Colombia
Reforming the Decentralization Law: Incentives for an Effective Delivery of Services
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<tr>
<td>CONPES</td>
<td>National Council for Economic and Social Policies (Consejo Nacional de Política Económica y Social)</td>
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<td>CR</td>
<td>Current Revenues</td>
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<td>DANE</td>
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<td>National Planning Department (Departamento Nacional de Planeación)</td>
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<td>Public health plan (Plan de Asistencia Básica)</td>
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<td>Basic health package (Plan Obligatorio de Salud)</td>
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<td>SISBEN</td>
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<td>UDT</td>
<td>Decentralization Unit in DNP (Unidad de Desarrollo Territorial)</td>
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<tr>
<td>UMATA</td>
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EXECUTIVE SUMMARY

1. Decentralization in Colombia is well advanced, having begun over a decade ago. Nonetheless, the process has recently been the focus of renewed attention. The issues under discussion include the performance and capacity of municipios (an issue addressed in World Bank (1995a)), the extensive use of earmarking of intergovernmental transfers, and the fiscal and macroeconomic implications of the system of intergovernmental transfers.

2. Despite the importance of such issues, in many ways the basic question underlying the current debates concerns the adequacy of existing institutional and financial arrangements to provide the incentives for an effective delivery of services in a decentralized environment. This is the question discussed in this report.

3. Many possible reforms are being discussed with respect to transfers. Indeed, Congress is required to consider adjustments in Law 60 (which establishes the responsibilities of different levels of government in essential areas such as education, health, water and housing, and the rules governing the system of intergovernmental transfers) in 1996. The challenge is to use this opportunity in a positive way in order to provide information and analyses that contribute to informed decisions by policy-makers.

4. Over the last eleven months, the World Bank has been collaborating with the National Planning Department (DNP) and other national agencies (including the Dirección de Apoyo Fiscal of the Ministry of Finance and the Ministries of Education and Health) in a revision of the institutional and legal framework ruling decentralization with the purpose of recommending adjustments. This report summarizes the findings emerging from that work and makes recommendations oriented to making decentralization work.

5. The report, however, does not constitute a formal proposal for the reform of Law 60, let alone of the broader set of intergovernmental fiscal issues currently under study in Colombia. Rather, it should be seen as an input to the discussion process among all interested parties in Colombia. The recommendations made in the report attempt to avoid, to the extent possible, conflicts with constitutional rules and minimize necessary legal changes. For example, the report takes as given the size of the transfers (as established by the Constitution and Law 60). The underlying logic of the report is to consider changes in the implementation, rather than the principles, of the existing framework for decentralization in order to make it more conducive to an effective delivery of services by local governments. The question of the fiscal sustainability of the system, especially of the increases mandated by the Constitution, is not discussed in this report. The recommendations in the report regarding the structure of the transfer system should be valid, within certain limits, regardless of the size of the transfers.

6. This document analyzes the problems of the system of intergovernmental transfers by, first identifying objectives, next the instruments that are being used, and finally evaluating the extent to which there is an adequate assignment of instruments to objectives.

7. One basic objective, indeed perhaps the principal one, of the transfer system derived from the National Constitution and Law 60 is to guarantee the provision of minimum service levels of education and health to the population. Given the important externalities
associated with those services and their special status, the national level has in effect assumed the responsibility of financing the provision of those services. The main guiding principle that we propose should be followed is that money should flow to the entities (even if they are not part of the public sector) that are actually responsible for the provision of these minimum service levels. This leads us to recommend that the cost associated with the provision of minimum service levels in education and health should be financed through a specific purpose transfer calculated on the basis of costs and number of beneficiaries. Given the institutional setting that prevails in these two sectors, more than one transfer will be needed for each sector. The main difference from the existing system is the establishment of a direct link between the guaranteed service and its financing that is not a function of complex formulae that attempt to measure poverty, fiscal capacity/effort, or other variables that do not represent the cost of providing the service.

8. The Colombian system assumes the national level will partially finance capital expenditures whenever it is necessary to expand coverage of critical services such as education, health or potable water, or in areas where there are large externalities as in the case of sewerage or roads. Other types of investment projects can be financed entirely by the beneficiaries either through taxes and betterment levies, and through borrowing in the credit markets. In a decentralized system, in principle, subnational governments identify infrastructure needs and execute projects. The national level only provides incentives to orient resource towards projects with externalities or those important for national goals. This leads us to recommend that national financing of lumpy capital investment projects undertaken by departments and municipios be done through matching grants and not through an automatic transfer.

9. The system of intergovernmental transfers would be incomplete without some type of general purpose grant which replaces the confusing use of redistributive measures in the Situado and Participaciones. Such grants enable all subnational governments to operate at some minimum level and provide other services besides health and education. At the same time they partially compensate for the large differences in fiscal capacity that exist among municipios, and hence place all municipios on a more level 'playing field' with respect to the equal (per service unit) capitation grant proposed for basic health and education. The key aspects of these grants involve the fact that the use of funds thus provided would be at the discretion of the municipio (and thus would exclude any type of earmarking) and, especially, that they would be distributed according to needs and fiscal capacity. It should be emphasized that if this grant should become too small the viability of the entire system may become suspect.

10. The natural way to implement the revised system would be to have three separate transfers. The amounts to be allocated to the education and health transfers would be determined based on the cost of providing the services, and not as a given percentage of current revenues. The amount allocated to the general purpose grant would be calculated either so as to level the fiscal capacity of all municipios to a given level, or as a percentage of GDP. However, the report argues that the main elements of the revised system can be accommodated within the existing constitutional framework which considers one integral transfer calculated as a percentage of current revenues.
11. Adjustments are required in addition to those recommended for the system of intergovernmental transfers. Changes are needed to give subnational governments more flexibility to use resources, eliminating all earmarking (and mandates) that do not respond to very clearly established needs. To a great extent, the difficulties of implementing Law 60 and decentralization in general are associated with the prevailing confusion regarding the responsibilities of different entities. This has created some important institutional bottlenecks that must be removed in order to improve the incentives for an effective delivery of services. While this matter is not the focus of the report, analyses and recommendations are included in the annexes to the main text.

12. Section 1 of the report identifies the main problems with the current system of intergovernmental transfers. Section 2 presents what we believe should be the guiding principles for a reformed system. Section 3 discusses in depth the principal components of the system. Finally, Section 4 discusses some of the critical options and decisions faced by reformers in their effort to redesign the main transfers. Several annexes analyze specific issues in more detail and serve as background to the proposals and recommendations made in the main text.
RESUMEN EJECUTIVO

1. El proceso de descentralización en Colombia ha avanzado mucho desde que se inició hace más de diez años. Con todo, en los últimos tiempos ha vuelto a ser objeto de especial atención. Las cuestiones que se están debatiendo son el desempeño y la capacidad de los municipios (tema abordado en un trabajo del Banco Mundial (1995a)), el amplio uso del destino específico para las transferencias intergubernamentales y las repercusiones fiscales y macroeconómicas del sistema de transferencias.

2. A pesar de la importancia de dichos temas, en gran mediea el interrogante básico de los debates que se están sosteniendo en la actualidad se refiere a la pertinencia de los sistemas institucionales y financieros existentes para proporcionar incentivos para la prestatción eficaz de servicios en un medio descentralizado. Este es el tema de este informe.

3. En la actualidad se están estudiando diversas posibles reformas en el campo de la descentralización. En 1996 el Congreso debe considerar la modificación de la Ley 60 (en la que se establecen las responsabilidades de los distintos niveles de gobierno en esferas esenciales como educación, salud, abastecimiento de agua y vivienda, y las normas por las que se rige el sistema de transferencias intergubernamentales). El desafío que se encara consiste en aprovechar esta oportunidad de manera positiva a fin de proporcionar información y análisis que ayuden a los responsables de las políticas a adoptar decisiones bien fundamentadas.

4. A lo largo de los últimos once meses, y en respuesta a un pedido por parte del Gobierno Nacional, el Banco Mundial ha estado colaborando con el Departamento Nacional de Planificación (DNP) y otros organismos nacionales (incluida la Dirección de Apoyo Fiscal del Ministerio de Hacienda y Crédito Público, y los Ministerios de Educación y Salud) en la revisión del marco institucional y jurídico relativo a la descentralización con el propósito de recomendar ajustes. En este informe se resumen las conclusiones que surgen de esa labor y se formulan recomendaciones orientadas a lograr que la descentralización dé buenos resultados.

5. Empero, el informe no es una propuesta formal de reforma de la Ley 60, mucho menos del amplio espectro de aspectos relacionados a las finanzas intergubernamentales que se están discutiendo en Colombia. Debe considerarse más bien como un aporte al proceso de estudio por las partes interesadas que está teniendo lugar en Colombia. Las recomendaciones formuladas en el informe tratan, en la medida de lo posible, de evitar conflictos con las normas constitucionales y reducir al mínimo los cambios jurídicos necesarios. Por ejemplo, el informe toma como dada la magnitud de las transferencias (establecidas en la Constitución y la Ley 60). La lógica en que se basa es considerar cambios en la aplicación, más que en los principios, del marco existente para la descentralización a fin de que sea más propicio para que los gobiernos locales presten servicios eficaces. El tema de la sustentabilidad fiscal del sistema, en particular del aumento en transferencias establecido por la Constitución, no es tratado en el informe. Las recomendaciones con respecto a la estructura del sistema de transferencias que se hacen en el informe son válidas, dentro de ciertos límites, independientemente del nivel de las transferencias.
6. En este documento se analizan los problemas del sistema de transferencias intergubernamentales identificando primero los objetivos y después los instrumentos que se están usando y, por último, evaluando la medida en que se han asignado los instrumentos adecuados para la consecución de los objetivos.

7. La meta básica, y tal vez la principal, del sistema de transferencia derivado de la Constitución Nacional y la Ley 60 es garantizar la prestación de niveles mínimos de servicios de educación y salud a la población. Habida cuenta de las externalidades importantes vinculadas a esos servicios y su condición especial, el nivel nacional ha de hecho asumido la responsabilidad de financiar su prestación. El principio rector que proponemos que se siga es encauzar dinero hacia las entidades (aunque no sean del sector público) que sean efectivamente responsables de la prestación de estos niveles mínimos de servicios. Esto nos lleva a recomendar que el costo vinculado con la prestación de niveles mínimos de servicios de educación y salud debe financiarse mediante una transferencia para fines específicos calculada sobre la base de los costos y el número de beneficiarios. Teniendo en cuenta el marco institucional que prevalece en estos dos sectores, se necesitará más de una transferencia para cada sector. La principal diferencia con el sistema vigente es la creación de un vínculo directo entre el servicio garantizado y su financiamiento, que no sea función de fórmulas complicadas para tratar de medir la pobreza, la capacidad y el esfuerzo fiscal u otras variables que no representan el costo de prestación de los servicios.

8. El sistema colombiano supone que el nivel nacional de gobierno financiará parcialmente los gastos de capital cuando sea necesario ampliar la cobertura de servicios críticos de, por ejemplo, educación, salud y abastecimiento de agua potable, o en esferas de grandes externalidades, como el alcantarillado o las carreteras. Otros tipos de proyectos de inversión pueden ser financiados íntegramente por los beneficiarios, ya sea mediante impuestos de valorización y otros, o la obtención de fondos en los mercados de crédito. En principio, en un sistema descentralizado, los gobiernos subnacionales determinan cuáles son las necesidades de infraestructura y ejecutan los proyectos. El nivel nacional de gobierno sólo proporciona incentivos encaminados a orientar los recursos hacia proyectos con externalidades o que revistan importancia para objetivos nacionales. Esto nos lleva a recomendar que el financiamiento de proyectos de inversiones indivisibles de capital que sean llevados a cabo por los departamentos y municipios se efectúe mediante donaciones de contrapartida y no de una transferencia automática.

9. El sistema de transferencias intergubernamentales quedaría incompleto sin algún tipo de transferencia de propósitos generales en reemplazo de la confusa aplicación de las medidas de redistribución que hoy se incluyen en el Situado Fiscal y las Participaciones Municipales. Dichas transferencias permiten a todos los gobiernos subnacionales funcionar a un nivel mínimo y prestar otros servicios además de los de salud y educación. Al mismo tiempo compensan parcialmente las grandes diferencias de capacidad fiscal que existen entre los municipios, y ayudan a ubicar a todos los municipios en mejores condiciones con respecto a las transferencias propuestas para educación y salud. Los aspectos fundamentales de estas transferencias son el hecho de que el uso de los fondos proporcionados de esa manera quedaría librado a los municipios (por lo que excluiría cualquier tipo de asignación específica) y, concretamente, dichos recursos se distribuirían de acuerdo con las necesida-
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des y la capacidad fiscal. Debe enfatizarse que si el volumen de esta transferencia fuese demasiado pequeño, la viabilidad del sistema como un todo estaría en duda.

10. La manera natural de implementar el sistema recomendado sería a través de tres transferencias automáticas separadas. Los montos asignados a las transferencias para educación y salud serían determinados en base al costo de proveer dichos servicios y no como un porcentaje de los ingresos corrientes. El monto de la transferencia de propósito general sería calculada de modo tal de igualar la capacidad de todos los municipios hasta cierto nivel, o como un porcentaje del PIB. Sin embargo, el informe argumenta que los principales elementos del sistema propuesto pueden ser también implementados dentro el esquema constitucional vigente que considera una transferencia integral calculada como porcentaje de los ingresos corrientes.

11. Es preciso hacer otros ajustes además de los recomendados en el sistema de transferencias. Es preciso introducir cambios que doten a los gobiernos subnacionales de más flexibilidad para el uso de los recursos, eliminando las asignaciones específicas (y los mandatos) que no se ajusten a necesidades establecidas con gran precisión. En gran medida, las dificultades para aplicar la Ley 60 y poner en práctica la descentralización en general se vinculan con la confusión vigente con respecto a las responsabilidades de las distintas entidades. Esto ha creado cuellos de botella institucionales importantes que deben eliminarse a fin de mejorar los incentivos para la prestación eficaz de servicios. Si bien esta cuestión no se trata especialmente en este informe, en los anexos se incluyen análisis y recomendaciones al respecto.

12. En la Sección 1 del informe se identifican los principales problemas del actual sistema de transferencias intergubernamentales. En la Sección 2 se presenta lo que consideramos que deberían ser los principios rectores del nuevo sistema tras la reforma. En la Sección 3 se analizan a fondo los principales componentes del sistema. Por último, en la Sección 4 se tratan algunas de las opciones y decisiones críticas que encaran los reformadores en su labor de reformulación de las principales transferencias. En varios anexos se analizan problemas específicos de manera más detallada; en ellos se apoyan las propuestas y recomendaciones contenidas en el cuerpo principal del informe.
1. THE MAIN STRUCTURAL PROBLEMS WITH THE CURRENT SYSTEM

1.1 The system of intergovernmental transfers in Colombia has three main components: the Situado Fiscal, the Participaciones Municipales, and the National Cofinancing System (SNC). The first two components are recognized in the National Constitution and regulated by Law 60/93, while the SNC was created by Decree 2132/92 (see Box 1). Questions have been raised about the fiscal sustainability of the system, especially of the increases mandated by the Constitution. This topic, which in itself could be the subject of a complete study, is not discussed in this report, which focuses on issues related to the structure of the system of intergovernmental transfers.

1.2 The design and functioning of this system is of critical importance for the economic and social development of the country. First, it influences the effectiveness of the provision of those services that have been decentralized. The transfers generate incentives that can be more or less conducive to the maintenance and expansion of coverage and quality of such services as education, health or water. Second, it could have an important impact on the efficiency of public expenditures both from the point of view of allocative and production efficiency.

1.3 One key problem with the current system is that it focuses too much on the entities receiving the transfer at the expense of the services or activities these transfers are supposed to finance. Thus, in many cases the basic purpose that justifies a transfer of resources (i.e. a subsidy to pay for health services of poor families) remains in the background with respect to the discussion regarding which level of government receives the transfer.

1.4 This document analyzes the problems of the system of intergovernmental transfers by, first identifying objectives, next the instruments that are being used, and finally evaluating the extent to which there is an adequate assignment of instruments to objectives. Table 1 presents a very simplified map of the Colombian system.

1.5 Five objectives are addressed with the three instruments considered here (the Situado, Participaciones and cofinancing):
- The first two objectives involve the provision of minimum service levels of edu-

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Box 1: Intergovernmental transfers

The Situado Fiscal constitutes a percentage of current revenues (CR) transferred to departments and districts to finance preschool, primary, and secondary education, and health. Law 60 establishes its size (2.7% of GDP or 24.5% of CR in 1995) and the formula by which it is distributed.

The Participaciones Municipales constitute a percentage of CR transferred to municipios and resguardos indígenas to finance social investments. The Constitution establishes that the Participaciones must reach 22% of CR by 2002, as well as the general criteria by which they must be distributed among municipios. Law 60 established the speed at which the Participaciones grow, the formula for their distribution and the rules for their use. In 1995 they represented 1.7% of GDP.

Finally the SNC consist of four funds: the Social Investment Fund (FIS), the Rural Development Fund (DRF), and the Funds for Urban Infrastructure (FIIU) and Road Infrastructure (FIV). The funds help to finance projects by subnational governments through matching grants. Their budget for 1995 represents approximately 0.8% of GDP.
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Table 1: The system of intergovernmental transfers

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<th>OBJECTIVES</th>
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<tr>
<td></td>
<td>Situado Fiscal</td>
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<tr>
<td>Finance Education Services</td>
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</tr>
<tr>
<td>Finance Health Services</td>
<td>✓</td>
</tr>
<tr>
<td>Finance Infrastructure</td>
<td>✓</td>
</tr>
<tr>
<td>Increase local capacity to finance other services</td>
<td>✓</td>
</tr>
<tr>
<td>Inter-regional Redistribution</td>
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The system of intergovernmental transfers pursues two additional objectives. It attempts to increase the fiscal capacity of territorial entities to finance a variety of decentralized or local services. The main instrument for this purpose is a percentage (20%) of the Participaciones that in principle can be allocated freely (transferencias de libre asignación). At the same time, the system tries to compensate differences in fiscal capacity or needs among departments and municipios. This is done through the Situado and Participaciones with distribution formulae that transfer proportionally more resources to the poorest entities. Cofinancing, through quotas (cupos) and differential matching rates, is also used as a redistributive instrument.

1.6 This map indicates that certain objectives are being pursued with more than one instrument and that some instruments are used for several objectives. This scheme generates inefficiencies of different types:

- Assigning the same instrument to finance the provision of education and health services, and to redistribute resources with the purpose of increasing fiscal capacity and compensate inter-regional differences generates important cost-inefficiencies. This is the case because costs are not directly associated with differences in income or wealth. For example, in the case of the Participaciones, per capita transfers are strongly influenced by a poverty indicator (the NBI) and thus vary significantly between municipios. It is not unusual to find that some municipios receive a transfer that, in per capita terms, is three to four times higher than that received by other municipios in the same department. However, an important part of these transfers is being used to cover the recurrent costs of providing education and health services. For example, 30% of the
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*Participaciones* spent on education were used to pay teachers salaries (DNP (1995c)). These costs do not vary between municipios by such large factors, and those variations are not linked directly to a poverty indicator. This arrangement could be contributing to large cost inefficiencies in some municipios.

- Using cofinancing, which by its nature is non-automatic, to finance the recurrent costs of providing education and health services limits the administrative capacity of subnational governments, creates dependency on the national level and thus reduces the efficacy with which services are provided. This is, for example, the case when cofinancing is used to pay for teachers, textbooks and other materials. We estimate that approximately two thirds of FIS’ education budget for 1995 corresponds to recurrent costs and only one third to capital expenditures. This arrangement has the additional detrimental effect of unnecessarily complicating the functioning of FIS, as described in more detail in a separate report (see World Bank (1995b)).

- Assigning the function of financing infrastructure (new water systems, roads, schools or hospitals) to an automatic and permanent transfer such as the Participaciones (whose value is not linked to coverage needs) generates two types of problems. First, the national level loses an important tool to implement the goals of its development plan and to direct resources to those regions with the most important coverage gaps. Second, it does not recognize the obvious fact that construction of infrastructure is a discrete event. To the extent that municipios may lack the flexibility to allocate these resources to other uses, this could lead to even more allocative distortions.

- In many occasions policy makers try to control the distortions generated by this inadequate assignment of instruments to objectives with administrative controls, such as establishing fixed percentages for certain sectors and limits to the free allocation of resources. This creates additional inefficiencies. The use of fixed percentages could easily lead to over-spending in certain sectors. For example, it is unlikely that 15% of the Participaciones can be the optimal amount to be spent on health subsidies in all municipios. However, this is what the current system implies. Also, the limited freedom to allocate these resources to different activities (i.e. recurrent versus capital expenditures) not only does not take advantage of the gains in allocative efficiency theoretically associated with decentralization, but also could lead to an increase in the volume of expenditures financed through credit as this is one of the few means local governments have to escape such limits. Finally, the emphasis on administrative controls distracts the national government from its genuine responsibility to monitor and evaluate the effectiveness with which subnational governments implement programs and provide the services for which they became responsible.

1.7 The inefficiencies and distortions generated by the rigidity implicit in the transfer system are, in many cases, amplified by the proliferation of norms and mandates imposed on municipios and to a certain extent on departments. Laws such as those on public services (Law 142/93), environment (Law 99/93) or sports (Law 181/95) earmark local resources or impose significant costs to local finances. For many municipios earmarking and unfunded mandates imply costs that surpass the 20% of the Participaciones that are not already earmarked (see Annex IV). On the other hand, most subnational governments have little flexibility to generate more fiscal revenues (see Section 3.e) in part due to decisions that still remain centralized. Even so, the evidence shows that increased intergov-
evelopmental transfers have not so far resulted in a reduction in own revenues for the local government sector as a whole (see Annex III).

1.8 Decentralizing the public sector in any country is a process that is not without danger (Prud’homme (1995)). However, even under the present distorted system of incentives facing local governments in Colombia, some early evidence in support of the developmental benefits of decentralization in terms of public sector effectiveness is surprisingly positive (World Bank (1995a)). With a better designed incentive structure, there seems good reason to hope that even more favorable outcomes may emerge over time. What is needed to improve efficiency of subnational expenditures is not so much a radical redirection of Colombia’s policy of decentralization as some redesign of transfers (within limits, regardless of their total size) and local revenues combined with better informed and more consistent implementation on the part of the national government than has been evident to date.
2. THE GUIDING PRINCIPLES

2.1 The basic principle that should guide the design of a system of intergovernmental transfers is the recognition that its purpose is not to finance entities but to contribute to an effective provision of services to the population. To the extent that services are provided by subnational governments without the fiscal capacity to fully finance them, that there are externalities associated with the services in question, and that inter-regional differences in needs are important, transfers are needed to accomplish that goal.

2.2 It is thus necessary to start with the identification of the objectives being pursued, the actors responsible for implementing those objectives, and finally the appropriate instruments to finance them. In other words, it is necessary to ensure that those responsible for the provision of the service have a clear mandate, resources to finance it (including, whenever needed, own resources), flexibility to make decisions, and are accountable for results (see World Bank (1996)). Simplicity, objectivity and transparency of the design are critical for the system to work well (see Box 2). These guiding principles are widely accepted in the international literature (for example Shah (1991) and Bird (1990)). The recommendations made in this report are consistent with those made for Colombia by others (for example, Bird (1984) and the IMF in Ahmad et al. (1995)). Table 2 presents the criteria proposed to address the objectives identified in Section 1.

2.3 Education and health services. One basic objective, probably the principal one, of the transfer system derived from the National Constitution and Law 60 is to guarantee the provision of minimum service levels of education and health to the population. Given the important externalities associated with these services and their special status (in accordance with the Constitution and economic development policy), the national level has assumed the responsibility of financing the provision of these services. The magnitude of the minimum service level and the extent of its coverage among the population constitute, however, variables determined by policy considerations and resource availability.

2.4 Colombia has initiated a process of decentralization in the education and health sectors because it considers that subnational governments are more effective in the provision of these services than the national level. To a great extent, the difficulties of implementing Law 60 and decentralization in general are associated with the prevailing confusion regarding the distribution of responsibilities. In the case of education, these are shared by departments and municipios although, according to the law, municipios have the responsibility of administering the education system. This implies that both levels...
Table 2: Criteria to adjust the transfer system

<table>
<thead>
<tr>
<th>OBJECTIVES</th>
<th>LEVEL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Department</td>
</tr>
<tr>
<td>Education services</td>
<td>Specific purpose transfer (unit efficient cost x number of beneficiaries). Assigned to entities (see Section 3.a) proportionally to cost covered</td>
</tr>
<tr>
<td>Health services</td>
<td>Specific purpose transfer (unit efficient cost x number of beneficiaries). Assigned to entities (see Section 3.b) proportionally to cost covered</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Cofinancing</td>
</tr>
<tr>
<td>Increase local capacity to</td>
<td>General purpose transfer</td>
</tr>
<tr>
<td>finance other services</td>
<td>might be considered</td>
</tr>
<tr>
<td>Inter-regional redistribution</td>
<td>General purpose transfer</td>
</tr>
<tr>
<td></td>
<td>distributed according to fiscal capacity and needs</td>
</tr>
</tbody>
</table>

should receive resources from the national level in order to finance this service (see Sections 3.a and 4). In the case of health implementation of the social security reform makes the process of decentralization even more complex. It is not just subnational governments that receive transfers from the national level but also quasi public enterprises (i.e. hospitals) and companies offering health insurance packages to the poor (i.e. the EPS). The complexity of this scheme is discussed in more detail in Section 3.b.

2.5 The main guiding principle is that money should flow to the entities (even if they are not part of the public sector) that are actually responsible for the provision of these minimum service levels. The magnitude of the transfer is the product of a unit cost (which could vary according to geographic and demographic conditions) and coverage. This leads us to recommend that the cost associated with the provision of minimum service levels in education and health should be financed through a specific purpose transfer calculated on the basis of costs and actual number of beneficiaries. Once the transfer is made, the receiving entity becomes responsible and accountable for the provision of the services both to the national government and to beneficiaries. A monitoring system will obviously be required (see paras. 3.55-3.59).

2.6 The main difference from the existing system is the establishment of a direct link between the guaranteed service and its financing that is not a function of either current revenues or complex formulae attempting to measure poverty, effort, or other variables that do not represent the cost of providing the service. A key decision to be made is how to recognize changes in costs and number of beneficiaries (coverage) over time (see Sections 3.a, 3.b, 4.a and 4.b).

2.7 **Infrastructure.** The Colombian system assumes the national level will partially finance capital expenditures whenever it is necessary to expand coverage of critical services such as education, health or potable water, or in areas where there are large externalities as in the case of sewerage or roads. Other types of investment projects can be financed entirely by the beneficiaries through taxes and betterment levies, and through the
use of credit at market rates. However, the construction of new schools, hospitals, *acueductos*, or roads does not require a permanent flow of resources.

2.8 *In a decentralized system, in principle, subnational governments identify infrastructure needs and execute projects.* The national level only provides incentives to orient resource towards projects with externalities or those important for national goals. It does so by lowering their cost through matching grants. The matching rates should reflect the priority given by the national level, the size of the spillover effect and the fiscal capacity of the local government so that, in principle, they stimulate similar responses in different places (see Section 3.c).

2.9 This leads us to recommend that the partial national financing of lumpy capital investment projects undertaken by departments and *municipios* be done through matching grants and not through an automatic transfer. The use of local taxes and borrowing will continue to be the key source of financing infrastructure projects. For this system of matching grants to work, it is necessary that the national level have very clear objectives and an operational system that can efficiently work with subnational governments interested in having access to these resources (see Sections 3.c and 4.c for further recommendations).

2.10 **The need for a general purpose grant.** The system of intergovernmental transfers would be incomplete without some type of general purpose grant which replaces the confusing use of redistributive measures in the *Situado* and *Participaciones*. Such grants enable all *municipios* to operate at some minimum level and provide other services besides health and education. At the same time, and more importantly, they partially compensate for the large differences in fiscal capacity that exist among *municipios*, and hence place all *municipios* on a more level ‘playing field’ with respect to the (essentially) equal (per service unit) capitation grants proposed for basic education and health. The key aspects of these grants (which may also be considered for departments) involve the fact that the use of funds thus provided would be at the discretion of the *municipio* (and thus would exclude any type of earmarking) and, especially, that they would be distributed according to needs and fiscal capacity (see Section 3.d and paras. 4.23-4.25).

2.11 **Additional adjustments required.** Improving the incentives for effective and efficient provision of services in a decentralized environment will require additional reforms and changes to those recommended with respect to the transfer system, which constitutes the focus of this report. In the first place, it is necessary to clarify the distribution of responsibilities between levels of government and address institutional bottlenecks in several sectors. The cases of education and health are discussed in Annexes I and II. Secondly, changes are needed to give subnational governments more flexibility to use resources, eliminating earmarking (and mandates) that do not respond to very clearly established needs (see Annex IV for some examples). Thirdly, changes are needed to give subnational governments more flexibility to mobilize resources (as discussed briefly in paras. 3.48-3.54, and more extensively in Ahmad et al. (1995)). Finally changes that promote responsibility and accountability in public sector performance at all levels are needed, as discussed in World Bank (1996).
2.12 In sum, the national government should: (i) decide more clearly what it is trying to do; (ii) redesign its policy instruments to the (considerable) extent it can apparently do, to achieve its objectives more efficiently; (iii) free local governments from many of the present restrictions on both revenues and expenditures that hamper them from operating efficiently; (iv) ensure that it has sufficiently accurate and timely information to know what is going on with respect to subnational finance; and (v) alter its policies if, and only if, it is necessary to do so in order to achieve some important national policy objective. Having done all this, the national government can and should then let decentralization take its course without constant changes in direction and policy. If the rules of the game are set up properly so that local governments account properly for funds they are expending on behalf of the national government, and there is at least a modicum of local political accountability for what they do with their own funds, there should be no need for the present cumbersome system of interventionist measures—many of which in effect attempt to compensate for the lack of clear national policies but which fail in this task and instead succeed mainly in making it impossible for anyone to run a subnational government sensibly.
3. THE DIFFERENT COMPONENTS

3.1 This section analyzes in detail the main elements of an adjusted and improved system of intergovernmental transfers along the lines suggested in Section 2.

A. FINANCING EDUCATION SERVICES

3.2 Education and health are the most important sectors in terms of intergovernmental finance in Colombia. The amount and design of all major transfers are dominated by concern for these two sectors. For this reason, special attention needs to be paid in discussing possible reforms in the system of national transfers to the connections between such reforms and the broader picture of finance and reform in the educational and health sectors.

3.3 An extensive diagnosis of the proposed institutional reforms in the educational sector may be found in Annex I. The key points for the present discussion are the following. First, it is not clear who is in charge of what. The relative roles and responsibilities of the national, departmental, municipal, and school-level authorities need to be disentangled and clarified. In what follows, it is assumed that the principal managerial responsibility for basic education will be at the municipal level, although the management of the key element in the education system, teachers, will continue to be a departmental responsibility. Moreover, it is likely to be the case for some time at least that the salaries of teachers will continue to be determined at the national level. A key problem in designing a more effective system for channeling national resources to finance basic education is therefore how to accommodate this divided responsibility.

3.4 Second, it is assumed that the provision of basic education to all Colombians is a fundamental goal of the national government, in accordance with both constitutional responsibilities and economic development policy. To achieve this goal, two elements must be taken into account in determining the basic transfers. The first is the determination of the cost of guaranteeing a minimum standard of basic education to those now in the official school system. The second is the cost of extending the coverage of the system to include those who now receive no or insufficient education. The discussion in this section assumes, for convenience, that both of these tasks may be accomplished by appropriately restructuring existing transfers. While this assumption does not seem unreasonable, given the present coverage and the apparently considerable scope for improved efficiency in the educational sector, it should be emphasized that it is not essential to the argument, which focuses on the appropriate structural design of the system rather than on the total amount of resources to be distributed for educational finance.

3.5 The essence of the proposed change in educational transfers is to move to a system which is clearly directed to financing a guaranteed minimum level of basic education for all Colombians. The key to achieving this goal is to establish a per capita transfer based solely on the recurrent cost of providing this standard to the relevant population. New infrastructure investment needed to expand coverage is assumed to be dealt with through cofinancing (and borrowing), as discussed below. A number of key questions need to be answered in order to design an effective educational transfer: the unit cost of provision,
the number of units provided, the rate of extension of coverage, adjustments to unit cost over time, the division of transfers between departmental and municipal levels of government, the rate of transition, and the monitoring and enforcement of the system. The last of these factors is discussed in general in Section 3.e. The balance of the present section discusses in turn each of the other factors.

3.6 **Unit cost.** This cost might be determined in a number of ways. For example, by assuming a target teacher-pupil ratio, an average teacher cost, and an expansion factor per teacher for non-salary costs (see Box 3). The Ministry of Education is currently working on the definition of a capitation which separates teachers costs from other inputs.

3.7 In principle, it would be best to have a standard national cost (possibly acknowledging cost differences by level of education) though it may be possible to accommodate a limited amount of variation (i.e. regional, rurality, density) without unduly complicating the formula. Caution is necessary in this respect, however, since it is all too easy to turn a simple, transparent formula into an obscure and manipulable one by introducing too much refinement in the definition of its elements. Another argument for a uniform national minimum guarantee might be to avoid any appearance of regional bias: throughout the country the national government guarantees exactly the same amount per unit (child) served, no matter where they live.

3.8 **Number of Units.** ‘Unit’ refers to the quantity costed in the preceding exercise. As suggested as a possibility above, the unit might conceivably be the number of students currently enrolled in, and in effect attending official schools. The number of students currently enrolled, however, may be a poor indicator of the extent to which the nation should be financing education in a particular *municipio*. A better indicator of ‘need’ might be the number of persons of ‘school age’. Some adjustment may also be needed to take into account the substantial, but widely varying, numbers of students accommodated in the non-public school system in different parts of the country.

3.9 **Extension of Coverage.** Different territorial units at present have different degrees of coverage. A goal of national policy is to extend the coverage of the basic education system to all eligible Colombians. The question is how to accomplish this goal within the framework of a per capita grant in support of education. For example, should the grant be paid from the beginning in terms of potential students? Or should it be paid initially in terms of actual enrollments with an adjustment for the extension of coverage? If the latter approach is taken, over what time period should the transition to full coverage take place? And how should the transitional increment be allocated between territorial units (i.e. proportionally to size of ‘gap’)? Section 4 considers some of the critical choices faced by the Government in redesigning inter-governmental transfers in this area.

3.10 **Adjustment of Unit Cost.** How should the initially determined unit cost be adjusted over time? Presumably, at a minimum it should be held constant in real terms, presumably using the (wage-dominated) government expenditure index.

3.11 **Departments and municipios.** At present, national transfers in support of education go to both departments (*Situado* and some cofinancing) and municipios (*Participaciones* and cofinancing). In addition, as discussed in Annex I, both levels of government provide significant support for education out of their own resources. As
Transfers similar to those recommended here for education and health have recently been proposed in South Africa, where these two functions are provincial responsibilities but almost all revenues are collected nationally. The equitable provision of these services is an important objective of national policy. The approach taken was to establish minimum amounts per beneficiary that should be spent by each province and ensure that the required funding is made available through a national transfer.

In the case of education the minimum standard was determined by estimating the average cost of teachers at the national average salary to allow all school-age to attend school. A 35:1 ratio of pupils to teachers was assumed. The grant thus estimated was then increased by 41% to allow for necessary costs other than teachers’ salaries. Provinces would be free to spend more than this if they wished to do so out of other resources, but they are expected to spend at least this amount.

In the case of health, the estimated per capita cost for the population was based on a detailed costing model of the provision of a basic set of health services, adjusted for such factors as population density and the extent of private sector health provision. As in the case of education, provision was made for phasing in complete coverage over a period of time (for fiscal reasons). The final health formula had three components: (1) qualifying population, weighted to adjust for utilization of private primary health care facilities; (2) target clinic visits per person per year of 3.5 (compared to the present 1.8) to be achieved in 8 years; and (3) a unit visit cost based on a stated primary care package.

3.12 One approach might be to share the cash transfers in some appropriate proportion between the departments (Situado) and municipios (Participaciones), while in addition giving municipios the right to an amount of teaching services proportionate in value to the cash transfer they receive, establishing the criteria to be used to allocate the resources from the Situado among municipios. Municipios would then in effect ‘purchase’ this amount of teachers from the departments, whose only customers would be the municipios.

3.13 Transition. The major transitional problem with the proposed transfer for education concerns the recommendation made in the last paragraph, which clearly implies a shift of teachers away from those municipios with an ‘excess’ of teachers towards those with a ‘deficit’ (in terms of the standard per student allocation). Similar adjustments may be needed between departments. As with all transitions, there are three dimensions that need to be taken into account: (1) the pace at which deficits are rectified; (2) the pace at which excesses are corrected; and (3) the resolution of the imbalance if (1) does not equal (2).

3.14 As a rule (and a rule unlikely to be breached in this case) it is easier to build up than to build down (although it is important not to dump too much new money too quickly into any governmental unit since it will always be spent, if not necessarily efficiently). Reducing government expenditures is never politically easy, particularly when, as in this case, it may often involve moving personnel from more to less desirable locations. The reality is thus likely to be that it will be difficult to move from the present inappropriate distribution of official teachers to one more in accord with needs without adding some
additional funding in the system to finance the slower pace of reducing the excess. Some aspects of this transition, particularly with respect to the distribution of the Situado, are discussed in more detail in Section 4 and Annex V. We illustrate the proposed grant by means of a numerical simulation based on specific assumptions about many of the factors mentioned above. What is important is not the specific numbers used for illustrative purposes but rather the principles that are illustrated.

B. FINANCING HEALTH SERVICES

3.15 The basic arguments for moving to a per capita grant in health are similar to those in the case of education, as are many of the decisions that have to be made. In the case of health, however, the situation is more complicated, for two distinct reasons. First, the official health sector currently receives a significant share of its support from earmarked departmental taxes and revenues generated by the system itself (see Annex V). Second, and more important, intergovernmental transfers related to health must be designed to work with, rather than against, the move from supply to demand subsidies mandated by Law 100 (see Annex II). Fortunately, this turns out to be possible, although there will remain a substantial transitional problem, as discussed below. It must be emphasized that a revised transfer system in itself will not make Law 100 into a reality.

3.16 As discussed in Annex II, expenditure in the official health sector (excluding infrastructure) may be divided into four categories: (1) that related to the establishment of the new system of ‘demand-driven’ health care, which implies public financing of health insurance premiums for the poor (the so-called POS-S under the Régimen Subsidiado); (2) that related to the provision of public health and related services (PAB, or Plan de Asistencia Básica); (3) costs of basic administration of health services in territorial units; and (4) the costs of the existing system of Tier 2 and 3 hospitals (until the time arrives that these costs can be encompassed within the POS-S).

3.17 A different grant system may be needed to deal with each of these, except perhaps the cost of basic territorial health administration. With respect to this item, perhaps the simplest approach is to assume that such expenditures will be adequately taken care of from ‘own resources’ (including the general purpose transfer discussed in Section 3.d below). Given the relatively minor amounts involved and the desirability of not confusing intergovernmental fiscal relations with a panoply of minor specific grants, this approach seems acceptable.

3.18 PAB. The most important part of Colombia’s health programs in terms of improving health outcomes is probably that concerned with preventive rather than curative health spending. In the present context, this activity may be assumed to be covered by the PAB. Public health programs have strong externalities and must be provided on a community rather than individual basis. If such programs are assumed to be of significant national importance but provided by territorial units of government, as is true in Colombia, what is required is a system of national grants that basically covers the entire cost of the PAB. A number of factors may enter into determining the allocative formula (population covered, density, epidemiological factors, etc.) but such details are not discussed here. Provision-
ally, the total amount to be distributed through such a grant may be assumed to be equal to the cost of the PAB.

3.19 **POS-S.** Preventive health measures may be important in terms of outcomes, but in Colombia, as in most countries, by far the most important part of health expenditures is directed to curative care. Traditionally, such transfers have been routed through the SSS (Servicios Seccionales de Salud) to the main suppliers of curative services in the official sector, namely, the hospitals. Under Law 100, however, the part of this transfer related to the provision of basic (Tier 1) health services is to be changed to a ‘demand’ rather than supply basis, i.e. related not to the existing structure and capacity of curative services but rather to the number of persons served (or potentially served) and to the unit cost of serving each person. In principle, all those presently included in the social security system will pay a POS annually through the existing payroll tax (with the funds flowing to the newly-created EPS, Empresas Promotoras de Salud, with which they are to be enrolled), while coverage will be extended to the poor through a subsidized POS-S initially half as high as the POS itself (again paid to the EPS), which will cover a basic package of Tier 1 services. The immediate task, seen from this perspective, is thus to ensure that the national health-related transfers to the departments and municipios get to the right people and places.

3.20 A simpler approach, however, would be to avoid as much as possible transferring any of these funds to the departments and municipios in the first place. One way to accomplish this might be to provide some modest financial incentives (for example a per capita enrollment payment) for municipios to ensure that everyone is enrolled with some EPS (which may be set up by the municipal government itself). Once everyone is enrolled (subject to the possible need for a transition period to expand coverage) payments could then be made directly to the appropriate EPS, thus cutting the departments and municipios completely out of the loop (except for providing a financial incentive to the latter to encourage the enrollment process). Some of the adjustments in the transfer system required to implement this alternative (which follows the logic of Law 100) are discussed in Section 4 and Annex V.

3.21 Costing this system is in a sense simple: the POS-S has been already determined to cost 60,500 pesos per person covered. As in the case of the capitation payment for basic education discussed earlier, many decisions need to be made on how to handle coverage expansion and how to increase the basic grant over time, with essentially the same factors as discussed with respect to the educational grant being relevant. In the case of health, however, there is no need to divide the transfer between departments and municipios because it is not to be paid to either of them but rather to the EPS. However, as noted above, it may prove to be the case that, formally, the amounts in question may have to be routed through the territorial governments to conform to constitutional requirements.

3.22 **From capacity to demand: the transitional problem.** Perhaps the most basic problem that must be resolved before a system such as that sketched above could be implemented is how to move from a system which is geared to financing existing capacity (at all three Tiers) to a system which will initially be demand-driven only for Tier 1 services. Apart from the problem that some Tier 1 services are in fact supplied by Tier 2 and 3 institutions, the question of how to provide public finance in an effective way that will encour-
age its efficient use by such institutions is one that will remain in some form for several years since the transition to a full demand-driven system is likely to take some time.

3.23 The good news, however, is that this is no different from the problem facing most publicly-financed health systems around the world, and that many of them seem to have resolved these problems to some extent. Basically, what is required is to face up to the fact that the public purse is not limitless (certainly not in Colombia) so that what is needed is a clear and explicit rationing system. This probably means paying hospitals and medical practitioners not on a fee for service (supply-driven) basis but on some sort of supply-constrained basis (i.e. through some combination of standard payments for particular services such as the DRG—diagnosis-related groups—approach developed in the U.S. Medicare system, and rationing by waiting time—triage). One option within the Colombian context might be to provide Servicios Seccionales de Salud with funds according to a capitation system, and allow them to experiment with alternative ways of paying hospitals. In any case, these arrangements should be such that the system eventually converges to one in which Tier 2 and 3 services become part of the POS-S and get financed through demand subsidies. There is no easy or simple solution to such problems: but unless the matters discussed here are considered and dealt with explicitly, the health budget may continue to rise with no visible effect on health outcomes.

3.24 Finally, to make the substantial changes sketched here feasible, significant technical assistance will likely be required by many hospital administrations (for example to improve the current abysmal accounting system) even after the transitional period. Some initiatives are already under way in this area. As usual, change from an inappropriate to a better system may save funds in the long run, and should certainly produce more services for the same money, but the transition process itself is likely to cause considerable friction and require that additional resources flow into the system for at least some period.

C. FINANCING INFRASTRUCTURE

3.25 The national government has two reasons for being interested in what local governments do in terms of financing infrastructure. First, some local infrastructure projects may involve significant externalities. Second, some such projects may constitute essential elements of national development programs. National support of infrastructure related to the provision of basic education and health services, for example, may qualify for both reasons, as may national support of projects improving the level and quality of water supply and sewerage treatment. Support of local roads and some rural development projects may be justified as part of the national effort to improve the economic productivity of the poor rural areas, and so on.

3.26 Whatever the rationale for national interest in local investment in physical infrastructure, however, three comments may be made about the present system of matching grants. First, concern for the provision of services and the creation of new infrastructure is inappropriately commingled in the cofinancing system. Second, the amounts allocated through the existing mechanisms bear no relation to any rational investment policy in critical areas such as education and health. And third, many of the projects currently sup-
ported (i.e. with respect to sports and recreation) should not be eligible for national support in any case.

3.27 A complete revision of the existing transfer system with respect to infrastructure thus seems needed in three respects. First, the financing of lumpy infrastructure investment in health and education should be removed from the municipal general grant and added to the cofinancing system. Second, the cofinancing system should be revised to remove many of the present obstacles to its efficient use. As discussed in detail in World Bank (1995b), such revisions include the reduction of the present unnecessarily detailed and cumbersome national approval procedures for even small projects, a simplified and more coherent set of priorities that is reflected in the choice of eligible projects, a more decentralized operation of the system, a simple matrix of matching percentages by project type, and a move to an essentially demand-driven system with sufficient local contributions to ensure ‘ownership’ of the cofinanced projects and consequently a greater likelihood of subsequent upkeep and maintenance. Implementation of some of these changes has begun recently. Third, unless departmental and municipal investment projects are of significant national importance or are essential elements in significant national projects, territorial governments should look after them out of their own resources (including the general purpose transfer discussed in the next section and, as appropriate, borrowing).

3.28 Financing large infrastructure projects from local resources alone is of course often not possible, given the scanty current revenues of most local governments. Moreover, small localities seldom have much access to private capital markets. If they are to carry out costly public works, they must therefore as a rule rely heavily on grants from higher-level governments, through means such as cofinancing. Subsidized loans could be used instead, but this common practice is undesirable. Rather than (in effect) mixing grants and loans in this way, it is better to keep them separate: give a grant where warranted, but otherwise require all lending to be done on commercial terms, with no explicit or implicit national subsidies or guarantees.

3.29 In theory, cofinancing (a matching grant, in which the central government pays part of the cost of an expenditure carried out by a local government) is the best way to finance projects in which some of the benefits from the local activity in question spillover to other localities. The share paid by the central government (the matching rate) should be related to the size of the spillover and may also depend in part upon the financial position of the local government (i.e. by altering the matching rate in accordance with local capacities one can, in principle, stimulate similar responses in different localities). Properly-designed matching grants also have the political advantage of introducing an element of local involvement, commitment, accountability, and responsibility for the aided activities.

3.30 To make cofinancing transfers for purposes of lumpy capital expenditure as effective as possible, a number of conditions should ideally be met. First, governments applying for such grants should be required to prepare both an adequate investment plan and an adequate maintenance plan (as well as an appropriate user charge policy, where appropriate). Second, localities that receive such transfers should be selected by a systematic process that pays attention both to need and capacity factors and to the economic evaluation of the project in question. Of course, many, particularly smaller municipios, may need some technical support if they are to be able to compete equitably in this framework.
A third essential is thus to make adequate technical assistance available to governments, for example through pre-investment funding of such assistance (which should certainly not be provided by the funds) to permit them to develop plans, arrange financing, manage construction, and operate the facility in the most efficient possible fashion. Fourth, the execution and operation of grant-aided work should be carefully monitored and evaluated, with periodic progress reports, field inspections, and formal evaluations of outcomes. Finally, ideally all governments receiving such aid should be required to provide surveys of the condition of the infrastructure to which aid is to be directed in order to permit adequate assessment of future needs.

3.31 Of course, such conditions undoubtedly seem like counsels of perfection. Nonetheless, to the extent such conditions are not satisfied, the results of central aid to local public works projects are likely to prove as unsatisfactory as the experience with ‘municipal development funds’ has been in many developing countries (Davey (1990)). Money alone will not do the job; it must be provided in the right framework, in the right amounts, and to the right recipients under the right conditions. Revising the present cofinancing system drastically, along the lines sketched above, is an obvious way to go.

D. GENERAL PURPOSE GRANTS

3.32 A major problem with the present Colombian system of intergovernmental fiscal transfers is that every program seems to be intended to achieve every objective (see Table 1). The result is that nothing is either clearly done or clearly achieved. In no area is this problem more obvious than with regard to the redistributive aspect of transfers. Every current transfer program seems to be intended primarily to give more to those who have less, but the result can hardly be said to be a pattern of redistribution that makes sense in terms of either efficiency or equity. Essentially, the preceding sections suggested that the two major growth-related programs with strong interpersonal redistributive elements—education and health—should be separated out and basically funded by a national capitalization system, thus emphasizing that the central distributional issue relating to these programs relates to redistribution among persons rather than regions. Similarly, the other main direct national interest in what subnational governments do (the provision of infrastructure related to these two programs and other projects with significant ‘spillovers’ to broader regions) should be separated out more clearly and financed on a matching grant basis. Such a system will not work properly, however, unless a final critical component of the system of intergovernmental transfers, which may be called a ‘general purpose’ grant, is put into place. One critical aspect of this grant is that local governments could treat these funds as own resources and be free to use them as they see appropriate.

3.33 Rationale for the transfer. Such a grant has two important, and distinct, rationales. The first rationale, and the most important from a systemic perspective, is to provide the necessary underpinning for decentralization in general, and for the other transfers proposed above in particular, by equalizing (to some level) the fiscal capacity of territorial entities. The second rationale is to provide sufficient resources to enable all local governments, even the smallest and poorest, to provide a basic package of local services other than health, education, or construction of infrastructure.
From a purely economic point of view, the second of these objectives may appear to make little sense in some respects. In Colombia at present, however, and no doubt for years to come, most smaller rural municipios will not be able to provide any significant local services based solely on their own resources. The lack of local resources should not be confused with a lack of local capacity to make and implement suitable expenditure decisions (see World Bank (1995a)). In any case, it is unlikely that there will be any major restructuring of local government in the near future. A critical question in transfer design is therefore how to provide the basic resources such municipal governments need to survive while maintaining adequate incentives for them to do what they can in terms of raising their own revenues. Fortunately, it turns out that the transfer design needed to make the capitation systems for education and health and the matching grant system for infrastructure function properly will also accomplish the politically necessary task of ensuring the survival of even the fiscally weak. And, as just mentioned, preliminary indications are that such localities seem, on the whole, to spend the money as well, or better, than would occur under a more centralized system.

Apart from this consideration, the basic economic case for ‘equalization’ transfers should be understood clearly. On the one hand, such a transfer may be needed to enable poorer local governments (defined in terms of their capacity to raise resources out of local taxes imposed on local residents and not in terms of how high the private incomes of those residents or the output of the locality may be) to respond adequately to central transfers intended to generate the appropriate level of public goods, as discussed further below. On the other hand, an equalization transfer may be needed to enable governments that are poor in the sense just defined to provide an adequate ‘minimum bundle’ of local public services to citizens. The argument in this case, similar to the familiar ‘basic needs’ argument, is that all citizens of Colombia should be entitled to some basic level of such services, regardless of where they happen to live. There is a possible conflict between this objective of providing similar public services regardless of location and the desirability of migration from less (privately) productive to more productive locations. Although this subject has been discussed extensively (if not very conclusively) in the literature, it is not further considered here on the implicit assumption that in Colombian conditions the relatively small differences in location-specific (i.e. excluding education and health, which are assumed to be portable) public service bundles in different locations that might result from an equalization program are unlikely to be significant factors in migration decisions.

Such transfers are often called ‘equalization’ grants. In some ways, however, this label is unfortunate, since it may be interpreted by some as implying that transfers are needed to equalize revenues (including transfers) and the actual expenditures of each local government. As Wiesner (1995) has emphasized, such gap-filling ‘fiscal dentistry’ makes no sense. Making up all gaps between actual outlays and actual own-source revenues for all local governments, like equalizing the actual outlays of local governments in per capita terms (that is, raising all to the level of the richest local government), ignores differences in local preferences for public and private goods and thus vitiates the basic economic rationale for local government in the first place. Moreover, such extreme equalization ignores local differences in needs, in costs, and in revenue-raising capacity. Finally, equalizing actual outlays clearly discourages both local revenue-raising effort and local expendi-
ture restraint, since under this system those with the highest expenditures and the lowest
taxes would get the largest transfers. For this reason also, an essential component of the
proposed transfer system is closing the 'soft' way out for local governments, making it
clear that the central government will not respond positively to specific requests for fund-
ing this specific project, or for dealing with the operating deficit crisis of this hospital or
that regional university. Only if such politically negotiated deals are ruled out will the
proposed system be able to achieve its efficiency objectives.

3.37 **Need, capacity, and effort.** In all countries with formal systems of equalization
transfers, the aim is either to equalize the capacity of local governments to provide a cer-
tain level of public services or the actual performance of this level of service by local gov-
ernments (Shah (1991)). The performance criterion, which adjusts the transfer received in
accordance with the need for the aided service (and which may also allow for cost differ-
entials) is in principle more attractive to central governments (or those concerned primar-
ily with the provision of certain services such as education or social assistance) since the
level of service to be funded is determined centrally and the transfer can be made condi-
tional on the provision of that level of service. For these reasons, the earlier discussion of
education and health transfers, assumed to constitute essential components of national so-
cial and economic development policy, emphasized the 'needs' factor. Unfortunately, this
approach suffers from the same disincentive effect on the revenue side as equalizing actual
outlays since that government which tries least again gets most, unless an appropriate ad-
justment is made for differential fiscal capacity.

3.38 Fundamentally, any sound design for intergovernmental transfers requires explicit
attention to some notion of 'revenue capacity'. At one extreme, the aim might be to pro-
vide each local government with sufficient funds (own-source revenues plus transfers) to
deliver a (centrally) predetermined level of services. Because such capacity-based trans-
fers are in principle based on measures of potential revenue-raising capacity (not on actual
revenues), no disincentive to fiscal effort is created by this approach. Differentials in the
cost of providing services (for example in rural or less densely-populated areas) may or
may not be taken into account. Of course, transfers based solely on capacity measures do
nothing to ensure that the recipient governments will in fact use the funds they receive as
the central government might wish—unless receipt is conditioned on performance and
compliance is monitored in some way.

3.39 The evidence on the effects of transfers on local fiscal effort available in Colombia
today does not show any negative effects (see Annex III). In any event, as discussed fur-
ther in Annex III, it is generally not a good idea to include an explicit fiscal effort element
in a transfer formula. Suppose, for example, that a transfer were to be made directly de-
pendent on the relation of the effective tax rate in the recipient municipio to the average
national effective tax rate (where 'effective tax rate' is defined as actual collections rela-
tive to some potential base: for an example with respect to property taxes). One problem
is that the measurement of fiscal effort is considerably more complex than usually seems to
be realized, even if local governments are largely restricted to non-exportable taxes. If tax
bases are sensitive to tax rates, as is likely, then the usual measures overestimate capacity
in low tax-rate areas (and hence underestimate the effort needed to increase tax rates) be-
cause the base will decline if the rate is increased.
3.40 More importantly, putting too much weight on fiscal effort in allocating grants un-
duly penalizes poorer areas, in which, by definition, a given percentage increase in effort
(as usually measured) is more difficult to achieve. The problem giving rise to the need for
equalization in the first place is that the capacity (tax base) of poor areas is too low, not
that their tax rates are too low. Most fiscal effort measures in theory thus tend to reward
the richer recipient governments, which find such tests easier to meet. Imposing such an
additional penalty on poor regions in a transfer program that almost invariably will fall far
short of fully equalizing fiscal capacity (see the simulations in Annex V) seems hard to
justify. On the other hand, contrary to much public opinion, estimates in a number of
countries, while always suspect, have often found that smaller and poorer localities when
considered comparatively seem to exploit (what little) capacity they have, while larger lo-
calities, with much more apparent capacity, seem often to make less effort to exploit it,
although their actual collections may of course be much higher.

3.41 To ensure local governments have adequate resources to carry out their essential
tasks in accordance with national policy objectives while at the same time maintaining
adequate incentives for local own revenue-raising efforts (as is needed to ensure account-
ability to local tax payers), in addition to the specific grants for education and health and
the matching grants for infrastructure proposed earlier, an additional basic general purpose
grant is essential. The key feature in any such grant is, as indicated above, some measure
of revenue-raising capacity.

3.42 Such a grant is needed especially at the municipal level, but it may also be called
for at the departmental level. Whether such a transfer is needed at the departmental level
depends in part upon what is done with respect to health finance. A significant fraction of
health finance currently comes from earmarked departmental revenues, mainly the so-
called rentas cedidas, national taxes allocated to the departments but earmarked to
(essentially) nationally-determined health expenditures. If this earmarking is abolished,
and these taxes were to become ‘truly’ departmental revenues, some adjusting transfer to
compensate for departmental differences in fiscal capacity would seem required to meet
the ‘national minimum standard’ set out in Section 3.b above. Such a transfer would ob-
nviously be less necessary from this perspective, if the rentas cedidas were to revert to the
national government and, in effect, the Situado for health correspondingly increased.
Even in this case, however, some departments are clearly much weaker fiscally than oth-
ers, so that there is strong case for some general purpose transfer to at least some extent
equalize their fiscal capacity if they are to continue to play an important role in providing
nationally important public services.

3.43 Design of the transfer. While many versions of general purpose transfers may be
found in the literature (Shah (1991)), in practice some version of the following simple
general formula would achieve this goal satisfactorily: \( G_i = eE_i - tR_i \); where \( G \) is the
amount of the grant, \( i \) refers to a particular municipio (or department), \( E \) is some measure
of expenditure ‘need’ (for example, population or any other simple indicator(s) that seems
appropriate and can be reliably measured), \( e \) is an assumed level of expenditure for each
unit of measured need, \( R \) is a measure of revenue capacity, and \( t \) is the assumed rate at
which this capacity is tapped (or taxed) at the national level. The main aspect of such a
design is that the amount of the grant is positively related to needs and negatively related
to fiscal capacity.

The critical elements in this formula are the measurement of ‘need’ and ‘capacity’: the other factors (e and t) can be adjusted to ensure that G, the amount available for purposes of this grant, is not exceeded. Some simple demographic variable (population, perhaps weighted by ‘rurality’) might suffice as a measure of need especially since the major ‘people-related’ services, education and health are financed separately on the basis of more specific ‘need’ criteria. Given the wide divergence among local governments in Colombia, perhaps different categories of municipios might be distinguished, with different weights (Bird (1984)). There is obviously both room for, and need for, considerable experimentation in this regard.

With respect to tax capacity, assuming that the total amount to be distributed by this formula (G) is set somehow—for example, as an amount equal to total Participaciones Municipales, as established by the Constitution, less the new education and health transfers, assuming that the amount available annually for cofinancing transfers is decided separately in accordance with national infrastructure and budgeting plans—the introduction of the tax capacity element (tR) in this formula has three important effects. First, the poor get more: funds are shifted from ‘high-tax capacity’ to ‘low-tax capacity’ recipients. Second, all recipients, regardless of their estimated tax capacity, will be strongly motivated to tax that capacity at the assumed rate (the average national rate). If they do not do so, the grant they receive (and hence the funds they have available) will be reduced precisely by the amount they fall below the assumed rate. Finally, if any recipient chooses to levy higher taxes than those assumed in the grant formula, it gets to keep all the extra revenues. That is, it is not ‘taxed’ by having its grant reduced (in other words, it faces a marginal tax rate of zero). In other words, this is as it were an ‘implicit’ fiscal effort measure incorporated in the formula.

Unfortunately, measuring tax capacity is difficult (Bird and Slack (1990)). Among the tax indicators one might examine (as data become available) are, for example, collections from the property tax and the tax on industry and commerce, but what one really needs are measures of tax bases (for example taxable cadastral values on an equalized basis). Alternatively, estimates of revenue capacity based on regression analysis may perhaps be explored, using information on such ‘macro’ variables as GDP per capita (for departments), urban population, and employment as independent explanatory variables. An earlier study (Bird (1984)) suggested that the urban variable seems particularly promising in Colombia, although of course further work on more recent data needs to be done on this matter. On the whole, however, even a crude measure of capacity—so long as it meets the essential tests of objectivity and non-manipulability mentioned earlier—seems much better than none at all, which is the current situation in Colombia. As an example Annex V simulates one simple design for this general purpose grant.

E. THE RIGHT ENVIRONMENT

Finally, two additional aspects of intergovernmental finance in Colombia need careful attention if decentralization is to function effectively, efficiently, and equitably. In
the first place, some changes are needed to improve the flexibility of subnational govern-
ments to raise and manage their ‘own’ revenues. Secondly, evaluation and monitoring
capacity needs to be improved at both national and subnational levels. While each of these
topics really requires much more detailed analysis than is possible here, a few words on
each follows.

3.48 Strengthening local resource mobilization. A principal conclusion emerging
from our analysis (see Annex III) is that there is not much evidence to support the appar-
tently widespread belief in Colombia that the expansion in national transfers has signifi-
cantly reduced local fiscal effort to date. Indeed, the major sources of subnational ‘own
revenue’ have in recent years continued to expand at, or above, the rates observed in ear-
lier years when transfers were lower. Looking forward, however, it is critical to consider
the extent to which local governments have, in effect, the ability to raise and manage freely
additional revenues.

3.49 On the revenue side, the two main sources of revenue are local charges and taxes.
The first rule of local finance should be: ‘wherever possible, charge’. Although in most
countries much less use is made of charging at the local level than is desirable (and many
of the charges levied are poorly designed from an efficiency point of view) appropriately
designed charges should be levied on the recipients of benefits, whether residents, busi-
nesses, or ‘things’ (real property). While user charges are likely to be viewed by hard-
pressed local officials solely as a potential additional source of revenue, their main eco-
nomic value is to promote economic efficiency by providing demand information to public
sector suppliers and to ensure that what the local public sector supplies is valued at least at
(marginal) cost by citizens. This efficiency objective is particularly important at the local
level since the main economic rationale for local government in the first place in the per-
spective adopted here is to improve efficiency.

3.50 Much as there is to be said for charging for local services, however, experience to
date in most countries is not very encouraging. Even where the common philosophical
objections to pricing in the public sector can be overcome, the prices charged are seldom
those needed for efficiency. The potential for improved user charge finance as a means of
financing local government thus remains more potential than reality. In practice, the most
important decisions with respect to local government own revenue thus inevitably concern
the design and implementation of local taxes.

3.51 A ‘truly local’ tax might be defined as one that is: (i) assessed by a local govern-
ment, (ii) at rates decided by that government, (iii) collected by that government, and (iv)
whose proceeds accrue to that government. Viewed in this light, there are no significant
‘truly local’ taxes in Colombia at either the departmental or the municipal level. Local
governments may have large receipts from what appear to be local taxes, but if, as in the
case of the property tax, they can neither set the tax rate nor determine the tax base, it is
difficult to see how they can be accountable to their constituents at the margin, as both
democracy and efficiency require. Unless local governments have some degree of freedom
to alter the level and composition of their revenues, neither local autonomy nor local ac-
countability are meaningful concepts. Rate flexibility is essential if a tax is to be ade-
quately responsive to local needs and decisions.
Box 4: Property taxes

The property tax is the most important form of local taxation around the world. Unfortunately, as Colombian experience demonstrates amply, the property tax is difficult to administer efficiently and equitably (Bird (1974) and Keith (1993)), and is never politically popular. Even in the most sophisticated countries, local property taxes can seldom yield enough to finance local services. In developing countries, property taxes seldom account for more than 20% of local current revenues despite substantial efforts in some countries and considerable foreign assistance (Dillinger (1991)).

A particular problem with property taxation concerns the temptation to indulge in politically painless but economically inefficient ‘tax exporting’ through imposing higher taxes on non-resident-owned business or indeed on business in general as opposed to residential housing. As with local business taxes in general, some constraint should ideally be placed on local taxation of nonresidential property in order to preclude localities from attempting to shift the costs of services to outsiders and hence overexpanding local service provision using ‘other people’s money’.

3.52 The property tax may be a useful, even a necessary, source of local revenue, but it is most unlikely to provide sufficient resources to finance a significant expansion of local public services in any country (see Box 4). Indeed, as shown in Annex III, Colombia has been hard-pressed even to maintain the present low relative importance of property tax revenues in the face of varying price levels and political difficulties. A number of conditions must be satisfied for local property taxes to play a more important role in financing local activities (Dillinger (1991)). First, and importantly, as already stressed, local governments must be allowed to set their own tax rates. Secondly, the tax base must be maintained adequately. Some form of index adjustment is therefore advisable: Colombia has such a system, but in fact, owing to national political choice, it has not been fully implemented, as shown in Annex III. Finally, a series of procedural reforms at both the national and local levels could help improve collection efficiency, valuation accuracy, and the coverage of the potential tax base (Kelly (1994)).

3.53 On the other hand, many of the constraints currently imposed on local government finance by the extensive use of earmarking and expenditure mandating should be removed. Although earmarking at the national level has been reduced in recent years, no similar changes have been made at the subnational level: most departmental ‘own source’ revenues, and a substantial fraction of municipal own source revenues are still required by national legislation to be spent on particular activities. In addition to such revenue earmarking, and increasingly in recent years, almost all national transfers to subnational entities are ‘earmarked’ in the sense that they must be spent on specific activities in amounts (or proportions) designated by national legislation. Finally, as shown in Annex IV, Colombia has many examples of unfunded legislative ‘mandates’, that is, expenditure obligations imposed by the national level on subnational governments with no additional funding being attached.

3.54 The constant extension, and frequent change, of these various attempts by the national level to direct subnational expenditure patterns in detail is not only basically inconsistent with the stated general intent of decentralization but it is also likely to guarantee that decentralization in the sense of developing effective and efficient subnational governments will fail. Children will never mature if parents continue to control their every decision, and local governments will never be fiscally responsible if the national level continues
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to mandate their every move. An essential ingredient of strengthening local fiscal capacity must therefore be a weakening of national control over what local governments do with their own money, and as already noted, a strengthening of the principle of 'no recourse' to national discretionary finance outside of the basic transfer system.

3.55 Strengthening evaluation capacity. A recent study (World Bank (1995c)) has categorized the institutional setting within which many local governments in developing countries must work into three groups: (i) the over-controlled local public sector; (ii) the under-controlled local public sector; and (iii) the perversely regulated local public sector. The first is perhaps the most common: central governments control all the details of local government (who they hire, what they pay, where the buses run, etc.) and leave no freedom of action for local initiative. In such settings, local citizens look to the national government to fix potholes on their street—and they are right to do so. As emphasized above, this model has been true in Colombia in the past but must be rejected if appropriate incentives for effective service delivery are to be created. While less common, the opposite ill of 'under-control' is beginning to emerge in some countries as a result of inappropriate decentralization strategies. For example, a number of transitional countries in eastern and central Europe have given local governments shares in national revenues as well as responsibility for important public service functions, but without setting up an adequate institutional structure to ensure that the central funds are being properly spent in, say, maintaining minimum standards of service in education or health (see Bird, Ebel, and Wallisch (1995)).

3.56 Whether over or under-controlled, local governments too often receive perverse signals from national governments in a number of ways. National officials frequently express concern about the poor quality of local government administration. While there is often good reason for such concern, to a considerable extent any country gets the local government it wants. Local government officials, like central government officials, respond to the incentives with which they are faced. The problem is obviously to alter the incentive structure to make it possible and attractive for honest, well-trained people to make a career in local government and to ensure that the decisions they make are made in an accountable fashion.

3.57 If decentralization is to work, those charged with providing local infrastructure and services must be accountable both to those who pay for them and to those who benefit from them. Enforcing accountability at the local level requires not only clear incentives from above but also the provision of adequate information to local constituents as well as the opportunity for them to exercise some real influence or control over the service delivery system. Informal community organizations almost by definition must be structured like this or they cannot exist, but it can be a real challenge to introduce a similar degree of responsiveness into formal governmental organizations. A recent village-level study of the provision of primary education in India and China (Dreze and Saran (1993)), for example, concluded that "the effective functioning of these services often depends crucially on combining local information (for example on the performance of village teachers) with a control mechanism that makes it possible to deal with observed problems". The needed information is often available to local residents; what may be missing is any way to use it. Popular dissatisfaction with educational services, for instance, may not result in change if
there is no way for local residents to control state-provided schools. Some meaningful way of ensuring local participation and at least some degree of local control, whether over the operation of the local school or the decision to fix a road rather than expand water and sewerage facilities, seems a necessary ingredient of any system of improved local accountability. Annex I discusses some ways in which local communities might be more empowered in this sense in terms of education.

3.58 Accountability is the key to improved public sector performance, and information is the key to accountability. The systematic collection, analysis, and reporting of information that can be used to verify compliance with goals and to assist future decisions is a critical element in any decentralization program. Information on not only the financial aspects (budgeting, expenditure reporting) but also on inputs, outputs and where possible outcomes is needed to ensure accountability. As Wiesner (1995) and others have stressed, such information is essential both to inform public participation through the local political process and to the monitoring of local activity by central agencies responsible for supervising and (usually) partially financing such activity. Unless local 'publics' are made aware of what is done, how well it is done, how much it costs, and who paid for it, no local constituency for effective government can be created. As a recent study of local government capacity in Colombia makes clear, a stronger community voice is an essential ingredient for improved government performance, both through making it easier to identify local preferences and through strengthening accountability (World Bank (1995a)).

3.59 A sound decentralization program must thus be accompanied by an improvement in national evaluation capacity, a point further discussed in World Bank (1996). Decentralization and evaluation are not substitutes; they are complements. An essential element of the 'hard budget constraint' system needed to induce efficient local decisions is thus adequate central enforcement capacity in the shape of credible information-gathering and evaluation. The 'carrot' of central financial support of local efforts must be accompanied by the 'stick' of withdrawn support if performance is inadequate, which of course requires both some standard of adequacy and some way of knowing how performance measures up. To mention perhaps the most obvious and simple example: if a recipient of transfer funds does not submit an adequate financial report, it should not receive such funds.
4. ADJUSTMENTS TO THE TRANSFER SYSTEM

4.1 The previous sections suggested some specific guidelines for the adjustment of the transfer system with the objective of improving the incentives for an effective delivery of services by territorial entities. There are diverse ways of combining those adjustments into a consistent reform package given the present basic structure of transfers in Colombia. The purpose of this section is not to define an ideal package nor to provide a comprehensive review of all possible alternatives. In other words, what follows—let alone the numerical illustrations of some of these ideas in Annex V—is not to be interpreted as a set of specific proposals. Rather, it simply attempts to present some of the basic options faced by the Government in trying to put into practice the recommendations made elsewhere in the document.

A. THE SITUADO FISCAL

4.2 The adjustments suggested in Sections 3.a and 3.b. regarding the financing of education and health services require the establishment of an automatic, specific purpose transfer to those entities certified under sectoral laws and regulations. In the case of education, this involves a transfer to departments, districts and potentially municipios of more than 100,000 inhabitants. In the case of health it could, potentially, involve the same group of territorial entities (see below). The implementation of these arrangements will require an extension of the process of certification to all entities that are legally capable, a matter particularly important in the case of education. Until this is done, these resources will presumably continue to be managed by deconcentrated national offices.

4.3 There are substantive motives to recommend the separation of the Situado into two independent transfers, one for education and the other for health. The criteria by which the resources of the Situado should be distributed between subnational governments are totally different for the two sectors. Thus, there is nothing to gain from having one transfer (whose value is determined as a percentage of current revenues) and then having to define a rule by which it should be divided among uses. This section, therefore, takes as a starting point a framework in which there are two Situados (one for education and the other for health) and analyzes them separately.

4.4 Neither this nor the other recommended changes affecting the Situado appear to require constitutional changes. Unlike in the case of the Participaciones Municipales, the Constitution does not establish the amount of the Situado in relation to current revenues, thus giving the flexibility to link its level more directly to the costs of providing the services. Article 356 of the Constitution establishes that 15% of the Situado (the alicuota) must be distributed in equal parts among departments and districts. Given the large difference in population between departments, this results in widely different Situados per capita. Law 60 interprets this provision as a way of making sure that each department receives at least a minimum amount. In that sense, if the Situado becomes a capitation system, as recommended here, the alicuota would be binding only for very few, sparsely populated, departments and thus not a major problem from the point of view of the transfer system.
4.5 **The Situado for education.** This would be one of the two basic components of a specific purpose transfer to guarantee minimum spending levels by pupil throughout the country (the other being a specific purpose transfer to municipios). A key aspect of the existing legal framework is that, once certified, the department is in charge of paying all teachers currently paid by the FER (the docentes nacionales and nacionalizados) that as a result become departmental teachers (see Annex I). The Situado for education would then have the purpose of assuring national financing (through an automatic and permanent transfer) of a minimum number of teachers for each certified entity as a function of their student population.

4.6 The recommendations made in Section 3.a imply the following adjustments to the current rules regarding the Situado:

- **Determining a base-line.** This should be set in accordance with national policy priorities and budgetary possibilities. The amount of the Situado effectively spent on education in 1995, if well distributed and used, appears to be sufficient to pay, on average (that is, based on the average teacher salary), the cost of one teacher to every 28 students, including not only those currently enrolled in public schools but also that percentage of the school age population that is currently uncovered. From this perspective, the Situado for 1995 provides an appropriate starting point if the trauma associated with a downward adjustment is to be avoided (see below). This is the approach taken for the simulation in Annex V, which suggest that the current level of the Situado is probably sufficient to pay for the cost of a reasonable student/teacher ratio for all students (including growth in enrollments), at least until the end of this century. Eventually, the level of the Situado would have to increase if that student/teacher ratio is to be maintained.

- **Establishing a rule by which that amount changes annually.** To the extent that this transfer would be financing the payment of salaries, it seems natural for it to increase on the basis of an index of teacher salaries. These are set nationally (that is, subnational governments have no influence over them) and so it seems only right that national funding accompany them in accordance with the principle of accountability. An alternative that would avoid explicitly linking the amount of the Situado to the result of the wage negotiations is for it to increase, for example, at the rate of inflation plus a small percentage that represents productivity growth. The salary increases already negotiated for the next few years would be covered by the Fondo de Compensación created for that purpose (which would eventually become part of the new transfer). Logically, there is of course no reason for the Situado to vary directly with increases or decreases in national current revenues.

- **Establishing a rule by which it is distributed between departments and districts.** The critical point is to replace the current distributive scheme (mostly inertial) with one that allocates resources in proportion to the student population. This could be done through a simplified version of the scheme that, according to Law 60, should start operating in 1997. Basically each department and district receives a so-called Situado Mínimo equal to the product of an efficient level of spending per student (for example, the cost of maintaining a student/teacher ratio of 30) and the number of students attending official schools (and those receiving vouchers). Our simulations (see Annex V) suggest that about 75 percent of the Situado might be allocated in this way depend-
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...ing, of course, on the size of the Situado and the per-student spending level that is used. The balance can be distributed according to the department’s share of potential enrollments. Over time, as enrollments increase, the share of the Situado distributed according to school attendance will increase and the system would converge to one of capitation.

- Establishing a rule by which it is allocated among municipios. Although these resources would not be actually distributed among municipios (as long as the department pays the salaries), they are allocated implicitly in the form of paid teachers. The rule for the allocation of these resources should be the same as that used to distribute the Situado for education between departments and districts, and municipios will need to be fully informed of the share of resources from the Situado that is supposed to be spent in their territories.

4.7 The changes required by the suggested adjustments to the Situado for education do not affect the substance of Law 60, only some specific aspects of implementation. From a fiscal perspective the Situado for education, as defined here, does not imply an increasing cost for national finances as long as GDP growth, in per capita terms, exceeds the real rate of growth of teacher salaries. The simulations in Annex V suggest that the Situado for education might even represent a diminishing percentage of current revenues.

4.8 These changes would necessarily involve a redistribution of resources between subnational governments. A simulation of these adjustments, under a specific set of assumptions, is presented for illustrative purposes in Table I of Annex V. The transition to this new framework will probably involve costs to the extent that one would attempt to make the ‘downward adjustments’ at a slower pace than the ‘upward adjustments’ (see paras. 3.13-14). However, the national government is already paying this cost on an annual basis as the current system does not have mechanisms conducive to cost control and expenditure rationalization. Under the proposed system this additional cost would, in contrast, have both an explicit purpose and a termination date (when the transition is complete).

4.9 The Situado for health. If one excludes the payment of demand subsidies (the POS-S discussed in Section 4b) which should cover all public financing of Tier 1 services, the Situado for health must partially cover (at least during a transitional period of an unspecified length) two types of expenditures. First, the provision (probably by public hospitals following some more or less explicit form of rationing, as discussed in para. 3.23) of Tier 2 and 3 services to those not covered by the POS through the Régimen Contributivo (see Annex II). Second, the cost of basic public health interventions by territorial entities, known generically as the PAB (see para. 3.18).

4.10 The specific character of these two expenditures and the rules by which the national level should finance them remain to be defined. Regarding the first component, as long as the demand subsidies do not cover Tier 2 and 3 services there will need to be some way of financing the provision of these services to the poor. While it is clear that the new system should not reward inefficiencies (and thus should not be based on traditional budgets) it is less clear whether it should pay for services produced, for potential users on a per-capita basis or some other formula. Eventually, public funding for these services should presumably also be transformed into a demand subsidy (i.e. through an increase in
the value of the POS-S, and the services it covers). Thus, the formula adopted to fund these services during the transitional period should be such that it leads, over a more or less specific period of time, to a unified system of financing the Régimen Contributivo.

4.11 Regarding the PAB, there is still no agreement as to the nature and cost of a reasonable package of basic public health interventions, nor on the relative role of departments and municipios in designing and implementing such programs. It appears that departments will need to play a role in this area either because some programs involve intermunicipal spillovers or because some municipios lack the capacity to administer some critical public health programs. For the purposes of conducting simulations we have assumed that only departments receive a transfer for the PAB. Also, we have assumed a PAB of $9,000 (in 1995 pesos) or the equivalent of US$10 per person (see Annex V). Both assumptions could easily be changed if a different consensus develops among experts.

4.12 This approach will involve changes to the use and distribution of the Situado for health. Currently the Situado is used to fund public hospitals and health posts (approximately 50% to Tier 1 and 50% to Tiers 2 and 3) together with a host of other sources of funds. This would need to change along the following lines:

- **Purposes.** (i) As long as the POS-S covers exclusively Tier 1 services, contribute to cover the costs (under conditions of efficiency and following national guidelines) of providing Tier 2 and 3 services to the uncovered population. Over time, these resources will need to shift toward the payment of demand subsidies. (ii) Finance a minimum spending level for public health activities by subnational governments.

- **Recipients.** The resources to cover the cost of Tier 2 and 3 services should go to departments (to the Servicios Seccionales de Salud) which could use them, if they so decide, to contract services with municipal or other hospitals. The resources for the PAB should go to departments (and potentially to municipios of more than 100,000 inhabitants).

- **Amount.** The amount of the Situado depends on what happens to the other sources of funding for the sector (i.e. mainly rentas cedidas but also rentas propias and others). If these remain in the hands of departments, the amount of the Situado for health that each department receives must correct for the distribution of those other sources. For example, our simulations estimate the amount of the Situado for health as the difference between the costs to be covered (discussed immediately below) and the total amount of other sources of funds (see Annex V):
  - (i) Initially, the Situado will need to cover that part of the costs of providing Tier 2 and 3 services to the poor left unfunded by the other sources. The current budget for Tier 2 and 3 hospitals (from all sources) is an upper bound of total costs, although, in principal, one should expect substantial savings as coverage by the Régimen Contributivo increases and as the efficiency of public hospitals increases as a result of the move away from traditional budget financing. As an illustration, our specific simulations presented in Annex V imply initial savings for 1996 in the order of 5%. Over time, public financing of Tier 2 and 3 services is expected to shift towards demand subsidies. For example, in our simulations we have assumed that the share of services to individuals fi-
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nanced through ‘supply subsidies’ diminishes by five percentage points every year (see Annex V).

- (ii) The amount for the PAB is easy to calculate: $9,000 (the assumed unit cost) times the total population of the country. Given the current distribution of population, we estimate that, if municipios of more than 100,000 inhabitants become recipients of this transfer, they would receive 50 percent of the resources.

- Distribution. The first, and most important, rule to be established concerns the criteria by which the Situado will be distributed among entities to cover the costs of providing Tier 2 and 3 services. One possibility is the use of prospective budgets based on potential users—at the department level—and ex-post adjustments based on actual delivery of services. It is necessary to further analyze alternative formulae, and international experiences might prove helpful in this regard. If the other sources of funding remain intact, the distribution of the Situado must take those into account. Finally, while a per-capita allocation of the resources for the PAB could be a good starting point, a more complex formula could recognize differences in epidemiological factors if this consideration is essential.

4.13 Although these changes sound complex, they imply only few adjustments to Law 60 (such as the distributive formula or the definition of qualified recipients) without making any changes to the substance of this law nor that of Law 100. From a fiscal perspective it appears that the Situado for health might represent a more or less constant share of current revenues until the end of the century. Of course, this estimate reflects the specific assumptions made in Annex V, and is subject to change.

B. THE PARTICIPACIONES MUNICIPALES

4.14 The recommendations made in Section 3 imply three uses for the resources that currently form part of the Participaciones: (i) financing the provision of education services at the municipal level (with exclusion of large investments associated with school construction and other large physical investments); (ii) financing the provision of basic health services to the poor in the form of a demand subsidy, the POS-S; (iii) a general purpose grant with the objective of increasing the fiscal capacity of municipios to provide additional services according to local preferences.

4.15 The National Constitution constrains in several ways the manner in which the Participaciones could be adjusted in order to fulfill these three purposes. First, it fixes the amount to be distributed as a percentage of current revenues that must reach 22% by the year 2001. Second, it establishes broad criteria by which the Participaciones should be distributed between municipios, heavily influenced by the NBI index (which as indicated in Section 1 is not a good indicator of the cost of, for example, providing education services). Third, it establishes that the only acceptable use for the Participaciones is for ‘social investments’ and could thus be interpreted as limiting the possibility of using them as a genuine general purpose transfer. A recent amendment to the Constitution partially solves this last problem allowing a specific percentage of the Participaciones of smaller municipios to be used for operational expenditures (gastos de funcionamiento).
4.16 In what follows we try to identify, for each component, some critical options the government would face trying to implement the recommended changes. If the constitutional framework allowed it, the natural way to implement the revised system would be to have three separate transfers. The amounts to be allocated to the education and health transfers would be determined based on the cost of providing the services, and not as a given percentage of current revenues. The amount allocated to the general purpose grant would be calculated either so as to level the fiscal capacity of all municipios to a given level, or as a percentage of GDP. The basic elements of the revised system, however, can be accommodated within the existing constitutional framework:

- The size of the Participaciones could continue to be determined as a percentage of current revenues. For our simulations, we have taken the progression of the Participaciones established by Law 60 as given (that is, increasing 1% each year up to 22% of current revenues in 2001).

- The scheme being proposed implies that the Participaciones Municipales are initially distributed among uses (that is, education, health and general purposes) and then distributed among municipios using the relevant indices (i.e. the NBI for education, for health and for fiscal equalization). This simply reverses the order in which the distribution is currently done.

- While it is possible to attach a more or less clear cost to the municipal transfers for education and health (and thus calculate their size), the same is not possible for the general purpose grant. Thus, for practical purposes, the report determines the size of the general purpose grant as a residual after covering the specific purpose transfers for education and health. This is a valid approach as long as this grant—which provides the necessary underpinning and incentive structure to make the decentralization process work—remains a sizable part of the overall transfer (see Annex V, pp. 64-66).

4.17 Municipal transfer for education. This is the complement of the Situado for education. As envisioned in Section 3.a, this would constitute a per-student transfer to all municipios to be used to pay for recurrent costs such as textbooks, materials, school maintenance, teacher training and additional teachers beyond those paid by the department. The critical decisions are:

- Amount of the capitation. We have used as a reference point in lieu of any better information (see Annex V) a transfer of $60,000 (1995 pesos) per student, equal to per student spending in 1995 if all municipios had spent 30% of their Participaciones on education, with exclusion of departmental and municipal own resources. At a minimum, this capitation should presumably increase annually in order to maintain its purchasing power. Increasing it in real terms over time (while freezing the total amount of the Situado) is an alternative worth considering in order to increase the role of municipios in the sector. In the simulation, and for illustrative purposes, we have assumed a substantial increase in the value of the capitation over time (6% annually).

- Enrollment data. For this scheme to work it is critical to develop an accurate and up-to-date information system on school attendance: it is not enough to know how many students enroll in schools at the beginning of the year, but how many attend school throughout the year. Another factor to be considered is including as beneficiaries those students from low income families attending non-official schools that are subsidized by local governments, something already contemplated by Law 60.
• **Speed at which coverage increases.** This factor will determine the claim for additional resources. In the simulations in Annex V we have arbitrarily assumed that the existing deficit in coverage is eliminated by the year 2001. However, it is important to consider the fact that under this scheme, the increase in coverage would be mostly endogenous (that is, not under the control of the national level). In other words, if *municipios* react faster than expected to the change in incentives, more resources will need to be made available, or the system will have to be adjusted.

• **Guidelines for its use.** The MEN would have to determine the specificity of the guidelines presented to *municipios* for the use of these resources (i.e. minimum standards such as number of textbooks per student, etc.). In addition, reporting requirements and enforcement rules would need to be clearly specified. This should be complemented by the introduction of a national testing system to help parents evaluate the quality of the education provided.

4.18 Based on the previous assumptions and considering a moderate rate of growth in the school-age population, the municipal transfer for education would represent between 30% to 35% of the *Participaciones* (see Annex V). However, even if the size of the municipal transfer for education represents the same percentage of the *Participaciones* at the national level as it is currently mandated by Law 60, it would certainly represent very different ratios for each *municipio* (see Table 2 in Annex V for an example). More importantly, the fact that it is a per-student grant makes it more transparent and effective as an instrument to pursue the objective of providing a minimum service of education to all Colombian children.

4.19 While having an independent transfer would be more transparent, this scheme could be adopted even if the *Participaciones* remain as a single transfer following all the rules currently established by the Constitution. For example, once the size of the *Participaciones* is determined, the amount of the municipal transfer for education (capitation x number of students) is subtracted and distributed according to shares of national enrollments (which could easily be interpreted as the relevant index of 'unsatisfied basic needs' — *NBI educativo* — for this specific purpose).

4.20 The municipal transfer for education would have to be complemented by conditional matching grants (probably cofinanced by the three levels of government) for school construction and by vouchers (*beiras*) for poor students attending private schools. Current resources for basic education (other than those from the *Situido* and *Participaciones*) would seem to be more than sufficient for those purposes. In 1995 those resources amounted to approximately $500,000 million ($179,000 million for the FIS and $318,000 million for the MEN) or the equivalent of 140% of the *Participaciones* earmarked for education for that year.

4.21 **Demand subsidies for basic health services.** Within the proposed framework, that part of the *Participaciones* specifically dedicated to health should be used to partially pay the cost of demand subsidies to the poor—the cost of the PAB is covered through the *Situido* which also covers, partially, the costs of Tier 2 and 3 services (see paras. 4.11-12). *Municipios* could allocate to the health sector, if they so desire, their own resources (including those received as part of the general purpose grant) but they would not be
forced to do so. The key decisions to be made regarding the implementation of this transfer are:

- **Amount.** If the Participaciones are maintained as a single transfer, a portion of those resources will need to be allocated to pay, together with other revenue sources, the cost of providing the poor with health insurance. Given that this would not be the only source of finance, a clear rule must be established to determine the amount of this specific transfer. For example, in our simulations we have estimated the amount of the municipal transfer for health as the balance needed to pay for the POS-S of all those enrolled in the Régimen Subsidiado once the resources of the Fondo de Solidaridad are used (see Annex V). The simulations suggest that achieving 100 percent coverage by the year 2001 would require approximately 25 percent of the Participaciones. However, if the necessary resources were to exceed that percentage significantly (and thus ‘eat up’ the balance available for the general purpose grant), other national resources (from the Situado or other sources) would need to be used in order to maintain the overall system of intergovernmental transfers alive (see Annex V, p. 64-66).

- **Distribution.** In strict sense this is not a territorial transfer: the resources are used to pay the EPS to cover the health insurance premiums of individuals. However, to the extent that the integrity of the Participaciones as one ‘global’ transfer is maintained, the easiest way to deal with this component is to distribute the total amount among municipios according to their share of beneficiaries. In that sense, the index used to identify beneficiaries becomes the ‘NBI for health’. However, even if this is the approach to be followed, the money does not need to physically flow to the municipal treasuries to be later paid to different EPS. A more practical alternative would seem to be for the national treasury to deposit the amount corresponding to each municipio in a sub-account within the Fondo de Solidaridad to be used to pay for the POS-S of citizens from that municipio.

- **Selection and enrollment of beneficiaries.** The process of identification and enrollment of beneficiaries can easily be separated from the process of financing the POS-S. Municipios should still be in charge of identifying beneficiaries and making sure they are enrolled in an EPS (which can be owned by the municipio). For this job they can be paid a one time fee. The current approach implies the use of the SISBEN as the instrument to determine who qualifies for the subsidy. Complaints have been made about its appropriateness for this purpose. Nevertheless, from the point of view of the design of transfers, the critical point is that the distribution of resources should be done on the basis of whatever index is used to determine the beneficiaries of the Régimen Subsidiado.

4.22 An important aspect of these arrangements is that, once the rule to determine the amount of resources from the Participaciones that will be allocated to pay health subsidies is agreed upon, the problem is no longer one of intergovernmental finances and becomes one of funding the social security reform. The speed at which coverage can be increased will depend on the rate of growth of wage contributions to the Fondo de Solidaridad and the resources from the national budget made available to it. Thus, this system has the additional advantage of making more transparent the national responsibility to finance the implementation of the Régimen Subsidiado.
4.23 **General purpose grant to municipios.** Much remains to be determined regarding the characteristics of this grant. The following is a brief list of the main issues that will need to be addressed to fully implement this critical component of a reformed system of intergovernmental transfers:

- **Purpose.** To increase the fiscal capacity of municipios to provide other services (even if they are of a local nature) including those associated with the municipal administration, and to increase their ability to match national funds for infrastructure projects on national interest and to provide local support for education and health as well.

- **Magnitude.** The amount transferred should vary inversely with a measure of the municipio's fiscal capacity and directly with their needs. Given our assumptions, the total amount available for this grant is the balance of Participaciones after deducting the capitation grants discussed above. This will obviously be insufficient to equalize local fiscal capacity. From this perspective, a tightly targeted grant design might focus solely on the poorer municipios. Given the constraints on local revenues in even the richest municipios, however, it might be better (and politically more palatable) for all to receive something from this grant. This is what is assumed for illustrative purposes in the simulations shown in Annex V.

- **Indicators.** It is necessary to define a simple formula based on indicators of need and fiscal capacity. As suggested in Section 3.d, population appears to be the most obvious choice of a need indicator. The choice of an indicator of fiscal capacity is a more difficult one, and Section 3.d suggests some options. One possible approach is to avoid rushing to define a specific indicator without careful consideration of its costs and benefits, and instead introduce the generic concept of fiscal capacity in the formula while using a simple categorization (i.e. per capita own revenues differentiated by category of municipios as in Annex V) during a transitional period. For our simulations we have grouped municipios according to size and used average per-capita own revenues for the group as an indicator of fiscal capacity. Under this scheme, the amount of the grant would be calculated based on average own revenues for the group to which the municipio belongs. If the municipio collects less (more) revenues than the average, its total resources will be lower (higher) than average.

- **Accountability.** This being a general purpose transfer, the resources should ideally be considered own resources for all practical purposes. A recent amendment to the Constitution (Acto Legislativo 1/95) limits the percentage of the Participaciones that can be used to cover operational expenditures (gastos de funcionamiento) depending on the category of municipio. In that sense, for many municipios there might be some limits to the possible uses of this grant. In any case, reception of these resources should involve certain obligations. The simplest and most obvious one is reporting on a timely and accurate basis the information on municipal resources and expenditures.

4.24 There are at least two ways in which this grant could be evaluated: the degree to which it equalizes fiscal capacities and the extent to which it increases municipal capacity to cover needs. Regarding the first criterion, there is clearly a trade-off between fiscal equalization (which would require concentrating the grant on the 'poorer' municipios) and attempting to transfer resources to all municipios. Our simulations (see Annex V) suggest that, assuming the size of the Participaciones remains as specified in Law 60, it should be possible to increase the fiscal capacity of all municipios of less than 500,000 inhabitants to...
between 60% to 75% of the national average (between 35% to 50% of the fiscal capacity of those with more than 500,000 inhabitants) depending on how many resources go to the five largest municipios. Even under the most ‘equalizing’ case, large differences in capacity would remain. Even though the total amount available for this transfer would increase over time, the degree of equalization would not increase significantly. Of course, if it was reduced, the degree of equalization would fall. Should it become too small (for example, less than 50-60 percent of the national average) the viability of the entire system proposed here may become suspect. The amount of this grant is also dependent, given the design of the transfer system, on the values of the capitations used for education and health. Thus, if those were set ‘too high’ the general purpose grant could become ‘too small’.

4.25 Regarding the second criterion, the average per capita transfer for general purposes would increase by approximately 25% over a period of six years based on the assumptions used in Annex V. According to our simulations, by the end of the century, such a grant would be able to increase the fiscal capacity, including locally mobilized revenues, of municipios of less than 500,000 inhabitants to slightly less than $50,000 (in 1995 pesos) per person. These resources would be the only available source to finance: (i) the provision of all other municipal services with the exception of health and education; (ii) spending on education and health above the minimum standards financed directly by the nation; (iii) local matching funds for infrastructure investment; and (iv) the administrative costs of running a municipio (This last item alone should consume, for an average municipio of 10,000 inhabitants, about 40% of the general purpose grant using estimates from DNP (1995f)). It is for this reason that we have emphasized the essential role of a significant general purpose grant as underpinning the entire revision of the transfer system proposed in this report.

C. OTHER TRANSFERS

4.26 The two final components of the new system of intergovernmental transfers that is being proposed are a general purpose grant to departments and the use of conditional matching grants for the financing of infrastructure projects at the departmental and municipal level.

4.27 Transfers to departments. In para. 3.42 the possibility of introducing a general purpose grant for departments was mentioned. Its purpose would be, as in the case of municipios, to partially equalize differences in fiscal capacity. The introduction of such a grant is critical if the earmarking of rentas cedidas is eliminated. It will still be a good option even if there is no change in rentas cedidas or if these are nationalized and replaced by the Situado to the extent that it would contribute to strengthen the fiscal capacity of departments to play an important role in the social sectors as well as in areas such as road maintenance. If this grant is introduced, its design should follow the same guidelines proposed for municipios. In the case of departments, however, there are fewer difficulties in identifying an indicator of fiscal capacity given the information available.

4.28 Cofinancing. Conditional matching grants are likely to continue to be an important component of this reformed system of intergovernmental transfers. Their purpose is to provide partial financing for infrastructure projects that either involve externalities or
are necessary to achieve national goals (such as increasing coverage of basic education). The adjustments proposed in Section 3.c and those discussed in World Bank (1995b) do not require legal changes, only changes in policies and procedures of the SNC. The critical changes (several of which have already started to be implemented by the national government) are to:

- Discontinue the practice of cofinancing recurrent costs and convert the SNC to a system of matching grants for infrastructure.
- Limit grants to very few, broadly defined, sectors or types of investment (i.e. school construction, road construction, etc.) that respond to national and sectoral policies and priorities and allow departments and municipios to choose specific projects.
- Simplify procedures and methodologies, and emphasize ex-post (rather than ex-ante) evaluation, and rely more extensively on monitoring mechanisms by the community.
- Adjust organizational aspects of the SNC that slow down its operations, for example by delegating responsibility for the promotion, approval and monitoring of projects to departments.
- Establish a very clear link between eligible projects, matching rates and national priorities.

4.29 **Earmarking.** The present, largely inappropriate earmarking of local resources should be eliminated (see Annex IV). Without this, the changes in intergovernmental transfers put forward in this report might not work. Once the basic design of the transfer system is defined along the suggested lines, local governments must be allowed to make their own decisions and their own mistakes. Addressing the problem of earmarking might require changes in other laws besides Law 60. Some of these were, in some way, mentioned or identified throughout the document. Many others probably remain unidentified. A concerted effort by the different levels of government and Congress is required to eliminate this diverse set of rules and mandates that could put the success of the decentralization process in serious jeopardy.