How Rules and Incentives Can Improve the Working of Demand-Driven Rural Investment Funds*

Central governments in Latin America often wish to retain some control over locally-managed projects, even if they pursue a general policy of decentralization. They view central control and guidance as necessary to curb ill-conceived schemes, coronelismo (political bosses who abuse discretionary control over spending) and clientismo (use of money to reward a mayor's patrons or kinship groups). To what extent can a carefully devised rule and incentive structure replace central control? Two World Bank researchers, Tom Wiens and Maurizio Guadagni, have examined this in the context of decentralized projects in Brazil, Colombia, and Mexico.

Their research focuses on three demand-driven rural investment funds (DRIFs): the Fundo Municipal de Apoio Comunitario (FUMAC) and Programa de Apoyo Comunitario (PAC) in Northeast Brazil; the Fondo DRI in Colombia; and the Municipal Solidarity fund (MSF) in Mexico. DRIFs target rural poverty and differ from ordinary social funds by their greater emphasis on participation and a focus on strengthening local institutions, including local governments. The researchers have looked at experience with different control mechanisms (all of which involve different trade-offs) in achieving various policy goals. DRIFs are at the cutting edge of poverty alleviation approaches, although they need to be further improved.

Goal 1. Targeting The Poorest Rural Localities. DRIFs' ambition is to target the poorest municipalities within the poorest states. A formulaic approach, using allocation criteria, is in use in Mexico (allocations between municipalities) and Colombia (allocation between departments) and is being tested in Brazil. In addition, to ensure a rural focus, subproject eligibility criteria are imposed. Fondo DRI limits investments to localities with less than 2,500 people, PAC/FUMAC to those with less than 7,500 people. Mexico's MSF requires 50 to 75 per cent of funds to be invested outside the urban core of a municipality. Unlike other funds, Fondo DRI uses the earmarking of funds for different activities (like rural roads, fisheries, water supply).

These rules have yielded only modest success in targeting the poorest of the poor localities, usually because political imperatives have limited the use or adoption of allocation formulae based on objective criteria. The researchers measured the correlation between the poverty ratio in a municipality and investment per capita. Brazil achieved a correlation of 7 per cent between 1993 and 1995. Colombia achieved 18 per cent in 1994, the best result by far. The correlation in Mexico was actually negative (-4 per cent), although some states gave a strong positive result (26 per cent in Hidalgo).

These results do not mean that targeting has failed since DRIFs already target poorer...
states/regions. However, progress must, and can be, made in reaching the poorest by improving and generalizing the use of an allocation formula.

**Goal 2. Enhancing Community Participation.**
The goal of ensuring demand-driven subprojects calls for a participatory decision-making process. Its extent varies, and is most constrained in Colombia.

Communities generate subproject proposals in all three countries. Those proposals are screened at a higher administrative level and/or at the Municipal level to ensure their feasibility and their adherence to eligibility criteria. Those criteria might include a ceiling on subproject cost ($45,000 in Mexico, $50,000 in Brazil) and a time limit on its implementation, a positive and/or a negative list, a cofinancing matrix for beneficiary contribution.

Communities do not always demand the most feasible or sustainable projects. Participation can degenerate into the creation of wish-lists. **Budgetary limits and cofinancing** (cash or kind) are vital, because they force locals to choose the most appropriate projects.

Clear rules guaranteeing the freedom and independence of MPCs are needed. Some of the important rules for MPC formation devised by the three governments are (1) specifying a minimum size, larger than the usual municipal council, to accommodate a diversity of community representatives, some of whom have had little say in decisions historically; (2) a quota for weaker sections like poor women and indigenous people; (3) the one person-one vote principle (though the mayor may have a tie-breaking vote).

In general, in order to curb coronelismo and clientismo, rural dwellers must be educated on their rights. Radio campaigns, simple booklets, and pamphlets can explain what DRIFs aim to do and how beneficiaries can influence them.

**Goal 3. Stengthening Municipal Capacity.**
Evidence from research shows that community and municipal capacity is greater than usually expected, albeit latent. Access to technical assistance greatly enhances local capacity and subproject performance. Various arrangements have been devised, including setting aside a percentage of project cost (8% in Brazil) for technical assistance.

At the same time, the creation of MPCs amounts to a mechanism that checks potential mayoral abuses and enhances community participation, which also improves municipal capacity, broadly defined. In Brazil, a "graduation" system is in place by which MPCs, upon improved performance in project management, take on increased operational responsibilities. By and large, community knowledge constitutes an underutilized resource that decentralization can harness.

**Goal 4. Improving Economic Viability And Sustainability.** This can be achieved in three ways—evaluation before clearance, post-project evaluation with rewards for good performance and penalties for bad performance, and the use of beneficiary participation to ensure project quality.
Rigorous evaluation of thousands of small subprojects would be very costly and time-consuming. Post-project evaluation is cheaper, but the cost is still high, and it increases the risk of poor project selection. Furthermore, the only practical penalty, denying subsequent funding, makes sense only where fraud or a deliberate breach of rules has occurred, not where project design has been faulty.

PAC and Fondo DRI rely mainly on project clearance by higher authorities. The Mexican MSF and Brazilian FUMAC also rely on decentralized participation within a budget constraint. This approach obliges locals to weigh the costs and benefits of different schemes and choose the most appropriate ones. This provides a huge saving in expenses on formal cost-benefit evaluation (a task for which higher authorities are often ill-equipped anyway).

Beneficiary participation is by far the cheapest form of project evaluation, and it creates one of the best incentives for honesty and efficiency. Mexico has relied almost entirely on beneficiary participation, yet, it looks at least as successful as other countries relying on more costly mechanisms, such as feasibility screening.

Additional low-cost ways can be devised to improve technical feasibility and economic sustainability. Standardized designs (for classrooms or culverts) can offer cost-effective options. Where local conditions dictate, however, communities should be able to modify these designs. Standardized designs cannot be mandatory, but they can pre-qualify a proposal, which saves time, technical assistance, and evaluation costs. In addition, more efforts should be devoted to developing and applying “rules of thumb” that could screen subprojects without requiring complex analytical studies.

The dissemination of best practices in different disciplines will help, as will stories of success and failure in other municipalities.

Goal 5. Improving Implementation. The World Bank and some other donors normally require competitive bidding to ensure cost-effectiveness. This approach is inappropriate for subprojects that are small (on average $20,000 in Brazil, $38,000 in Colombia, and $10,000 in Mexico) and spread thinly over remote areas, which makes them unattractive for contractors. Communities can implement some such projects themselves, using national shopping and direct contracting. Mexico and Brazil allow direct contracting subject to a ceiling of $50,000 per subproject. Bolivia is experimenting with limited local bidding (restricted to the project region).

National shopping and direct contracting raise issues of cost and quality, and incentives are needed to conserve funds. Mexico has come up with a successful innovation. It disburses against budget estimates rather than contracts, and allows communities to keep any cash savings for future use in additional projects. Because of this incentive (and because MSF uses community labor), works cost 30-50 per cent less than those going through normal municipal processes. Brazil is now using a similar procedure.

Goal 6. Improving Fund Management. Monitoring and evaluation are problematic when thousands of subprojects are involved. Numbers, signatures, and data on service delivery are easily falsified. Possible remedies are (a) supervision by DRIF staff; (b) management information systems, though they can be costly; and (c) beneficiary-based monitoring systems. All three can be used simultaneously; however, beneficiary-based monitoring is by far the cheapest and is likely to be most effective if accompanied by a lively civil society and periodic elections.

Devices like direct contracting simplify procurement but complicate disbursement. Donors and lenders like to control the release of funds, in order to check abuse. This becomes difficult if discretionary power is decentralized, and thousands of small disbursements and receipts are involved. A successful Brazilian innovation that greatly simplifies matters is to disburse funds, not against the supply of inputs,
but against certification of satisfactory completion.

Most actors in implementation try to hide irregularities and fraud. Prosecuting violators will curb fraud, but this is time-consuming. Suspending further funds is an option, but may unfairly penalize successor regimes. The most frequently used device in the three countries is the recovery of disbursed funds. Colombia has an interesting innovation where municipalities guilty of non-critical irregularities that do not merit suspension of disbursement much provide insurance—such as a performance bond or guarantee—before receiving new funds.

Goal 7. Improving Operations And Management (O&M). This is a problem area. In theory, participation should ensure beneficiary commitment to O&M. Mexico asks for assurances from communities on recurring expenses. Colombia requires O&M estimates as part of project proposals. Brazil gets a legal commitment from beneficiaries. Yet such commitments may not be honored, and the limited data suggest some projects have become unsustainable.

Correcting this problem is not easy. An adequately funded local government agency could be put in charge of O&M. Monitoring project performance will improve O&M. Over time, beneficiary participation could induce better O&M.

Goal 8. External Priorities. Eligibility or priority may be given to certain types of subprojects by virtue of conformity to national priorities (e.g. to education or health) or other identified strategies (e.g. priority given to rural infrastructure). All three projects have imposed external priorities on the process of participatory identification—Brazil through budget constraints by subproject type, Colombia by rigid fund allocation by subproject type, and Mexico through priority given to basic needs as well as high cofinancing requirements for amenity structure. Lack of data prevents any comparative analysis and drawing of conclusions about the resulting distortion of local preferences.

Conclusions

The researchers say that in the absence of data from systematic monitoring and evaluation, few generalizations are possible on optimal rules for DRIFs. Besides, no single blueprint can be appropriate for different places with differing characteristics, and DRIF rules need to be negotiated with local actors in each case. It makes sense to learn from experimentation and pilot projects. The important thing is to be clear about the objectives of the DRIF, of the trade-offs among them, and of the rules and incentives that can best achieve them. The study gives some examples of rules and incentives that have worked well, but experience will surely produce many more.

One lesson stands out. Beneficiary participation and decentralized mechanisms can improve project design, selection, and monitoring at virtually no budget cost. Research is needed to establish ways of making participation more effective. Experience the world over suggests that periodic local elections and a strong civil society can be a great help.