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Decentralization to Local Government in LAC: National Strategies and Local Response in Planning, Spending and Management

by

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with

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Infrastructure and Energy Division

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PREFACE AND SYNOPSIS

Preface.

1. This Regional study on decentralization in LAC covers selected aspects of decision-making, resource allocation and expenditures by local governments. The present study, managed by LATIE, focuses on program effectiveness and efficiency of local government. A companion study, being managed by LATPS for completion in FY92, focuses on resource mobilization and intergovernmental transfers. The Report is based on data and information gathered from missions to three countries (Brazil, Chile, and Mexico) as well as from review of secondary data on an additional six (Argentina, Colombia, Ecuador, Guatemala, Honduras, and Venezuela).

2. The products of the study fall into three categories: intermediate inputs (country reports and background papers), dissemination notes, and this final report. Country reports are in-depth examinations of decentralization in selected countries (Chile, Brazil, and Mexico).1/ A dissemination note on social funds (Campbell, 1991) has already been issued; and others are being prepared. In addition, background materials have been prepared on Colombia and Ecuador and notes and materials gathered on Argentina, Guatemala, Honduras, and Venezuela, based in part on operational missions. This final report synthesizes the findings of the study and presents salient policy issues, conclusions, and a recommended strategy of action. A review group, consisting of Messrs/Mmes Tarcisio Casteneda, Ken Davey, Bill Dillinger, Barbara Nunberg, and John Redwood reviewed some or all of the report.

Synopsis.

3. National decentralization strategies in the nine countries studied have shifted money to local governments in a manner which is out of phase with both expenditure responsibilities and local management capacity. These moves risk macroeconomic instability and decreases in efficiency. However, state reform in most countries is still in transition, and because decentralization is driven to an important degree by political imperatives of power sharing, local public sector empowerment, as opposed to recentralization, is likely to continue over this decade. Therefore, the major challenges for both the Bank and its borrowers lay not only in adjustments of intergovernmental fiscal arrangements, an area in which the Bank has experience and expertise, but also in redefining intergovernmental spending authority and strengthening the accountability and sustainability of local government, areas in which the Bank must increase its knowledge base. To be effective in these newer areas requires revisions in the Bank's present, implicit approach to municipal strengthening, which relies mainly on financial tools to leverage efficiency. A more comprehensive strategy is needed which combines financial tools with an emphasis on allocative efficiency, production efficiency, and equity in local government. To adopt this approach, in turn, implies entering new conceptual and policy terrain political and legal accountability in governance, and a possible shift in the Regional skill mix.

1/ Chile has been developed in detail. Reports on Mexico and Brazil are forthcoming and cover only selected aspects of decentralization: matching grants in the case of Mexico and intergovernmental health planning in Brazil.
EXECUTIVE SUMMARY

A. Purpose and Scope.

1. This study takes stock of decentralization of planning, spending and decision-making responsibilities from central to municipal governments in nine countries of the LAC Region (see Table ES-1). The purpose of this study is to analyze the efficiency and equity effects of this decentralization in relation to the provision of municipal infrastructure and services (confined to water, sewerage, primary health care and primary education). The study addresses questions such as whether decentralization has led to decreases in the effectiveness of service delivery, whether service level changes have been achieved at the expense of, or along with, improvements in efficiency and equity, especially of services to the poor, and whether local capacity can be increased in a manner which is sustainable. An important limitation of the study is that it freezes a swiftly moving phenomenon and understates the rapidity of change and diversity of experience in the Region. Nevertheless, the study charts out the broad implications for Bank policy and lending of these decentralization reforms in the public sector and harvests good ideas for use elsewhere.

2. The organization of the study, replicated in this summary, poses the problem and approach in Chapter I, frames conceptual issues in Chapter II, and provides an overview of national strategies in Chapter III. The main issues are discussed in Chapter IV. Chapter V, optional for some readers, identifies promising innovations for future Bank sector work and lending. Chapter VI reformulates recommendations in the report along strategic lines for Bank action.

3. Significance of Decentralization. In the past decade, constitutional, legal, financial and political shifts to subnational levels of government have affected 90 percent of the urban population and nearly an equal proportion of local governments in the Region. These shifts coincide

Table ES-1: Countries Studied

<table>
<thead>
<tr>
<th>Country</th>
<th>Pop. (millions)</th>
<th>Pol-Adm System</th>
<th>GNP (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>32</td>
<td>F</td>
<td>2,520</td>
</tr>
<tr>
<td>Brazil</td>
<td>144</td>
<td>F</td>
<td>2,100</td>
</tr>
<tr>
<td>Chile</td>
<td>13</td>
<td>U</td>
<td>1,510</td>
</tr>
<tr>
<td>Colombia</td>
<td>32</td>
<td>U</td>
<td>1,120</td>
</tr>
<tr>
<td>Ecuador</td>
<td>19</td>
<td>U</td>
<td>1,120</td>
</tr>
<tr>
<td>Guatemala</td>
<td>8</td>
<td>U</td>
<td>900</td>
</tr>
<tr>
<td>Honduras</td>
<td>5</td>
<td>U</td>
<td>860</td>
</tr>
<tr>
<td>Mexico</td>
<td>84</td>
<td>F</td>
<td>1,760</td>
</tr>
<tr>
<td>Venezuela</td>
<td>19</td>
<td>F</td>
<td>3,250</td>
</tr>
</tbody>
</table>

Notes: 1988 population in millions; F = federal, U = unitary; GNP in 1988 US$. from 1990 WDR.

Decentralization in LAC
with a turning point in Bank lending and policy in the urban sector. Urban lending is being re-directed to subnational governments in recognition of their role in macroeconomic performance—e.g., local spending represented six percent of Argentina’s 1986 GDP— and to correct past deficiencies of lending in the sector. The recently adopted Bank urban policy, reflecting ex post evaluations in the Region, notes that past urban activities have failed to achieve sustainability, i.e., major lasting improvements in technical and financial capacity at the local level. Sustainability of local governments is addressed in part as an accountability issue in this study.

B. Central-Local Government Relations: An Analytical Framework.

4. The policy issues in decentralization arise from efficiency and equity consequences of two major areas of state reform: i) the division of labor among a country’s levels of government and ii) the form of financing capital investment and service delivery. In organizing expenditure responsibilities, governments must find a balance between two dimensions of efficiency: a) efficiency in production of infrastructure and services, which is often centralist due to economies of scale, and b) efficiency of resource allocation, which tends to be decentralist because local jurisdictions know best what they need. Equity issues arise because local governments will almost always underspend on poverty. Efficiency and equity in financing is another matter. Revenue raising is usually more easily achieved by central governments, yet leaving revenue responsibilities to the center threatens to loosen fiscal discipline at the local level. The scope of the present study is not to recommend a blueprint for these intergovernmental arrangements in spending and finance. Rather, the study addresses efficiency and equity issues within an analytical framework that recognizes the influence of financing arrangements on local government choices, but focuses the analysis on the mechanics of planning, spending, and management in local government.3

5. Public choice theory and fiscal federalism provide the theoretical foundations for this analysis. These bodies of theory are also a source of analytical constructs commonly used to guide arrangements for local public decision making and spending. Two analytical models are of particular relevance: 1) a principal-agent model, typical of unitary systems in LAC where central government retains large measures of control over program and project decisions to be implemented by municipalities as agents; and 2) the local fiscal choice model found usually in federated systems in LAC where local governments are given significant increases in decision-making, spending, and sometimes revenue raising powers. The main distinction between the models— and the most challenging policy area for the future—is in the degree of autonomy and accountability relative to revenue raising, planning, decision-making and spending. Local fiscal choice leaves accountability to the electorate; principal agency ideas stress accountability to the center. In practice, elements of both models are found in most countries of the LAC Region.

3/ The issues of efficiency in revenue raising and rules of transfer have been taken up in several previous studies by the Bank, for example, Bird (1978). The LATD companion study on fiscal decentralization will also address some of these issues.
6. **Blending local fiscal choice and principal agency.** Experience of developed countries shows that, in the main, the local fiscal choice model offers the most promise for increasing and sustaining efficiency in local government. In this model, beneficiaries and the constituents of the local public sector are most effectively confronted with the consequences -- taxation or other revenue raising measures-- of their spending decisions. Feedback to local government is muted in principal agency and in less pure fiscal choice models (for instance, where elections are indirect, or tightly controlled). Moreover, local choice best sustains the legitimacy of power sharing. However, principal agent approaches are the most effective to advance policy design for, and to improve conditions of, both poverty and environmental conditions. Therefore, elements of both approaches are required and should be applied flexibly to achieve efficiency, equity, and sustainability in decentralized systems.

C. **Patterns in National Decentralization Strategies-- An Overview.**

7. Although the nine countries reveal a wide mix of experience with decentralization, and though most are in a transitional phase, four policy areas are common in all country decentralization strategies. These are intergovernmental arrangements for and degrees of local autonomy in: i) revenue raising, ii) spending authority, iii) institutional responsibilities and iv) local decision-making. Our review of data-- drawn from a variety of sources including previous Bank sector work, and country and appraisal reports-- reveals surprising patterns:

- **Decentralization is driving up central government investment costs.** All of the Region's decentralization programs have involved new and substantially larger central government transfers to local (sometimes state) government. Revenue transfers generally have run well ahead of expenditure or functional transfers, implying that over the intermediate term, at least, decentralization will add to central-government costs, but not necessarily because of decreases in efficiency. Rather, costs are likely to rise because central governments continue to invest in capital stock for which local governments are nominally responsible.

- **Transfers are intended to stimulate local infrastructure investments.** In most cases, all or part of the new revenue transfers must be spent on local capital investment while formal requirements are written into the transfer terms to try to ensure that this investment is "additive" (i.e., that transfers do not substitute for local capital spending).

- **Local revenue raising capacity is falling.** Little action has been taken to grant new revenue-raising authority to local governments. Local governments, swamped in some cases (Guatemala) with more money than they can spend, feel less pressure to raise own-revenues.

- **The strategies are having salutary effects on local autonomy.** Revenue transfers are moving increasingly towards clearer, and more stable, formula basis, and away from negotiated transfers, creating the potential for a "hands-off" orientation to local choice. Also, virtually all countries have moved into democratic elections of mayors.
and councils. A major obstacle to efficient local functioning is the short terms of office permitted for local officials.

The instruments of efficient decision-making in the local public sector are cumbersome and inadequate. Political and administrative mechanisms to detect and verify demand and ensure accountability at the municipal level are woefully inadequate and are not being strengthened quickly enough. Auditing powers are weak and electoral processes are cumbersome and costly.

8. This overview of patterns reflects national strategies which are unbalanced, incomplete or hesitant. Consequently, the dangers of decentralization—macroeconomic instability, inefficient local public sector, and worsening poverty and environmental conditions—arise not merely because countries have chosen to decentralize. Most countries feel compelled to do so in response to a political need to share power. Rather, national strategies have not gone far enough to prepare local governments for efficient and sustainable management. At the same time, most countries are in a transitional phase, and many tactical and strategic adjustments remain to be made.

D. Issues, Conclusions, and Recommendations

9. The next steps in decentralization are potential turning points in the effort to achieve a sustainable and effective local public sector. The key policy issues include efficiency, equity, and accountability:

10. Allocative efficiency and planning. Efficiency in public sector management necessarily extends to the political sphere because, unlike private goods, market mechanisms are not available to determine pricing signals. Deciding priorities and mix of local investment depend on collective, political decisions. Ways must be found to facilitate both expression and detection of demand, to verify demand under different "price" conditions, and maintain legitimate accountability of governments and utilities to constituents in order to operate efficiently.

11. In practice, allocative efficiency is effected in three arenas: a) electoral, b) technical, and c) projects. Virtually none of the country cases examined in this study fulfill fully the electoral mechanisms needed to satisfy efficiency criteria for policy and demand expression, even though most countries have electoral laws and institutions in place for this purpose. The predominance of central government funding means that local citizens have rarely had to deal with the realities of budget-constrained choice. As a result, citizens tend to "demand" far better service that is realistic and blame distant bureaucratic bodies when it fails to materialize.

12. Other choice-making solutions include "technical" and "project" modes. In the "technical," politicians and planners set policies, programs, and project investments in accordance with their own perception of true

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4/ By "price" conditions, we refer to the cost-sharing and other conditions pertaining to contributions or participation by beneficiaries in programs or projects.
demand. Stronger technical bases (surveys, hearings, advisory councils) are
needed to gauge public interest and demand. Selection and implementation of
projects—particularly social funds, local neighborhood improvement funds, as
well as Bank projects—represent still a third choice-making arena. With
guidance and assistance, local governments can make better use of local
projects to improve demand detection, accountability, and the gauging of local
response to alternative program, project, and "price" options.

13. **Recommendations.** In each of these areas the transaction costs of
decision-making and the quality of technical inputs need to be improved. The
Bank can help explore ways to reduce transaction costs in public sector
decision-making and to increase the availability and technical quality of
public policy analysis. The Bank's technical assistance and training efforts
should include topics of strengthening local democratic institutions—
hearings, community fora, surveys, advisory councils, community organizing—
without violating political sovereignty. Efforts at building democratic or
participatory practices at the local level reinforce the Bank's own objectives
of improving the process of identification, evaluation, and implementation of
sub-projects financed through social funds or municipal development projects.

14. ■ **Production efficiency.** The study assembled partial evidence on
local infrastructure costs and this will help to pinpoint issues that need to be
addressed in future studies on production efficiency. **Recommendations.** The
Bank can foster increased local production efficiency by supporting one or
more of the following methods discussed in this report: i) private sector
competition, as in contracting out specific services such as solid waste; ii)
competition between public and private services (as in Chilean education);
iii) public-public competition, though rare, is permitted in Venezuela's new
constitution; iv) local implementation, using local oversight and supervision,
has been effective in many countries; v) information banks on construction and
services costs can also help local governments evaluate contracting bids.

15. ■ **Inter-Governmental fiscal arrangements.** Revenue transfers have
outpaced expenditure transfers by a wide margins in most countries. For
instance, by one measure, Brazil will have to cut almost one-sixth of the real
1988 spending in order to correct fiscal imbalance created by revenue
transfers. Fiscal imbalances such as these raise the question of whether the
decentralization programs—which usually are scheduled to take place over
several years—will in the end be implemented in full or, if implemented,
will prove stable. Faced with the political difficulty of shifting
expenditure responsibilities to states and localities, central governments
must either drastically cut back on direct financing of domestic programs or
go into deficit to finance the revenue transfers. Either outcome is
foreboding for central governments. Transfers have also led to a predictable
loss in local revenue raising. Most of the revenue sharing plans adopted by
central government have been tied to requirements that local government
channel all or much of the transfers into local infrastructure investment.
**Recommendations.** The remedy requires revising expenditure responsibilities
and fiscal arrangements in line with intergovernmental functional
responsibilities.

16. **Fiscal imbalance in local governments, in contrast, appears to
raise few macroeconomic issues. In none of the countries we examined were**
local government deficits large enough to pose significant macroeconomic impact. Examination of government financing over the last decade in our case-study countries shows that this macroeconomic concern is a legitimate fear only at the state or provincial level.

17. ■ Poverty: targeting and service delivery. The study reveals that local governments are being conferred the authority for a greater role in poverty alleviation, and although by and large they are more responsive, in policy and intention, to the needs of the urban poor, the record in actual spending change is uneven. In addition, rural and poor municipalities do not have the technical capacity to equitably handle the administrative burdens of poverty assistance. Recommendations. Improvements in equitable treatment of the poor depend upon: i) an active, if not aggressive role, by central governments in setting standards, formulating targeting criteria, and providing direct transfers or assistance to municipalities to help the poor; and ii) a stronger role by local governments, if warranted, in identifying beneficiaries and in delivering services. The Bank can help through dialogue and sector work, to clarify the division of labor among levels of government and by identifying mechanisms for improving assistance, such as linking targeted social funds with mayor's funds and matching grants.

18. ■ Capacity for efficient local management. Present and prospective decentralization make local government more important than ever. This study sees civil service reform as a long term objective and introduces the possibility of revised municipal schemes of service based on efficiency in management as a second best, and more rapid alternative to wholesale civil service reform. Without significant improvements in personnel, salaries and job security, training and technical assistance must be discounted sharply. Questions of administrative and legal accountability also arise. Efforts must be made to buttress local auditing functions, perhaps by relying on states in federal systems, and by resuscitating the budgetary control functions of locally-elected councils. Further improvements in accountability may require reform and strengthening in judicial systems (civil procedures, appeals, due process), and (in largest cities) regulatory agencies and practices, all with possible benefits to private sector participation.

19. Recommendations. A long term, strategic view of local government is required to address the needs for capacity strengthening brought on by decentralization. In personnel, this means not merely reducing numbers of employees, but increasing productivity of function and accountability of management. Professional job security and more attractive salaries, among other things, are required before it makes sense to focus on training and technical assistance. Priority should be given to providing national minimum standards of service and building cadres of selected technical positions and department heads in municipal government in order to establish administrative continuity across political terms of office. The Bank should also place more emphasis on building capacity in auditing and budgetary controls in local governments, and training and technical assistance in contract management and project cycle skills.
E. The Harvest of Innovations.

20. Although most local governments in the Region have been peppered with problems and demands, some governments have been innovative in creating institutional formats, inventing organizational procedures, and incorporating market principles, which lead to more efficient provision of local goods and services. A handful of these innovations stands out as the most promising "harvest." (See Table ES-2).

Table ES-2

<table>
<thead>
<tr>
<th>Innovation</th>
<th>Country</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steering decentralization</td>
<td>Venezuela</td>
<td>A presidential council (COPRE) marshals conceptual ideas, tries out policy and legislation, develops guidelines and administrative models.</td>
</tr>
<tr>
<td>Integrated service planning</td>
<td>Brazil</td>
<td>Demonstrates the hallmarks of efficient program design and division of intergovernmental labor--clear policy objectives, strong technical capacity, highly participatory in allocation responsibilities and finance among the three levels of government, and effective service provision at the local level.</td>
</tr>
<tr>
<td>Matching block grants</td>
<td>Mexico</td>
<td>Federal, state, and local governments, (sometimes neighborhood groups) participate in financing eligible projects, selected and often implemented by localities.</td>
</tr>
<tr>
<td>Social and local funds</td>
<td>various</td>
<td>Social and local (neighborhood improvement) funds productively engage neighborhood energies in project selection, implementation, and resource mobilization. In addition, they provide a training ground for municipal strengthening in accountability.</td>
</tr>
<tr>
<td>Poverty targeting and assistance</td>
<td>Chile</td>
<td>Municipalities play a central role in identifying eligible families, delivering services, and often coupling the delivery of reimbursable services with direct payments and other municipally provided services, achieving positive scaler effects in poverty assistance.</td>
</tr>
<tr>
<td>Competition in public service delivery</td>
<td>Brazil, Chile and others</td>
<td>Public-private and public-public competition is set up through subsidized health and education and by municipal contracting out for a wide variety of services.</td>
</tr>
<tr>
<td>Local capacity strengthening</td>
<td>Chile</td>
<td>Municipal civil service reform and training in Chile put muscle in local governments, but the process took nearly 14 years.</td>
</tr>
</tbody>
</table>

21. Recommendations. Although some of these innovations have been documented in separate reports (e.g., Campbell, 1991; Campbell, Peterson, and Brakarz, 1990), others (contracting and municipal role in poverty targeting, market competition) deserve further scrutiny for possible wider application. It is notable that the study turned up no commendable experiences in auditing, local budgetary controls and electoral reforms, and (except for Brazilian health care), appropriate intergovernmental division of labor. These represent priority areas for future work.

F. Strategic Lines of Action for the Bank.

22. Though decentralization springs from powerful social and political forces, it is still possible that fiscal instability and poor local management will foster recentralization in specific countries or sectors. Whether or not these pendular reversals take place, the long term requirements for efficiency, equity, and sustainable local governments depend upon policy reform in center-local relations and restructuring of local governments. A
strategy to do this is based on the recommendations in this report re-
organized into four areas (summarized in Table ES-3). The strategy

<table>
<thead>
<tr>
<th>Table ES-3</th>
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<tbody>
<tr>
<td><strong>Regional Strategy to Improve</strong></td>
</tr>
<tr>
<td>Efficiency, Equity and Sustainability of Local Government</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Strategic Areas</strong></th>
<th><strong>Action Components</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Policies on central-local relations and development</td>
<td>Formulate Bank position and urge country actions</td>
</tr>
<tr>
<td></td>
<td>Define expenditure authority and adjust revenue sharing</td>
</tr>
<tr>
<td></td>
<td>Enter dialogue on macroeconomic and sectoral issues</td>
</tr>
<tr>
<td>2. Efficiency in local government.</td>
<td>i) Public choice making</td>
</tr>
<tr>
<td></td>
<td>Strengthen public choice-making</td>
</tr>
<tr>
<td></td>
<td>Develop technical options for demand detection</td>
</tr>
<tr>
<td></td>
<td>Support municipal role in social and local funds</td>
</tr>
<tr>
<td></td>
<td>ii) Local production</td>
</tr>
<tr>
<td></td>
<td>Encourage forms of competition</td>
</tr>
<tr>
<td></td>
<td>Build cost data banks</td>
</tr>
<tr>
<td></td>
<td>Diffuse contracting assistance</td>
</tr>
<tr>
<td>3. Equity in treatment of the poor.</td>
<td>Define municipal role in targeting and delivery of assistance</td>
</tr>
<tr>
<td></td>
<td>Adjust intergovernmental support for poverty</td>
</tr>
<tr>
<td></td>
<td>Develop, as needed, local capacity to deliver assistance</td>
</tr>
<tr>
<td>4. Local capacity, accountability, sustainability</td>
<td>Upgrade personnel profile and increase professional ranks</td>
</tr>
<tr>
<td></td>
<td>Strengthen auditing and budgetary controls</td>
</tr>
<tr>
<td></td>
<td>Explore impacts of judicial and regulatory deficiencies</td>
</tr>
</tbody>
</table>

complements and strengthens the emphasis presently given to financial dimensions of municipal strengthening (e.g., in Argentina Municipal Strengthening Project) by adopting an approach which adds dimensions of planning, spending and management.

23. The strategic approach outlined below is designed to increase efficiency through competition and accountability and to lay the basis for sustainable improvements in local government. This strategy can be implemented through articulation of Bank-wide policy, ESW, lending and TAL operations, and adjustments in staffing mix. The broad outlines for this approach include the following:

1. **Policies on central-local relations and development.** Decentralization has only gone part way in restructuring central-local relations. Clearer divisions of labor must be established before revisions in
intergovernmental financial arrangements can be addressed. To start with, it would be useful for the Bank to articulate the importance of balanced intergovernmental relations, in functional and fiscal terms, and to provide a framework for dialogue on macroeconomic and sectoral issues. The framework should address criteria for division of labor, sequencing of steps leading to new arrangements (see below), and the problems of administrative discontinuity presented by short electoral regimes.

2. **Efficiency in local government.** Actions are needed in two broad areas: i) to reduce the transaction costs and improve the quality of local public choice-making, and ii) efficiency of producing and delivering local public infrastructure and services. The focus in (i) choice-making should be on expanding the options and refining techniques to reduce economic and financial costs in choice-making and increase quality of, and options for, technical analysis (surveys, fora for community consultation, policy analysis). Suitable mechanisms for diagnosis and actions are TALs, technical assistance, training, EDI courses and cooperation with bilateral donors. The Bank should also promote local government participation in social and local funds as staging and proving grounds.

   (ii) **Production efficiency** can be improved by introducing different forms of competition at the local level, building and diffusing cost data banks, and giving more emphasis to local contracting and local supervision in the context of lending and project implementation.

3. **Equity.** Improve the equity of poverty assistance by defining or clarifying the role of local governments in poverty assistance, by equilibrating central government assistance according to need (of regions, municipalities, and groups), by taking advantage of local capacity to identify eligible families and by taking advantage of flexibility in service delivery.

4. **Local capacity, accountability and sustainability.** Increase the productivity of personnel by upgrading the professional profile, adopting local schemes of service and increasing the supply of professionals to increase continuity of service. Also, auditing and budgetary control mechanisms must be strengthened and the adequacy of judiciary capacity and regulatory arrangements should also be explored.

G. **Implementing the Strategy.**

24. The diversity of conditions and administrative actions taken by countries in the Region to decentralize make tidy classification impossible and a blanket approach by the Bank impractical. Rather, the analytical framework and prototypical issues treated in this report constitute starting points for further analysis on a country-by-country and sector-by-sector
basis. Sector and analytical work are the predominant modes for implementing the Regional strategy, although many aspects of capacity strengthening, accountability and sustainability can be addressed in the context of project lending. The TD can help to chart out sectoral aspects of decentralization, for instance in health and education, and perhaps by starting a dialogue to coordinate analysis and actions with the IDB.

25. 1. Policy sequencing and sector work. The sequence of policy issues to be addressed by the Bank is largely determined by the Bank's own hierarchy of policy concerns-- macroeconomic linkages, followed by expenditure assignments, intergovernmental financial arrangements, and capacity strengthening. Priority should be given to gauging the macroeconomic effects of uncoordinated spending among governments and next to exploring expenditure assignments and intergovernmental financing arrangements in order to avoid further possible destabilizing effects of decentralization. Issues of autonomy in own-source revenues and cost recovery logically flow next, once intergovernmental financial responsibilities are settled. However, efficiency in spending and production, together with institutional strengthening (capacity building, accountability in auditing and budgetary controls, and sustainability) must go hand in hand with financial responsibility. The longer term structural and personnel problems of local government need to be addressed in parallel by attention to public sector management.

26. 2. Emerging issues and skill mix. Decentralization puts a new light on old issues and broadens the scope of needed analytical skills in the Bank. More emphasis is needed in areas of legal and regulatory matters and participation in local government. For instance, power sharing and broader public participation may well affect the priority ranking of environmental problems (local publics may very well prefer more pollution in favor of basic sanitation). Different kinds of legal skills are needed to handle intermunicipal cooperative arrangements in the largest cities and in contractual assistance in small ones. Skills in specific areas of participation and in local government are acutely under-represented in the Bank.

5/ Nevertheless, two country variables shape the approach CDs may wish to take in addressing decentralization issues. First is the state administrative organization (e.g., unitary versus federal). The administrative organization of the state affects the approach to, and choice of implementing instruments for, such matters as national policies on expenditure assignments, grant financing, equity, and capacity strengthening. A second variable is the number of cities by size. In general, feasibility of actions to improve efficiency and equity in local government is roughly proportional to city size, irrespective of the organization of the state. For instance, very large cities can be treated as a class in either federal and unitary systems for such issues as local decision-making, planning, spending controls, and poverty assistance. The same is true for small and rural municipalities, although of course qualitatively different kinds of assistance are needed. Further discussion of criteria for expenditure assignments appears in Annex VI.1.

Decentralization in LAC
CHAPTER I. INTRODUCTION

A. Background

1. In the past few years, the Region has seen swift and sometimes turbulent changes in intergovernmental arrangements due to decentralization and democratization. In the past decade, more than half of the governments, representing over 90 percent of the urban population and a large majority of local governments in the LAC Region, have taken steps to decentralize authority to plan, spend, and manage local affairs. Large federated systems and unitary governments alike have approved constitutional reforms, passed major laws, and even adopted new constitutions (in Brazil and presently underway in Colombia) which effectively redefine the state, giving more power and authority to local government. Most decentralization initiatives strongly affect the intergovernmental flow of finance, and here too subnational governments have both more money and more say in how things are managed at the local level, although few have the power to change rate structures on their own. Over a period of only a few years, central governments have run the risk of fiscal imbalance by the wholesale and uncoordinated transfer of significant fractions of total income to local governments. Transfer systems in most countries are out of phase, resulting in either more new local spending without commensurate cutbacks of central spending or without new local revenue-raising authority.

2. The wave of decentralization appears to spring from a genuine effort to legitimize government by sharing power. In Mexico, the process was described by former President de la Madrid as "strengthening federalism," and in many countries the political rhetoric is linked to broadening the base of support, strengthening democratic institutions, and incorporating popular participation. In large federated systems, Brazil, Mexico, and Venezuela, the states have become important political players. Governors in both Mexico and Venezuela described the new power arrangements in their states with virtually the same words, to the effect that "before (elections) when the President called, we would respond, now (after elections), we decide if it is convenient for us."

3. In most cases these power shifts were replicated at the local level, some of them started there, because many constitutions grant to local governments autonomy in local affairs. Indeed election of local officials, and often even the separation of powers between mayor and council, are now institutionalized. These changes restore for the first time in decades an apparatus for public decision-making which accommodate greater participation and accountability. But except in a handful of cases, mayors have to work with an antiquated institutional setup and an anemic technical capacity. In

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1 The term 'decentralization' is used in this paper to refer to any transfer from central government to lower levels of government of the "authority to plan, make decisions, (finance), or manage public functions" (Rondinelli, 1981). This definition excludes two actions sometimes labeled "decentralization" in the Latin American context: deconcentration of central government offices and personnel from the capital to other locations; and transfer of functions from central government agencies to parastatals controlled by the central government (sectoral decentralization). Both of these actions are best viewed as administrative changes within the central government structure.

2 Analysis of intermediate levels of government is beyond the scope of this study but has been the focus of some Bank analysis and policy regarding new divisions of labor and intergovernmental responsibilities.
Venezuela, newly elected councils and mayors, not to mention organized political parties, have scarcely realized the scope of electoral mandates, the fiscal burden of new opportunities, and the pressing resource constraints on local initiatives.

4. These new circumstances radically alter the challenge for the Bank, since lending, technical assistance, policy questions, and other operational matters such as procurement and auditing must increasingly address subnational, as well as national, levels of government. Because decentralization is driven partly by political motives of power sharing, substantial demand for further decentralization, as opposed to retrenchment, may be anticipated.\(^3\) Abrogation of the state-led model of growth, together with growing privatization in LAC, encourage the gathering momentum to decentralize, as do events in Eastern Europe and the Soviet Union.

B. Purpose of the Study

5. This study aims to provide perspective on these trends in LAC, to document the strategies of decentralization in selected countries, to gauge the progress being made, and to chart out the broad implications of these changes for the Bank. From a policy perspective, the study aims to locate national decentralization strategies in relation to macroeconomic objectives and fiscal controls as local governments are accorded greater freedoms in taxing and expenditures. At another level, the study will identify where and under what circumstances decentralization to local governments increases responsiveness to local priorities and whether such achievements are won along with, or at the expense of, increases in production efficiency, and targeting to the poor.

6. On a more operational plane, a specific purpose of this work is to spot connections to project implementation and to harvest promising ideas— in areas of policy, administration, and institutional organization— for application in other sectors in a country or other countries in the Region. The study normalizes cross-country observations by focusing on the delivery of infrastructure and services— particularly water, sanitation, health and education— and by assessing the extent to which decentralized modes of service delivery meet the needs of low income populations.

7. Decentralization and Bank policy. This review of decentralization coincides with a turning point in Bank policy in the urban sector as well as with a growing concern about urban projects in the Region. The Bank's new urban policy rests in part on the premise that past projects "have not had an impact on the policies of national and local governments" and were not replicable because "many urban programs did not achieve sustainable policy reform and institutional development...(INURD, 1990:ii)." Project reviews by OED and the TD echo this position, pointing to problems of institutional instability, poor accountability, and weak capacity, both financial and

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\(^3\) For instance, Colombia is presently considering wholesale constitutional revisions in decentralization, including changes in fiscal and functional responsibilities; Chile is contemplating new election laws and organizational arrangements for local governments; Honduras has recently passed and must now implement a new organic law for municipal government; and Venezuela is exploring new functional responsibilities to accompany revenue transfers to state and local governments.
technical. Local institutional weakness in implementation has led to misallocation of resources and to projects which are not completed, poorly built, little used, or badly maintained. Virtually every urban sector review and project appraisal calls for significant technical assistance and training for local government. However, the institutional weakness is not merely one of "technical" competence, but also of poor connections between local government and the public that uses and pays for government services.

8. Breaking new ground. To an important degree, the nature of this subject-- decentralization in democratic environments-- enters relatively new terrain for the Bank: the political dimension of managing local affairs. The key to demand efficiency of local government depends fundamentally on accountability. The devices for establishing and sustaining accountability --local elections and other forms of citizen input-- therefore need to be addressed head-on in Bank policy. For the most part in urban and municipal affairs, the feasible options for urban residents to increase accountability, particularly for the poor, revolve around "voice," not "exit." Thus, democratic institutions at the local level are integral as means of expressing citizen demands and as vehicles for government accountability to the citizenry. These political and participatory dimensions of urban management, often referred to as 'governance,' are indispensable analytically and operationally for the Bank and, except in a few cases, need not intrude into political areas proscribed as off limits for the Bank (see Shihata, 1990).

C. Universe of Study.

9. In choosing countries for study, selection criteria were designed to take into account governmental structure, socio-economic circumstances, political organization, and other factors such as differences in approach to the process of decentralization. The cases chosen, listed in Table I-1 along with abbreviated indicators, represent 80 percent of the population in the Region and 90 percent of the urban population. They also constitute a representative mix of socio-economic and other factors, as discussed in more detailed in Annex I-2. However, the reader should note that even with this cross-section of cases, the study is a static comparison and underestimates the importance of dynamic processes in policy and practice in the Region.

<table>
<thead>
<tr>
<th>Country</th>
<th>Pop (mnls)</th>
<th>Pol-Adm</th>
<th>GNP (cap)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>32</td>
<td>F</td>
<td>2,520</td>
</tr>
<tr>
<td>Brazil</td>
<td>144</td>
<td>F</td>
<td>2,100</td>
</tr>
<tr>
<td>Chile</td>
<td>13</td>
<td>U</td>
<td>1,510</td>
</tr>
<tr>
<td>Colombia</td>
<td>32</td>
<td>U</td>
<td>1,120</td>
</tr>
<tr>
<td>Ecuador</td>
<td>10</td>
<td>U</td>
<td>1,120</td>
</tr>
<tr>
<td>Guatemala</td>
<td>8</td>
<td>U</td>
<td>900</td>
</tr>
<tr>
<td>Honduras</td>
<td>5</td>
<td>U</td>
<td>860</td>
</tr>
<tr>
<td>Mexico</td>
<td>84</td>
<td>F</td>
<td>1,760</td>
</tr>
<tr>
<td>Venezuela</td>
<td>19</td>
<td>F</td>
<td>3,250</td>
</tr>
</tbody>
</table>

Notes: 1988 population in millions; F = federal, U = unitary; GNP in 1988 US$ from 1990 WDR.

* The terms 'exit' and 'voice' refer to Hirschman's (1970) popular analytical model of market versus political actions, respectively.
CHAPTER II: ANALYTICAL FRAMEWORK

1. The analytical construct employed in this study is framed around policy questions of efficiency and equity of the public sector in development. This chapter describes the theoretical foundations and conceptual models used to map out decentralization strategies as seen in the LAC Region. The chapter develops the linkages in principle between decentralization strategies and the three outcomes of most direct concern to the study: efficiency of public service delivery, equity in attending to needy populations, and sustainability of local governance.


2. The policy issues in decentralization arise from efficiency and equity consequences of two major areas of state reform: i) the division of labor among a country’s levels of government, and ii) the form of financing capital investment and service delivery. In organizing the division of expenditure responsibilities, governments must find a balance between two dimensions of efficiency: a) efficiency in production of infrastructure and services, which is often favored by centralization due to economies of scale, and b) efficiency of resource allocation, which is often better decentralized because local jurisdictions know best what they need. Striking a balance in practice depends upon many factors, prominent among them institutional capacity at the local level. Equity issues arise because local governments will almost always under spend on poverty and central governments need to play a normative role to achieve a greater measure of equity. Efficiency and equity in financing is another matter. Revenue raising is usually more easily achieved by central governments, yet leaving revenue responsibilities to the center threatens to loosen fiscal discipline at the local level.

3. The scope of the present study is not to recommend a blueprint for these intergovernmental arrangements in spending and finance. Indeed, many solutions are possible, depending on individual country circumstances. Rather, the study addresses efficiency and equity issues within an analytical framework that recognizes the influence of financing arrangements on local government choices, but focuses the analysis on the mechanics of planning, spending, and management in local government.¹

B. Economic Models of Decentralized Governance

4. Public choice theory and fiscal federalism provide the theoretical foundations for this analysis. These bodies of theory are also a source of analytical constructs commonly used to guide arrangements for local public decision-making and spending. Two analytical models are of particular relevance: 1) local fiscal choice and 2) a principal-agent model.

¹ The issues of efficiency in revenue raising and rules of transfer have been taken up in several previous studies by the Bank, for example, Bird (1978). The LATD companion study on fiscal decentralization will also address some of these issues.

Decentralization in LAC
The economic theory of the local public sector is dominated by the North American and Northern European model of local fiscal choice (e.g., Tiebout, 1956; Hirschman, 1970; Oates 1972, 1977; and Musgrave, 1989). This model of how local governments behave has influenced assessments of decentralization policies as well, since analysts often assume that the decentralization process is (or should be) designed to remove central government from direct responsibility for public service provision, thereby clearing the way for municipalities or other sub-national governments to act in accordance with the principles of local fiscal choice.

5. 1. Local fiscal choice. In the theory of local fiscal choice, local governments raise most of their revenues on their own from local taxpayers. Public sector decision-making then has to deal with the realities of budget-constrained choice. That is, to be efficient the choice of service level should be made collectively by residents in the light of these constraints. This framing of the question places special importance on local institutions whose function it is to collect citizen expressions of service demands and hold local governments responsible for satisfying them. In one institutional variant, found in many parts of the United States, Switzerland, and other countries, local taxpayer-voters express their demand for tax and service combinations directly at referenda (Peterson, 1975; Pommerehne, 1985; Rubinfeld, 1987). For instance, citizens vote directly on the school tax rates used to pay for public schools, on special taxes for garbage collection districts or hospital districts, and on local bond issues to finance local capital expenditures. In other variants, local candidates run for public office on alternative tax and service platforms, with the result that local elections serve as plebiscites on public spending proposals. The same electoral processes enforce accountability. Officials who ignore the public’s tax and service demands, or operate the local public sector with great inefficiency, are voted out of office or trigger tax revolts.2

6. 2. Principal-agent. Another model of intergovernmental relations portrays the relation between central and local government as that between principal and agent (say Heymann, 1989 and, for a review of literature, Levinthal, 1988). The central government in this case sets the priorities for the public sector. However, it recognizes that decentralized implementation of these priorities may be the most efficient strategy, and that local governments, like all effective agents, need to enjoy some freedom and flexibility if they are to act with initiative in implementation. The challenge to intergovernmental program design is to find the right set of incentives and constraints to channel local initiative in the desired direction. Fundamental to this approach is the conception that local

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2/ The local fiscal choice model contains another important means of expressing citizen demand: voting with one’s feet. If the local mix of public services is out of line with a resident’s preferences, or if the costs of providing services in his municipality are out of line with the costs in neighboring communities, the individual can move to another jurisdiction. Empirical studies have confirmed that a significant part of local household mobility in countries whose conditions approximate those of the local fiscal choice model is caused by citizens moving in response to differentials in school quality, differentials in local tax rates, or differentials in other aspects of the local public service bundle (Tiebout, 1956).
government owes its ultimate accountability not to local taxpayer-voters but to the central government.

C. Efficiency and Equity and Decentralization

7. **Efficiency.** One of the most commonly cited objectives of decentralization is greater efficiency of service delivery and infrastructure investment. However, it often is not clear exactly what is meant by efficiency or different efficiency concepts are confusingly combined. It is important to discriminate three specific aspects of efficiency: production efficiency, allocative efficiency, and what we term 'fiscal' efficiency. These concepts are defined here and linked in a preliminary way to decentralization strategies. The empirical issues raised in this linkage are analyzed in Chapter IV; further discussion of theoretical issues appears in Annex 2-2.

8. **Production efficiency.** Production efficiency measures the costs at which specific bundles of services or infrastructure are produced. In economic terms, production efficiency is a matter of operating on the production possibility frontier, regardless of what output mix has been chosen. Full production efficiency (i.e., least cost production) is achieved by selecting the right input mixes for production, transforming these efficiently into output, and paying the lowest possible prices for the factors used in production. For individual activities, relative production efficiency can be measured by comparing the costs of standardized bundles of output. In the urban infrastructure sector, for example, costs per square meter can be compared for installing a certain road surface of a certain depth, or for installing a standardized type of community handpump. On a more aggregate scale, when a fixed bundle of health or education services is transferred from one level of government to another, the real cost differences that emerge (after control for service quality) may be interpreted as a measure of the production efficiency of the respective providers.

9. **Allocative efficiency.** This measures how well service or infrastructure bundles match consumer preferences. Do the level and mix of public services reflect citizen demand, given the costs of provision? That is, are public resources being spent on what the majority view as the priority items for the public sector to provide? Note that the very definition of allocative efficiency favors a local fiscal choice model, in which the purpose of the local public sector is to satisfy the wants of local residents. Note, too, that the optimal level and mix of public services from a local perspective will depend upon the price structure that local residents face. This will depend not only upon the real costs of production, but upon the structure of grants-in-aid and intergovernmental subsidies, which may lower the net costs to the community of providing certain types of services. The locally efficient output level and mix will coincide with the nationally efficient one only if intergovernmental price incentives have been adjusted correctly.
10. 'Fiscal' efficiency has two dimensions, the intergovernmental grants structure and national fiscal impact of local budgets. In decentralized systems, especially those in which the central government collects most of the taxes, the grant formulas for distributing revenues to local governments carry a large capacity for distorting both local demand and production efficiency. An efficient grant structure, under a local fiscal choice model, corrects for externalities but does not otherwise alter local incentives. (Under a principal-agent model, the grant structure may be designed to elicit numerous other outcomes, including greater electoral support for a particular party, more effective local implementation of a centrally designed expenditure program, or more opportunities for personal payoffs in intergovernmental transactions.) The second dimension of fiscal efficiency concerns the national fiscal impact of local budgets. Local expenditure behavior, or local revenue raising decisions, may conflict in important ways with the overall macroeconomic management policies of government. A fiscally efficient system leaves local government as much budgetary latitude as possible, while constraining local authorities to act in ways that are consistent with national policy for aggregate public spending, debt issuance, and pricing. With respect to macroeconomic management, the national government indisputably is the principal.

11. 2. Equity. Equity in public spending--i.e., redistribution of public revenues to provide services for needy populations from general funds--poses a special challenge to decentralization policy. In general, local units of government, if left to their own devices, will carry out less redistribution than the nation as a whole wants to sustain. The reason for this is that if any local unit of government introduces, on its own, strong local programs of support for needy populations financed by local taxes, it will tend to attract from outside new residents who want to receive the benefits, while driving out some of the high-income taxpayers and firms who must bear the local tax costs. This escalates the costs of the program, triggering another round of out-migration by local taxpayers. The same "voting with one's feet" that helps produce efficiency in service provision when households vote for the service levels they desire for themselves sharply limits the amount of redistribution that local governments can implement from own resources.

16. The traditional solution to this dilemma is to make redistribution a central government function. One design consistent with decentralization is for the central government to specify the characteristics of equity programs and fund them with central revenues, but to have local governments implement the programs within the local community. Another approach is to build a large equity component into grant formulas, so that poor communities receive more central funding than wealthy communities. In the extreme case, central grants may be structured to equalize the revenue per capita that every jurisdiction can raise from equal local tax rates. Local communities then are allowed discretion in deciding how to spend funds on behalf of poor families.

2/ Budgetary controls at the local level is covered in connection with institutional strengthening in Chapter IV.
D. Achieving Efficiency and Equity in Decentralized Governance.

12. In practice, elements of both models are needed to improve efficiency, equity, and sustainability in local government. Experience of developed countries shows that, in the main, the local fiscal choice model offers the most promise for increasing and sustaining efficiency in local government. In this model, beneficiaries and the constituents of the local public sector are most effectively confronted with the consequences -- taxation or other revenue raising measures-- of their spending decisions. Feedback to local government is muted in principal agency and in less pure fiscal choice models (for instance, where elections are indirect, or tightly controlled). Moreover, local choice best sustains the legitimacy of power sharing. However, principal agent approaches are the most effective to advance policy design for, and to improve conditions of, both poverty and environmental conditions. In addition, both models are accommodate policy interventions for purposes of influencing demand (for instance, through grants in aid), to incorporate public-private sector interaction (for local service with some "publicness" characteristics), and to allow incentives to competition (vertical and horizontal) between public sector entities. Each of these aspects is discussed in greater detail in Annex 2-1. Therefore, elements of both approaches are required and should be applied flexibly to achieve efficiency, equity, and sustainability in decentralized systems.4

4/ For fiscal efficiency and equity objectives, we have kept an open mind in determining how much direction the central government wants to impose on local authorities. However, even insofar as demand and production efficiency are concerned, it generally will not be true that "inefficient" decentralization systems are merely poorly designed. Rather, they are either out of phase or typically designed to achieve other purposes: to retain or even enhance central control over important local events, or at least to channel local actions in directions that are desired by central-level actors. Rather than specify how these decentralization designs can be "corrected" to make them more efficient from the perspective of local fiscal choice, it often is more instructive first to work backwards from the existing design to identify whom it benefits and judge whether the design is likely to have been deliberately adopted for this purpose.
CHAPTER III. NATIONAL DECENTRALIZATION STRATEGIES

A. Overview of Decentralization Strategies

1. The state-led model of development is being restructured with hesitation and without a secure sense among central governments that local capacity is up to the tasks being devolved to local governments. In effect, governments are engaged in balancing two forces: first, the internal pressures to restructure the state and second, the fears of losing control over fiscal and political affairs at the local level. The results so far are jerky and rough. Many countries are moving at an uneven pace and with built-in restraints concerning transferred powers and responsibilities. Table III-1 summarizes key policy choice variables—covering revenues, expenditures, intergovernmental institutional arrangements, and power sharing—common to the nine countries covered in this study.1/

2. The Table distinguishes, first, the revenue side of decentralization from the expenditure or service-function side. Two polar approaches to revenue decentralization were indicated in Chapter II. In one approach, the central government cedes significant authority to local governments to raise taxes and fees on their own. It can do so by granting sub-national governments control over new tax bases or fees as in Venezuela, allowing them greater latitude in establishing rate structures (Honduras), or permitting them to re-value traditional tax bases (e.g., the property tax base) more aggressively. In the alternative approach, the central government retains revenue-raising responsibilities, for instance in Brazil, but shares a larger proportion of its receipts with lower levels of government, either through tax-sharing arrangements or new intergovernmental transfers. Usually, these changes in revenue sharing arrangements are fundamental enough to be incorporated into the basic municipal law or to take the form of Constitutional modifications. Of course, the two revenue strategies are not mutually exclusive; central government may simultaneously cede local governments more revenue raising authority and increase revenue transfers from centrally collected funds, as in Venezuela.

3. There is a parallel choice of strategy on the expenditure or service-delivery side. The role of local government can be strengthened either permissively—by allowing local governments to expand service responsibilities at their discretion as, especially in states of Venezuela, or through negotiated agreements with parastatals and other centralized providers—or through obligatory arrangements as in Chile, in which the central government formally transfers service functions to lower levels of government. An intermediate strategy (followed in the United States during the Reagan administration), involves the central government's unilateral withdrawal from certain functional responsibilities, or a sharp reduction in central funding for these activities, forcing states and localities to decide whether they will step in to assume the central government's role. The first

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1/ The sources for Table III-1 include data directly obtained on mission as well as from Bank sector and analytical work, government reports, and national legislation.
# TABLE III-1

**SUMMARY OF DECENTRALIZATION STRATEGIES**

<table>
<thead>
<tr>
<th>Country</th>
<th>Revenue Strategy</th>
<th>Expenditure Strategy</th>
<th>Intergovernmental Institutional Arrangements</th>
<th>Democratic Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Reorganized</td>
<td>Varies by Provinces</td>
<td>Yes</td>
<td>F</td>
</tr>
<tr>
<td>Brazil</td>
<td>Increased</td>
<td>Existence</td>
<td>Not explicit but some de facto.</td>
<td>A</td>
</tr>
<tr>
<td>Colombia</td>
<td>Increased</td>
<td>Yes</td>
<td>Yes</td>
<td>F</td>
</tr>
<tr>
<td>Chile</td>
<td>Increased</td>
<td>No</td>
<td>Yes</td>
<td>F</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Reorganized</td>
<td>No</td>
<td>Yes</td>
<td>F proposed</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Increased</td>
<td>No</td>
<td>Yes</td>
<td>F</td>
</tr>
<tr>
<td>Honduras</td>
<td>No</td>
<td>Yes</td>
<td>Some</td>
<td>F</td>
</tr>
<tr>
<td>Mexico</td>
<td>Increased</td>
<td>No</td>
<td>No</td>
<td>A</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Increased</td>
<td>Negotiable</td>
<td>Yes (states)</td>
<td>A</td>
</tr>
</tbody>
</table>

*Until 1990, local elections were tied to votes cast for parties in presidential elections.*

Decentralization in LAC
column in the table under Expenditure and Services Strategy indicates whether there have been significant transfers of service responsibilities from the central level to the sub-national level. The second column indicates whether local governments have been given more discretion in deciding which services they will provide, or how they will provide them. (Examples of the latter choice include local discretion in deciding which service functions will be provided locally and how these will be managed institutionally; or more freedom to contract with private sector firms or parastatals for service delivery.)

4. In practice, one of the most common decentralization strategies has been for central government to require that a large part of its revenue transfers be dedicated to local capital investment in infrastructure facilities. Consequently, an index is included in the table to show whether there is significant earmarking of centrally provided funds for local capital investment.

5. The third broad category in Table III-1 addresses intergovernmental institutional arrangements. It shows whether intergovernmental relations have moved toward greater reliance on fixed and clear formulas in allocating aid and service functions or have moved toward greater use of negotiation and agreements (convenios) between the central government and states/localities as the basis for fiscal cooperation. These alternative strategies imply quite different approaches to decentralization. A fixed and transparent intergovernmental aid system clears the way for independent choice-making by local governments. A system of negotiation through convenios, in contrast, guarantees closer contact between the different levels of government, at least during the often prolonged period of negotiation, and very likely beyond that.

6. The final set of indices in the table concerns the nature of democratic participation in local government. One index notes the recent onset of local elections and whether mayors are elected by local councils in a collegial system or separately from councils, thus effecting increased accountability in budgetary and administrative matters. The index also notes the lengths of elected terms. The other index indicates whether the central government has introduced new, "corporatist" planning methods, which are intended to establish direct links between community-level participation and the central government structure. "Corporatist" planning arrangements set development priorities outside the voting process. The planning structure typically bring together central-government, local and community officials, as well as representatives of other collective entities (e.g., business groups, unions, and political party leaders).

7. Classification schemes always carry the potential for oversimplification. Several of the measures in Table III-1 are more properly continuous variables than yes/no indices; for some variables there are other logical alternatives than the ones recognized in the table (e.g., country decentralization plans could move in other directions than either clearer aid formulas or greater use of negotiated agreements). However, for most countries and most measures, the appropriate classifications seem to carry little controversy.
B. Interpreting the Region's Decentralization Strategies

8. The decentralization strategies revealed by Table III-1, and in particular, the imbalance between spending and revenues, are in some respects surprising, given the rhetoric that has surrounded decentralization plans, both in national politics and in the professional literature. In this respect, it is important to remember that the restructuring process in the Region is dynamic and time-consuming. Moreover, the characterization of strategies in this report is constrained in that the analysis is largely static and covers mainly the initial phases of decentralization in most countries. It should be recognized that countries are already in the process of making strategic and tactical adjustments as they move through a transition to decentralized governance. These circumstances make it important both to interpret cautiously the findings reported below and to revisit these themes in the near future at the country and Regional levels. With this as a preface, the key features of national strategies are highlighted here and analyzed in greater detail in Chapter IV.

9. 1. Driving up central government investment costs. All of the Region's decentralization programs have involved new and substantially larger central government transfers to local (sometimes state) government. This pattern is surprising in light of the fiscal constraints operating on most nations in the Region. Highly indebted nations in general have been cutting back on the growth of central government budgets (World Development Report, 1988; Hicks 1989). A central-level commitment to decentralization would be compatible with this cut-back perspective if it were designed primarily to shift financing responsibilities to the local level. However, for the countries reported in Table III-1, this is not true. Revenue transfers generally have run well ahead of expenditure or functional transfers, implying that over the intermediate term, at least, decentralization will add to central-government costs. This issue is considered at greater length under intergovernmental fiscal relations in Chapter IV-C.

10. 2. Money is transferred without commensurate spending responsibility. The transfer of central government functions under conditions where local governments must finance service delivery has generally proved difficult to implement and has most often taken the path of least political resistance. Resources have been transferred to the local level, but recipient governments have not been required to take on specific functional responsibilities of comparable cost, and have not required central government bureaucracies to formally abandon their involvement in service provision. Unless the potential duplication of roles is sorted out at a later date, this strategy runs the risk of driving up total costs in the public sector.

11. 3. Transfers are intended to stimulate local infrastructure investment. It is paradoxical that decentralization strategies should be adopted at a time of severe budgetary pressure on central governments, and against a backdrop of budgetary retrenchment, yet be designed so as to impose large net costs on central budgets. To compound the paradox, the decentralization plans put into effect are plainly designed to stimulate local governments' spending as well, especially for infrastructure projects. In
most cases, all or part of the new revenue transfers must be spent on local capital investment, while formal requirements are written into the transfer terms to try to ensure that this investment is additive (i.e., that central government transfers do not substitute for local funding). These provisions have not been freely effective—i.e., many local authorities have cut back on local revenue collection and substituted central transfer for own-source revenues—but the intent of decentralization has been to increase local capital spending, and this outcome has been achieved in significant degree.

12. 4. Local revenue-raising is being enervated. There has been relatively little movement toward what might be called the North American "fiscal choice" model of decentralization. Recall from Chapter II that this model simultaneously devolves service responsibilities and local taxing authority, so that municipalities must make budget-constrained service choices from their own resources. As can be seen from Table III-1, there has been much less action to grant new revenue-raising authority to local governments than there has been to increase centrally-financed resource transfers. Indeed, the table is likely to overstate the practical significance of the changes in local revenue-raising authority. In several cases where local governments have been granted more tax or fee-setting discretion, the influx of central resources has made use of the new taxing authority unnecessary.

13. 5. Democratization. Decentralization in the region has been closely tied to democratization, at least in the sense that the great majority of decentralization initiatives have been accompanied by the introduction of local elections or substantial reforms in the local electoral process. Perhaps the most important of the reforms is the election of mayors separately from councils (except in Chile and Mexico) and the introduction of self-succession (in Venezuela and Ecuador). These reforms tend to increase accountability. On the other hand, short terms of office (two years in Colombia and three in many countries) pose an obstacle to continuity in investment programs and administration.

14. At the same time, there is a counter-current that does not identify "closeness to the people" with multi-party local democracy or separation from central government authority. In Mexico in particular, but also in Chile under the Pinochet government and in other countries of the region (e.g., Guatemala) decentralization has been accompanied by newly created, "participatory" institutions for linking community investment and community decision-making more directly to central authorities. The new institutions either by-pass local government altogether or abridge its autonomy. This form of decentralization, which attempts to strengthen, rejuvenate, and legitimize the role of the central government and the political party which controls it by establishing direct links to the community and organized populace, has been observed in other regions, especially Africa. One author has labeled it "recentralization through decentralization."

15. 6. Formula-driven transfers. The preponderant intergovernmental strategy has moved in the direction of clearer, more stable formulas for distributing revenues. These measures create the potential for greater local autonomy in expenditure choice, and reflect what might be labeled a "hands-
approach to guiding the local response to decentralization. However, in Mexico and Venezuela, the basic approach to decentralization has been negotiated agreements between federal and sub-national authorities. These agreements cover investment priorities and allocation of service functions, as well as the amounts and form of intergovernmental aid. In Venezuela, the process is designed to be transitional; the final negotiated agreements should lay out clear and stable guidelines for the future allocation of funding and functional responsibilities. In Mexico, the negotiation process has been incorporated into the national planning arrangements, and is intended to be permanent. Each year, federal, state, and (less extensively) municipal authorities are expected to negotiate mutually acceptable investment and financing priorities. As applied in Mexico, this strategy establishes the basis for the federal government, as the senior partner in these arrangements, to exert continuing control over sub-national expenditure priorities. It also consolidates a large element of political discretion in the intergovernmental grant structure (see Campbell, Peterson and Brakarz, 1991). Although most countries in the Region have moved toward more stable and predictable forms of revenue sharing, it must be emphasized that this is still a fragile development. Many local officials have expressed skepticism that the revenue sharing laws will be (or even are being) implemented as written.

16. 7. Sharper focus on apparatus for decision-making and management. Democratization and, in many cases, constitutional provisions or municipal laws have formally enlarged the autonomy of local or state governments and sharpened the focus on local machinery for managing municipal affairs. In many respects, municipal organizations, analytical tools, and procedures are cumbersome and inadequate. Most governments have identified these problems, but have not yet fully attended to the needs of local governments for stronger mechanisms in policy and decision-making and increased accountability. Many local governments cannot accurately detect demand and are unable to ensure accountability in management. Until decision-making and managerial skills are increased, for instance by improving auditing systems, local governments will remain hobbled and unable to effectively exercise many aspects of independent rule.

C. Conclusions.

17. In sum, decentralization measures have been put into effect across a broad spectrum of countries with adverse consequences for macroeconomic stability, at least in the short run. At the same time, central governments are hesitant and sometimes uncertain as to how far to go with local autonomy. But again it is important to emphasize the transitional character of decentralization and the drawbacks of a one-time glimpse afforded by reports of this type. Decentralization efforts are still far from complete in most of the Region. Indeed, many countries are in an initial phase of government restructuring. The outcomes of decentralization, will turn on the ability of governments, both central and local, to adopt new arrangements on intergovernmental divisions of labor, improve fiscal responsibility and increase local government accountability. For these reasons, the Bank may well need to revisit these themes again in the near future in order to better understand the process of decentralization and to enhance capacity in the Region to provide policy and technical advice.
CHAPTER IV. ISSUES IN DECENTRALIZATION

1. This chapter examines efficiency and equity issues raised by uncoordinated national strategies and analyzes tools and mechanisms which can be used to transform local governments into more efficient providers of service. The chapter also indicates the role the Bank can play to assist in this transformation.

A. Allocation Efficiency and Decision Making.

2. Efficiency in local resource allocation measures how well service or infrastructure bundles match consumer preferences. Do the level and mix of public services reflect citizen demand, given the costs of provision? That is, are public resources being spent on what the majority view as the priority items for the public sector to provide? The chief challenge for increasing efficiency in resource allocation at the subnational level is to improve the system for managing public sector decisions about investment projects. Local governments must not only detect, but to a degree which satisfies the electorate, also reflect, local priority in investment decisions and be subject to accountability by political and other means. In other words, decentralization is not in itself the major concern for the Bank nor for most of its borrowers. Rather, it is decentralization in the context of power sharing—democratization and expanding democratic practices among local governments—which occasions the shift of focus in the Bank’s work on public sector management. The transfer of power to locally elected governments—in other countries as well as in Chile now moving into full democratic control—places the locus of action and accountability more squarely onto the local level and to "local publics," that is, organized interest groups, political parties, neighborhoods, and other constituencies. This shift creates an opportunity to improve the mechanisms of efficiency and accountability at the local level.

3. 1. Efficiency criteria. In practice, allocation efficiency is most likely achieved when individuals and localities are confronted with the cost burdens (initial and recurring) of their decisions, and these economic and financial consequences are reflected in the local electoral process. In
this local fiscal choice ideal, choice making and management extends to the political sphere. Elections empower governments, and governments and utilities in turn, are accountable to constituent publics. But whether in public choice or principal agency modes, ways must be found to facilitate both expression and detection of demand, to verify demand under different “price” conditions, and strengthen accountability to constituents. Second best efficiency conditions are also desirable in some cases, i.e., local governments have authority and responsibility for local expenditures, even if financing originates from intergovernmental transfers.

4. Recent experience in countries. In practice, allocation efficiency is affected in three arenas: a) electoral, b) technical, and c) projects. By way of preview, virtually none of the country cases examined in this study fulfill fully the electoral mechanisms needed to satisfy efficiency criteria for policy and demand expression, even though most countries have electoral laws and institutions in place for this purpose. The alternative solution employed in most countries may be called "technical," that is, the setting of policies, programs, and project investments by politicians or planners in accordance with their own perception of true demand, whether this is done patronistically or, in a more benign gauging of public interest where no true demand is detectable, such as in pollution control in metropolitan areas. Selection and implementation of projects represents still a third arena in which demand expression, detection, and accountability may be gauged through local response to alternative program, project, and "price" options.

5. a. Elections. In most countries, minimum conditions for electoral choice-making—that is civil liberties and at least quasi-competitive parties—apply mainly, with notable exceptions, to selection of national candidates. The long dominance of central government and parastatals in service supply has worn away voter identification with local government as an instrument of service choice and service supply. As a result, local officials rarely are judged by their service performance record. In this environment, even when there are local multi-party elections, they tend to become miniaturized battlegrounds for expressing preferences regarding national-scale political issues or political ideology, rather than service demands. Even more fundamentally, the predominance of central government funding means that local citizens rarely have to deal with the realities of budget-constrained choice. As a result, citizens tend to "demand" far better service than is realistic and blame distant bureaucratic bodies when it fails to materialize. Lack of accountability in local governance is a major impediment to the efficient functioning of decentralized models of service delivery.

6. The study uncovered numerous examples of effective electoral mechanisms, for instance in the alternating of power between pro-infrastructure and pro-social services mayors in Sao Paulo and in the

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4/ By “price” conditions, we refer to the cost recovery, cost-sharing and other conditions pertaining to contributions or participation by beneficiaries in programs or projects.

5/ Broadly speaking, democratic choice making requires the following: i) conditions of civil liberties and political freedoms; ii) well understood and transparent channels of participation and communication; and iii) the availability of competitive choice among candidates, policies, and programs (see Diamond, 1990). Most countries in the Region are making progress in the first two, but have major problems with the third.
impeachment of a mayor in Para state in Brazil. These instances of effective electoral machinery are unusual. Many obstacles block more effective electoral controls such as prohibitions against self-succession, preference for party slate (versus district representation), the absence of referenda (except in Venezuela) and recall, and other issue-oriented measures submitted to vote (at one extreme, bond issues). The new electoral law in Venezuela—allowing both self-succession for one term and popular referenda—is unique among the countries covered in this study and deserves monitoring. Most countries (by national constitution or organic law) prohibit more than one three-year term for mayor (two years in Colombia and Bolivia), although re-election once is usually possible. These proscriptions build in a source of discontinuity in local development. Changes in local electoral terms usually require constitutional amendments, and countries usually bristle at the mere broaching of this subject. Also, legislative powers of local councils, except in Brazil and Argentina, are severely curtailed. High priority should be given to the invention of ways to compensate for these institutional imbalances and discontinuities. Other obstacles to more effective use of elections include instability in national political parties and local organizations.

7. The Bank's overall mission of adjustment, stabilization and growth is perhaps the most effective course for developing stability and continuity in governmental management. Constitutional prohibitions against self-succession and other aspects of electoral regimens are not easily remedied, but it may be possible and worthwhile to address these concerns in the course of policy analysis and sectoral work. Some or all of the obstacles to formalized choice-making—in elections, referenda, and legislative powers—are addressable by the Bank. As we shall indicate below, the Bank may, in the interests of efficient management and public choice, wish to support institution-strengthening measures designed to make local elections and referenda easier to hold and less expensive for those countries or jurisdictions interested in taking advantage of them.

8. b. Technical forms of demand detection. In the absence of a clear policy mandate from constituencies in the electoral process, and to complement electoral means of detecting demand, most political leaders at the local level resort to "technical" means—surveys, local advisory councils, participation by local groups, political pulse taking, hearings and the like—to determine needs and priorities at the grass roots level. Some of the most popular, locally-elected officials proclaim a legitimate "feel" for local needs. Others contract survey firms to sound out issues and priorities among the electorate. The danger of these "technical" means is the possible introduction of undue political influence, the exercise of personal bias, or the flat exclusion of minority opinion or groups in conceiving or implementing programs. These errors can lead to mis-allocation of resources and projects.

6/ In the case of Argentina, short electoral periods determined by provincial constitutions inhibit participation by mayors in investment credits. To encourage borrowing, grace and payback periods were shortened in order to promote credit financing of municipal projects.

7/ Stability depends partly on the "political culture," for instance, tolerance for opposing views and success with alternating party leadership. These are eroded in nations buffeted by powerful factors such as such as debt, inflation, gyrating oil prices, and recession and are likely remedied only by sustained growth.

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which are not implemented, poorly built, little used or badly maintained, as has frequently been the case in municipal improvements projects by both the Bank and the IDB. Nevertheless, improvements in "technical" means complement electoral expressions and are the preferred alternative in the absence of institutionalized democratic channels.

9. Survey and participatory techniques are the two main technical tools available to local governments. Surveying is not a widely accepted methodology, partly because of cost and because local leaders feel they "know" the people. City officials in Belo Horizonte and Monterrey, for example, have relied on survey techniques to sound out local needs and justify their investment program to municipal councils at budget approval time. Participatory techniques are more widespread.\(^8\) Incorporation of grass roots groups—typically either community-based or issues-oriented—play an important role in mobilizing and expressing local opinion about issues and preference in choice, and could be used to a greater degree in mobilizing resources and implementing projects. Virtually every country has a tradition of grass roots organizations which are recruited for everything from planning to maintenance.\(^9\)

10. Although grass roots groups have been employed, sometimes exploited, for political purposes in urban programs in the LAC Region, they (as NGOs or PVOs) have only recently been seen as a legitimate part of the development effort. The fraction of ODA awarded through NGOs reached 3.5 percent in 1985, up from .7 percent in 1975. Cernea attributes their growth, among other things, to "the realization that neither government nor the private business sector has the will or capacity to deal with certain acute socioeconomic problems..." (Cernea, 1988: 13). In the context of decentralization and democratic development, grass roots groups can properly be seen as fundamental building blocks (Cernea calls it "social capacity building") to improve efficiency among democratic countries undergoing decentralization. The U. S. war on poverty in the late 1960s and early 1970s made the mobilization of local groups an explicit pre-condition of poverty assistance. Chile's municipal reform legislation provides an innovative model to formalize this process (as described in Chapter V).

11. A variety of options is open to the Bank to increase the effectiveness of technical means of demand detection and decision-making, including strengthening of local democratic processes, improving project evaluation techniques, and the introduction of market like mechanisms for local governments to qualify and utilize NGOs in local services. These ideas are discussed in greater detail in the closing section of this chapter.

12. c. Programs and projects. Programs and projects constitute a separate domain from election and technical means for communicating national priorities and for verifying demand. Most governments derive information about demand strength and resilience in the form of conditions attached to

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\(^8\)/ Participant observation of the kind described in Salmen (1987) is a proven cost-effective method of potential utility for the Bank as well as project implementation teams.

participation in the design and implementation of programs, such as poverty assistance and childcare, and in capital investment, such as neighborhood improvement projects. In nearly all of the countries studied, municipal governments maintain funds—known variously as "local," "mayor," or "neighborhood improvement" funds—often requiring counterpart contributions from neighborhood groups for local improvement projects. Though they are frequently used as loose financial cannons in local political battles, municipal funds should employ conditions which are objective, transparent, equitable, and efficient, and which verify the demand among intended beneficiaries by requiring counterpart in cash, participation in implementation, and responsibilities for maintenance. The Bank has already begun to support municipal funds in Argentina, Brazil and Ecuador. Though the policy scope of local funds may be narrow, such funds are nevertheless highly useful training grounds for local choice-making.

13. Social investment funds and matching block grants represent a distinct category in this domain. Social funds deserve attention because of the prospects for building democratic processes at the local level as well as for the dangers they present of undercutting the long term institutional development objectives of Bank work (see Campbell, 1991). Matching block grants, such as the CUDs-PNS in Mexico, represent still another format for eliciting demand and coordinating federal, state, and local investments. Under "best practice" principles, both social funds and matching block grants should establish clear, objective, and equitable criteria for eligibility of beneficiaries and projects. Under these conditions, local governments are in a position to encourage participation in priority sectors, to mobilize local resources, and to "read" the revealed preferences of social groups and governments under different pricing conditions.

4. Policy options and role of the Bank. Whether a national strategy follows a principal-agent or fiscal choice model, the Bank must take steps to improve efficiency and transparency in the conduct of local affairs. Resource allocation issues need to be addressed on technical grounds, i.e., on the accountability and efficiency of investment choices. But to adequately address these issues requires the Bank to take an approach quite different from that of institutional strengthening and public administration taken in the past.

14. At present, several distinct approaches to local government efficiency are taken by different CODs in the Region. In some CODs, subnational governments, if not the urban sector as a whole, are treated as explicit and important parts of national development and macroeconomic strategy. This is reflected in the coordination of conditions in project lending aimed at improving financial performance and efficiency of local government across real sectors. Other CODs give less attention to subnational governments. All CODs and most SODs in the urban and municipal sectors tend to give greater emphasis to financial performance and resource mobilization over issues of allocation efficiency and equity in managing local government. Without stronger emphasis on accountability, local governments with new

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10/ Of the main facets of accountability—legal, financial, administrative and political—we are concerned here mainly with public choice-making. Subsequent sections of this report take up selected legal, administrative and financial aspects of accountability.
spending and revenues are not likely to be able to sustain efficient operations and legitimate government.\textsuperscript{11}

15. The more profound challenge under circumstances of decentralization and democracy is that of laying the foundations for efficient local government by engaging institutional mechanisms and political processes involved in efficiency, accountability and sustainability. These include, broadly speaking, stronger participatory arrangements, including the electoral process, participation in policy discussion, education, and policy research. The Bank can act in all or some of the following areas:

- Prepare a policy paper, to complement those on the urban sector and on governance, to signal the increased importance attached to efficient management of local governance, to lay out the principles of good conduct (such as open, popular choice among competing policies, transparency, and accountability, the importance of continuity in local government), and to identify the options for action in such areas as public choice-making. A particularly knotty issue is electoral terms. Because changes in local electoral terms require national constitutional amendments in most countries, it is unrealistic to expect action on this issue, but the importance of the issue needs to be communicated.\textsuperscript{12}

- Provide for the strengthening of local participatory mechanisms by (perhaps through EDI) providing training in, and the use of, public debate and diffusion mechanisms—such as community fora, hearings, and advisory councils—to increase the level of public awareness and debate and to step up the effectiveness of participation. Also the transaction costs in decision-making can be reduced, for example by improving election technology (to reduce costs, time delays, and sources of error). Issue-oriented elections, such as local referenda now allowed in Venezuela, represent an unexplored possibility for which training, technical assistance, and monitoring of the Venezuelan case would be useful.\textsuperscript{12}

- Lend stronger support for strengthening capabilities in public policy analysis and academic degree programs.

- Incorporate institutional dimensions of efficiency and accountability at the local level in Bank sector work. Sector and analytical work should include such matters as the degree of competition in public policy and choice, effectiveness of demand detection, and extent and nature of accountability.

\textsuperscript{11} The recent initiative in democratic institution strengthening by LATPS (in Chile) is an innovative and constructive move to broaden the Bank’s effectiveness in public sector efficiency.

\textsuperscript{12} The institution strengthening measures to buttress electoral choice mechanisms need not conflict with political sensitivities often of concern in the Bank. Such strengthening need only be carried out where electoral choice is the established mode (Mexico City being a notable exception).
The Bank should include as a part of its modus operandi with social funds and matching block grant schemes: a) the melding, or at least making consistent, the conditions for and selection and eligibility criteria for financing of local projects (through social funds, matching grants, and neighborhood funds); b) employ project and beneficiary eligibility criteria which are transparent, efficient, equitable and which are implemented objectively and with measures of local autonomy; c) require explicit cooperative agreements (contract plans and the like) with national bureaucracies and local governments to support, maintain, and participate in project implementation and maintenance to further development of local accountability and efficiency.

Assist local governments in techniques to identify, evaluate, register and mobilize local grass roots groups for such purposes as participation in policy fora, project identification, implementation of neighborhood improvements, delivery of social and poverty assistance, maintenance of social infrastructure, and the like.
B. Production Efficiency.

1. As noted in Chapter II, the production efficiency of decentralized service provision relative to centralized provision can be gauged in principle in either of two ways. One approach is to directly compare the total costs of providing standardized service packages under the two regimes—e.g., before and after decentralization or between similar programs run by central and local authorities. Although such comparisons can be suggestive, to be taken literally they require strict comparability of production conditions. Moreover, a large number of independent observations in a particular country are required before drawing any conclusions, even for a particular service function, as to whether decentralization has yielded production cost savings. An alternative approach to the cost question is to identify the changes in program structure resulting from decentralization that are most likely in theory to affect production costs, and look for empirical evidence as to whether the predicted cost changes are taking place. This approach may not always be able to identify the "total" costs of production, but it has the advantage of focusing on the areas where changes are most important and seeking to explain why costs have changed.

2. A large-scale, carefully controlled comparison of standardized service costs is an ambitious undertaking, well beyond the scope of this project. However, the present study did assemble preliminary pieces of evidence for parts of a cost analysis. These help pinpoint the issues that need to be addressed in future studies and future policy design.

3. 1. Competition as a form of cost control. Competition in municipal service markets, like competition in other markets, is a potentially powerful element for controlling costs. Some decentralization strategies have expressly coupled greater local government authority with greater use of competition in service provision. This competition can take many forms: competition between private providers under public supervision, competition between public and private providers, or competition between alternative public providers. Examples of each of these approaches can be found in recent decentralization strategies.

4. Contracting out of service functions to private providers under competitive franchise arrangements is one way to take advantage of competitive markets. Chile has gone furthest in this direction, expressly linking decentralization to private contracting. Most Chilean municipalities now contract with private firms for solid waste collection, street cleaning, almost all construction projects, maintenance and repair of street lighting and traffic signals, and maintenance of city equipment. The central government stimulated local contracting out by instructing municipalities to compare the costs of private provision of trash collection and other services with the costs of continued municipal provision. Specific instructions were

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1 The importance of competition to cost savings is also illustrated by Chile's experience. Municipalities in 1989 experienced an 11 percent increase in the real costs of contracted solid waste collection. Cost increases were greatest in those jurisdictions where municipal government had dismantled its solid waste collection capacity and where only a single firm bid on contract renewals. In these situations, competition no longer served as a constraint on pricing. Indeed, municipal authorities outside of the capital region expressed the fear that consolidation of private trash collectors would result in regional private monopolies, which would be free to hike prices strongly in the future, without fear either of private competition or re-
distributed as to how cost comparisons should be made and how competitive
bidders for franchise awards should be structured. By 1988, 70 percent of
solid waste collection in Chile's larger cities was operated by the private
sector, and recent studies (Leite, 1990 and Yepes and Campbell, 1990) judge
public service to cost in the area of one and a half to four times more than
comparable private providers. Further detail on contracting appears in
Chapter V on Innovations.

5. Realization of the cost savings potentially available from
privatization also requires an administrative restructuring of municipal
government. It implies a reduction in the municipality's unskilled labor
force, and an increase in professional managers able to conduct competitive
bidding and manage private sector contract performance. The experience of
Chile (described in Chapter V) illustrates extensive restructuring of
municipal personnel.

6. Deliberately designed, continuing competition between public and private
service providers is relatively rare. However, it is just this type of
competition that underlies Chile's approach to decentralization of education.
At the same time the central government turned over public elementary and
secondary schools to municipalities for administration, it opened the field
for competition from private schools on equal terms by reimbursing public and
private alike with per pupil payments. Since the reform of school
arrangements, per-pupil school costs in Chile have in fact risen at a rate
below the overall rate of inflation because municipalities were given more
flexibility in personnel management. Although these links to decentralization
assisted in cost control effects, overall cost savings were forced upon
Chile's school system primarily by the decision to increase centrally
reimbursed tuition payments by less than the rate of inflation. This budget
constraint is passed on to municipalities. Municipal governments are free to
contribute additional amounts from their own resources, and increasingly some
have done so, but the limited revenue position of municipalities sharply
constrains their financial commitments. Thus, the grant structure has been
used by central government specifically to control costs of decentralized
service functions.

7. Competition between different levels of government is even rarer.
However, this approach is contemplated in Venezuela's new constitution, which
allows any state government to identify service responsibilities it wishes to
take over from central government, in return for the current level of central
government expenditure. It is hoped that this vertical competition will
result in placing service delivery at the level of government where it can be
performed most efficiently.

8. 2. Local construction and supervision of public works.
Proponents of decentralization frequently affirm that local construction or

entry of the public sector into service provision, since under existing laws municipal governments have had
their total personnel plant frozen. This experience serves as a reminder that the cost savings of privatization
do not result from a mere substitution of private firms for public ones but from (actual or potential)
competition that forces suppliers to act more efficiently. Permanent cost advantages require the preservation
of competitive arrangements.

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supervision of infrastructure projects will produce cost savings because local authorities and the local community have greater incentives than central authorities to use funds efficiently.

9. The case study for Tulua, Colombia, carried out as part of this project, investigated relative costs for standardized sewer pipe installation in Tulua by the central government agency (INSOPOPAL) in 1985, before decentralization, and Tulua's Water and Sewerage Company in 1989, after decentralization. The per meter cost of local construction was Col. $3,638 vs. central construction costs of Col. $6,106, both in pesos of 1989. Although it would be unfair to read too much into this single point comparison, local authorities in Colombia argued that the savings were representative of relative costs more generally, and attributed the savings to working with local rather than national-scale contractors, thereby saving on labor wages and the costs of moving equipment and machinery into the city. They also stated that there was substantially less opportunity for corruption in locally administered works, because of the community's participation in project oversight and because of the fewer approvals that were required for the project to move ahead.

10. Community supervision of projects, in fact, was commonly cited as a source of cost saving in other countries, as well as an important factor in the timely completion of projects by contractors. Local officials in Mexican cities stated that, although they had experimented with community self-help in construction, they had found that the most effective involvement of the community is in supervision. Community organizations participate in the design of local water, sewer, and road projects; then form committees of supervision to oversee the private contractor's performance.

11. 3. Sorting out of duplicative administrative responsibilities. A third source of potential cost saving in decentralization schemes is the sorting out of functional responsibilities among different levels of government so as to reduce overlap. The Project was unable to uncover any controlled studies of the cost savings resulting from such administrative rationalization. However, savings of this type often have been the objective of decentralization plans. On occasion, extensive local experiments have been conducted, which have led authorities to conclude that a sorting out of responsibilities involving decentralization does indeed produce cost savings. One example of such sorting out is the creation of the Unified and Decentralized Health Systems (SUS) in Brazil. This restructuring of the health system stemmed from a conviction that the old health system, in which municipal, state, federal, and private philanthropic hospitals duplicated one another over the entire range of health services, led to large amounts of waste. Over a five year period, local experiments in coordinated health delivery were carried out in some 2,500 municipalities. (See Chapter V for further detail).

12. 4. Information banks on cost experience. A significant potential advantage of decentralization in controlling production costs, especially for infrastructure installation, is the natural benchmarking that results from having scores or hundreds of communities carry out similar local projects. The local replication of road paving, water pipe installation, and other local infrastructure projects establishes a range of costs at which similar projects
actually have been carried out. Publication and wide sharing of this cost experience can help control future costs. Communities entering the bidding process have benchmarks for what reasonable costs per square meter of road surfacing or costs per linear meter of sewer pipe installation should be. Moreover, if data banks are maintained with contractor identifications, patterns of systematically high-cost and low-cost contractors can be distinguished. In the inbred world of municipal construction contracting, no cost control device is likely to be more effective than the regular publication and distribution to municipalities of cost experience in other communities, standardized by type of construction project, and with identification of the private contractors carrying out the work. Guatemala is in the process of setting up such a comparative data bank to bring cost pressure on contractors under the 8 percent set-aside for local infrastructure works.

13. 5. Role for the Bank.

- The Bank in Regional projects utilizing decentralization construction of infrastructure projects should encourage or require the establishment and use of data banks on comparative costs experience. Project cost records from different municipalities in the source province or region should be maintained and standardized to yield per unit costs for similar projects. This information should be distributed regularly to municipal governments to establish cost benchmarks. Cost records should also be maintained by contractors, and the average costs per standardized unit by different contractors published regularly. This procedure should provide further information for municipalities to use in competitive awards and place cost control pressure on contractors.

- Similar cost comparisons should be maintained for projects executed by municipal governments and by central government agencies. Cost monitoring of this type would have further payoff in cost containment, as it would highlight any producers whose costs are out of line. It would also permit a systematic analysis of the cost impacts of decentralized vs. centralized infrastructure provision, and thus help shape strategic decisions about future support for decentralization plans.

- At the outset, at least, a data bank of this description should be set up independently with considerable external technical assistance. There are likely to be strong political and corporate pressures on the cost analyses, precisely because of their impact on future decisions about who will implement construction projects. In addition, there are difficult technical questions about how to allocate costs in public sector agencies, and how to standardize between construction projects.

- All Bank projects in support of decentralization should include analysis of how the decentralized units will use competition and markets to lower production costs. A competitive strategy to stimulate supplier competition should be required of every local borrower. The effectiveness of the strategy would be monitored from the project data bank.
C. Inter-Governmental Fiscal Relations.

1. This section examines intergovernmental fiscal relations under decentralization. It addresses four questions: i) Has decentralization involved net costs or net savings to central government budgets? ii) Does the grant structure from central to local governments encourage or discourage additional local spending, or is it neutral in this regard? iii) What attempts have been made to earmark central level transfers for local capital investment, and how successful has this earmarking been? and iv) How have central governments sought to control aggregate local spending, local debt issuance and other local behavior that has consequences for central macroeconomic management?

2. **Net costs to central government of decentralization.** Despite the fact that decentralization initiatives often have been motivated by the perceived need to bring central government spending under control, most of the decentralization strategies analyzed in this project have involved additional net costs to central government, frequently on a large scale. Central government revenue retention generally has fallen more steeply than central government expenditures. In fact, in most cases there has been essentially no reduction in real central-level spending responsibilities. Some of the net costs of decentralization may still prove to be costs of transition, which will be reduced as expenditure transfers catch up with revenue transfers, but experience to date indicates that the hoped-for expenditure reductions have been very slow to materialize.

3. In Colombia, the initial estimate of the Controller General was that the expenditure transfers proposed in the decentralization decree, Decree 77, would by 1992 reduce central government expenditures by 6.1 billion pesos (1987 pesos), compared to a loss of 39.0 billion pesos in revenue to the central budget from the additional sharing of IVA revenues prescribed by the law (Uchimura, 1989). Thus, decentralization from the outset was recognized to be a financially costly proposition for central government. Even this calculation, however, has turned out to be optimistic. The Bank's studies now indicate that there will probably be at best only a small net reduction in central-government expenditure from decentralization by 1992. The annual net cost to the central government from decentralization will be approximately equal to its loss of retained revenues under the new revenue sharing arrangements.¹

4. In Brazil, the 1988 Constitutional changes are projected to cut about six percentage points from the central government's share of the final retention of public sector revenues (Cordeiro, 1990). This share declines from 42.5 percent of final revenues in 1987 to about 36.5 percent. The Constitutional modifications do not formally transfer expenditures responsibilities from the central level to states or municipalities to compensate for this revenue loss. Although the central government has begun to cut back on some of its traditional expenditure functions--e.g., with respect

¹ Some small savings may be effected by selective disengagement by central ministries from work in local governments, such as Public Works construction of highways within municipal boundaries, and by increased central government resolve to deny municipal requests for financial relief from local government deficits.
to roads and local health programs—on the presumption that states and localities are now better positioned to finance them, and may reduce its share of financing under some of its negotiated agreements with states and municipalities, expenditure reductions have lagged far behind revenue transfers. By one measure (Shah, 1990), the gap between central government’s revenue share and its expenditure share implies that central authorities will have to cut almost one-sixth of their real 1988 spending in order to restore budgetary balance, once the constitutionally mandated revenue transfers to lower levels of government are fully in place.

5. In Guatemala, the new Constitutional requirement to transfer 8 percent of central level revenues to local governments has not been offset by any transfer of central-government direct spending responsibilities. Some local road and water projects formerly financed by central funds are now being financed by municipal revenue sharing, but the displacement of central expenditures is a very small fraction of the total revenue loss to central government, in large part because direct government investment in local activities outside the capital region already was low.

6. In Venezuela, the decentralization legislation increases the states’ share of centrally collected revenues from 15 percent to 20 percent over a five year period ending in 1995. A legal framework is in place for transferring services and expenditure responsibilities to states, but actual transfers require voluntary, negotiated agreements, and revenue transfers take place regardless of whether expenditure agreements are reached. Although the eventual outcome of this process cannot be predicted, it’s clear that for the five year transitional period, at least, revenue transfers will run well ahead of expenditure transfers. A similar picture is found in the other countries in the Region that have adopted fiscal decentralization strategies.

7. Only in Chile, Ecuador, and Argentina has reform of intergovernmental financing been used as an instrument of central government budgetary restraint. In Chile, the government, at the same time it transferred primary and secondary schooling and primary health care responsibilities to municipal governments, also transferred funds to pay for those functions, and promised to adjust per pupil and per patient payments in the future in line with inflation. However, the subsequent economic downturn led to retrenchment in these transfers. The military government used decentralized service provision as a device for fiscal constraint—both by requiring local governments to pick up an increased share of school and health costs and by breaking up the national public employee unions that were thought to promote cost escalation. Under the newly restored democratic government, pressure has built to both restore the real value of education and health transfers and to restore national union bargaining.

8. In Ecuador and Argentina, intergovernmental financing reform essentially sought to hold the line on transfer payments, while shifting the funding mix to greater reliance on municipal or provincial borrowing. Ecuador’s revenue sharing reform seeks to stabilize deterioration in central government transfers to local government. These fell 39 percent in real terms between 1980 and 1988, principally as a result of the drying up of petroleum revenues which had been earmarked in large part for municipal transfers. In Argentina, the 1987 revenue sharing law was planned to be accompanied by a 15
percent increase in the total value of national to provincial transfers. However, the value of the transfers was eroded (like all central government revenues) by runaway inflation and breakdowns in tax collection.

9. The fact that revenue transfers have outpaced expenditure transfers by such a wide margin raises the question of whether the decentralization programs-- which usually are scheduled to take place over several years-- will in the end be implemented in full or, if implemented, will prove stable. Faced with the political difficulty of shifting expenditure responsibilities to states and localities, central governments must either drastically cut back on direct financing of domestic programs, raise central level taxes, or go into deficit to finance the revenue transfers. Any of these solutions will place great pressure on central governments. In the past, net transfers of revenue to sub-national governments have tended to be transitory. They have been introduced during periods of national revenue booms, then withdrawn (or offset by expenditure transfers) as central budgets tightened and the cost consequences of the decentralization policy were felt in full. (See summary of Argentina's experience with the 1973 revenue sharing law in Table VI-1).

10. 2. Form and impact of central transfers. In seven of the nine countries examined, the fiscal reforms accompanying decentralization led to substantially greater reliance on unrestricted revenue sharing, with more transparent and fixed allocation rules. New constitutional amendments or new municipal laws increase local entitlement to share in nationally collected taxes, or prescribe that a certain amount of central revenues (either in the aggregate or from designated sources) be turned over to local governments. Only in Mexico has a matching grant system been adopted. Even there, the system does not operate as a true matching grant, where localities are free to choose the expenditure mix, subject to matching support from central government funds. Rather, the central government prescribes cost-sharing requirements for localities. The local cost-sharing proportion is adjusted by sector and wealth of state, so that "discretionary" local expenditures in rich states require a higher local matching plus borrowing than are required for the same services in poor states.

11. From a local perspective, the revenue transfers associated with decentralization initiatives have typically generated a large increase in total local revenues. The 8 percent revenue transfer in Guatemala has increased the total revenues of the median municipality by a factor of three to four times. Even the total revenues, including local taxes, local fees and other transfers, of the 36 largest cities outside of Guatemala City have more than doubled as a result of the new program. In Brazil, inter-governmental transfers now account for almost 70 percent of total municipal revenues, a percentage that has risen sharply since the early 1980s.
<table>
<thead>
<tr>
<th>Country</th>
<th>Principal New Form of Central Government Revenue Transfer</th>
<th>Net Cost to Central Government of Revenue Transfer Policy</th>
<th>Expenditure Transfers and Intended Expenditure Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Revenue Sharing</td>
<td>Large Increase (8% of Provided Revenues)</td>
<td>No expenditure transfers*</td>
</tr>
<tr>
<td>a. 1973 Law*</td>
<td>Revenue Sharing</td>
<td>Moderate Increase</td>
<td>No expenditure transfers.</td>
</tr>
<tr>
<td></td>
<td>(After Hiatus)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>Revenue Sharing</td>
<td>Large Increase (6% of central revenues)</td>
<td>No formal transfers. However, central government has begun cutting back on functional expenditures in roads, health, etc. Policy intended to increase local capital investment, especially in smaller cities.</td>
</tr>
<tr>
<td>1988 Constitution</td>
<td>Payments to Cover Transferred Functional Responsibilities (Education and Primary Health Care)</td>
<td>Large Increase</td>
<td>Central revenue transfers covered service costs in base year, but have failed to keep pace with subsequent inflation. Policy intended to restrain growth of public spending. Now face demand for restoration of real value of transfers by elected local governments.</td>
</tr>
<tr>
<td>Chile</td>
<td>Revenue Sharing</td>
<td>Large Increase (6.1 billion 1987 pesos)</td>
<td>Modest transfers of expenditure functions, but essentially no net expenditure saving to central government. Policy intended to increase local infrastructure spending.</td>
</tr>
<tr>
<td>1982, 1987</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>Revenue Sharing</td>
<td>No net increase in transfers. Large increase planned in lending to municipalities.</td>
<td>No expenditure transfers. Policy intended to stimulate local infrastructure investment, support local elected government.</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Revenue Sharing</td>
<td>Large Increase (8% of central revenue)</td>
<td>No formal expenditure transfers though modest reduction in central spending on roads and water projects. Policy intended to stimulate local infrastructure investment, support local elected government.</td>
</tr>
<tr>
<td>Honduras</td>
<td>Revenue Sharing</td>
<td>Moderate Increase</td>
<td>No expenditure transfers. Policy intended to stimulate local infrastructure investment, support elected local government.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Community-level public works (Solidaridad); local and state matching grants</td>
<td>Modest Increase</td>
<td>No expenditure transfers. Solidaridad is federally funded community investment. Intended to stimulate community infrastructure projects, solidify support for PRI.</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Revenue Sharing</td>
<td>Large Increase (5% of central revenues)</td>
<td>To be negotiated between central government and states. Revenue transfers to take place regardless of outcome of negotiations about expenditure transfers.</td>
</tr>
</tbody>
</table>

* Initially, no transfer of expenditure functions were made. Later, as pressure on central budget intensified, expenditure functions were transferred, first for primary education and medium sized hospitals in 1978 and in 1980-82, water, electricity, adult education, and large hospitals. These expenditure transfers led to more demand for revenue transfers and a breakdown of the system.
12. In these circumstances it would be remarkable if central revenue sharing had not substituted to some degree for local revenue collection. In fact, the empirical evidence shows a strong pattern of substitution. New sources of centrally allocated revenues have increased the total expenditures of local governments, but they have also discouraged municipalities from raising revenues from their own resources. Strong evidence of this substitution effect has been found in Colombia (Uchimura, 1989); Guatemala (Peterson, 1990); and Brazil (Rodrigues and Augusto, 1990). The decline in the real value of locally collected resources ranges from 10 percent to more than 40 percent in Guatemala, in the space of four years.

13. Substitution of central-government transfers for the own-source revenues of municipalities has at least two undesirable effects. First, it weakens the connection between demand expression and local taxpayer-user payment of the costs associated with service provision. The efficiency arguments for decentralization depend upon this connection remaining intact. Although in principle revenue-sharing or tax-sharing transfers, if viewed by localities as entitlements they are guaranteed to receive, need not distort local expenditure decisions, in practice when massive amounts of new aid are poured into a community, it is difficult to think of these as "own" resources which the municipal government can decide to allocate, just as it would locally generated funds. The external aid comes with formal strings attached, and with lots of informal pressure from central authorities, as well.

14. Second, the loss of local revenue-raising capacity may jeopardize the long-run prospects for sustained decentralization. For at least the last century and a half, there has been a cyclical tide in the Region in decentralization. Periods of keen interest and experimentation with new forms of decentralization have been followed by re-centralization efforts. The costs to central governments of this round of decentralization raise the prospect that not all of the initiatives will be carried out as planned, and that others may be curtailed in the future. It is easier, however, to reverse central revenue sharing arrangements than to resuscitate local taxing authority or local revenue collection capacity, once it has been allowed to lapse. The high level of central transfers underpinning the current decentralization programs may well limit municipalities' options in the future.

15. **Earmarking for local infrastructure investment.** Most of the revenue sharing plans adopted by central government have been tied to requirements that local government channel all or much of the transfers into local infrastructure investment. By themselves, such requirements would not be expected to have great impact on local spending patterns. The transfers received from central government, though legally restricted to certain purposes, are functionally fungible. That is, the local revenues and other grants previously used to pay for capital expenses can be shifted to other purposes (or returned to taxpayers), while the central transfers are used to pay for local capital spending. The net effect of this adjustment is to convert the earmarked capital funds into the equivalent of unrestricted general revenue sharing transfers.
16. Central transfers can be designed, however, so that they have a net stimulative effect on local capital spending. The sheer magnitude of transfers can go far to ensure this outcome. If central transfers earmarked for local capital funding exceed the total capital budget that local authorities otherwise would finance, and the capital restrictions are enforced, the grants must lead to increased local capital expenditure. Precisely this result is observed in several countries. In Guatemala, for example, the 8 percent revenue sharing funds for local infrastructure investment vastly exceed local governments’ previous investment levels, leading necessarily to substantial increases in local capital outlays.

17. Another strategy that has been employed is to couple government revenue transfers with increased lending to municipalities, in a double-barreled attempt to stimulate local infrastructure spending. In Colombia, the new tax sharing entitlements of local government can be pledged as guarantees of repayment for special infrastructure loans made through the Financial Fund for Urban Development. These loans are targeted above all for local water system investment. Initial estimates by the FFDU were that the additional IVA transfers alone would increase local infrastructure investment tenfold between 1986 and 1992, while FFDU loans would at least match in magnitude the increase in revenue transfers. The case study investigation in Tulua, conducted under this project, confirmed that between 1985 and 1987, at the beginning of the transition period, real municipal infrastructure spending already had quadrupled.

18. 4. Macroeconomic control. Decentralization sometimes has been resisted by central governments on the grounds that it will jeopardize the central government’s macroeconomic management. If local governments are free to set their own expenditure levels and incur their own debts, they may choose to operate in a continuously deficit position. If this happens, sub-national deficits in the short run must be financed in one of two ways: by squeezing out borrowing in the private or central government sectors, much of which is destined for capital formation, or by money creation, which adds to inflationary pressures in the economy. Both of these strategies are likely to be inconsistent with central development planning. Because of these dangers, central governments often have argued that they cannot surrender budget authority to local governments, but must retain the power of final budget approval.

19. Examination of government financing over the last decade in our case-study countries shows that this macroeconomic concern is a legitimate fear only at the state or provincial level. Even then sub-national governments' deficits are large enough to affect macroeconomic conditions only in countries with federal systems, where states or provinces have large expenditure responsibilities and state banks exercise substantial independent authority, including the authority to indirectly finance states' fiscal deficits and to lend money for major types of quasi-private investment.

20. Decentralization to local governments, in contrast, appears to raise few macroeconomic issues. In none of the countries we examined were
local government deficits large enough to pose significant questions of macroeconomic impact. The largest deficits, relative to gross national product, were found in Brazil. Even there, in the peak year of the 1980s, 1988, municipal credit financing needs reached a high of only 0.5 percent of national product. Although this was large enough to represent a significant issue in governmental finance, and had risen rapidly from earlier in the decade, it is not a large contribution to national borrowing or public sector macroeconomic management. Municipal borrowing has subsequently declined in Brazil, as intergovernmental transfers have risen. In the other countries of the Region local government borrowing has been much lower. In fact, Bank studies have concluded that local borrowing is lower than reasonable, given local government responsibilities for capital formation.

21. In any event, the structure of municipal lending in most countries offers the central authorities ample room for control of aggregate municipal credit, without imposing detailed budget supervision. In Mexico, Honduras, Guatemala, Colombia, Ecuador and Venezuela, municipalities do the overwhelming majority of their borrowing from central-government municipal credit institutions or directly from the Ministry of Finance or Central Bank. (In Chile, local government borrowing is prohibited altogether.) These central institutions determine the interest-rate terms on which loans will be available to local governments for different purposes, as well as the aggregate amount of credit financing. Local government borrowing outside of this framework is minuscule, except for short-run supplier credits. These in turn are sharply limited by suppliers' self-interest.

22. The macroeconomic issue, insofar as it is raised in discussions about decentralization to the municipal level, is largely artificial. It has been put forward by central governments that want to continue to exercise control over local budgets for political reasons or reasons of presumed government efficiency.2

23. 5. Conclusions. Some of the net costs of decentralization may still prove to be costs of transition and can be reduced as expenditure transfers catch up with revenue transfers, but experience to date indicates that the hoped-for expenditure reductions have been very slow to materialize. The threat to macroeconomic objectives posed by these transitional costs underscore the need for increased emphasis on balancing expenditure assignments. Because so many variables affect the feasibility of expenditure responsibilities, no single prescription applies; solutions have to be worked out on a case by case basis. However, a few principles--of simplicity, clarity, and connection of investments to both revenue sources and operations and maintenance--may be employed to guide expenditure assignments (see Annex

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2 From time to time, central governments express similar exasperation with local governments when they are unable to control their pricing behavior. For example, the central government of Brazil quarreled with the City of Sao Paulo about the latter's stated intention not to submit to the federal price freeze. This dispute, however, had nothing to do with formal federalism or the legal position of local government, but with the practical political independence of Sao Paulo.
IV-1). In addition, transfers may be designed so that they have a less disruptive effect on overall public sector spending. Increased accountability of subnational to central governments, particularly in federal systems, may also be improved by such means as conditional grants.
D. Balancing Equity with Shared Power.

1. Poverty in the Region increased dramatically during the time many countries were devolving spending authority to local governments. This section will discuss some of the impacts of these coincidental trends. At issue here is the impact decentralization on poverty assistance. Nelson points out that decentralization is not always a reliable way to help the poor, since local elites are often not as progressive as national ones (Nelson, 1988). This study reveals that local governments in many instances became more responsive to local needs including poverty— as illustrated by increases in priority and spending for low income areas— but these actions are not coordinated with national programs, are not sustainable in fiscal terms, and in many ways inherently inequitable and inefficient under present conditions. Improving capacity alone will not remedy imbalances in poverty assistance in decentralized regimes. Central government mandates, administrative measures, and direct well-targeted transfers are also needed.

2. The numbers of urban residents below the poverty line is on the order of 140 million, a doubling over the previous decade. Table IV-2 shows these figures as well as the more than proportionate increase of poverty to population. A slight decline was also registered in the proportion of "extreme poor," defined as those individuals with incomes below that needed to purchase a basket of minimum consumption needs. CEPAL data (cited in LATHR, 1990b) show extreme poverty to be increasing more rapidly in urban than in rural areas during 1980-1986, increasing by 12.4 million people (as opposed to 2.9 million in rural areas).

```
<table>
<thead>
<tr>
<th>Population</th>
<th>1980</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor</td>
<td>52.8</td>
<td>103.7</td>
</tr>
<tr>
<td>Extreme Poor</td>
<td>17.3</td>
<td>39.4</td>
</tr>
<tr>
<td>Total Poor</td>
<td>70.1</td>
<td>143.1</td>
</tr>
<tr>
<td>Total Pop.</td>
<td>287.4</td>
<td>416.4</td>
</tr>
</tbody>
</table>

Table IV-2
Urban Poor, 1980-1989

-as % of Total | 24.3 | 34.4 |

Source: LATHR, 1990b
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3. 1. Empirical evidence. Data gathered in this study (Table IV-3) indicate that local governments are being given authority for poverty matters, are responsive to needs of the urban poor, but appear not prepared to translate these concern into budgetary outlays. 'Authority,' in Table IV-3 refers to legal mandate or power to affect programs and 'priority' to stated perceptions by mayors, council members or local residents as to the importance of assistance to the poor. The sample is not scientific, in the sense that respondents were not selected randomly, but the data were gathered systematically in the both form and content of inquiry. The Table reflects an across-the-board increase in local government authority over poverty related programs and services such as water, sewerage, neighborhood improvement, primary health and primary education, day care centers, and nutrition. Seen in these ways, local governments have more authority and express greater concern than was true before decentralization brought authority increases. However, increases in spending, the 'outcome' in the Table, has not materialized.
Table IV-3
Effects of Decentralization on Poverty Efforts

<table>
<thead>
<tr>
<th>Country/ City and Sector</th>
<th>Authority</th>
<th>Change in Priority</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil (Health)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Campo Largo</td>
<td>Y</td>
<td>Y</td>
<td>14% budget increase</td>
</tr>
<tr>
<td>Riberao de N</td>
<td>Y</td>
<td>Y</td>
<td>operating clinics</td>
</tr>
<tr>
<td>Benin</td>
<td>Y</td>
<td>Y</td>
<td>operating hospitals</td>
</tr>
<tr>
<td>Belem</td>
<td>N</td>
<td>Y</td>
<td>decrease</td>
</tr>
<tr>
<td>Rio de Janeiro</td>
<td>Y</td>
<td>Y</td>
<td>municipal budget increase</td>
</tr>
<tr>
<td>Sao Paulo</td>
<td>Y</td>
<td>Y</td>
<td>municipal budget increase</td>
</tr>
<tr>
<td>daycare</td>
<td>N</td>
<td>Y</td>
<td>licensing, contracting PVOs</td>
</tr>
<tr>
<td>Chile, most cities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>Y</td>
<td>Y</td>
<td>sig. increase in budget</td>
</tr>
<tr>
<td>Education</td>
<td>Y</td>
<td>Y</td>
<td>sig. increase in budget</td>
</tr>
<tr>
<td>Nutrition</td>
<td>N</td>
<td>Y</td>
<td>mod. increase in budget</td>
</tr>
<tr>
<td>Colombia</td>
<td>Y</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Y</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Honduras</td>
<td>Y</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Guatemala (cabeceras)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roads, Water</td>
<td>Y</td>
<td>P</td>
<td>n.a.</td>
</tr>
<tr>
<td>Mexico (Upgrading)*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merida</td>
<td>N</td>
<td>Y</td>
<td>sig. increase in spending</td>
</tr>
<tr>
<td>Chihuahua</td>
<td>N</td>
<td>Y</td>
<td>increase in spending</td>
</tr>
<tr>
<td>N. Laredo</td>
<td>N</td>
<td>Y</td>
<td>increase in spending</td>
</tr>
<tr>
<td>Venezuela</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Various)</td>
<td>N</td>
<td>P</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Key: Y = Yes; N = No; P = Probable; n.a. = unknown

* Recent modifications in the administration of the National Solidarity (poverty)
Program effectively shift responsibility for assistance in poor neighborhoods from local to
national authorities in states where opposition candidates made strong showings in the elections
of June, 1983.

Overall, except for Chile, it is not possible to determine whether poverty
efforts in the cases studied are any more effective. In Mexico, spending for
programs benefiting the poor has increased substantially, but in many cities,
these increases are under the direct control of the federal government, or
through local spending induced through matching grants.

4. In the most advanced cases, Chile and Brazil, municipalities have played an active role in poverty alleviation programs by finding eligible families, making adjustments in programs in accordance with local needs, and delivering assistance directly or by contract. Chile stands alone in the
hemisphere in the scope and effectiveness municipalities have achieved in the
administration of poverty assistance. Conditions of the poor showed marked
and continuous improvement over the latter years of the last decade, in part because targeting was effective, poverty assistance was maintained at constant or increasing levels, and because targeting and delivery mechanisms were improved. Social expenditure per capita grew from a decade low of US$94.9 in 1976 to US$172.5 in 1984 (Pfeffermann, 1986: 7). Vergara (1990) estimates that 3.1 million people were receiving assistance in 1985, representing by some estimates 90 percent of the country's poor.1

5. Many other anecdotal, but quantifiable, examples of increased attention to the poor were found in the study. For instance, many municipalities have engaged in the formalized process of planning and delivery of primary health care in the Brazil's unified health care system, and over a thousand health posts have been taken over under this system by the state of Rio de Janeiro. Most municipalities in Brazil (and other subnational governments in several states) have shifted spending to augment national school lunch programs. Upon the re-instatement of mayoral elections in state capitals in 1989, (e.g., Cuiaba), incumbents rushed to secure voter support among low-income neighborhoods by addressing priority needs for basic water and sanitation. Since then, mayors have been uneven in sustaining assistance to these programs. Several cities in the Curitiba metropolitan area have been decisive and inventive. Campo Largo's mayor shifted about 14 percent of the capital investment budget in 1990 from road paving to health as a result of community hearings. Curitiba invented a unique method to combine transfers and environmental quality: bus tokens are offered to the urban poor in exchange for plastic bags of solid waste gathered from areas of difficult vehicular access.

6. Although decentralization may have increased responsiveness, and we remind the reader that there is no systematic evidence that this is so, effective change in poverty efforts depends importantly on the size and capacity of local governments "receiving" authority for programs and revenue raising. The fact is that the largest, most urbanized, and wealthy municipalities respond most effectively. Small, rural, and poor municipalities generally struggle because most national strategies make no or too little provision for the wide variety of technical capacity available locally to deliver poverty assistance. Accordingly, the poverty impact of decentralization has been seriously impeded. Unequal delivery is a central issues in rural Chile an is to be addressed in sector reform (see Lashman, 1990). Small and rural municipalities appear to have difficulty managing the administrative burden required for fee-for-service reimbursements.

7. 2. Needed actions. An even more acute danger would be to go too far in the direction of local choice, opening the possibility of uneven standards and service delivery of basic education and health. The development of local social standards would lead to undesirable variations in national health care and would contravene customary central government policies designed to achieve positive externalities in basic health and education. The proper remedy for these problems of regional or inter-municipal inequalities lies with compensatory adjustments by means of intergovernmental transfers.

1/ More detail is provided in the case report on Chile (see Campbell, et al 1990) and in Chapter 5 on Innovations.
8. 3. **Regional equity.** Another equity issue—assistance to lagging regions—arises in connection with revenue sharing schemes. Many countries support regional development policies designed to help lagging areas, such as the Northeast in Brazil and the Center South in Mexico. These policies need to be reviewed in light of increases in revenue sharing and the transfer of expenditure authority to states and municipalities. Transfers to sub-national governments as a part of decentralization sometimes (as in the case of Brazil, Chile, Mexico and Venezuela) may come at the expense of direct central government investments for poverty programs. Prud'homme (1990) argues that revenues shared with states and municipalities in Brazil may end up transferring less resources to lagging regions than was spent there by the central government before fiscal reforms were put into effect.  

9. 4. **Role of the Bank.** Country economic and sector work should review poverty assistance in light of national decentralization policies and determine the extent to which central government policies and programs need to be strengthened, and targeted assistance provided, to offset the risk or reality of swerving away from support to the poor during adjustment and decentralization. The Chilean assistance program represents the most fully developed and effective model of this assistance. 

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2/ The Bank is supporting the channeling of productive and social assistance to municipalities in the poorest states of Mexico as a first step in pursuing the preferred policy to attack poverty following an inter-personal, as opposed to inter-regional, principle of equity.
E. Local Government and Management Efficiency

1. The efficient management of local governments requires them not only to "read" and verify local demand under changing "cost" conditions, but also to implement services and projects efficiently, and to be accountable to constituents in a timely and effective manner. Without improvements in these areas, effective decentralization will be stymied, and the intended benefits of achieving greater efficiency at the local level will continue to be out of reach. Although comprehensive coverage of administrative and civil service reforms are beyond the scope of this study, national reforms in these areas are often indispensable for building and maintaining an efficient and sustainable business-like organization at the municipal level. However, full scale civil service reform may not be necessary to achieve minimum prerequisites for going further with decentralization. Instead, the issue of strengthening management efficiency—by increasing professional and technical skills, job security, prospects for career advancement, and salary—may be resolvable by modifying local capacities in accordance with national standards.

2. 1. Hypertrophied personnel? Questions of government pay policies, wage bills and performance have only in the past few years attracted close scrutiny in the Bank (e.g., see WDR, 1988; Lindauer, 1988; Nunberg, 1988), but without conclusive findings regarding efficiency at the local level. Some evidence shows increases in wage bills for the public sector in a handful of countries in LAC (Lindauer, 1987; Nurberg, 1988), but again, little if any evidence is available on the subnational portion of the wage bill. Most local governments are prone to powerful political influences particularly during the election season which force them to bloat the unskilled ranks of personnel. Although systematic comparative data on municipal employment were not gathered in (and anyway beyond the scope of) this study, spotty data are compiled on the subnational public sector in LAC and in selected developed countries. These data suggest that on a per capita basis, where functions are roughly similar, municipalities in the LAC Region employ numbers of municipal officials comparable to or below U.S. or European counterpart cities (Table IV-4). The important thing is that skill levels and mixes are markedly different. Most evidence shows that skilled and professional strata of municipal employees are under-represented, and unskilled workers over-represented. Equally important, data on turnover in technical staff, are not available. Turnover every two or three years as new administrations take office is the rule for directors and decision makers in most of the municipalities we visited (except Chile), and turnover among directors and managers can be all but fatal for sustaining a strengthening effort.

<table>
<thead>
<tr>
<th>Table IV-4</th>
<th>Municipal Employees, 1985-1988</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country</strong></td>
<td><strong>Total (000s)</strong></td>
</tr>
<tr>
<td>Brazil</td>
<td>945.6</td>
</tr>
<tr>
<td>Chile</td>
<td>20.5</td>
</tr>
<tr>
<td>Ecuador</td>
<td>12.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>660</td>
</tr>
<tr>
<td>Venezuela</td>
<td>21.5</td>
</tr>
<tr>
<td>U. S. Avg.</td>
<td>2,467</td>
</tr>
</tbody>
</table>

Source: Mission data.
3. But comparisons of this type are hazardous for many reasons. It should be noted that interpretation of the data in this Table, and the challenge of institutional strengthening in the Region, are conditioned by the structure of government (federated and unitary) and by municipal size. Local governments have various degrees of power in federated republics, and the largest republics as well as some unitary systems. count on intermediating levels of government (states and provinces) which can be decisive in assisting local governments in technical functions and accountability. Equally important is the size of cities. If the 13,000 units of government in the Region are visualized as a pyramid, then the 10 cities of over a million sit at the "peak," and at the "base," are on the order of 10,000 small municipalities. Metropolitan areas and million sized cities number in the hundreds. Cities in each of these lower "strata" imply stronger role by central and intermediate (provincial, state, departmental) governments in standards and technical assistance (see Annex VI-1).

4. But data on personnel and city size mask a deeper flaw in decentralizing countries: civil service frameworks and career schemes offer neither minimum skills, employment protection nor career prospects regarding municipal officials. These limitations both reflect and reinforce the "personalismo" character of local and even national politics, as well as other vested interests, such as political patronage, corruption, and tradition. The Nunberg-Nellis (1990) review of Bank work on civil service reforms finds little progress, but concludes that continuing importance must be assigned to this problem over the long run. The difficulty of reforming civil service schemes to guide personnel in government can be gauged by the U.S. Civil Service Reform Act of 1977. Despite having substantial technical capacity already in place at the local level, the critical measures of the Act, such as upgrading and skill training, were only beginning to be implemented in 1990. In addition, many administrative, legal, and technical problems at the national and subnational levels impede action. In some federal systems, Argentina and Brazil for example, municipal personnel, career, salary, and electoral regimes follow provincial or state dictates.

5. Anyway, full civil service reform may not be necessary. The most striking example of municipal strengthening is the transformation of Chilean municipalities from politically-influenced employers of low-productivity labor to the present-day status as the most highly professionalized level of local government in the Region. A national program was launched to transform municipal administrations by reclassifying municipal employees following specific guidelines tailored to city size. In addition, steps were taken to increase salaries, strengthen tenure, and foster a training program focussed on economic analysis and project preparation. Nearly three thousand professionals from both municipal and central agencies were trained in courses lasting from four months to two years. This training, combined with other reforms (described in greater detail in Chapter V), helped contribute to a seven-fold increase in professionalization of municipal employees at the same time the number of municipal employees was reduced on a per capita basis (Table IV-5).

6. 2. Recent Bank actions. Bank studies and reviews have identified civil service reform, pay scales, skill mixes and institutional strengthening as major shortcomings, and although the Bank has taken measures (such as TALs
connected to SALs) to address some of these problems (Buyck, 1991; Gray, et al, 1990; Paul, 1990; Adamolekun, 1989; and Paul, 1989), Bank strategies have not been geared to address the special character of local governments in democratic environments. LATPS has made creative overtures in such instances as the Venezuela TAL, the Bolivia Second Public Financial Management Operation and the proposed Chilean Public Sector Reform loan. But again, the focus of attention remains largely at the national level.

7. Typical components of Bank urban or municipal projects have run at cross-purposes to local governments. For one thing, project timetables in finance and works completion conflict with short terms of local political administrations. For another, many urban and municipal projects—seeing correctly weak qualifications of municipal employees, low motivation, low salaries, and high turnover—do not attempt to address these problems in the horizon of one to three projects in their pipeline. The most recent projects in the Region—Brazil, Argentina, and Ecuador—rely on financial reforms to leverage policy and efficiency changes, but there is no certainty that this approach will be sufficient. Another important tool for local strengthening is EDI's SACDEL institutional strengthening program based in Quito. But these and other proposals to increase salary levels or to organize self-replicating training programs, though headed in the right direction, are confined to a few countries in isolation from more fundamental reforms and will require a many-fold increase in effort to bring the desired results. The most successful approaches—in Europe, the U.S., and Chile—combine salary and training improvements with a broader scope of career development.

8. 3. Increasing accountability. Decentralization adds another dimension to the customary approach to institutional strengthening of local government. Local institutions must now acquire legitimacy and accountability in the conduct of local affairs. This means that, besides strengthening electoral and other participatory mechanisms discussed in Section A of this

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1/ The World Bank/UNDP Urban Management Program is currently reviewing institutional strengthening in urban and municipal projects and in the LAC Region and will have case studies and recommendations early in FY1992.

2/ In Germany, employment at any level of government, with the proper qualifications, confers the recognized status of "Beamter" (civil servant) with transferable pension and security of tenure and these are transferable also to other public authorities. Transferability is also possible in Britain across local governments.

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chapter, the Bank can and should do more in budgetary and auditing controls, judicial and regulatory systems, and technical capacity of personnel.

9. **Budgetary controls.** Except for the focus on cost improvements in recent Bank lending for municipal strengthening, the Bank has focussed very little on budgetary control functions of local governments. The Bank needs to expand analytical work to cover this area and should work to strengthen the oversight functions of legislative branch of local government. Municipal legislation of virtually all local governments in the Region provide for council oversight of budget and a separation of powers, but these powers have atrophied in the state-led model of development. The Bank needs to understand better the constraints and possibilities of budget control functions in local government and educate borrowers on the need for, and techniques to, resuscitate budgetary control as a tool of accountability.

10. **Auditing.** As spending increases among local governments, physical, financial, and contractual auditing become more important. Auditing functions at the local level have in many countries been relegated to state and even national agencies which are unable to audit promptly and effectively. One key problem to be addressed is in the division of labor horizontally and vertically, so that central governments are not overloaded with control responsibilities over local levels. Mexico, for instance, has maintained effectiveness of auditing functions at the state level. State auditors cover municipal accounts and are able to improve techniques and disseminate best practice. In general, auditing needs to be strengthened and a balanced load devised, whether through states, or in unitary systems, deconcentrated agencies.

11. **Judicial and regulatory.** Although outside the original scope of this study, the fair and open administration of justice, and in larger cities, the functioning to regulatory bodies, cannot be ignored if accountability of local government is to be taken seriously by countries in the Region. Effective civil procedure, commercial law, and criminal justice are important foundations for assuring legitimacy, as well as to increase the transparency, of government. It has not been possible to ascertain the extent to which these areas of government are deficient, but they should be investigated in an exploratory manner to determine whether legal and administrative problems will only frustrate efficiency and accountability at the local level once other issues, for instance in privatization and contracting, are resolved.

12. **Increasing technical capacity.** The organizing principle for addressing capacity problems of local governments is drawn from Bank experience and the example of Chile: *shape the skill mix and productivity of local governments in accordance with agreed levels of service.* Three priority areas must be addressed:

13. 1) **Career schemes and salaries.** The Bank must work over the long term to develop a civil service framework suitable to sustained developmental capacity at the national level, but in the intermediate term at the local

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3/ That is, by constitution and statute, by agreement among levels of government, and by direct or indirect ratification of local publics.

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level, simpler schemes of service following well-defined national standards of service and pay scales tailored to recruit minimum levels of competence and retain them. Career systems, either by wholesale revision or by attaching the municipal to a state or national system, is indispensable for long term stability and efficiency. Central governments can use their authority to establish landmark legislation which can be followed by localities, as in the French model of a highly professionalized, stable bureaucracy.\textsuperscript{4} In Latin America, few countries have a developed a nation-wide career system. The implied increases in wage bills can be offset partially or wholly, as in Chile, by decreases in numbers of employees and improvements in productivity, as through contracting and corporations, as mentioned briefly below and described in Chapter V.

14. ii) Training and technical assistance. In any case, training and salary increases should not be undertaken in the absence of career schemes which require minimum standards and offer basic protections, relatively strong salaries, and prospects for advancement relative to other public sector employers. Normally, major training efforts take a long time to have an impact. In the example of Chile, sustained training was necessary over more than a decade. A built-in demand for trainees, in the form of Chile's mandatory project evaluation and data bank system, helped make this skill preparation a success. Career prospects were also built in as trainees had the perspective of moving from local to a central agency and the privileged status of the planning staff. Without career prospects, the benefits of training favor mainly the private sector. Broadscope "public administration" programs have limited impacts, are difficult to evaluate, and should be left to academic institutions. Every effort should be made to recruit into training programs the many high quality technical institutions found in many countries of the Region.

15. Technical assistance should focus on building medium and long term strategies for local government personnel, depending on city size and other factors. Strategies should attempt to identify the key personnel-- municipal secretaries, and heads of finance, public works, economic development, and social departments (for project evaluation and participation, respectively)--to be gradually transformed into pools of qualified professionals which incoming administrations can tap for managerial talent.

16. iii) Contracting. Contracting provides an under-utilized technique to handle services and infrastructure with fewer personnel. The technique has been proven in Chile and is spreading to many other cities in the Region. The most commonly contracted services are public works and solid waste collection or disposal. Contracting is being used increasingly in street clearing, equipment and vehicle repair, facilities maintenance, and administrative services (billing, personnel payroll, etc.). Moreover, the experience in developed countries is elaborate and, comparatively speaking, more directly transferable than many management systems and technologies.

\textsuperscript{4} Cochrane (1983) stresses the need for a comprehensive plan and continuing central government role--such as horizontal and vertical integration of professionals--to help local government strengthening.
4. Conclusions. The vision of efficient, business-like local governments fits both a local fiscal choice or principal agent strategy and requires a long term perspective. Full reform in national civil service may not be necessary, but governments must be willing to implement policies allowing alternative schemes of service meeting minimum efficiency criteria before massive programs in training and technical assistance are undertaken. The objective is to transform the municipal manpower profile in accordance with efficient management by reducing overall size and increasing productivity through training and contracting. The Bank's competitive advantage in these areas rests on two foundations. First is the Bank's expertise in public sector management. Second is the very long term nature of institution building required for sustained development. Further Bank work is needed to draw up a long term strategy for: a) reforms in civil and municipal schemes of service; b) training and technical assistance geared to improve contract management, project identification, evaluation, and implementation; and c) development of selected cadres of municipal employees (secretaries and key department heads) to build a pool of transferable civil servants acceptable across political administrations in order to establish continuity of practice. The Bank should also investigate possible judicial and regulatory deficiencies.
CHAPTER V. A HARVEST OF INNOVATIONS

A. Introduction

1. Governments at all levels have invented intergovernmental mechanisms and organizational formats to fill needs and solve problems of decentralization. These innovations, flagged briefly in the previous chapters, are culled from among many experiments based on potential for utility and diffusion more widely in the Region. This chapter describes these experiences in more detail and points out their limitations and constraining conditions.\(^{1/}\)

The innovations are grouped in five categories: i) guiding implementation, ii) inter-governmental arrangements, iii) community participation and funding, iv) private and market approaches to services, and v) capacity strengthening at the local level (see inset).

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Box 5-1

Promising Innovations in the Region

Agency Guide to Implement Decentralization

Inter-Governmental Planning and Implementation
- inter-governmental planning and implementation of health care
- matching block grants

Community Participation and Funding
- social funds, neighborhood development funds and community groups
- community input in planning and implementation
- municipal implementation of poverty programs and services

Private and Market Modes of Local Services
- market choice mechanisms for health and education
- software for contracting of private service providers

Local Capacity Strengthening
- long term training of municipal technicians and officials
- municipal civil service reform legislation

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B. Guiding Implementation

2. Though governments have been hesitant and some perhaps secretly fearful of decentralization, a few have dived into the process with more vigor and thoroughness than others. Inventing strategies and thinking through the process is a complicated intellectual and political process. Some countries have been a little ragged and uneven about this business, Brazil for instance has been preoccupied with stability and adjustment and rewrote their constitution, dismantled the federal bureaucracy, created powerful new financial transfers to municipalities and did little else to control and smooth out the implementation, for instance to give policy instructions to ministries and encourage states to take initiatives in social policy and municipal development. Mexico has been more systematic in its thinking, more careful

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\(^{1/}\) Some readers may wish to skim this chapter briefly and move directly to Chapter 6 on conclusions and recommendations.

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and dogged in its implementation, and more reticent perhaps than any of its neighbors to fully decentralize political power.

3. Chile and Venezuela fall into the best practice category, but with strong caveat about the authoritarian government in Chile. The implementation style is not replicable for many reasons and may not be sustainable even now. Both countries were determined to cure sick local governments of partisan political influence in municipal administrations, but Venezuela was perhaps more circumspect. Venezuela established a public reform commission (as did Brazil, Chile, and others in more ephemeral and transitory ways) to guide state reform. But the Venezuelan version (COPRE-- Presidential Commission for State Reform) continues to function as consultant, referee, and helper to all levels of government. These guiding functions are particularly important given the speed with which Venezuela has undertaken decentralization. A small staff and academic atmosphere, and its location in the Presidency, give COPRE the scope and stature needed to marshal resources and publish interpretations and guidelines. Other countries, particularly Brazil, now needing adjustments, Colombia having undergone constitutional reform, and Costa Rica, embracing on its own reforms, could gain from international exchange and make good use of similar arrangements.

C. Inter-Governmental Arrangements for Planning and Spending.

4. Despite the emphasis and rhetoric given to decentralization, many countries retain key responsibilities at the center for such things as supply responses to health care, project choice-making, and implementation of projects. Two examples of arrangements among governments to share decision-making and spending are the unified health care system in Brazil and the grant system in Mexico.

5. 1. Brazil's integrated health care planning (Sistema Unica da Saude or SUS) represents the best example-- in theory, if not in practice--encountered in this study of inter-governmental division of labor which takes into account comparative levels of technical competence, demand for service, delivery capability and financial responsibility.

6. Transferring responsibilities to municipalities in health care is based on expected advantages in terms of service quality and efficiency in spending. Although the experience is fairly recent, in the most advanced states, transfer of responsibility has meant a strong commitment by municipalities and states both in the rehabilitation of facilities and maintenance costs. The system is also designed to enhance supervision over personnel and general service quality. Personnel expenses have increased, and they are severely limited by the financial constraints of localities. Between 1987 and 1989 global federal expenditures in health were reduced by a real 5 percent, while the direct transfers to states (passed on to municipalities) increased by 50 percent.

7. This model appears to have secured a foothold in Brazil thanks to a consensus among health professionals concerned about maintaining quality care during times of fiscal and political uncertainty. Enabling legislation was approved due in large part to a public interest lobby group (partido sanitario) composed of many of the nation's public health professionals. Many
Box 5-2: Brazil's Unified Health Care System.

1. The Brazilian Unified Health Care System (SUS) transfers previously federal health care units to municipal governments. Planning and coordination is the responsibility of all three levels of government, but in practice is managed by states. States also manage the allocation of federal health funds for municipalities. Public health continues to be funded to a large extent by a federal Social Security Tax, which is apportioned to states and on to municipalities according to criteria designed to compensate for the costs of providing health and medical care in each jurisdiction. Local governments, nevertheless, are compelled to increase own revenues to finance personnel, maintenance, and capital investments over and above agreed minimum levels.

2. Planning and coordination among local, state, and federal levels is handled by councils established to program and follow up sector activities. The planning process begins with an assessment of health needs in sanitary districts, taking into account patient loads, health campaigns, and other work. These estimates of health care demands are translated into state plans and are reviewed at the national level by a national council of health secretaries, consisting of state and federal authorities. State data and plans form the basis for allocating the national health care budget.

3. To deal with the lack of specialized health care skills at the local level, both state and national facilities and personnel have been transferred to municipal governments. Physicians and other medical staff retain their status as federal or state employees, but come under the direct supervision of local authorities. This arrangement cleared one of the main obstacles to decentralization of specialized functions often found in the region: the matching of needs at the local level for highly skilled staff normally found only in central government posts.

problems remain to be solved, starting with salary adjustments by municipalities for medical professionals formerly on federal payrolls. Not all countries can count on professional consensus and effectiveness like that shown in Brazil. Nevertheless, the SUS model has useful demonstration effects for health sectors in other countries and possibly for other sectors, such as environment and education, characterized by service pyramids requiring differentiated skills at different levels of government.

8. 2. Quasi-matching grants in Mexico is a financing mechanism designed to induce subnational investments in priority sectors, to coordinate intergovernmental expenditures, and to compensate local governments for externalities, for example, treatment of air or water pollution, normally beyond their fiscal or administrative "reach." We use the term "quasi-matching" because local governments are not completely free to decide the mix of spending in any given sector. Grants are made available to states, and in turn to municipalities under state auspices, for specified categories of capital investment. Each year, the central government in Mexico has been increasing the fraction of grants to cover mainly roads, water, sewerage, and schools, although many other urban and rural projects are eligible. Federal expenditures through the contractual arrangements (known as CUDs) have reached 20 percent of the country's capital expenditure and has increased with the onset of the national poverty program (Solidaridad).

9. Like health care planning in Brazil, matching grants in Mexico provide a mechanism for central governments to devolve selected functions—the choice and implementation of projects and mobilization of resources—to sub-national governments while maintaining degrees of control through conditions and restrictions. These take the form of delineating eligible functions, targeting sectors, stipulating conditions, and setting caps on funds available. The bargain in Mexico is a win-win game for the public sector: central governments improve coordination of investments, improve efficiency of resource allocation through better evaluation mechanisms, and
leverage public sector spending. Subnational governments leverage their own funds and often enjoy political gains.

Box 5-3: Mexico’s Matching Grants (CUDs and COPLADES).
1. Starting in the late 1970’s, the Mexican government established state level commissions aimed at defining regional investment priorities and improving program coordination among the federal and state governments. By the late 1980s, state planning committees (called COPLADES) were established in all states. One of the chief function of COPLADES is to define annual investment programs to be financed by matching grants. States typically “match” at 20 percent or so of federal contributions, although states have an incentive to increase their contribution. Each year’s allocation is based on the previous year’s level of execution.

2. The institutionalized instrument for the transfer of funds and follow-up of investment projects is an intergovernmental agreement called CUD, for “Convenio Unico de Desarrollo.” This instrument in itself represents an advance in the way the federal government operates in the states. It is called “unified” because it replaces the numerous individual contracts (convenios) successively established by separate ministries over the 1970s and 1980s. The CUDs consolidate and make more transparent the amounts and purposes of grants. Over time, CUDs regulations have become standardized and have gradually improved project evaluation and financial discipline. For instance, water projects financed in rich states by CUDs monies must involve credit and earn a minimum return. Similar projects in poorer states have fewer requirements.

10. Key drawbacks are that the allocation criteria for CUD investments by state are far from transparent, and the process of project selection is vulnerable to political manipulation at the local level. However, the present system represents an advance over previous years, and expansion of CUDs investments has been recommended by the Bank. (See Campbell, et al, 1991 for more detail on Mexican grants.)

D. Community Participation and Social and Local Funds

11. 1. Local and social funds. The effervescence of neighborhood interest and issue-oriented groups surpasses the capacity of most local governments to take full advantage of them. Decentralization has infused NGO, PVO and grass roots groups with a heightened sense of expectation and broader horizons. The larger municipalities in virtually every country have administrative structures to encourage and recruit local voice and contributions, but local governments are limited in their capacity to fully mobilize grass roots participation. Neighborhood improvement funds is one of the most effective vehicles for recruiting and channeling local interest groups into making contributions to local public goods and services. Social funds may be seen either as precursors or complementary to municipal development funds, which have served as unusually vital building blocks of community development in most parts of urban Mexico, Brazil, Colombia, Chile, and elsewhere. Such funds in one municipality in Chile accounted for 35 projects worth US$5 million last year. While the financial magnitudes are small, the procedures and practices -- of targeting, priority setting, project selection, implementation, partial or full cost recovery, maintenance, and widespread participation in each of these phases -- are beneficial experiences for community groups and municipalities alike.

12. Bank financed social funds are growing increasingly popular as mechanisms to help absorb adjustment shocks in the region (see inset). Since the Bolivian Emergency Fund was approved in 1987, nearly a dozen social funds
have been identified and several presented to the Board. Most involve municipal governments. The significance of social funds, not widely debated so far in the Bank, is their potential for fostering capacity strengthening at the municipal level. At the same time, there is a danger of bypassing main line ministries and undercutting institutional development and reform efforts of the Bank. Some social funds have been set up as a direct line of contact between the poor and the central government. In Mexico, this connection has been politicized in cities where opposition votes are strong, undercutting the governments stated objectives of shifting power and autonomy in spending decisions to municipal government. The Guatemala fund, on the other hand, was designed to give explicit support to the government's decentralization strategy by requiring municipal governments to contribute financial counterpart for eligible projects. At the same time, the Guatemalan fund requires cooperative arrangements with main line ministries for long term support, maintenance, and use of personnel for assistance in project development at the grass roots level (see Campbell, 1991).

13. 2. Local participation. Many local project functions—ranging from sounding out opinions to service delivery—have been successfully carried out by local groups under municipal supervision (see inset). Local participation in managing project implementation— for instance, supervising contractors—has been encouraging in several countries. For instance in the Mexican block grant schemes, although community infrastructure projects are paid for by the municipality using federal funds, or directly by the federal Solidaridad program, each bill rendered for project progress must be approved by the community committee, which certifies completion and adequate functioning of the work being billed. This procedure, variants of which are used in other countries, minimizes the chance for corrupt approvals of work not performed, an important source of cost escalation as well as frustration to community residents. It takes

<table>
<thead>
<tr>
<th>Table 5-1: Social Investment Funds in the LAC Region.</th>
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<tbody>
<tr>
<td><strong>Country</strong></td>
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<tr>
<td>-------------</td>
</tr>
<tr>
<td>Bolivia I</td>
</tr>
<tr>
<td>Bolivia II</td>
</tr>
<tr>
<td>Brazil*</td>
</tr>
<tr>
<td>Chile*</td>
</tr>
<tr>
<td>El Salvador</td>
</tr>
<tr>
<td>Guatemala</td>
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<tr>
<td>Guyana*</td>
</tr>
<tr>
<td>Haiti</td>
</tr>
<tr>
<td>Honduras</td>
</tr>
<tr>
<td>Panama*</td>
</tr>
<tr>
<td>Venezuela*</td>
</tr>
</tbody>
</table>

Key: * = at early design state; E = Employment, I = Infrastructure, P = Poverty, Pr = Productive activities (includes financial intermediation), S = Social programs. Source: IDB

<table>
<thead>
<tr>
<th>Table 5-2: Innovative Use of Community Groups</th>
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<tbody>
<tr>
<td>In addition to project supervision, the study turned up many innovative uses of grass roots groups to improve demand expression and implementation. These include:</td>
</tr>
<tr>
<td>o election of advisory councils in Chile;</td>
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<tr>
<td>o tax increases to be used for local neighborhood re-investment only in Monterrey, Mexico;</td>
</tr>
<tr>
<td>o techniques for neighborhood groups to define their own public spaces (&quot;pinta su raya&quot; in Mexico City);</td>
</tr>
<tr>
<td>o consultative fora, or open, large &quot;community hearings&quot; on policy questions in Mexico and Brazil;</td>
</tr>
<tr>
<td>o contracting out certain social services (child care) to licensed grassroots groups in Sao Paulo</td>
</tr>
</tbody>
</table>

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advantage of community residents' direct and powerful interest in the completion of works from which they directly benefit. Similar reports were seen in Tulua, Colombia, Chilean municipalities, and elsewhere in the world.

14. 3. Poverty assistance in Chilean municipalities. Chilean municipalities have compiled an impressive record of flexible administration of poverty assistance. Many countries in the region will be interested in understanding how the Chilean experience in social assistance might be emulated. Chilean municipalities were in effect substituted for a large national bureaucracy of poverty assistance providers. Beginning in the late 1970s, Chilean municipalities were given instructions to organize municipal social assistance departments, as an obligatory organizational feature for all municipalities. These were staffed with highly skilled professionals who began to reach into communities with a social worker mentality. Later, social action departments were recruited to administer household census instruments designed to identify and measure the magnitude of households qualifying for poverty assistance.

15. By the late 1980s, municipalities were administering assistance--arranging for direct delivery or contracting pre-school meals, nutrition supplements, day care and other poverty aid--to an estimated 90 percent of the urban poor in the country, some three million persons. The efficiency gains in this substitution are very likely realized from a) decreases in central government expenditures on personnel; b) improvements in getting assistance to families meeting eligibility criteria; and c) increased flexibility to adjust to changing circumstances. Poverty assistance, like other achievements of Chilean municipalities, depends importantly on the build-up of institutional infrastructure as noted earlier in Chapter V.

E. Private and Market Modes for Local Public Services.

16. Numerous market-oriented innovations have been developed in the Region covering areas such as management, demand detection, and consumer choice. Two cases are presented here: i) in Chile, market choice in health and education, and ii) the use of contracting.27

17. 1. Market choice in health and education in Chile. Chile established a subsidy system for financing primary health and education services on a per capita reimbursement basis to municipalities. The innovation lies in the options available to consumers: subsidized public schools run by the municipality or private subsidized schools and, for the poor, primary health care operated by municipalities. Arrangements for schools (see inset) contain sufficient incentives for private sector participation, as evidenced by substantial migration out of municipal schools. Central government ministries set standards, regulations, and rules concerning interregional and interpersonal equity. Many problems must be addressed, including adequacy of inflation adjustments for per capita payments and the difficulties of poor and rural municipalities to handle administrative matters and of retaining qualified personnel.

27 Privatization is discussed in detail in numerous other publications and studies, for example in PRE Working Papers.
Box 5-4: Decentralization of Education in Chile

1. Starting in the early 1980s, the Chilean government began implementing a comprehensive program to transfer responsibilities in education and primary health to local governments. A few years later, a system of private providers was introduced. Decentralization in education involved the transfer to municipalities of facilities and personnel (who were heavily fired and re-hired by mayors on a "selective" basis). Funding for public education continued to be primarily a national responsibility, but the distribution of these resources was done through a system of subsidies which were given to municipalities, and later to private schools also, on the basis of the number of students attending classes each day. The subsidy was calculated to cover the variable costs of education per student, with only a small margin allowed for investments.

2. By allowing private schools to qualify for the educational subsidies, the government created an incentive for their establishment in poor neighborhoods, expanding the choices of schools for low income families. This had also the effect of inducing municipal governments to cut back on operational costs in order to stay within a fixed per-student budget. At the same time, for political and social reasons, municipalities felt pressure from residents to improve the quality of public schools and the "mix" of services (lunches, pre-primary, day care) in order to retain or attract more students. Many of the largest municipalities created corporations to take charge of school administration. The majority of them require supplemental funding from the local budget.

3. Since the system began, the number of private schools in poor neighborhoods has multiplied while municipal schools had to adjust to lower levels of enrollment. The public perception is that educational performance of students in private schools is better than in public schools, although reliable evaluations of educational quality have not been produced.

18. Although these links to decentralization assisted in cost control effects, overall cost savings were forced upon Chile's school system primarily by the decision to increase centrally reimbursed tuition payments by less than the rate of inflation. This budget constraint is passed on to municipalities. Municipal governments are free to contribute additional amounts from their own resources, and increasingly some have done so, but the limited revenue position of municipalities sharply constrains their financial commitments. Thus, the grant structure has been used by central government specifically to control costs of decentralized service functions.

19. The Chilean approach has explicit efficiency goals based on minimizing production costs. Low income households benefit from choices of service providers. The key to the strategy is to build a system of financial incentives that attracts suppliers, stimulates competition, includes clear specific rules of the game along with training.

20. Contracting. Although less novel, contracting provides a way for municipalities to absorb new functional responsibilities without a wholesale revision in the personnel profile. The key is oversight, auditing, specificity in contracts, and competition in services. Whenever these conditions can be met-- as they have in Colombia, Chile, and elsewhere in the Region in the largest cities-- local governments can effectively and efficiently carry out service responsibilities.

21. Contracting is appealing for municipalities because of the lack of specialized skills, such as data processing, financial management, project preparation and others. Also municipalities are often compelled to contract out services because of the limitations imposed by labor legislation and local personnel regimes. Economic advantages also accrue in the form of savings in capital investment, equipment maintenance, fixed personnel costs, plus the
Box 5-5: Contracting Municipal Services

1. Municipalities Colombia, Mexico, Brazil, and Chile contract a wide range of services with declared cost savings of various kinds, some due to intensity of local scrutiny, others to superior technical skills, still others to economies of scale. Very few are corroborated in hard fact. Services as common as bus systems and solid waste; Chilean municipalities also contract maintenance of street lights and the motor pool.

2. Many factors enter into the choice and successful implementation of contracting regime:
   - Economic considerations can be complicated—weighing immediate costs with the long range effects, such as depreciation and replacement costs for equipment and other fixed assets, salaries and retirement benefits for permanent works.
   - Transparency in the bidding process is a critical requirement to insure economical results.
   - Remuneration system for urban services is another key issue, in which the decision of the risk for the operation is defined. The alternatives to pay a contractor on the basis of the level of services provided or to allow them to collect fees and tariffs directly from users (in which case the figure is of a service concession). Both can be made on a competitive bidding basis, but the second, when applicable, implies less risks and costs to the municipality.
   - Administrative, supervision, and legal remedies—to cover reliability of the contractors, risks of sudden termination of contracts and projected cost increases—also represent transaction costs impeding wider use of contracts.

3. The key breakthrough for widespread diffusion of contracting is the promulgation of rules of thumb, guidelines for calculating costs, model legal contracts, and legal assistance provided to municipalities by the Ministry of Interior in Chile. These aids make it possible for over 70 percent of the municipalities to contract solid waste and many other services there.

Administrative costs of managing larger staffs. Contracts facilitate unitary cost controls, by isolating one service from the other governmental expenditures; likewise they allow the municipality more flexibility in making adjustments on the level of quality and areas of coverage of urban services. On the other hand, the lack of specialized contractors in traditional publicly rendered services or in small towns can limit contracting options, although the Guatemalan experience with revenue transfers indicates that the private sector responds very quickly to new, rural markets.

22. The practice of contracting can be promoted by central authorities, through both positive incentives to use this form of delivery, by the removal of legal or other existing obstacles to contracting (especially administrative control guidelines), and by imposing restrictions on hiring personnel, on fixed investments and on the types of activities municipalities can undertake. Although almost every activity developed locally can be contracted out to the private sector, some services like education, police, social assistance and others may be retained for either political or strategic reasons. In some cases the risks of the operation are too large to make the service attractive, or conversely the cost of contending with those risks too high for the municipality.37

23. As the number of services contracted increases, the skills required by the municipal staff undergoes a qualitative change. More emphasis is placed on control and supervision activities, on legal matters and on performance analysis and evaluation. It requires, thus a qualitative

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37 This is the case of the garbage collection service in mountainside port of Valparaiso, where the high costs of servicing the hilly areas, where trucks could not transit safely, discouraged all bidding, forcing the mayor to continue with the municipal service.
improvements that is consistent with the decrease in the staff’s overall size. This reduced and more qualified core can have their salaries improved, while services can be expanded at a small incremental cost.

F. Local Capacity Strengthening

24. Perhaps the most striking finding of the case studies is the transformation of Chilean municipalities from politically-influenced employers of low-productivity labor to the present-day status as the most highly professionalized local governments in the Region (see inset, page 10). The Chilean experience provides a rare case documenting the large magnitude of effort needed to substantially change technical capacity at the local level, undertaken in command and control circumstances. Also, the Chilean strengthening efforts beginning in the early 1970s—consisting of civil service modifications, career service schemes and salary reforms for municipal workers—make most typical institutional strengthening components of Bank projects look anemic by comparison.

Box 5-6: Putting Muscle in Chilean Municipalities

Before the military government came to power, municipal governments maintained large staffs of unskilled workers often due to political influence. The military government required municipalities to greatly reduce their unskilled labor force, in favor of a better trained and better paid, but much smaller permanent staff. Part of the motivation was to increase economic efficiency. Another part was a desire to destroy traditional political party practices of job patronage.

Measures to Streamline Municipal Personnel. Chile moved on several fronts to improve the efficiency of local government apparatus. The first was to improve career prospects for municipal workers including longevity and training. The 1976 Municipalities Organic Law, together with companion provisions, established equivalence between municipal and central government employees in labor relations under the Public Sector Administrative Statute. This set the stage for greater stability and career prospects for municipal employees. A second step was to enforce arbitrary limits on local government staff. In 1981 a new decree law (No. 3551) required municipalities to define and submit staff plans for the review by central finance authorities. Many forms of incentives and requirements led to further reductions in numbers and increases in quality of staff.

A third step was to greatly increase training. Two varieties of training were implemented: i) national programs and ii) municipal and regional initiatives. Nearly 3,000 persons were trained in courses lasting from several weeks to two years. Most training involved specialized university training centers, and differentiated clienteles. Training focused on project preparation and evaluation, given the concern of ODEPLAN with establishing a national planning system. The training of local and regional personnel to support the Project Bank became a major priority.

Results of the Measures. These measures resulted in a decrease by about 12 percent of municipal workers per capita and dramatic increases—by a factor of seven—in professionalization of local government workers all while expenditure caps were put on administration and service increases.

G. Major Gaps

25. Although some of these innovations have been documented in separate papers or dissemination notes (e.g., Campbell, 1991; Campbell, Peterson, and Brakarz, 1990), others deserve further scrutiny. In particular, further work should be done to understand the potential role of municipalities in poverty identification and assistance and in the modes and outcomes of market competition for social services. Documentation of contracting schemes would also be useful. Several areas of common concern are not represented in this

Decentralization in LAC
harvest. The study turned up no commendable experiences in auditing, local budgetary control, and electoral reform, and aside from the Brazilian experience in health care, good rules of thumb for an inter-jurisdictional division of labor regarding functional authority and expenditure responsibility. These are priority topics for future sector work and research.
CHAPTER VI. CONCLUSIONS FOR THE BANK

A. Where to From Here?

1. For most of the Region, decentralization is approaching a turning point, and the role of the Bank can now be decisive. Central governments have extended a hand of power sharing, but intergovernmental financial flows are out of sync with responsibilities and capacities of subnational governments. While pressures may be building to re-centralize spending and functional controls, the amplitude of the next pendular swing back towards centralization is likely to be dampened by popular pressures exerted in the relatively new environment of democracy. The door to local autonomy is open and subnational governments more and more expect to share power. Under these circumstances, governments need assistance--and the Bank can help--in taking the next steps to restructure central-local relations and to reform the local public sector. There are good economic and developmental reasons for doing so: to avoid further macroeconomic stress, improve efficiency and equity in the supply and delivery of local public goods and services, and lay the groundwork for long-term sustainability of local governments.

B. A Strategy to Promote Efficiency, Equity and Sustainability.

2. The key recommendations woven throughout this report constitute the components of a strategy to improve efficiency, equity and sustainability in the local public sector. The Bank's present (implicit) strategy of financial leverage needs to be complemented with concepts and tools on the expenditure side of local government. The report's recommendations are re-grouped here, constituting four strategic areas of action by the Bank and borrowers (see Table VI-1). The areas are: 1) national policies on central-local relations and development strategy; 2) efficiency in resource allocation and production at the local level; 3) equity in treatment of the poor; 4) capacity, accountability and sustainability of local government. The Bank should begin to integrate these themes into Bank-wide policy, ESW, lending and TAL operations, and (as we shall discuss later) staffing mix. The broad outlines for this strategic approach include the following:

1. Policies on central-local relations and development. Virtually all countries are struggling with central-local relations, and few have begun to address in earnest the problems of efficiency, equity and sustainability, much less reach a new equilibrium concerning functional responsibilities and corresponding fiscal adjustments. Reaching this balance depends in part on the economic model of decentralized governance. The models discussed earlier in this report achieve efficiency through two services: local voting to express collective demand, and competition among alternative providers.

Decentralization strategies that are designed in a coherent way to boost local government efficiency through local public choice will want to devolve expenditure and revenue responsibilities and simultaneously

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strengthen voting and competition at the local level. Strategies that rely on what we have called the Prud'homme variant will couple devolution of expenditure responsibilities with fiscally neutral revenue sharing from the central government to pay for the new responsibilities. Governments aiming to follow principal agency strategies of incentives and proscriptions can glean some useful lessons from Chile.

Table VI-1

<table>
<thead>
<tr>
<th>Strategic Areas</th>
<th>Action Components</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Policies on central-local relations and development</td>
<td>Formulate Bank position and urge country actions</td>
</tr>
<tr>
<td></td>
<td>Define expenditure authority and adjust revenue sharing</td>
</tr>
<tr>
<td></td>
<td>Enter dialogue on macroeconomic and sectoral issues</td>
</tr>
<tr>
<td>2. Efficiency in local government.</td>
<td>i) Public choice making</td>
</tr>
<tr>
<td></td>
<td>Strengthen public choice-making</td>
</tr>
<tr>
<td></td>
<td>Develop technical options for demand detection</td>
</tr>
<tr>
<td></td>
<td>Support municipal role in social and local funds</td>
</tr>
<tr>
<td></td>
<td>ii) Local production</td>
</tr>
<tr>
<td></td>
<td>Encourage forms of competition</td>
</tr>
<tr>
<td></td>
<td>Build cost data banks</td>
</tr>
<tr>
<td></td>
<td>Diffuse contracting assistance</td>
</tr>
<tr>
<td>3. Equity in Treatment of the Poor.</td>
<td>Define municipal role in targeting and delivery of assistance</td>
</tr>
<tr>
<td></td>
<td>Adjust intergovernmental support for poverty</td>
</tr>
<tr>
<td></td>
<td>Develop, as needed, local capacity to deliver assistance</td>
</tr>
<tr>
<td>4. Local capacity, accountability, sustainability</td>
<td>Upgrade personnel profile and increase professional ranks</td>
</tr>
<tr>
<td></td>
<td>Strengthen auditing and budgetary controls</td>
</tr>
<tr>
<td></td>
<td>Explore impacts of judicial and regulatory deficiencies</td>
</tr>
</tbody>
</table>

The Bank should summarize its own position on these matters, perhaps in a brief policy paper, to underscore the importance of balancing intergovernmental relations in functional and fiscal terms and of strengthening decision-making and management capacity at the local level in order to provide a framework for dialogue on macroeconomic and sectoral issues.
The paper should also provide a framework to guide appropriate divisions of labor concerning intergovernmental responsibilities for spending. A few basic principles, spelled out in Annex IV-1, call for simplicity, clarity, and financial coherence.

Bank practice in the Region should be oriented to the design principle of financial form follows function. This means that systems of intergovernmental finance—revenue sharing, conditional grants, and own-source revenue raising—should be designed after expenditure responsibilities are assigned.

Bank practice should also address the issues of administrative discontinuity due to short terms of office for elected municipal authorities.

2. Efficiency in local government. Actions are needed in two broad areas: i) reducing the transaction costs and improving quality in local public choice-making, and ii) efficiency of producing and delivering local public infrastructure and services.

i) Public choice-making. The Bank can give more emphasis to the expenditure and decision-making side of local government, to revitalize the sluggish choice-making mechanisms at the local level, and to channel the effervescent energies of local groups into improved mechanisms for decision-making. The focus should be on expanding the options and refining techniques for participation and feedback in local public choice in such matters as stating preferences, ranking priorities, and implementing projects at the local level. The following specific actions can be taken:

Support participation in public choice-making and help strengthen choice-making capacity at the local level with an eye toward reducing technical and financial costs of making decisions. Suitable mechanisms for diagnosis and actions are TALs, technical assistance, training, EDI courses and cooperation with bilateral donors.

By means of technical assistance and support from EDI, improve the technical means of communicating preferences and feedback through surveys, public fora, hearings, and consultative groups, and strengthen the analytical capacity of public policy choices. All these activities should be a more regular aspect in sector analysis and operations.

The Bank should seek to strengthen the role of municipal governments in social funds and to build upon municipal development funds as tools to stimulate local participation in the voicing of demand and to assist in project implementation (see 3, below).

ii) Production efficiency in the local public sector. The Bank need not wait for more thorough evidence of the most efficient methods of service production and delivery. A great deal can be achieved by following rules of thumb, such as:
Orient capacity strengthening and local development projects towards the several forms of competition discussed and illustrated in this report: public-private; private-private; public-public, plus local implementation.

Introduce data banks in the context of lending as a tool for local governments to make cost comparison in bidding by local contractors;

Diffuse proven contracting formats and procedures as a part of project design.

3. **Equity in treatment of the poor.** Equity of benefits produced (among income groups as well as municipalities) and the distribution of their costs across the population both require stronger central government actions along the lines of principal agency. The Bank can take the following steps:

- Help countries set poverty assistance targets, establishing objective, transparent criteria for assistance, and create or refine financial and technical means to reach the poor in large municipalities and small.

- Adjust fiscal equity of inter-jurisdictional assistance in order to equilibrate regional and individual assistance.

- The Bank should assess whether some local governments should be more deeply involved in identifying the poor (by making use of inventory tools such as the LQMS) and delivering poverty assistance in order to exploit local competitive advantage to make adjustments and flexibly administer poverty assistance. As recommended earlier, (2-i), the Bank should incorporate municipal governments in social funds (and possibly integrate local funds with social funds) following objective, transparent and equitable eligibility criteria as a way to strengthen local capacity for management and accountability.

4. **Local capacity, accountability and sustainability.** The Bank needs to face head-on the problem of accountability in governance. Both the recent discussion paper on governance and recently-approved urban policy paper raise the issue of government as a possible constraint to productivity. But efficiency of management will come to naught if sustainability, that is the possibility of replicating efficient local management, is not made a part of the Bank's broad strategic objectives. The scale of effort needed is large and should be oriented toward productivity and accountability of the municipal organization. This requires the transformation of local government skill structure (along the lines of a contract manager model as opposed to a direct provider of goods and services) and strengthening of financial and administrative

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1/ INURED's *Urban Policy and Economic Development: An Agenda for the 1990s*, was discussed and approved by the Board in January, 1991.
control mechanisms, in addition to strengthening other forms of accountability mentioned earlier.

- Professionalize key levels of municipal service by developing options to enhance career service, salaries for qualified managers, and prospects for tenure.

- Build up, by means of local technical and private institutions wherever possible, the supply pool of key functional and skill positions in order to create a professional practice in municipal posts of confidence.

- The Bank needs to focus on auditing and budgetary control systems at the local level (in addition to exploring possible economic and political costs of deficient judicial and regulatory systems). Bank sector work and lending provide suitable conduits for implementing assistance in these areas.

C. Implementing the Strategy.

3. The diversity of conditions and other contextual factors influencing decentralization strategies in the Region make it difficult to classify countries for purposes of developing a blanket response by the Bank or even by individual Departments. Rather, the analytical framework and prototypical issues discussed in this report constitute starting points for further analysis on a country-by-country and sector-by-sector basis. Sector and analytical work are the predominant modes for implementing the Regional strategy, although many aspects of capacity strengthening, accountability and sustainability can be addressed in the context of project lending. The Technical Department can play a coordinating role, perhaps by forming a Task Force to help chart an approach to individual sector issues and to establish a policy and technical dialogue with the IDB on sector and country aspects of decentralization.

4. Two country variables shape the approach CDs may wish to take in addressing decentralization issues. First is the state administrative organization (e.g., unitary versus federal). The administrative organization of the state affects the approach to, and choice of implementing instruments for, such matters as national policies on expenditure assignments, grant financing, equity, and capacity strengthening. Unitary systems present the challenge of setting and promulgating incentives and ensuring compliance through a centralized administrative apparatus. Federal systems present the additional complication (in many cases the potential resource) of state governments whose independence in revenue raising and priority setting can either frustrate or facilitate national objectives.

5. A second variable is the number of cities by size. In general, feasibility of actions to improve efficiency and equity in local government is roughly proportional to city size, irrespective of the organization of the

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2/ Further discussion of these factors appears in Annex VI-1.
state. For instance, very large cities can be treated as a class in either federal and unitary systems for such issues as local decision-making, planning, spending controls, and poverty assistance. The same is true for small and rural municipalities, although of course qualitatively different kinds of assistance are needed. By the same token, states can, and often must by constitutional provision, regulate metropolitan organization and provide technical assistance to local government.

D. Policy Sequencing.

6. The sequence of policy issues to be addressed by the Bank is largely determined by the Bank's own hierarchy of policy concerns--macroeconomic linkages, followed by expenditure assignments, intergovernmental financial arrangements, and capacity strengthening. Priority should be given to gauging the macroeconomic effects of uncoordinated spending among governments and next to exploring expenditure assignments and intergovernmental financing arrangements in order to avoid further possible destabilizing effects of decentralization. Issues of autonomy in own-source revenues and cost recovery logically flow next, once intergovernmental financial responsibilities are settled. However, efficiency in spending and production, together with institutional strengthening (capacity building, accountability in auditing and budgetary controls, and sustainability) must go hand in hand with financial responsibility. The longer term structural and personnel problems of local government need to be addressed in parallel by attention to public sector management.

E. Emerging Issues, Sector Work and Skill Mix.

7. But the Bank's knowledge base in all of these areas is thin. Not only is sector work the preferred vehicle for understanding more fully the dimensions of decentralization, but also the content of sector needs to change. For instance, decentralization has given states new responsibility for metropolitan affairs and cities new responsibility for environmental quality. Decentralization may mean that local publics articulate a concern for more pollution, not less, in favor of higher priority to basic services or poverty. Already, sector work is probably inadequate for the present and proposed lending in the Region (see Table VI-2). Aside from the present study, sector work on subnational government has been carried out only in Argentina, Brazil and Mexico. Table VI-2 illustrates the weakness of effort in sector analysis for supporting a three year, US$2.5 billion lending program directly or indirectly affecting local governments. Except for Regional analysis, local government capacity will be addressed in only four countries over the next three years. The new burdens on local governments and
new areas of analysis would suggest the need for a substantially increased analytical effort.

8. The shift in focus to the subnational level also implies a strain on present skill mix in the Region. Skills for the present focus—on strengthening financial aspects of local governments—are probably adequate (Table VI-3). But, as indicated in the table, analytical skills are weak in the areas of participation, (e.g., with NGOs, PVOs) and possibly judicial and regulatory issues. Legal skills are needed to handle civil procedures in matters of transparency for privatization, regulatory matters, contracting arrangements, inter-municipal cooperative arrangements in the largest cities. Skills in specific areas of participation and management of local government are acutely under-represented in the Region. In addition, the present divisional organization in the Region separates public sector from urban and municipal expertise. To tackle the
efficiency and equity problems of local governments in earnest may require flexible deployment of skills across Departments, more likely across Regions, as well as reconsideration of the current division of labor and territory between the I and E Divisions and the PSM Division in the TD.
ANNEXES

Annex I-1: A Note on Terminology

1. Decentralization affects the pattern of authority and governance. As Samuel Beer (1988) has pointed out in reference to the United States, some citizens may have strong preferences about the very organization of government—they may want to be governed in some matters by small governments and in others by large ones, quite apart from consequences—but overwhelmingly, for most citizens the distribution of authority among levels of government is a means to an end, not an end in itself. Often, the ends are not subtle. In 19th century Latin America, out-of-power caudillos and provinces that felt they had been neglected in national economic development strategy often espoused decentralization as a principle that would effectively deliver them more resources and power. Once they gained control of the central government apparatus, however, these groups tended to re-direct central authority to serve their own ends, rather than curb it in the name of decentralization. A parallel feature may be found in contemporary decentralization. It is seen as the only practical way of getting resources and decision-making authority to outlying provinces or groups that historically have been neglected.

2. In several instances, both in the Region and elsewhere, decentralization continues to be an indirect strategy of empowerment, especially for groups which historically have been excluded from access to political control of the central government. In Guatemala, for example, the constitutionally prescribed turnback of 8 percent of national revenues was adopted expressly as a means of incorporating marginal Indian populations into political decisions about public investments and service provision. In Colombia, local government revenue transfers and service authority have been strengthened in part as a political response to revolutionary forces, whose inroads have been greatest at the periphery.

3. In this report, we consider decentralization as an instrument for achieving more limited but specific objectives: primarily, greater efficiency in local service delivery, better targeting of public programs to needy populations, and greater democratic participation in governance. Given the great variety of decentralization strategies, we do not expect to find that 'decentralization' is uniformly associated with a certain set of outcomes. Rather, the particular decentralization design—the way in which authority and resources are transferred to lower-level government—should strongly influence the outcomes. It is the objective of this Report to link decentralization strategies to their consequences.


1. In choosing countries for study, selection criteria were designed to take into account governmental structure (e.g., federated republics and unitary systems), socioeconomic circumstances (country size and economic performance), political organization (several degrees of democratization), and other factors such as differences in approach to the process of decentralization. The cases chosen constitute a representative mix of these factors (see Table I-1). Chile
Table I-1
COUNTRIES SELECTED FOR STUDY
Social Economic Indicators
Summary Table

<table>
<thead>
<tr>
<th>Country</th>
<th>Pop. mlns</th>
<th>Prcnt Urban</th>
<th>GNP/capita</th>
<th>Infnt Mortality</th>
<th>Govt Structure</th>
<th>No. Munis</th>
<th>Cities &gt;500k</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>32</td>
<td>86</td>
<td>2,520</td>
<td>31</td>
<td>Fed.</td>
<td>600</td>
<td>5</td>
</tr>
<tr>
<td>Brazil</td>
<td>144</td>
<td>75</td>
<td>2,100</td>
<td>61</td>
<td>Fed.</td>
<td>4,400</td>
<td>14</td>
</tr>
<tr>
<td>Chile</td>
<td>13</td>
<td>85</td>
<td>1,510</td>
<td>20</td>
<td>Unit.</td>
<td>325</td>
<td>1</td>
</tr>
<tr>
<td>Colombia</td>
<td>32</td>
<td>69</td>
<td>1,120</td>
<td>39</td>
<td>Unit.</td>
<td>1,006</td>
<td>4</td>
</tr>
<tr>
<td>Ecuador</td>
<td>10</td>
<td>55</td>
<td>1,120</td>
<td>62</td>
<td>Unit.</td>
<td>162</td>
<td>2</td>
</tr>
<tr>
<td>Guatemala</td>
<td>8</td>
<td>33</td>
<td>900</td>
<td>57</td>
<td>Unit.</td>
<td>326</td>
<td>1</td>
</tr>
<tr>
<td>Honduras</td>
<td>5</td>
<td>42</td>
<td>860</td>
<td>68</td>
<td>Unit.</td>
<td>284</td>
<td>0</td>
</tr>
<tr>
<td>Mexico</td>
<td>84</td>
<td>83</td>
<td>1,760</td>
<td>46</td>
<td>Fed.</td>
<td>2,700</td>
<td>7</td>
</tr>
<tr>
<td>Venezuela</td>
<td>19</td>
<td>75</td>
<td>3,250</td>
<td>35</td>
<td>Fed.</td>
<td>269</td>
<td>4</td>
</tr>
</tbody>
</table>

Definitions and Notes

The data on populations, urbanization, GNP, and cities over 500,000 come from The 1990 World Development Report and are 1988 data, except for city sizes (1980).

The term 'federal' refers to a political system in which power is constitutionally divided between the central government and the nation's constituent subdivisions (provinces, states, regions, etc.). Each of the two sets of governments exercises authority directly on the people; neither owes its powers to a grant of authority from the other, but to a constitution that is superior to both. Municipalities are usually governed by state constitutions. However, there are many variations in federal systems, depending on the distribution of powers. Thus, although Brazil is said to be the most decentralized of governments in the LAC Region, the national congress need not obtain state approval to change the constitution, as is the case in Mexico.

The term 'unitary' refers to a political system in which all power is centralized in the national government. In the unitary system, the subnational units of government are created by the central authority, which grants them whatever powers they exercise. Municipalities, like other units of government, are thus direct administrative extensions of the central government (Plano, 1982).

is an example of a unitary system which decentralized under strong military rule and appears about to confer significant new political powers to democratically elected local government. Colombia is a country with an unitary system of government in the process shifting very large revenue sources to sub-national governments.

2. Standing in contrast are the cases of Mexico and Brazil, the two largest federated republics in the Region, where local elections have helped to shape the strategy of decentralization from the beginning. Mexico and Brazil must cope with the intergovernmental complexities of federated republics with the benefits and drawbacks of a strong history of local elections and political party

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influence. Yet the authority given to local governments in these two republics, for instance in revenue raising and rate setting, are vastly different from each other. Guatemala and Honduras represent yet a third group of countries undergoing decentralization: small unitary systems with weak institutional capacity at the local level.
Annex II-1: Intervention in Fiscal Choice Models

1. In both local fiscal choice and principal-agent models, higher levels of government exercise influence over local choices and financing by means of fiscal transfers, both grants-in-aid and revenue sharing (Dates, 1977). Most emphasis is placed on categorical or programmatic grants by which central governments subsidize the local cost of particular services or investment. Decentralized decision-making retains its efficiency attributes under such a grant structure. There may also be general revenue sharing grants between the central government and localities. In the local fiscal choice model, these entitlement grants merely augment community income. They do not change any of the relative prices affecting public service choice. General revenue sharing is viewed as the appropriate instrument for redistributing local fiscal resources in order to compensate for differences in local wealth or local tax bases. Otherwise, it is seen as an inefficient instrument, since revenues must make the round trip from the local level, where they are collected, to central government, then back to the local level, where they are expended. At each step of this process there is an administrative cost.

2. The local fiscal choice and principal agent models can be extended into public-private sector relationships, as well. Publicly provided services should in principle be limited to those that require collective expression of demand or collective consumption. Other services are more efficiently provided through private markets. Even services that have some aspects of "publicness" to them can often be provided by private firms under franchise contract from the public sector or be provided by the private sector subject to public regulation or benchmark competition from public providers. For both models, local governments experiment with different public/private service arrangements, in search of the least-cost production point consistent with public objectives, while households constantly weigh the choice between publicly provided services and private alternatives.

3. Finally, the models recognize and encourage competition between governments in service provision. Competition between local governments is critical. The winners in this competition--those able to provide better services at lower tax costs--attract more residents and business firms, while the losers suffer outmigration and thus come under pressure to bring their costs under control and make their service mixes better reflect local demand. There may also

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1 Although the local fiscal choice model has dominated the economic theory of local government behavior, the "pure" model is of no means the only one that can serve as a reference point for decentralization strategies. One alternative (Prud'homme, 1990) emphasizes that a heavy reliance on local revenue collection may not be appropriate, especially in the developing world. If central government is better equipped to collect revenues and to command taxpayer compliance, it may be desirable to have the central government perform most of the revenue collection responsibilities, then share part of its receipts on an automatic basis with sub-national governments. Here, the efficiency advantages of central government as tax collector outweigh any administrative losses from having revenue collections make the round trip to central government before being turned over to local authorities. Revenue-sharing or tax-sharing plans then become an integral part of decentralization design on efficiency grounds, quite apart from redistribution or equity objectives.
be vertical competition, in which different levels of government overlap for a time in service provision, with service responsibilities eventually being entrusted to the governmental unit that does the best job at least cost.

Annex II-2: Efficiency in Decentralization Strategies

1. In many discussions, the connections between decentralization and efficiency are less clearly spelled out, and appear to be almost affirmations of faith rather than empirically testable propositions. It is often asserted, for example, that decentralization will encourage production efficiency because local authorities (i) have a greater motivation to use funds efficiently, since they benefit directly from any costs savings they can achieve; (ii) can save on supervision costs of infrastructure projects by avoiding repetitive approvals at higher levels of government, each of which involves delay and transaction costs; (iii) can take advantage of the prices in local markets, rather than pay the higher prices that prevail in the capital, as is true of nationally designed and implemented programs.

2. None of these common-sense considerations constitutes a decisive case in favor of the cost efficiency of decentralization. Local authorities may or may not have greater incentives to use resources efficiently, depending upon the intergovernmental grant design. Even when they do, their greater desire to be efficient may be outweighed by a lack of skills in project design or administration, just as the savings achieved by avoiding higher-level project supervision may be outweighed by the lesser competence of local supervisors. As for the advantages of buying inputs in local markets, although it is true that unskilled labor typically can be bought more cheaply outside the capital, other markets frequently show the reverse pattern. Provincial towns often have difficulty in finding construction firms willing to bid on their projects, and may end up paying higher prices because of the lack of competition. Prices for construction materials and machinery tend to be higher outside large cities.

3. In the end, the production efficiency associated with decentralized service delivery is an empirical matter. There have been a modest number of analytical studies that compare the costs of delivering standardized packages of services or infrastructure at the local and central levels. The studies that have been carried out (see Appendix I) tend to report that locally selected, administered, and financed projects cost less than centrally selected and provided services, though the findings are by no means uniform. Moreover, the cost savings seem to reflect a combination of production efficiency, local preferences for less costly designs, and greater revenue stringency at the local level, which forces cost reductions regardless of household preference or efficiency (e.g., capital-cost reductions that show up later in higher lifetime costs because of increased maintenance requirements). Above all, the studies highlight the dangers of an unstructured empiricism in carrying out cost comparisons. Production costs are sensitive to so many factors—from the idiosyncrasies of the workers assigned to a project to the type of soil in which projects are constructed—that a mere comparison of costs between "central" and "decentralized" projects is not likely to be revealing. There is much greater potential payoff to understanding which parts of the production system have
changed as the result of decentralization, then looking in theory and empirical experience for the cost differences these changes have produced.

4. With respect to allocative efficiency, there is intuitive appeal to the proposition that decentralization, by bringing choice-making closer to the people, makes it more likely that local priorities will be attended to. However, the validity of this proposition depends fundamentally on the institutions and procedures used to express local service demands. Without local elections, local officials are free to respond to whatever interest groups they want. Indeed, some country studies suggest that decentralization has merely strengthened the dominance of local elites over the public sector, since the countervailing power of other interest groups (like unions) is much weaker at the local than at the national level.

5. Similarly, there is no reason to expect that decentralization in general will involve more or less equity targeting than centralized administration of programs. Everything depends upon the exact design of revenue sharing and the way poverty programs are financed and administered under decentralization.

6. For most of this report, we adopt the perspective of local public choice as a recommended standard against which we assess the impacts of decentralization programs on demand and production efficiency. For fiscal efficiency and equity objectives, we have kept an open mind in determining how much direction the central government wants to impose on local authorities. However, even insofar as demand and production efficiency are concerned, it generally will not be true that "inefficient" decentralization systems are merely poorly designed. Rather, they are either out of phase or typically designed to achieve other purposes: to retain or even enhance central control over important local events, or at least to channel local actions in directions that are desired by central-level actors. Rather than specify how these decentralization designs can be "corrected" to make them more efficient from the perspective of local public choice, it often is more instructive first to work backwards from the existing design to identify whom it benefits and judge whether the design is likely to have been deliberately adopted for this purpose.
Decentralization in the LAC Region is not an isolated phenomenon of political administration. It is tied to a re-definition of the role of the state occurring throughout the world and, within the Region, to other important economic and social events. At least three factors can be singled out to explain the pervasive nature of decentralization initiatives and the probable direction of future policy evolution: 1) the challenge to state-led growth in which central government directs economic development; 2) the fiscal crises of governments; and 3) the rising demand to share power and decision-making authority at the subnational level. 

2. **Challenge to the state-led growth model.** Since the Second World War, virtually all countries in the LAC Region have adopted a model in which central government directs economic development. Central governments expanded their production and service activities— even into domains historically and constitutionally municipal— as a way of promoting economic development and supplying basic social services. Although significant successes were achieved, an inflection point was reached when sovereign debt and fiscal crises overwhelmed the capacity of central authorities to manage local affairs. At the heart of demand for decentralization, however, is the widespread feeling that, in proliferating their functions so widely, central governments have lost their ability to provide basic local services in a time and reliable manner that responds to local demands. Decentralization is seen as a response to the "failure" of the state and as a means of reducing the responsibilities of over-extended central governments.

3. **Fiscal crisis.** The fiscal crises of the 1980s provided an additional impetus for decentralization. Faced with increasing fiscal deficits and pressures to reduce their levels of expenditures, central governments became more receptive to the idea of transferring spending responsibilities either to sub-national governments or to the private sector. It remains to be determined whether decentralization strategies actually have reduced public sector spending, or even have improved the budget balances of central government by shedding expenditure responsibilities faster than revenues. However, decentralization, like privatization, is widely seen as an instrument of budgetary retrenchment. At a minimum it seems to reduce the risk of future runaway public sector expansion by reversing the central government's tendency to encroach on the functions of private sector and lower levels of government.

4. **Power sharing.** Decentralization is not tied by definition to the sharing of power, but in fact the two have been closely intertwined in the LAC Region. Purely administrative delegations of authority can take place under any regime, including military ones. The most common pattern has been to restore elected governments at the national level first, then to restore or strengthen the democratic basis of local governments, while at the same time, giving elected

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3 Power sharing in many cases also refers to the implicit bargaining of authority and resources to local governments in exchange for support for national political figures or policies. These notions are discussed in more detail in Annex 2-1.
local governments more resources or more authority to provide local services and infrastructure. Decentralization then can be viewed as part of the consolidation of democratic governance.
Annex IV-l: **Principles of Expenditure Assignment:** (The following is the substance of a memo to me written by William Dillinger, PRE.)

With the exception of national defense (always national) and garbage collection (usually local)--patterns of functional assignments vary widely even among industrial countries, and that there appear to be many ways to successfully organize the delivery of public services. I suggest, nevertheless, a few common principles. Here they are:

1. The assignment of functional responsibilities between levels of government should be clear and unambiguous, regardless of which level does what. Consumers need to know who to hold accountable for the services they are consuming. (This stands in contrast to the deliberate obscurity of responsibilities in Brazil, for example, where consumers do not know who to blame for service failures, and federal, state, and local governments appear to be engaged in a perpetual game of chicken.)

2. Revenue assignments should correspond to expenditure assignments. The allocation of specific revenue sources should, in fact, follow from the assignment of expenditure responsibilities. Generally, revenue sources should function as prices--rationing consumption according to willingness to pay--as well as serving as a means of shifting resources from taxpayers to government. Opportunities to confront consumers with the cost of the services they consume should therefore be exploited. (How feasible this is depends on the characteristics of the particular service--the extent to which benefits are confined to individuals and the extent to which charging is administratively feasible.)

3. Intergovernmental transfers should pursue only a few simple objectives. Multiple objectives tend to offset each other. And the extent to which transfers can be used to fine-tune local performance is limited by the shortage of relevant data at the municipal level.

4. Responsibility for capital investment should not be separated from responsibility for operation and maintenance. This separation (usually with central government in the former role, local government in the latter) obscures accountability, and creates perverse incentives. (Central public works agencies, for example, have a tendency to overdesign, where they don’t have to worry about operating costs or debt service.)

5. Central governments should trim their regulatory powers to match the quality of their information. Central governments often insist on retaining control over the details of local government operations--tariff schedules, equipment purchases--even where they lack the information on which to exercise these powers intelligently. They shouldn’t.
Two final caveats: First, the notion that central governments assign particular functions to local government and then have no further interest or influence over the outcome is an oversimplification. Local governments are creatures of their national governments (or in some federal countries, their state governments) and the performance of local government is of ongoing interest to these higher levels of government. Central governments can therefore be expected to exercise continuing influence, even over functions nominally assigned to local government. Their influence can be either direct (through function-specific regulation and financing) or indirect (through the rules under which local governments operate--election procedures, limitations on the power to raise revenues, budget approvals, etc.). When the Bank discusses functional assignments, we should be nominally responsible for the performance of a particular function, and (2) the incentives under which that entity will operate.

Second, in discussing expenditure assignment, it is always useful to bring up the traditional public finance distinction between provision and performance (i.e. who decides how much to produce, versus who actually does the production). This is particularly relevant to the decentralization discussion, much of which is couched as a trade-off between allocative efficiency (where local government is perceived as having an advantage, on the grounds that its superior knowledge of local preferences will yield a mix of services that best matches consumer preferences) and production efficiency (where central government's presumed technical superiority is believed to yield more output per unit of input). In theory, this is a red herring: it should be possible to get the best of both worlds, by having one entity provide and another entity perform. (Los Angeles County's Lakewood plan, where the county performs services under contract to municipalities, is often cited as a successful example of this approach.) For the Bank, a more relevant example would be a case where local government sets the standard for garbage collection but contracts the actual performance of the service to private firms. This separation of provision from performance need not undermine accountability, as long as the lines of responsibility are clear: the local government is accountable to the consumers, the contractors are accountable to the local government.

Decentralization in LAC
Annex VI-1: Conditioning Factors Affecting Bank Response to Decentralization

1. Most countries are characterized by a cross-currents of historical, financial, political and economic factors which make tidy classifications impractical and Bank responses necessarily individualized. Neither stage of implementation, nor degree of change in autonomy in expenditure or revenues, permits useful classification beyond that already presented in Chapter III. For instance, Mexico embarked on decentralization nearly two decades ago and Venezuela only in the mid eighties, yet Venezuela allows elections of mayors separate from council, permits self-succession, and authorizes councils to make local revenue increases, whereas Mexico has none of these features. In the same way, Chile began decentralizing in 1973, yet now faces across-the-board challenges in most aspects of decentralization under a new democratic environment. Similarly, few countries have addressed systematically expenditure assignments and intergovernmental finance. Therefore, this report is intended to provide an overall conceptual framework and range of issues to consider in preparing future analytical work on a country-by-country and sector-by-sector basis.

2. Nevertheless, several independent variables—administrative organization of the state and the size and number of cities—shape the approach CDs may wish to take in addressing decentralization issues (see Table, below). The state administrative organization of the country in question (e.g., unitary versus federal) affects the approach to national policies on expenditure assignments, equity, and capacity strengthening. Unitary systems require more attention to central mechanisms to implement control and assistance (e.g., incentives, conditions, and penalties, for instance in grants and revenue performance). Federal systems require more attention to the possible role of states in intergovernmental finance, investment coordination, auditing, and capacity assistance to local governments.

3. A second variable is the "population" of cities by size. In general, city size affects the feasibility of local autonomy in decision-making, planning, spending controls, and poverty assistance. The 10 cities in the Region of more than five million persons will require more help on intergovernmental cooperation as compared to the hundreds of cities in the 100,000 to one million size range. All larger cities can be expected to play a stronger role in budgetary execution, local budgetary control and auditing, and judicial and regulatory systems. The thousands of small and rural municipalities, on the other hand, will need more routine assistance in most strategic areas, perhaps by means of greater reliance on contractual assistance.
<table>
<thead>
<tr>
<th>Strategic Actions</th>
<th>Organization of State</th>
<th>City Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policies on central-local relations</td>
<td>Federated systems define the role of states in expenditure assignments, financial flows. Unitary systems focus on targeting and incentive mechanisms to achieve objectives.</td>
<td>Support decision making formats (elections, surveys, participation) in largest cities; give more emphasis to technical in small and rural. Diffuse technical assistance on contracting, competition, and costing tailored to city size.</td>
</tr>
<tr>
<td>Efficiency in local government</td>
<td>States can foster demand detection through joint financing with cities and help increase accountability in project implementation at local levels. Also facilitate metropolitan associations. Unitary systems organize regional approaches to demand and set up incentives and penalties to induce efficiency.</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>Central and state roles in poverty assistance</td>
<td>Degree of involvement depends critically on installed capacity of city organization. Large cities can run programs, others help in targeting only.</td>
</tr>
<tr>
<td>Capacity, accountability, sustainability</td>
<td>States play helping role in capacity strengthening, auditing, and judicial and regulatory schemes.</td>
<td>Largest cities can expand auditing and budgetary controls, and attention to judicial and regulatory matters. Small and rural need assistance in basic personnel.</td>
</tr>
</tbody>
</table>

**Summary of Actions:**
Federated: Decide role of states in expenditure assignments, degree of competition and coordination with municipal governments in financing and delivery of services, role of states in capacity strengthening, auditing and budgeting, judicial and regulatory.
Unitary: Incentive and targeting mechanisms to achieve national objectives and standards of service, penalties if needed, and capacity strengthening. Decentralize (deconcentrated) administration of auditing.

Metropolitan Areas: Revenues mobilization, financial information, cooperative arrangements with states and adjoining municipalities, local budgetary and auditing controls.

Large Cities: Mobilize revenues, basic information systems, basic personnel system and administrative capacity, state or local auditing and local budgetary controls, contracting.

Small and Rural: Assistance required to technical demand detection, budgeting control, contracting.
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