporations and public enterprises) that bear important subnational development responsibilities. Significant differences also exist among countries. While some federal countries have made significant progress in transferring responsibilities and resources to subnational governments, there are others that are only beginning to discuss the topic. The issues confronted by central governments in transferring responsibilities and resources also vary significantly with size. Large federal countries find it convenient to decentralize many responsibilities while smaller countries find that they are better served by more centralized systems of service provision. However, the regulatory and fiscal framework under which the process of transferring resources and responsibilities is taking place in almost all countries is highly imperfect. Often, subnational institutional capacity to discharge the new responsibilities is not up to par. Reforms are required to attain the objectives set by governments. The Bank can play a significant role in supporting these reforms through its lending and technical cooperation activities.

Bank lending in support of subnational development represents a sizable portion of the Bank's portfolio totaling US\$17.4 billion (in 1992 dollars) or 13 percent of the total lending by the Bank in its forty years of operations. Demand for Bank support has grown steadily. Average municipal lending measured in constant dollars has tripled in the last twenty years, from US\$104 million per year in the 1980s to US\$298 million per year the 1990s. Demand for

Bank assistance in this sphere of development is high, as indicated by the 71 projects in the Bank's 1999-2001 pipeline (amounting to US\$8.3 billion in loans).

The Bank has learned several lessons from its long involvement with subnational governments. Investment lending for service and infrastructure expansion is not enough to improve provision. Significant institutional developments are also required. Consequently, the Bank is currently supporting a wider variety of subnational development activities, including financing for investments and institutional development targeted to large- and medium-sized municipalities, states and provinces of federal countries, conglomerates of municipalities in charge of large metropolitan areas, and central government agencies linked to subnational governments.

The scope and objectives of Bank operations have also changed significantly. In addition to expanding service capacity by financing infrastructure investments, Bank operations to date also address fiscal and institutional issues affecting subnational performance. However, the effectiveness of Bank assistance has been hampered by faulty structures of intergovernmental relations and governance and by the failure of regulations to impose a hard credit discipline on subnational governments plagued with institutional weaknesses.

These lessons indicate that, notwithstanding the positive evolution of Bank operations in support of subnational development, more is needed to match the expanding socioeconomic development needs of subnational territories and the profound reforms required to ensure the proper development of subnational governments in most countries of the region. The present strategy document is intended to guide future Bank operations so that they address the complex issues faced by borrowing countries in supporting the development of subnational territories, particularly in improving subnational government performance.

CENTRAL ISSUES IN SUBNATIONAL DEVELOPMENT

Responding to the increasing complexities of the development process in a global economy, subnational governments are being entrusted with new functions ranging from promoting new economic activities in their territories to the regulation of privatized utilities. At the same time, they are required to expand the range of services and infrastructure for the population (like education and health) and to support economic activity. Further, they are to improve the efficiency with which they discharge their more traditional functions (maintenance of parks and roads, land use control, environmental management and emergency response). To effectively discharge these expanded functions, subnational governments need clear mandates, suitable sources of revenue, efficient institutional structures and effective democratic governance systems.

Effective subnational governments require a system of well-designed rules and incentives to encourage appropriate behaviors on the part of decision-makers. Two sets of rules are paramount: the rules defining the assignment of responsibilities and resources among different tiers of government, and those that regulate the exercise of power by elected representatives. Ill-defined responsibilities among different tiers of government lead to the duplication of effort and lack of accountability. Partial solutions to these problems often lead central governments to intervene unnecessarily in local service provision, expanding its size and the scope of its interventions. Lack of transparency and of effective channels for community involvement in local decision making, lead to popular disenchantment with local political processes.

The lack of an adequate institutional capacity at the subnational level is one of the most important obstacles to the realization of the benefits of government decentralization. Although this problem is particularly acute in small and poor subnational governments, it also affects large subnational governments

that need to tackle the mounting poverty problems affecting urban areas. The high rotation of personnel and the hiring and promotion of staff on political rather than merit grounds, compound the problems generated by inadequate organizational and operational structures. Simultaneous and coordinated changes are also required in other public management areas, including policy making and strategic planning, fiscal management and oversight, and evaluation systems. For public agencies to work efficiently, the diverse management systems must generate incentives that lead the individuals within the organization to work in harmony towards a specified objective and with reasonable competence and effort.

Significant parts of the structure of incentives under which local decision-makers operate originate in the system used to finance subnational activities. Own sources of revenue need to be developed; intergovernmental transfers should not displace them. Transfer mechanisms used establish another set of incentives. For instance, 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 despite the fact that they reduce the capacity of higher tiers of government to attain specific sector objectives. Borrowing by subnational governments may lead to fiscally irresponsible behavior on the part of decision-makers when used in contexts where: (a) subnational governments are not subject to hard budget constraints, (b) capital markets fail to impose a hard credit discipline, (c) officials are not fully accountable to their constituencies and (d) commitment by central governments not to bail out defaulting subnationals is not credible. Developing an efficient and equitable system of financing for subnational governments should be a priority for design and implementation of subnational development strategies.

The diversity of subnational government is seldom matched by an equal diversity in management rules and policies to promote their development. One-size-fits-all legislation and policies abound, often impairing local development. Successful subnational development must recognize the diversity and heterogeneity of the universe of subnational governments and devise an equally diverse and heterogeneous set of policies and interventions.

PURPOSE OF THE STRATEGY

The subnational development strategy provides the Bank with a comprehensive framework to support borrowing member countries in their efforts to promote socioeconomic development through the devolution of responsibilities and resources to subnational governments. To this end, the strategy defines the objectives that the Bank would like to promote among borrowing countries committed to subnational development. It also makes recommendations concerning effective ways to achieve those objectives, and identifies the specific instruments and resources that the Bank can mobilize in this pursuit. The strategy serves several purposes. It is designed to provide orientation to Bank teams in charge of country programming, sector studies and the preparation of loan and technical cooperation operations. It is also designed to facilitate dialogue with country officials and other stakeholders, including civil society organizations. Further, the strategy provides guidance regarding the issues involved and the most effective way to deploy Bank financial and institutional resources to attain the objectives set jointly with the countries. It also describes an operational framework for implementation, including a time frame for executing the activities, budgetary implications and a frame of reference for evaluation.

II. Bank Strategy in Support of Subnational Development

A STRATEGIC APPROACH

It is recommended that Bank activity in support of subnational development center on assisting interested 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 infrastructure. This requires a change in the way the Bank approaches lending for subnational development, shifting its attention from financing the expansion of capacity and promoting good financial management at the local level to addressing in an integrated fashion the system of incentives built into the different structures that determine subnational government outcomes. These are:

- ? the structure of intergovernmental 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 long-term coordinated 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 sources. The Bank will support governments in putting in place the required reforms through technical studies, policy advice and best practices, and will finance eligible expenditures required for their implementation.

FOCUS ON THE EXPANDED DEVELOPMENT ROLE OF SUBNATIONAL GOVERNMENTS

The objective of supporting the development of subnational governments is to improve the well-being of the population by promoting the development of the local economy and providing infrastructure and services. To this end the Bank will assist countries in implementing the reforms and institutional strengthening activities required to build efficient and democratic subnational governments able to perform the functions described below.

- ? Promote economic development in their jurisdictions to generate productive employment for the population.
- ? Provide services to ensure good living conditions for the population and to enhance the degree of social and territorial equity in the distribution of the benefits of development.
- ? Provide infrastructures that are essential for the well-being of the population and for the growth of economic activities.

Promoting Local Economic Development

The goal of economic policy in a given territory is to enhance competitiveness and attract new investments in a broad base of businesses of different sizes capable of generating robust growth in local employment and income. Three basic factors need to be considered:

- ? The use of endogenous capabilities and assets for economic development including the resources of their territories and the population's productive and entrepreneurial skills.

- ? The generation of external economies within the territory.
- ? The reduction of business transaction costs.

Local factors influencing local economic development include both tangibles (infrastructure) 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 heavily dependent on the activities of the private sector. This makes private-public partnerships an effective mechanism to promote local economic development. The partnerships are the milieu where subnational governments, the business community and civil society organizations (particularly universities, chambers of commerce and entrepreneurial organizations) discuss economic development goals, make strategic plans and design and jointly implement projects. Small- and medium-sized enterprises are key players in the local economy and they benefit greatly from the improved business environment generated by subnational government interventions.

The source of public funding for local economic development must be consistent with sound fiscal discipline. The objective to be pursued is the growth of dynamic, competitive and self-sustained enterprises that become tax contributors and not consumers of fiscal resources.

Complementing national policies, subnational governments influence local economic development in different ways. They can reduce regulatory barriers to private investment and create a favorable environment for putting unused or underutilized local resources into full production. They can improve the capacity of their territories to compete with others for new direct investment through: (a) the provision of good quality local infrastructure, (b) policies and regulations that promote the efficiency of firms (ranging from labor training to the regulation of natural resources including the operation of real estate markets), (c) the promotion of key business development serv-

ices in the local economy (accounting, maintenance, informatics) and (d) the promotion of cooperation among enterprises to faster economies of scale in the provision of certain goods and services. The growth and productivity of rural production systems are also influenced by factors under the control of local governments, like the availability of feeder roads and the efficient management of water. The Bank's sector strategy on the *Development of Small and Medium Enterprises* provides further guidance on these matters.

Provision of Social Services

Taking advantage of their capacity to tailor services to the needs and preferences of communities, subnational governments are in a good position to provide public services whose benefits are localized, particularly when centralized provision presents intrinsic problems of inflexibility and administrative inefficiencies. This is the case for social services that are people oriented and require good targeting. It is also the case of services whose provision involves the management of a multiplicity of small units. As advocated in the Bank's strategy on social services delivery (*Supporting Reform in the Delivery of Social Services*), these can be better supplied locally in a competitive environment. However, central funding of some of these services may be required to address externalities and inequities. By the same token, it is advantageous to encourage and support multiple service providers since this can reduce costs through competition, improve and maintain quality, enhance responsiveness to changing needs, and encourage innovation. Providers of services can include subnational entities or autonomous enterprises in addition to private for-profit and nonprofit organizations. To improve services and take full advantage of economies of scale and scope as well as of efficiency gains from coordination among levels of government, some functions may need to be decentralized while others may need to be centralized.

The financing mechanisms used for the provision of social services are important for setting up the cor-

rect structure of incentives. For instance, making the funding for services respond as closely as possible to demand for the service is a key feature to provide clients a choice among providers and make public resources follow them to the chosen providers. This calls for public delivery systems budgeted on the basis of output and not inputs. Capitation grants are one mechanism that can serve this purpose well. Attention must be given to complementary actions required to assure that outcomes are properly measured and rewarded.

As governments confront institutional difficulties in delivering services, nongovernmental organizations (NGOs) and, to a lesser extent, community based organizations (CBOs), have stepped in to provide services, particularly to low-income households. These initiatives often encompass a large variety of mostly isolated projects that profess to rely heavily on popular participation. Although sometimes successful in alleviating poverty at the community level, these initiatives frequently do not escape the limitations of the institutional setup in which subnational governments operate. Care must be taken to overcome the difficulties that NGOs and CBOs face in sustaining their activities in the long-term and in developing activities of sufficient scale to tackle the problems effectively.

Provision of Infrastructure

The provision of infrastructure is a traditional field of activity of subnational governments and encompasses a variety of essential services (water, sewerage and waste collection services, roads and drainage, public lighting, markets, abattoirs, transportation terminals). Current approaches to infrastructure provision seek efficiency gains through privatization and charging user fees, whenever possible. This represents a change in the role for subnational governments from that of direct provider of water and sewerage services to a regulator of privatized utilities, from administrator of municipal markets and abattoirs to overseer of private facilities.

Consistent with the *Public Utilities Policy*, future Bank activities will support the reforms needed to put in place the correct system of incentives and the regulatory institutions required for the sustainable and efficient provision of infrastructures either through loans for infrastructure expansion by utilities or through subnational loans.

The development of an adequate regulatory framework for the private provision of infrastructure is an area of concern where subnational governments also need to develop capacity, especially to enforce compliance by local service providers. To fully tap the potential of private sector participation, subnational governments need to develop strategies to identify the most efficient privatization schemes given local circumstances. Further, local governments need to develop institutional capacity to outsource services, sell or lease assets, award concession and supervise contracts or build infrastructures under innovative financial and operational arrangements.

The provision of infrastructure and services that cannot be privatized represent another challenge that requires institutional development ensure the appropriate supply of services in a cost effective manner. Charges to beneficiaries are the preferred source of financing and local taxes or contributions should be used when charges are not appropriate. If subsidies are the most efficient way of achieving the public policy goals of equalizing access among population groups, direct transfers to the poor (e.g. through some variant of vouchers) are to be preferred. Subnational governments need to implement clearly defined and well-funded social programs that do not jeopardize the financial foundations of service provision. These policies should include an explicit statement and clear justification of the chosen social objective; a procedure ensuring a mechanism for financing, whether from general taxation or tariff revenues; and a transparent mechanism for allocating funds to the target group.

INTERGOVERNMENTAL RELATIONS

Objectives

A well-designed structure of intergovernmental relationships provides subnational governments with incentives to efficiently allocate resources to the most socially profitable uses. Specifically, the Bank will stress that subnational governments need:

- ? clearly defined responsibilities,
- ? sufficient resources to discharge the assigned functions and
- ? must also face hard budget constraints that force decision-makers to assume full responsibility and understand the trade-offs involved in collecting, allocating and managing a limited pool of resources.

To foster the efficient allocation of resources at the subnational level, the Bank will assist borrowing countries to achieve a close correspondence between those who benefit and those who pay for government programs and services. This will 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 sound local decisions.

Discussion

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

- ? Who does what? The question of expenditure assignment.
- ? Who levies what taxes? The question of revenue assignment.
- ? How is the (virtually inevitable) resulting imbalance between the revenues and expenditures of subnational governments to be resolved? The question of vertical imbalance.

- ? 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.
- ? Can subnational governments borrow, and under what conditions? The question of subnational borrowing autonomy.

Assignment of Expenditures

The most important question about the assignment of expenditures is what is done by whom and how well it is done. Therefore, efforts need to focus on achieving clarity in that assignment, on how the assignment is determined and implemented, and on how expenditures are managed at all levels of government.

Clarity of assignment (in terms of specifying exactly what services each governmental agency is responsible for delivering) must be matched by accountability (in terms of both political democracy and transparency of operation) as well as by authority (in terms of both the ability to manage expenditures and to determine (within limits) revenues). In all circumstances, subnational governments must be accountable for the actions they undertake and particularly to those citizens that finance those actions. This accountability relates to three constituencies, which are described below.

- ? *Local service purchasers*: subnational governments should charge for the services they provide.
- ? *Local taxpayers*: when charging is impracticable, subnational governments should finance such 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.
- ? *The central or regional governments*: to the extent that they pay via transfers (as a result of national policies) for the provision of services.

Assignment of Revenue

In addressing the assignment of revenue among levels of government, policy makers need to be aware of two fundamental facts. First, that the central government inherently can collect most types of taxes more efficiently than subnational governments. Second, that 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. These problems can be resolved by adequately balancing the contribution of different sources to the subnational budget and by assigning these resources to their more efficient use. A good approach to subnational revenue assignment is based on three principles.

- ? Matching expenditure and revenue needs at different levels of government.
- ? Ensuring that all levels of governments bear significant responsibility, at the margin, for financing the expenditures for which they are politically responsible.
- ? Ensuring that subnational taxes do not unduly distort the allocation of resources.

Financing schemes for local services need to rest on charges to beneficiaries and address potential exclusion problems through subsidy schemes that support demand and are financed with resources from general revenues. User charges are to be preferred, either as service fees or prices for the sale of publicly produced goods to identifiable private agents. The *Public Utilities Policy* provides guidance for addressing these issues.

Specific benefit taxes play multiple roles in subnational government. They are a source of revenue as well as a mechanism to send signals to markets on the social costs of providing a service or in using the commons. Subnational governments need to be empowered to impose special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary taxes

related to the provision of sewers or street lighting, development exactions and charges, delineation levies and the like, in cases in which these are efficient mechanisms to collect payment for public improvements or regulate the use of the commons.

The property tax is an important source of revenue for most subnational governments. Improving collection and enforcement can enhance the yield of property taxes. Improving basic information through cadastral surveys and valuation exercises are (resource-consuming second tier developments) that can profitably be promoted once collection and enforcement have reached efficient levels. Local business taxes, a widely used source of revenue, need to be carefully managed to avoid the externalities associated with tax exportation. In cases where regional governments or large municipalities have significant responsibilities that local sources of revenue cannot fully cover, surcharges on income taxes or value added taxes may be a good source of financing and should be considered.

Given the complex interplay that exists among these different sources of revenue and the general weakness of tax administration, subnational governments need tax revenue management strategies. These strategies allow them to take advantage of the opportunities offered by each of the revenue sources, tap their potential for improvement and at the same time avoid introducing perverse incentives.

In sum, Bank support for subnational development will rest on the principle that subnational governments are more likely to carry out their important expenditure functions responsibly when they have to raise their own revenues. So long as local governments are spending what they and their constituents view as “other people’s money,” they are unlikely to be under much local pressure to spend this money efficiently.

Vertical and Horizontal Imbalances

Regardless of the revenue sources made available to local governments, transfers from central to local governments will continue to constitute an important feature of the public finances of many countries as they address vertical and horizontal imbalances among subnational territories. A well-designed system of intergovernmental transfers is an essential component of any decentralization strategy. Together with a properly designed subnational tax base, a properly designed transfer system is essential to ensure adequate incentives for encouraging fiscal responsibility at the local level.

Solutions for vertical and horizontal imbalances should impose accountability at the margin. Even if some subnational governments are almost entirely dependent on central transfers, it is still possible for them to be fully accountable, as long as the amount of the transfer is predetermined (i.e. if it cannot be altered as a result of action by the recipient). Well-designed formula-based transfers can ensure that, at the margin, local actions to raise or lower local revenues or expenditures will directly affect outcomes – a condition necessary to ensure political accountability. As with user charges, the guiding principle 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. The essential ingredients of most formulas for general transfer programs are needs and capacity. (This compares to matching grants which are intended to finance narrowly defined projects and activities, particularly those involving externalities).

Many countries use intergovernmental transfers to compensate shortages of revenue in poor areas and produce some degree of redistribution among jurisdictions. Transfers designed according to the principles stated in the previous paragraph can be efficient in equalizing infrastructure provision among jurisdictions and contribute to leveling the playing field on which private investment decisions take place. However, this approach may not be as effective in

mitigating income inequalities. The key problem is that 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.

In general, direct transfers to the poor (e.g. through some variant of vouchers) are to be preferred over indirect transfers to localities. The Bank strategy *Supporting Reform in the Delivery of Social Services* provides guidance concerning effective approaches for delivering social services to the poor. If such key poverty-related services as education and health are provided through subnational governments, very careful attention has to be paid to the three features described below

- ? Getting the prices facing service providers right (e.g. via a well-designed system of grants).
- ? Setting up effective information and inspection systems to ensure that the desired services are in fact delivered to the target groups.
- ? Devising some system for dealing with the non-compliant.

Care must be taken that special transfer mechanisms designed to address pressing social issues, specific emergencies, or to promote central government goals (like co-financing funds for promoting municipal investment in sanitation or social investment funds) are designed according to the described principles. This will prevent these transfer mechanisms from distorting local resource allocation preferences or encouraging fiscal laziness on the part of the beneficiary subnational governments.

Macroeconomic Impacts, Borrowing and Deficits

The transfer of responsibilities and resources to subnational governments may have negative effects on macroeconomic performance if it is not carefully designed and implemented. The most critical effects are those that result in increased spending or deficits.

These may arise under two conditions as described below.

- ? When resources transferred to subnational governments are increased without transferring equivalent expenditure responsibilities.
- ? When revenue sources are transferred down to subnational governments, and these fail to exert adequate effort at mobilizing resources; or when transfers are increased and subnational governments reduce the efforts on the revenue sources they already control.

Macroeconomic performance can also be undermined if central governments lose control of a large share of total government expenditures or revenues controlled by subnationals or when the central government fails to impose hard budget constraints on subnational governments.

A clear case can be made for subnational governments to have some capacity to borrow. 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. However, borrowing autonomy can potentially lead to soft budget constraints for subnational governments if central governments do not make a strong commitment to not bailing out state and local governments when they are in financial trouble. Absent this commitment, borrowing autonomy may well result in irresponsible fiscal behavior on the part of subnational governments. This behavior is nothing more than an optimal response to incentives if there is the perception that they eventually will be bailed out.

When it comes to subnational borrowing there is “good” borrowing as well as “bad.” It is as important to facilitate the former as it is to block the latter. There is the need for prudential regulation of financial markets and for central governments to avoid moral hazard in their rules governing subnational

borrowing. Hard rules concerning subnational borrowing need to be accompanied with flexibility for the subnational governments to adjust their revenues and expenditures, thus facilitating the necessary adjustments in times of financial distress and making bailouts less likely.

Central Functions to Improve Outcomes

Experience around the world suggests that outcomes of good intergovernmental relations can be further improved if good information and analysis is available. An institution concerned with intergovernmental finance issues may provide these services as well as 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 providing:

- ? a nonpartisan forum within which various relevant actors may get to know one another in a nonconfrontational setting;
- ? a common informational basis trusted by all parties;
- ? a formal and informal training to a cadre of experts in local service provision, and fiscal and financial areas;
- ? a forum for coordinating borrowing by subnational governments when federal authorities lack other means of regulation, and
- ? information supporting the allocation of grants.

A body whose main formal role is 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 obviously be relevant to both the central government and to citizens in general, might be more credible if the agency does not have a formal reporting role to the central government, and its output is accepted as the work of competent and politically neutral analysts. Similarly, an intergovernmental fiscal body might play a very useful role,

from the point of view of subnational governments, by monitoring and reporting on the effects of possibly intrusive central government policies.

GOVERNANCE

Objective

Well-functioning mechanisms of citizen representation and oversight are essential to hold elected subnational officials accountable and to make the management of local affairs transparent. Attainment of these governance objectives, which are essential conditions for democratic oversight, is also a necessary condition for good fiscal management and accountability at the subnational governmental level. The strengthening of the central functions related to setting performance standards, performing evaluations and ensuring the transparency of subnational government operations is also required to ensure good governance.

Discussion

If the benefits of decentralization in terms of allocative efficiency and accountability are to be fully realized, a profound democratization of local government must take place. This makes it necessary for Bank-sponsored operations in support of subnational development to pay attention to the democratic institutions and practices that shape the behavior of subnational public officials, that is, the incentives they have to govern responsibly and effectively and in accordance with the preferences of their constituents. Critical accountability institutions include:

- ? Electoral systems that facilitate citizens' ability to voice their preferences in respect to local issues and to hold public officials individually accountable for their performance.
- ? Representative bodies with the capacity to assimilate the full range of citizen and group preferences and to oversee the executive.
- ? Formal institutions in which citizens have real opportunities to air their complaints, articulate

their preferences and receive and provide information and advice.

- ? Central government regulatory regimes requiring subnational governments to regularly provide reliable information about legislation, financial matters, and public service provision.

The rules governing the election and removal of local officials are an important part of the system of incentives affecting the accountability of subnational governments to citizens and the efficiency and honesty of public officials. They include the system for electing the head of government; the degree of separation between subnational and national elections in respect to their relative timing and the possibilities of expressing candidate preference in the ballots for representative bodies; the length of the head of government's term and the possibility of his reelection; the powers of subnational legislative bodies; and the possibility for citizens to participate in law-making through initiatives and referenda. To ensure that subnational governments face the correct set of incentives, reforms to the electoral systems and to the distribution of power and resources between the branches of subnational governments may be required.

To strengthen subnational democracy, Bank-sponsored operations will encourage the continual involvement of citizens in government affairs. This entails the development and regularization of a variety of forums or mechanisms (such as community advisory boards, open town meetings, public hearings by planning boards and regulatory commissions, citizen complaint centers) and the strengthening of the judicial system so that citizens can better protect their rights. Such forums can encourage government accountability and responsiveness by providing opportunities for citizens and civil society organizations to articulate their preferences, air their grievances, and influence policy and investment decisions beyond election day. 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 proportionate to their presence in the population. The adequate representation of women is critical. In addition, the profile of public office holders should be gender balanced and mirror to the greatest extent possible the underlying sociocultural diversity of society. Bank sponsored operations will assist interested governments in establishing effective mechanisms to promote the leadership and representation of women, indigenous and afro-Latin groups, and other marginalized constituencies so that their specific interests are adequately represented.

Productive and effective participation requires accurate and comprehensive information. Citizen involvement in investment planning, zoning decisions and others, is enhanced when citizens are guaranteed in law full access to the findings of review panels, to government records, to company data and other relevant information. Disclosure of information thus forms an important part of the set of incentives and conditions that are needed for subnational government to be efficient and democratic providers of services. Transparency is also required for efficient central government oversight of subnational government, a necessity when lower tiers of government execute programs on behalf of the central government and when part of subnational financing comes from national funds. There is a need to establish appropriate central government structures to monitor and support local governments and to ensure that the relevant central government agencies have adequate incentives and the ability to monitor and regulate subnational activity. Further, it is necessary that subnational governments have sufficient incentives to provide the necessary information. This involves 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 such data in a timely fashion. Also needed is a formal reporting and evaluation system adapted to the

needs of the public to whom subnational governments are accountable.

INSTITUTIONAL DEVELOPMENT

Objective

Subnational governments need to have sufficient institutional capacity to discharge their responsibilities at socially acceptable levels of performance. A comprehensive approach to capacity building in subnational governments is needed in order to enable them to carry out their responsibilities. This requires concerted efforts to ensure that administrative and management systems are reformed and modernized in order to correct deficiencies or misalignments of institutional capacities that could undermine performance and governmental responsiveness to citizen demands and social needs. Three institutions and systems are of special concern: (a) civil service institutions and human resource management systems, (b) adequate legal and financial procedures for revenue and expenditure management, and (c) control and evaluation systems. The Bank will stress the need for their coordinated development when providing technical and financial assistance to countries willing to undertake subnational institutional development programs.

Discussion

Civil Service Institutions and Human Resource Management Systems

Subnational governments suffer more acutely than other levels of government from deficiencies in the human resources base. Administration posts are often filled with inadequately qualified and undermotivated staff. Subnational government administrations are plagued by the excessive turnover of professional staff. These deficiencies in turn result from widespread practices of clientelism in which public employment is treated by politicians more as an instrument to reward supporters than as a valuable resource for carrying out the government's responsibilities.

Well-functioning subnational governments require strong civil service institutions that provide incentives for continuity and the professional development of subnational civil servants. These include changes in the patronage-based personnel systems to allow skill and labor needs, individual merit, and incentives for good performance to be fully taken into account. However, creating a capable public administration staffed by adequately trained, well-motivated, and properly directed individuals requires reforms to prevent patronage and develop systems of human resource management that are clearly linked to the strategic goals of public sector institutions. Public institutions depend critically on professional knowledge and experience to address the demanding challenges of the public interest. Investing in recruitment, training, career development and adequate compensation packages is a must if the necessary organizational capacities are to be built.

Appropriate civil service institutions and personnel policies are also required to ensure that marginalized groups, including, women, indigenous populations, people of African descent and handicapped individuals have equitable access to career opportunities.

Adequate Legal and Financial Procedures for Revenue and Expenditure Management

The effectiveness of subnational governments in managing revenues and expenditures is usually constrained by the limited discretion they have in selecting tax bases, setting tax rates and choosing how to spend funds transferred from the central government. These problems, stemming from the structure of intergovernmental fiscal relations, can be partially mitigated by expanding subnational capacity to optimize local tax administrations and maximize fulfillment of tax obligations; integrate revenue and expenditure information; harmonize subnational financial management systems with central government systems and practices; and efficiently and accountably allocate public resources among sectors and programs. Transparency, reliability, and comparability in budgetary information are essential to

promote accountability through the electoral and other participatory mechanisms. These are also prerequisites for efficient financial management, which in turn will help prevent corruption.

As with good fiscal practice anywhere, good subnational budgeting should take place within the framework of a medium-term expenditure framework. 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). 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.

At the same time, control and evaluation mechanisms have to be reinforced to allow subnational governments the capacity to monitor their own activities, 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). Most countries that have efficiently devolved responsibility and resources to subnational governments developed specialized institutions to provide the public with trustworthy (nonpartisan) information on what the different levels of government are doing, separately and together. Developing such institutional infrastructure is an essential step if countries want to transfer important public sector activities to subnational governments without losing touch with what is going on in these parts of the public sector. Unless specialized agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized.

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

efficient fiscal management in particular, deserve a comprehensive approach involving both policy and institutional strengthening activities. 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.

Flexible Organizational Structures and Procedures Including Public-Private Partnerships

Creating a reliable and competent institutional capacity in subnational governments requires reforms not only in civil service and financial management systems, but simultaneous and coordinated changes in other areas that result in a coherent configuration for policy making and service delivery. In this respect, the organizational setting in which subnational governments operate seems critical to the purposes of democratic accountability, the legal certainty of government decisions and the effectiveness and efficiency of public service management.

For the organization to be right, the idea of a uniform structure applicable to all government functions must be abandoned. Organizational structures in the public sector have to be designed according to the specificity of the particular policy requirements. Overall coordination has to be addressed considering the diversity of government policies, putting an emphasis on common goals and values instead of on common procedures and structures. When designing the appropriate structure for the delivery of services it is necessary to adapt the organization and working procedures to the policy environment, questioning hierarchical and bureaucratic arrangements imposed by principle. Differentiation and flexibility in government structures and procedures along with substantial policy coordination mechanisms are necessary.

Flexibility in structures and procedures also involves the need to coordinate with other subnational governments and with institutions outside government when their capacities are required and available.

This coordination can take the form of associations of subnational governments (commonly municipalities) or public-private partnerships. Where service delivery can be transferred to private providers in a market setting, a competitive framework should be established. When civil society can offer distinctive capacities for policy-making and implementation, without market discipline, cooperative arrangements should be put in place to enable the joint use of public and private resources on behalf of the public interest

FINANCING SUBNATIONAL GOVERNMENTS

Objective

Sufficient sources of financing are essential for ensuring good subnational government performance. The Bank will assist interested governments in structuring subnational finances according to sound technical principles in order to reach this goal. Own sources of revenue should be the principal source of financing for subnational governments, using fee for services rendered where possible. Otherwise, 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 can also be used to solve vertical and horizontal imbalances, however, they must 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 financial markets combined with a sound structure of intergovernmental relations must impose on them a hard credit discipline. Subnational development projects financed by the Bank need to take into consideration and complement strategies aimed at developing financial markets and their regulatory framework.

Discussion

To attain the stated objectives, the Bank will assist interested countries to design and implement programs consisting of technical assistance, credit enhancement and lending activities. Under this approach, emphasis will be first placed on technical assistance to develop the different aspects that support creditworthiness from the perspective of private lenders. After achieving a reasonable degree of credit worthiness, subnational access to financial markets can then be assisted through credit enhancements.

Building the Foundations for a Hard Credit Discipline

The Bank will focus its assistance on strengthening the areas that form the basis for hard credit discipline. In addition, the Bank will support the reforms required to enhance subnational borrowing in financial markets. As already discussed, a key element of the reforms is the prudential regulation of financial market activities relating to credit policy, risk management, portfolio activity and financial market supervision. The need for establishing central government regulations to avoid moral hazard was also indicated, an issue that is discussed in the section that follows. Some of the specific considerations are discussed below.

- ? *Improved intergovernmental relationships* that generate a favorable environment for the strengthening of the financial capacity of subnational governments.
- ? *Local institutional capacity* to fully execute the responsibilities that local authorities are now being assigned.
- ? *Increased private sector involvement* in the financing and provision of local services. This can create incentives for the subnational governments to strengthen their financial capacity to tap 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 his-

tory and credit culture needed to secure the levels of funding necessary.

- ? *The development of local financial markets*, particularly capital markets, including the legal and regulatory infrastructure such as rating agencies, underwriters, and bond insurers. The recommendations of the Bank's *Capital Market* and *Financial Market Strategies* should be followed in this regard. Shallow local capital markets are a major obstacle to improvements in private financing of subnational government activity in infrastructure provision. 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 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.

Lending to Subnational Governments

Bank Lending

The traditional lending program attempt to strengthen the financial autonomy of subnational governments and enhance their capacity to access financial markets. It will foster private sector participation in financing infrastructure and the expansion of services provided by subnational governments, as well as strengthening institutional capacity to enhance the delivery of these services.

Lending with Sovereign Guarantee. All Bank loans to subnational borrowers have been provided with full sovereign guarantees of repayment. On several occasions, the Board of Directors has waived the full

joint and several guarantees and authorized guarantees on the provision of the local contribution and on compliance with the objectives and purpose of the loan to be provided by the borrower.¹ The Bank should continue to require full sovereign guarantees of repayment and will explore mechanisms to mitigate the moral hazard risk involved in requesting this guarantee.²

Several of the reforms discussed in the section on intergovernmental relations are aimed at reducing moral hazard and the likelihood of bailouts. The Bank will promote these reforms. The elimination of discretionary transfers to subnational governments is partly justified by the need to dissolve a non-transparent vehicle for the national government to provide bailouts. The allocation of significant revenue autonomy to subnational governments, apart from other advantages, increases the commitment of central governments to resist a bailout, since it allows the subnational government to avoid financial trouble by increasing taxes. Establishing caps to subnational government debt imposes limits on their ability to get into trouble and require a bailout. These measures, while reducing the scope for subnationals to misbehave, do not eliminate moral hazard completely. A way of further reducing moral hazard would be to require a simultaneous counter-guarantee from the subnational government, for instance allowing the central government to recover the cost of repayment from future transfers due to the

¹ Management is preparing a proposal to the Board of Executive Directors to authorize that the guarantees on the provision of the local contribution and on compliance with the objectives and purpose of the loan to be provided by entities other than the sovereign.

² Management will study the conditions under which lending to subnational governments with less than the full guarantee contributes to the development of prudent and sustainable public financing practices in the beneficiary. Such study will include, among other things, the impact of limited guarantees on reducing moral hazard and on the contribution that this approach can make to the attainment of national objectives concerning subnational development.

subnational government in the case that it is forced to repay the loan.

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 deal with issues of market failure. In this context, this approach will be pursued when private markets are unwilling or unable to provide some service and it can be proved that the activities would not distort the market. These activities will also be justified when local capital markets are shallow and lack the institutions capable of lending to subnational governments. According to the Bank's *Financial Markets Strategy*, Bank operations with publicly-owned and managed financial intermediaries must be based on an understanding of the incentives facing public banks and their comparative advantages vis-à-vis private banks. The strategy states that "The IDB should continue its support for the rationalization of state owned banks operating as first tier institutions, promoting their operation along the lines of their private sector counterparts. Likewise, on-lending of IDB funds by state-owned second tier financial institutions should be at rates that approximate market rates of similar terms and conditions and be limited to private first tier institutions that are able to demonstrate solvency, financial strength, and the ability to intermediate term funds. Funds should preferably not be directed at any specific sector of the economy, unless market failures are proven, and all subsidies should be fully transparent, funded and disclosed in the government's budget"

The Intercept. Transfer intercepts have been used to automatically pay back loans out of the revenue transfers that would otherwise correspond to the debtor government. However, this practice has serious long-term drawbacks. Fundamentally, it reduces the incentives for private lenders to fully develop capacity to assess the risk posed by individual subnationals, thus weakening the borrowing discipline that the market can exercise. In addition, it may

crowd out lending to the private sector, unduly distorting the allocation on resources in financial markets. Committed to promoting a hard credit discipline for subnational governments, the Bank will not advocate the use of the intercept when it would discourage lenders from assessing the full risk presented by subnational governments. For the intercept to yield 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. However, consideration must be given to other options that may achieve the same results without using the intercept, e.g. the establishment of irrevocable trust funds by subnational governments to guarantee repayment of loans.

Credit Enhancement

Credit enhancement mechanisms are required whenever the undeveloped nature of local financial markets make 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 in subnational finance and promote higher degrees of 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 beforehand, ensuring they are reasonably priced and that the structure of all agreements is negotiated in great detail.

INTEGRALITY OF BANK SUPPORT

To fully place the subnational development process on a self-sustained path the reforms and institutional developments discussed in the preceding recommendations ideally need to be in place simultaneously. Therefore, the Bank will seek as integrated a response as possible when discussing subnational development issues with borrowing member countries, giving priority to Bank support for subnational development. The objectives for Bank support are *setting the incentives right* in all the critical areas, including intergovernmental relationships, governance, institutional development and financing.

Given the complexity of the issues to be addressed, the resulting lending program may involve a sequence of interventions that, in time, tackle the critical issues. This, in turn, requires the Bank to discuss with borrowing member countries their mid- and long-term goals concerning subnational development to agree on a country-specific program for Bank support. Country subnational development programs designed in line with the objectives established in this strategy will require coordinated efforts in different fields, thus expanding the scope and complexity of Bank operations.

III. Strategy Implementation

IMPLICATIONS FOR BANK SUPPORT OF SUBNATIONAL DEVELOPMENT

Shifts in the Emphasis of Bank Lending: The Core of the Strategy

Pursuing the strategic focus proposed require a shift in the emphasis of Bank lending for subnational development. The Bank will no longer lend just to expand infrastructure but will also support borrowing member countries in their efforts to correct distortions in the resource allocation process and attain fiscal responsibility on the part of subnational governments. These issues lie at the core of the capacity 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 that results in unsatisfactory outcomes. Access to Bank resources will facilitate committed governments to undertake the necessary reforms. Given the complexity of the issues involved, Bank support for subnational development will need to be structured as a phased sequential program involving the coordinated use of the full array of Bank instruments.

Themes to be Addressed in Bank Operations

The proposed strategic focus has implications for the scope of themes to be discussed with the borrowing member country while addressing subnational development issues. It involves expanding the scope of activities eligible for investment financing and institutional support.

In actively promoting reforms to the underlying incentive structure shaping the behavior of subnational governments, the Bank will have to bring into the discussion the complex issues described below:

- ? The system of intergovernmental relationships that determines whether or not subnational gov-

ernments face tight budget constraints and are encouraged to behave in a fiscally irresponsible manner.

- ? Subnational governance systems that provide elected officials with incentives to respond to their constituencies and to behave in a fiscally and administratively responsible manner.
- ? Institutional issues that determine the capacity of subnational governments to manage human and financial resources to mount effective responses to the needs and priorities of their communities.
- ? The legal and budgetary rules governing subnational government borrowing and the response of local financial markets that determine whether or not governments and markets are imposing a hard credit discipline on subnational governments.

Expanded Opportunities for Bank Development Assistance

The support of this reform agenda and the formulation of coherent country subnational development programs open opportunities for the Bank to assist countries in an integrated fashion with policy advice and knowledge transfer. Sector and country studies and best practice research activities need to be expanded to assist governments in confronting the complex challenges posed by subnational development. They provide necessary inputs for policy dialogue and the design of country specific reform programs.

Tailoring the Support Mechanisms

The complexity of the development agenda described is augmented by the diversity in size, resource endowment, population, and level of development that exist among subnational territories in a given country. This is further complicated by the differences in institutional capacity observable in subnational governments. The Bank will encourage borrowing countries to diversify their policies to ad-

dress the specific development needs of different types of subnational territories and governments. Country strategies will differentiate the diverse demand for Bank support by type of subnational, states and provinces of federal countries, large cities and metropolitan areas, medium-sized cities, medium-sized municipalities and small municipalities.

Diversification of Execution Agencies

Project financing and institutional development activities have few elements in common that justify execution by the same agency. A clear separation of lending and institutional support functions is advocated to entrust responsibility to specialized institutions. Ensuring the rationality of investment decisions made by subnational governments should be the responsibility of national, state, provincial or municipal planning departments and elected officials and not of the financial intermediaries. The development of institutions capable of performing these tasks is urgently needed. Government efforts to support institutional development at the local level are better entrusted to institutions (public, private or nongovernmental organizations) in which subnational governments have a management and financing role. The national associations of subnational governments that have emerged and are acquiring increasing representation and institutional capacity constitute potential executors of Bank-financed institutional development activities. To the greatest extent possible, delivery mechanisms for institutional strengthening should be demand driven, empowering beneficiaries to choose topics and providers of institutional development assistance.

The creation or strengthening of independent institutions (financed partially by the government and partially by users) with the responsibility of collecting and analyzing information on subnational finances and institutional capabilities is required. Such information is critical for ensuring the transparency and accountability of subnational government.

The central government plays a role in the prudent regulation of subnational debt issuance and in ensuring that financial markets impose a hard credit discipline on subnational governments. A well developed regulatory framework is strongly advocated to allow financial markets to flourish and to develop the capacity to lend to subnational governments while at the same time ensuring that they are subject to hard credit constraints.

INSTRUMENTS FOR SUPPORTING SUBNATIONAL DEVELOPMENT

The strategic focus proposed for supporting subnational development requires an integrated response by the Bank. It should provide coordinated support on a variety of fronts. To achieve this degree of coordination the Bank will seek broad agreements with the borrowing country concerning the objectives, instruments and sequencing of interventions and the Bank's role in supporting them. On the basis of these agreements, the Bank will identify the lending and nonlending products that can be put at the disposal of the borrowing country to assist its subnational development efforts. In implementing the strategic approach described in this document, the Bank will make coordinated use of all of its available instruments: technical studies, policy advice, best practice research and dissemination, loans to central governments and subnational entities, loans to the private sector, MIF operations and technical cooperation. Attainment of the above conditions has implications for most Bank activities, from programming to evaluation.

Programming

Policy Dialogue

For countries committed to subnational development that seek assistance, the Bank will extend the scope of the programming process so that it becomes a vehicle for an integrated discussion with the central government of the issues confronting subnational development in the country. In countries placing a priority on Bank support for this area of lending, this

exercise should lead to Country-Bank agreements on a long-term subnational development program. Such an agreement should also be the result of a broad consultation process involving all stakeholders. Inasmuch as this program will assist national policy-making it constitutes a non-financial product of the Bank in support of the country. A second outcome of this exercise is ensuring that Bank assistance is tailored to the specific needs of the country providing a precise definition of the scope of the support (national, subnational levels), the priorities among the different topics to be addressed (local economic development, provision of services, intergovernment relationships, governance, institutional development, local financial market development), the subnational governments that will be included in Bank operations and the sequencing of Bank intervention.

Given the long-term nature of the interventions required to foster subnational development, the Bank's operational program will have a corresponding long-term perspective. In the best of circumstances, the programming process should lead to Country-Bank agreement on a multiphased program to address the key issues of subnational development with a sequence of coordinated Bank operations designed to accomplish well-defined objectives. Reaching agreement on such a country program requires long-term commitments on the part of governments in order to provide greater stability to subnational development policies. Definition of a medium-term Country-Bank program allows individual operations to be fitted into a well-designed policy framework. This greatly facilitates the coordination of different Bank products so as to promote changes in the different sectors that have an impact on subnational development. It also facilitates loan preparation, appraisal, negotiation and start up.

Sector Work

In countries requesting Bank support for subnational development, sector studies will be completed to gain a solid understanding of the issues involved.

These studies will support the policy dialogue. The Bank will assist borrowing countries to undertake these studies and other sector activities as required, including technical studies, seminars and meetings to identify and promote policy reforms that foster the attainment of the government's decentralization objectives. The sector work also aims at coordinating the reforms promoted in the country subnational development strategies with those planned or under execution in related sectors (like capital market promotion, tax reform, decentralization of health and education, reform of the state programs and enterprise development) supported either by the Bank or by other agencies.

Investment Lending

Lending

Lending with sovereign guarantee will remain the principal instrument available to the Bank. However, the strategic focus on decentralization adopted in this strategy calls for the coordinated use of Bank instruments and resources. These include investment loans for public utilities under the purview of subnational governments; reform of the state operations benefiting institutions of the central and subnational governments; policy driven investment loans with sovereign guarantees, multiphased program loans or multiple works loans to national institutions, states or provinces (in federal states), and municipalities; innovation loans; and reimbursable and non-reimbursable technical cooperation. Bank financing will cover all eligible expenditures involved in the implementation of the reforms, institutional developments and investments required to attain the objectives of the Country-Bank program. MIF operations can support aspects of the reforms, in particular those concerned with 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 requires a prior agreement on the policy framework and a multi-year Country-Bank program that allows the country and the Bank to select the

most suitable combination and sequencing of Bank instruments for attaining the agreed objectives.

In the array of Bank products, two types of operations stand out as particularly suited for promoting the objectives of the strategy. These are policy-driven investment loans, innovation loans and technical cooperation loans.

- ? *Policy-driven Investment Loans* and the *Multi-phase Program Loans*. Policy reforms are central objectives for the former, while the latter provides a coherent framework to incorporate gradual policy reforms and institutional development objectives into loan conditionality. Both mechanisms increase the capacity of the Bank to leverage investment resources to promote sector reforms.
- ? *Innovation Loans* can also play a similar role at the early stages of the implementation of a multi-phased strategy. In addition to financing technical studies and capacity building activities, they can also be designed to finance the cost of administrative reforms and institutional re-engineering. Because they focus on institutional issues, these operations can play a critical role in the early stages of implementation of the multi-year Bank strategy and can be instrumental in preparing the ground work for later Bank operations focusing on expanding local service capacity.
- ? *Technical Cooperation Loans*, given their flexibility, are particularly suited to support policy reforms and institutional development.

However, most of these instruments have been developed with a bias towards national development, and therefore are not an adequate instrument to finance certain activities required in direct economic and social reform operations at the subnational level. As such, there may be a need to modify them or to develop new ones to assist borrowing member countries in tackling the special economic reform programs to develop subnational territories. In particular, policy-based lending, successfully applied at the national level may need to be extended to the

subnational level after the appropriate adjustment in the instrument are made for these cases.³

Traditional *multiple-works* municipal loans make effective instruments to support service expansion by subnational governments when the major objectives of the reforms are attained and the institutional setting for subnational development is on a strong footing. This type of loan will be best used in circumstances where subnational development is well advanced or when the institutional capacity of the beneficiary subnational governments is high. This entails changing current practices that make this type of loan the standard for supporting subnational development. The Bank will use *time-slice* operations only in cases where well-structured institutional frameworks exist for the management of investment resources.

Private Sector Lending

The Bank contributes through its Private Sector Window to the financing of private investors working in areas of subnational responsibility that have been privatized. 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 fill subnational development financing needs. The institutional developments pursued by the strategy are pre-conditions for the effective use of this line of financing.

The Multilateral Investment Fund (MIF)

The MIF can support two areas of concern for the subnational development strategy: the development of the institutional framework for the privatization of infrastructure and services and the establishment of institutional mechanisms for the promotion of subnational economic development. The Bank will also expand MIF activities in support of national regula-

³ The development of these instruments forms part of a separate line of work of the Board and the Administration.

tory bodies concerned with privatized public services and in support of the development of local capital markets.

Program Development Products

The Bank is in good position to provide policy advice and good practice research to facilitate the design and implementation of reform programs and contribute to the improvement of ongoing experiences.

These activities can be based on products emerging from the programming process or in products expressly developed like the comparative analysis of subnational development experiences.

Products Generated in the Programming Process

The approach to programming recommended by the strategy results in two program development products: the technical studies completed as a part of the recommended sector work and the multi-phased subnational development program resulting from the policy dialogue.

They will improve the understanding of the problems and help sharpen the policies and reforms pursued by the governments. Bank management will coordinate the use of these products to assist countries in pursuing effective subnational policies. The operational program resulting from this process allows governments to coordinate activities and phase interventions, whether they are or are not financed by the Bank.

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 and comparative studies of subnational development experiences make a significant contribution to the quality of policies and projects. Additionally the Bank is well positioned to identify and disseminate good practices in subnational development. The Bank will actively pursue these studies, as they open the scope of solutions considered in subnational development strategies and shorten the time required for innovations to take root.

IV. Coordination with Other Development Institutions

Other multilateral development institutions support subnational governments in Latin America and the Caribbean. The proposals of the subnational development strategy do not contradict these efforts and take full advantage of synergies. 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 Bank in several countries. The most recent policy paper concerned with municipal development stresses the need to promote sustainable cities and towns that fulfill the promise of development for their inhabitants (in particular by improving the lives of the poor and promoting equity) while contributing to the progress of the country as a whole. Although the focus is different from that on this strategy, there are no incompatibilities and no conflicts can be expected. Similarly, there are no incompatibilities with the policies of the United Nations Center for Human Settlements (HABITAT), which concentrates on supporting efficient urban management, neither with the European Commission's Urban Latin American Program (URB-AL), which is directed toward the establishment of partnerships between cities of Europe and LAC to foster exchanges of experiences and to develop common interests.

Several bilateral cooperation agencies are active in subnational development in LAC, some with substantial programs. US AID focuses on the stimulation of local economic growth, cost effective provision of urban services, environmental protection and governance issues. The German Society for Cooperation (GTZ) has an active municipal development program focusing in improving citizen participation in local decision making, the development of investment projects focused on the low-income population and local economic development. The Swedish International Development Agency (SIDA) is active in low-income LAC countries mostly working with poor municipalities in the improvement of 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. The Bank will actively seek coordination with these initiatives in countries where they are in operation in order to take full advantage of the synergies.

V. Corporate Impacts

Addressing the needs of subnational governments represents a significant challenge for the Bank. The new focus for lending proposed in this strategy, which 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, is more demanding on Bank resources than present activities. The bigger challenge is the proper coordination of all Bank instruments in the countries where the Bank embarks on assisting subnational development. Traditional municipal development loans, which 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, MIF and private sector operations to address, in addition to current concerns, the systemic issues concerning the regulatory framework of subnational governments.

Bank operations will have to engage all relevant central, state, and municipal entities that work with subnational governments, nongovernmental organizations and civil society organizations that play a role in improving subnational performance. Loan preparation, negotiation and execution will be done in an expanded set of counterpart agencies adding complexity to the process and making it more time consuming. Further, the Country Offices will assume more complex responsibilities in the supervision of policy driven and multiphased loans in as much as these operations require closer technical supervision.

ADDITIONAL TRANSACTION COSTS

Cost of Sector Work

To support the policy dialogue that should precede the adoption of a country sector strategy, the Bank and the borrowing countries will have to finance the required sector studies and consultation exercises. Furthermore, regional operational departments may find it useful to adopt subregional strategic approaches to better target their efforts. The Bank will have to progressively incorporate in its annual budget the additional resources required to undertake these activities.

Coordination of Bank Expertise

The Bank will coordinate the use of available human resources pooling the expertise available in different operational divisions to form adequately staffed project teams. Central departments will expand their support to the regions, particularly with the expertise available in the Fiscal Division (INT/FIS), the Research Department and the technical divisions of SDS. In sum, to properly conduct sector work in a given country, a major collaborative effort will have to be launched among the operational units of the Bank and the central departments.

Loan Processing and Execution

The number of municipalities, states and provinces that can approach the Bank for loans with sovereign guarantee is large. This holds the potential to greatly expand the number of clients the Bank will have to deal with, thus enlarging the administrative effort the Bank must exert to respond to this demand. The challenge for the Bank is to work with a large number of partners. However, it can only directly work with a limited number of subnational governments.

The choice of operations will be highly dependent on the results of the policy dialogue and the long-term subnational development strategy emerging from national programming exercises. The Bank will actively manage the pipeline to ensure efficient response to clients with the limited resources available at any given point in time. As a result, integrated lending programs in selected countries will replace isolated operations in many countries. The Bank's administrative budget will need to include the additional cost of the more complex and time consuming processing and supervision required by these operations.

Financing of Program Development Products

Focusing on the institutional development aspects of subnational governments requires the Bank Group to expand the range of program development products to support the soft aspects of the reforms. The development of program development products consumes significant amounts of staff time and other resources that will be incorporated into the annual programs of the central and regional operation departments.

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. It will develop supervision and evaluation methodologies to assess the effectiveness of operations during execution and also to be capable of identifying corrective actions. The methodologies will include the use of, among other elements, quantitative indicators; questionnaires to gather data and calculate values for quantitative indicators, public opinion surveys and periodic evaluation

meetings. 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.

Evaluation of Strategy Implementation

The forces propelling subnational development in the region are many and complex. The Bank is but one of many actors in the process. This prevents measuring the implementation of the strategy 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 in the scope and nature of Bank operations in support of subnational development. To this end, the Bank will undertake a baseline study to assess the extent to which Bank projects in the last four years have included the key themes addressed in the strategy. The same study will be conducted after five years of implementation to assess whether the new crop of operations incorporated the themes and orientations provided by the strategy. This methodology allows a measure of the influence of the strategy on Bank operations, a significant dimension of impact.

POLICY IMPLICATIONS

Within the framework of the existing operational policies, the Bank Group can execute most of the interventions that may emerge from the strategy. Therefore, no new policies will have to be developed to execute the proposed strategic approach with the exception of the possible need for new lending instruments for assisting economic reform for subnational development, an issue that is addressed separately by the Board.

BUDGETARY IMPLICATIONS

As stated above, implementation of the proposed strategy is not budget neutral. The full implementation of the strategy will require additional pre-

paratory work and involve more actors than those usually involved in more traditional operations. Even though the Bank has already moved in this direction in the last few years, the present strategy proposes a deepening of this trend. If no additional resources are made available for the operational departments to undertake the activities proposed, resources will have to be diverted from other activities or the implementation of the strategy will have to be partial. To fulfill the targets established in the Action Plan, the regional departments will require resources, both of staff and consultants, to undertake the sector studies and conduct country dialogue. Extra resources (including legal support) will also be required to process the relatively more complex loans emerging from the country subnational development programs agreed with the Bank. Additional costs will be incurred in project preparation but fundamentally in project supervision and evaluation.

Central departments will have to prepare guidelines and issue and good practice papers in support of the implementation of the strategy.

Additional resources are required due to the wide variety of issues that need to be addressed. The strategy outlined in this document is part of the trend in the Bank of providing more focused, effective, broader and higher quality services to the clients, all of which has a cost.

ACTION PLAN FOR STRATEGY IMPLEMENTATION

Putting the proposed strategy into effect is a complex undertaking that will have to be phased in. Furthermore, opportunities for the Bank to pursue the proposed strategic focus will depend to a great extent on the willingness of borrowing countries to seek Bank support in their subnational development efforts. Seizing these opportunities is the responsibility of management. The following tables provide indicative goals for putting the strategy in place. They cover the first five years and are organized according to the instruments available to the Bank to support subnational development, namely: programming, investment lending and program development products.

Instruments	Indicative Targets		
	Year 1	Year 3	Year 5
Programming	<ul style="list-style-type: none"> ? For countries in early stages of decentralization, at least 1 country per region with sector studies under preparation and engaged in policy dialogue with the Bank for the definition of a Bank-Country Strategy ? For countries with more advanced decentralization processes, at least 1 country per region actively engaged in policy dialogue with the Bank to develop loans including reforms to the subnational development framework to improve either/or intergovernmental relations, the governance structure, institutional development, financial intermediation for subnational lending and to assist subnational governments undertake expanded responsibilities 	<ul style="list-style-type: none"> ? At least 1 country per region with agreed country subnational development strategy ? At least 3 additional countries that have made subnational development a priority, have sector studies under preparation and are engaged in policy dialogue with the Bank in order to establish a subnational development strategies supported by the Bank. ? In all countries undergoing programming exercises with the Bank that have made subnational development a priority: analysis of the subnational development issues discussed in the strategy document, included in Country Paper and in the dialogue with the government. 	<ul style="list-style-type: none"> ? Six Bank-Country subnational development strategies under execution ? Two more countries that have made subnational development a priority have sector studies under preparation and are engaged in policy dialogue with the Bank to establish subnational development strategies supported by the Bank. ? In all countries undergoing programming exercises with the Bank that have made subnational development a priority , the subnational development issues discussed in the strategy document are analyzed, included in the Country Paper and in the dialogue with the government
Investment lending	<ul style="list-style-type: none"> ? In at least half of the operations in the pipeline that support of subnational development, the Bank discusses with governments and include components to address 	<ul style="list-style-type: none"> ? At least 1 country per Region are either preparing or executing loans that already form part of a subnational development programs agreed with the Bank 	<ul style="list-style-type: none"> ? At least 3 loans under execution form part of country subnational development programs agreed with the Bank ? All loans loans in support of subnational

Instruments	Indicative Targets		
	Year 1	Year 3	Year 5
	<p>(a) new functions and responsibilities, and (b) the deficiencies of the framework of intergovernmental relations, the governance structure, institutional development, financial intermediation for subnational lending. These issues are discussed in Profiles II and Project Documents.</p>	<p>? All loans in support of subnational development incorporate a discussion of intergovernmental relations, governance, institutional capacity and financial intermediation and address issues emerging from the expanded functions transferred to subnational governments. This discussion is included in Profiles II and Project Documents.</p> <p>? At least half of the loans executed or under execution include components to address the problems identified above.</p>	<p>development under preparation (whenever pertinent) include components to address deficiencies of the framework of intergovernmental relations, governance, institutional capacity and financial intermediation and issues emerging from the expanded functions transferred to subnational governments.</p>
Program development products	<p>? Review of Bank portfolio of subnational development projects under execution. Baseline study for Strategy evaluation</p> <p>? Operational Guidelines for the Subnational Development Strategy.</p> <p>? Preparation of a set of indicators to assist Regional Departments in assessing the status of subnational government in countries.</p>	<p>? Technical studies in support of Bank lending on issues and good practices for:</p> <ul style="list-style-type: none"> - Strategic planning for subnational development - Poverty programs - Metropolitan governance - Promotion of local economic development 	<p>? Technical studies in support of Bank lending on issues and good practices for:</p> <ul style="list-style-type: none"> - NGO participation in subnational development - Public private partnership for subnational development