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Institutional and Governance Review
Towards an Inclusive Decentralization
(In Two Volumes) Volume I: Main Report
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Public Sector Group
Poverty Reduction and Economic Management Sector Unit
Latin America and the Caribbean Region
**REPUBLIC OF BOLIVIA—FISCAL YEAR**

January 1 – December 31

**CURRENCY EQUIVALENTS**

(as of December 7, 2005)

Currency Unit = (Bs) Bolivianos

US$1 = 8.02

**ABBREVIATIONS AND ACRONYMS**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tr>
<td>CAINCO</td>
<td>Cámara de Industrias, Comercio, Servicios y Turismo (Chamber of Industry, Commerce, Services, and Tourism)</td>
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<tr>
<td>CCF</td>
<td>Certificados de Crédito Fiscal (Fiscal Credit Certificates)</td>
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<td>CFAA</td>
<td>Country Financial and Accountability Assessment</td>
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<td>CPAR</td>
<td>Country Procurement Assessment Report</td>
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<tr>
<td>DFID</td>
<td>Department for International Development (UK)</td>
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<td>FRL</td>
<td>Fiscal Responsibility Law</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GTZ</td>
<td>German Technical Cooperation</td>
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<td>HIPC</td>
<td>Highly Indebted Poor Countries</td>
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<td>IADB</td>
<td>InterAmerican Development Bank</td>
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<td>ICE</td>
<td>Impuesto de Consumo Específico (Special Consumption Tax)</td>
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<td>IDH</td>
<td>Impuesto Directo de Hidrocarburos (Hydrocarbon Direct Tax)</td>
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<td>IEDH</td>
<td>Impuesto Especial de Hidrocarburos (Special Hydrocarbon Tax)</td>
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<td>IGR</td>
<td>Institutional and Governance Review</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IMR</td>
<td>Infant Mortality Rate</td>
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<td>LPP</td>
<td>Law of Popular Participation</td>
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<td>MMR</td>
<td>Maternal Mortality Rate</td>
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<td>NFPS</td>
<td>Non-Financial Public Sector</td>
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<tr>
<td>PRF</td>
<td>Programa de Renovación Financiera (Debt Rescheduling Program)</td>
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<td>PRI</td>
<td>Institutional Reform Project</td>
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<tr>
<td>SAFCO</td>
<td>Ley de Administración y Control Gubernamentales (Law for Public Sector Administration and Control)</td>
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<tr>
<td>SEDES</td>
<td>Secretaría Departamental de Salud (Departamental Health Agency)</td>
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<td>SEDUCA</td>
<td>Secretaría Departamental de Educación (Departamental Education Agency)</td>
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<tr>
<td>SEPCAM</td>
<td>Secretaría Departamental de Caminos (Departamental Road Agency)</td>
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<tr>
<td>SIOMA</td>
<td>Seguro Universal de Salud (Universal Health Insurance)</td>
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<td>SUMI</td>
<td>Seguro Universal de Salud (Universal Health Insurance)</td>
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<tr>
<td>VAT</td>
<td>Value-Added Tax</td>
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<tr>
<td>UCAC</td>
<td>Unidad Coordinadora de Asambleas Constituyentes (Coordinating Unit of the Constitutional Assembly)</td>
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EXECUTIVE SUMMARY

The Challenges of the Second Phase of Decentralization

ES.1 **Bolivia is now beginning the second phase of its long march to decentralization.** The first phase of decentralization started in 1994 and was municipal in nature. Municipalities now play an increasingly important role in public service delivery. The second phase is focusing on strengthening the regional level of government. The driving force of this new phase is the struggle over dividing the natural resource pie, which has taken the cloak of a demand for greater regional autonomy ("autonomías regionales") and the proposed withholding by departments of a share of "locally produced revenue." The driving forces behind Bolivia’s new decentralization effort are not its needs for service delivery improvements, reduction of regional inequalities, or greater fiscal responsibility, despite their importance.

ES.2 **Two decisions for decentralization have already been taken for this second phase:** (i) the popular election of *prefectos*; and (ii) the new Hydrocarbon Law (HL) will provide roughly two-thirds of additional tax resources (an estimated US$240 million in 2006) to the regions and municipalities without transferring new responsibilities. These new revenues to the regions and municipalities could increase significantly as an immediate effect of the nationalization of hydrocarbons recently made by the Government.

ES.3 **This second phase of decentralization presents three problems:**

(i) **Inadequate strategy:** Starting decentralization with the political election of regional authorities, without previously putting adequate institutional and fiscal arrangements in place; and transferring new resources without any requirement to take on new responsibilities, does not constitute an optimal sequence of implementation. This can lead to weak fiscal responsibility, unhealthy competition among regions and municipalities and consequently overlaps in responsibilities for service delivery.

(ii) **Weak institutional arrangements:** The institutional framework is inefficient and provides limited accountability. Departmental governments do not have minimum institutional capacities, sufficient autonomy to manage resources, and responsibilities among government levels are disjointed and fragmented.

(iii) **Inequitable fiscal decentralization:** The intergovernmental fiscal framework does not distribute resources equitably or encourage proper fiscal responsibility by sub-national governments. Fiscal transfers from the HL allocate, for instance, US$16 per capita to La Paz (which has one of the largest communities of the poor) while Pando (among the least poor) receives US$407.

ES.4 **The country has only limited options to address these problems due to three constraints.** The three constraints are the following: (i) decentralization is being driven largely by strong inter-regional differences over the control of natural resources; (ii) there are considerable inequalities in public services, which are deficient across all sectors and regions; (iii) there is no room for increased public spending. This environment set limits on the options for decentralization as some of its elements are mutually inconsistent: reducing public expenditures is not easy to reconcile with improving public services; meeting the political demand for more autonomy might not necessarily contribute to better governance; strengthening
municipalities might conflict with creating regions; increased autonomy might make it more difficult to reduce interregional disparities in terms of service quality and availability of resources. Managing these trade-offs represents a daunting challenge.

ES.5 A failure to resolve the above-mentioned problems before moving forward could seriously jeopardize the country's governance, public finances, and undermine social inclusion. If decentralization is not well implemented there could be a further decline in service quality, and increased public spending pressures could undermine the recent fiscal improvement. While today there is macroeconomic stability, increased public expenditures could create a fiscal gap and as a result undermine the economy's ability to remain on a stable footing. Furthermore, inter-regional disputes could worsen, weakening the state's functioning and undermine governance. Finally, without addressing the problems outlined above, departmental governments cannot easily strengthen social inclusion.

ES.6 As one of the most unequal countries in Latin America, Bolivia cannot afford inequitable spending on behalf of subnational governments. In Bolivia the richest ten percent obtain 42 percent of national income while the poorest only receive 0.3 percent. Poverty and exclusion are particularly harsh on the indigenous people, who comprise more than half of the population. In 2002, 40 percent more indigenous Bolivians lived in poverty than non-indigenous Bolivians, up from 30 percent in 1997. Infant mortality in rural areas is almost twice that in urban areas. A decentralization process that shifts more and more resources to departmental and municipal governments in an inequitable manner does not contribute in any way to social inclusion. Public spending will continue to be inequitable. Also, a macroeconomic crisis as an outcome of fiscal indiscipline will hurt the poor the most. The poor have a great interest that decentralization does not hamper macro-economic management.

ES.7 This Institutional and Governance Review (IGR) aims to assist Bolivia's decision-makers to address the afore-mentioned problems and constraints. More specifically, the report provides guidance on: (i) crafting a coherent decentralization strategy; (ii) structuring the required institutional arrangements; and (iii) underpinning the intergovernmental fiscal framework. This report provides analytical information; recounts pertinent experiences from other countries that faced similar challenges; and offers a set of alternative policies—they are contained in Volume I (Main Report) and Volume II (Detailed Technical Analysis).

Crafting a Coherent Decentralization Strategy

ES.8 A coherent decentralization strategy can help deepen social inclusion, protect national public finances, alleviate regional inequalities, while at the same time improve public service delivery and governmental responsiveness. It would have, however, to be generally agreed on by the different actors involved. Such a strategy should ideally:

- establish a vision of the future roles and responsibilities of departmental governments;
- coordinate transfer of expenditure responsibilities in light of uneven institutional capacities at national and subnational levels;
- lay out a sequence for gradual implementation so that fiscal pressures are kept in check;
- build incentive frameworks for improving services that lead to more accountability, and;
- give priority to fiscal responsibility over sub-national autonomy in use of resources to protect national fiscal and macroeconomic interests.
Once the decentralization strategy is set and agreed upon its implementation could occur in three stages. The following are policy options for the short-, medium-, and long-term.

Policy Options for the Short-Term: Ensuring Basic Institutional Capacities and Correcting Inequalities

Decentralization should preferably be directed initially at ensuring basic institutional and implementation capacities at national and subnational levels; and at correcting fiscal inequalities in the transfer system.

- **Institutional:** (i) consensus building mechanisms would help facilitate political dialogue, reduce potential conflicts among level of governments, and improve decision making on decentralization; (ii) up-grading public management tools would help foster trust among different levels of government by increasing transparency as well as accountability. The following are key management tools for departmental governments that would ensure basic institutional capacities are in place:
  - a financial management system to allow access to budget information by authorities at different levels of government and citizens;
  - human resource management tools to make the public wage bill transparent as well as contribute to more competitive staff recruitment and hiring;
  - public procurement; and,
  - mechanisms for monitoring and evaluating the quality of public services.

- **Fiscal:** (i) improve resource distribution through establishment of per capita formulas for transfers of hydrocarbon revenues to departmental governments; (ii) install basic fiscal responsibility rules, e.g., curbs on new departmental debt.

Policy Options for the Medium-Term: Separating Responsibilities among Levels of Government and Improving the Efficiency of Public Services

The strategy for the medium-term is focused on separating responsibilities among the national, departmental, and municipal levels to promote more accountability and efficiency. The departments also need to demonstrate that their services meet suitable standards and that they can improve them, before assuming more responsibilities.

- **Institutional:** (i) clarify and separate roles and responsibilities assigned to the different levels of government for greater efficiency and accountability in each of the sectors; (ii) combine the decisions on services with adequate responsibilities for human resource administration (recruiting, hiring, firing, monitoring and salaries), as well as planning and budget management.

- **Fiscal:** (i) gradually phase in a new funding formula for current services to provide incentives for their improvement as well as to reduce inequalities in resource distribution; (ii) once basic fiscal responsibility rules are working well, it would be possible to relax present fund ear-markings for more decision-making autonomy in resource use.

Policy Options for the Long-Term: Deepening Responsibilities of Sub-national Governments

Once the short and medium-term measures have been implemented and greater capacities are created, departmental governments would be better able to adopt additional responsibilities and use more resources.
Institutional: (i) authorize sequential transfer of additional responsibilities for secondary roads, health, and education; (ii) strengthen intergovernmental coordination.

Fiscal: (i) refine the distribution of resources related to revenue-sharing and transfers from hydrocarbons revenue; (ii) consider permitting departments to raise taxes, e.g., domestic share of ICE (Special Consumption Tax); and a gasoline and diesel sales tax.

Expected Outcome

ES.13 As an outcome of the policy options implemented over the short-, medium-, and long-term, there could be basic equity in resource distribution, and more accountable departmental governments. Decentralization can serve as a useful tool for better social inclusion. Achieving this requires a clear strategy of sequenced measures that do not upset the country’s finances or the capacity of different levels of government to deliver public services. This IGR is aimed at helping the Government develop and implement that strategy.
INTRODUCTION

I. Background and the Context of Decentralization in Bolivia

1. The Government of Bolivia is in the process of further decentralizing power and resources. This is taking place against the backdrop of the 1994 decentralization to the municipalities, the recent first popular election of governors, the proposed referendum on regional autonomy in July 2006, and the projected Constitutional Assembly in August 2006. These developments are also occurring in the new environment created by the election of President Evo Morales, who took office in January 2006 as the country’s first indigenous leader.

2. These momentous events are accompanied by a climate of national political crisis. Therefore, there is a widespread feeling that the country needs a new social contract for future political stability and economic development. A central element of this task clearly concerns how Bolivia can attain greater equality and inclusion. This is of national urgency since the country is among the most unequal countries in Latin America. It has significant disparities in the distribution of its assets (education, land, and housing) and earning differentials by gender, ethnicity, sector and types of employment. According to the 1999 National Household Survey, the richest decile of its population obtained 42.3 percent of national income while the poorest only received 0.3 percent. Infant mortality in rural areas is almost twice that in urban areas. Poverty and exclusion have been particularly harsh on the indigenous, who comprise more than half of the population—and their conditions have deteriorated. In 2002, the indigenous had 40 percent more persons living in poverty than the non-indigenous, up from 30 percent in 1997.

3. The issues of equality and inclusion are intimately related to a set of controversial issues which need to be resolved in the new social contract. The key topics would be the conflicts over land distribution, indigenous rights, distribution and uses of hydrocarbon revenues, and the extent of regional autonomy. Bolivians are deeply divided over these matters. And it is quite likely that their differences will intensify as opposing groups maneuver to increase their power or steer national policies towards their individual interests.

4. A central element is the struggle over dividing the natural resource pie. This has taken the cloak of demands for greater regional autonomy and for the departments’ withholding of shares of “locally produced revenue.” These demands are highly questionable from a methodological viewpoint. However, they clearly reflect the political impetus for more decentralization and how divided Bolivia is over the underlying issues.

5. Decentralization can play a useful role in this situation. It generally involves moving the control of public services from the national to regional government levels, and shifting responsibilities for raising taxes and expending their proceeds. Through these changes, decentralization innately influences the distribution of power in a society. Therefore, reaching a new basic consensus on how political authority and responsibilities, revenues and expenditures, are to be distributed would be an important contribution for the new social contract.

6. Moreover, decentralization itself can have positive effects on socio-economic development. Bolivia is a highly diverse country, with quite different ethnic groups, and extremely diverse climates, resource endowments, land uses and urbanization patterns. Given this diversity, it would seem reasonable to allow the departments greater autonomy to make decisions according to their needs and preferences. But policy makers also need to attend to the worrying signs of increasing regional inequality. Much of this reflects the growth in Santa Cruz’s
economy and those other departments which benefit from hydrocarbon production. The resulting disparities have increased internal rivalries, fueling regionalist demands. For example, the lowland departments feel that their economic contributions to the country are not reflected in their political powers, while highland departments feel that they deserve a larger share of national wealth to help alleviate their poverty.

7. At the same time, it is important to recognize that decentralization can contribute to inclusion only indirectly. It is not a panacea and by far not the only means to achieve inclusion. The increase in political participation made possible by decentralization creates opportunities for the poor for greater presence in decision-making bodies. Similarly, a more efficient and above all more equalitarian supply of public services will benefit the poor, provided that transfer systems to sub-national governments are also equalitarian, or clearly discriminate in favor of poorer areas. The poor are the ones who stand to benefit most from growth or to suffer most of the lack of growth. They therefore have a great interest at sound macro-economic management, and therefore in the making sure that decentralization characteristics do not hamper macro-economic management. But in any case decentralization cannot be seen as a substitute for an explicit inclusion policy that is ideally based on a variety of other mechanisms.

8. Addressing the above mentioned challenges is a daunting task that will require significant efforts. Whatever direction the country takes, any move forward will not occur in a vacuum. Particular relevant in this regard is the “institutional landscape” that resulted from the municipal decentralization after 1994. Taking into account the outcomes and lessons learned from this first phase of decentralization could be critical in designing a strategy for the second phase that the country is now initiating.

II. The First Phase of Decentralization (1994-2004)

9. The first phase of decentralization, triggered by the 1994 Law of Popular Participation (LPP), created municipal governments. Although their functioning is far from perfect, municipalities now play increasingly significant economic and political roles.

10. Subsequently, in 1995 departmental governments (prefecturas) were established in the country’s nine regions (departamentos). When they were created, they were not yet fully autonomous sub-national governments but were instead hybrid institutions. They were designed as deconcentrated units of the central government headed by presidially-appointed governors (prefectos). But there are also Departmental Councils (Consejos Departamentales) with representatives appointed by the municipalities, which prepare the programs and budgets for departmental expenditures. The departments are still very weak, though, and have limited service delivery capacity.

11. Before the approval of the HL, expenditures of municipalities represented about 18.3 percent of total public spending, and expenditures of departments amounted to 8.6 percent.¹ Both municipalities and departments accounted for some 27 percent of total public expenditures. However, sub-national governments raised less than 6 percent of total taxes and royalties. They (especially the departments) have been heavily dependent therefore on transfers.

¹ This excludes payroll for health and education which is a national government responsibility.
12. There are several outcomes as well as lessons from this first phase of decentralization (Box 1). Considering them could be key to moving forward in the second phase.

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**Box 1. Lessons Learned from the First Phase of Decentralization (1994-2004)**

1. **“Voice” and inclusion:** municipal decentralization and popular participation have provided “voice” to citizens and have facilitated social inclusion. The number of indigenous mayors and local elected representatives has increased steadily. Indigenous and campesino communities have acquired a greater say in public investment. Social control, through the civic control committee or other means, has served to improve the capacity of local communities to direct resources to their priority needs. However, it is also true that social control has had a focus on inputs and process, not necessarily on results; and that the incentive to invest has often diverted attention away from service delivery. A new challenge arises now for governance at the national level: in the absence of institutionalized mechanisms for conflict resolution—among levels of government, and among different social groups—diverging interests are being put on the political agenda in an unmediated fashion. This creates dead-lock in the governance system. The lesson learned is that departmental decentralization, by only furthering inclusion without creating institutional mechanisms for conflict resolution, may perpetuate the governance challenge the country currently faces.

2. **Equity:** resource distribution to municipalities is equitable but resource distribution by Sector Ministries remains unresolved. Decentralization to the municipal level has changed both the distribution and focus of national investment by being more poverty focused and prioritizing social programmes. This also implies a stronger distribution from municipal capitals to rural communities. However, still unresolved is the distribution of resources by sector ministries in health and education, among others. Teacher distribution, for instance, is inefficient and inequitable: throughout the country, some 9,000 teachers are not needed where they work but they are needed in other places. Resources need to be better distributed within and across departments. The lesson learned is that regional decentralization needs to address inter- as well as intra-departmental resource distribution, but with a focus on improved services.

3. **Fiscal Responsibility:** low transparency, high informality, and absence of graduated sanctions have weakened fiscal responsibility. Arrangements for sub-national debt management are cumbersome and there is not sufficient data on municipal debt. Only top-down monitoring and administrative controls have proved insufficient to achieve more transparency. The central government as main provider has provided incentives to lend, but not to collect debt service. The status of departmental debt is ambiguous. On the other hand, the transfer of investment expenditures to municipalities allowed for “quick wins” to achieve fiscal neutrality, but this came at the cost of fragmenting decisions over resource allocation. The lesson learned is that departmental decentralization needs to create commitments for fiscal responsibility, while the central government alone cannot set good incentives for better debt management.

4. **Assignment of responsibilities:** political drivers are the main reason for uncoordinated approaches for transfer of expenditure responsibilities. Following the political impetus of decentralization, the transfer of responsibilities was not carried out jointly among departmental and municipal levels. Decisions over investment and current expenditures, as well as service delivery, were disjointed. This has led to ambiguous assignment of responsibilities and low efficiency. For this reason, it has been extremely difficult to achieve service improvements in the sector areas (health, education, roads) across all levels of the state and regions of the country. In the meantime, pilot experiences with regards to create associations of municipal governments (mancomunidades) to achieve higher economies of scale have not been sustainable. The lesson learned is that departmental decentralization should be designed such that decisions on investment and current expenditures are taken at the same level of government; coordinated and sector-approaches are needed for decentralization to lead to better services.

*Source: World Bank.*
III. The Second Phase of Decentralization and its Challenges: Towards an Inclusive Decentralization

13. Bolivia is now initiating its second phase of the country’s long decentralization effort. This new phase has a much stronger emphasis on the regional level. It also differs from the earlier effort by being driven by inter-regional differences over the control and distribution of revenues from natural resources, particularly from hydrocarbon exploitation and land use. This issue is particularly heated in the Santa Cruz and Tarija regions, which want to keep as much as possible of those resources for themselves. This has created a major national debate over how to share revenues from a non-renewable source.

14. Two important decisions have already been taken on the second phase:

(i) **The election of department governors (prefectos).** This represented a milestone because the prefectos derive their mandate from a new constituency—the people—instead of the head of state. Departmental governments will de facto be autonomous irrespective of their constitutional status. A legal framework for the new regional authorities must still await the decisions of the upcoming Constitutional Assembly. But negotiations are already underway among the Central Government, the prefectos, and the departmental councils, about defining the transitional stage of the new prefectos.

(ii) **Roughly two-thirds of the additional tax resources** to be collected from the HL, (estimated to total US$240 million in year 2006) will be given to the regions and municipalities without their assuming new responsibilities. For prefectures, this represents on average an increase of more than 50 percent in the level of transfers.

15. Unfortunately, these decisions constrain the future path of decentralization. They limit some of the country’s options because decisions that might otherwise have been used to set incentives for institutional strengthening or better service delivery have already been taken. Also, Bolivia’s earlier decentralization experience (and similar efforts elsewhere) showed that the desired benefits do not materialize if they are not implemented in a basic framework that requires fiscal transparency and responsibility, overcomes horizontal imbalances in resource allocations, and matches resources with roles.

16. Given these recent decisions, the challenge of the second phase is how to achieve inclusive decentralization. This is evident both in resource distribution as well as the quality of public spending and service delivery.

17. As noted, Bolivia is among the most unequal countries in Latin America. And the central government’s fiscal transfers to departments from hydrocarbon revenues are themselves highly inequitable. They provide US$15.8 per capita to La Paz (which has one of the largest incidences of poverty) while Pando (among the least poor) receives US$407.2. As a consequence of HL, the new spending of departmental governments will also be highly unequal in per capita terms.

18. In addition, the quality of services in all sectors is uneven across regions. The quality of services in health, education, among others is also unequal within each department, showing significant disparities between urban and rural areas. However, improving public services is not

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2. These values were calculated before the adoption of Decree no. 28701 from May 1, 2006.
at the center of the current debate. This is unfortunate, because in fact, as shown in this report, inadequate resources are not the main causes of inadequate service delivery, particularly in the cases of education and health.

19. Therefore, a more inclusive decentralization needs to be based on more equitable resource distribution as a means to achieve better and more uniform service provision. These two elements are key and can contribute to reducing inequality and achieving greater inclusion as part of a new social contract.

20. This second phase of decentralization faces three sets of problems.

(i) **Inappropriate Decentralization Strategy:** The strategy for the implementation of decentralization is sub-optimal due to the entry points that have been selected as well as the sequence of implementation. Decentralization reforms are debated, enacted, and implemented in a disjointed manner among regional and municipal levels.

(ii) **Weak institutional arrangements:** Departmental governments do not have sufficient autonomy to manage resources adequately; and responsibilities among levels of government are disjointed and fragmented. This leads to weak accountability and inefficiency.

(iii) **Inadequate fiscal decentralization framework:** The intergovernmental fiscal framework leads to inequity in resource distribution and weak fiscal responsibility. Underlying to this are the ear-marking of revenues to certain regions; fiscal pressures generated by current royalty distributions; resources transferred without expenditure responsibilities; the lack of own revenue on departmental level and high transfer dependence on the Central Government; inequalities in transfers among regions; as well as non-transparent management of sub-national debt.

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**Box 2. Latin American Experiences with Decentralization: Risks and Opportunities**

After more than two decades of decentralization, Latin American countries have accumulated a wealth of experiences that are useful for Bolivia. Decentralization has been primarily politically motivated. Since 2002, all countries in the region have held municipal elections. The strengthened legitimacy of subnational governments appears to be the main impact of decentralization so far in the region.

Beyond the political effects, decentralization has brought with it a series of risks. One of particular concern is related to fiscal transfers. Often arrangements for intergovernmental transfers through revenue-sharing measures preceded transfers of expenditure responsibilities. This has increased fiscal burdens when transfers were not linked to any changes in responsibilities. Their consequences have been added pressures to spend, except in such cases as Peru, which strictly applied the principle of fiscal neutrality in its decentralization. Granting political autonomy to sub-national governments without installing a proper fiscal rules framework has also had adverse effects.

The lack of own revenue at local levels has been a stumbling block for decentralization, particularly for regional governments. Many regions or states in Argentina, Mexico, Peru and Venezuela, although nominally autonomous, still largely depend on transfers for their revenues. This has prolonged accountability to the center (instead of local citizens and taxpayers), perpetuated transfer dependence, and limited borrowing capacity. And when taxing powers were in fact granted to sub-national governments—such as in Brazil with its VAT—it resulted in sub-optimal tax collection. States competed in “fiscal wars” over tax rates in “races to the bottom.” The Brazilian experience also demonstrated the complexity of sub-national tax administration with cross-jurisdictional sales.

The transfer of expenditures to sub-national governments has also been difficult. In most countries,
decentralization has not resolved ambiguities in assignments. These are evident in the inappropriate uses of "exclusive" and "concurrent" functions, e.g., Ecuador, Nicaragua, Peru and Venezuela. Unfortunately, sectoral approaches were rarely followed. As shown in Chile and Spain, sectoral approaches have contributed to greater intergovernmental coordination and better services. On balance today, most countries in the region have not improved overall service delivery through decentralization. Only a few have materialized in sub-national governments that pursued consistent, long-term delivery policies, as in Bogotá (Colombia).

Fiscal responsibility is of increasing concern. Argentina, Brazil and more recently Colombia and Peru, have all suffered painful experiences from the profligacy of sub-national governments. These have jeopardized the provision of reliable, adequate public services—for which the central government may have ultimate political responsibility—the safety of financial systems, international creditworthiness, and overall macroeconomic stability.

For Bolivia to ignore these experiences could be risky. This is particularly true because of the decentralization strategy which is being followed, the weak institutional arrangements, the inadequate fiscal framework, and the country’s fragile conditions.


21. Without tackling these three problems there is a risk that the second phase of decentralization would not lead to the desired outcomes. Following international experience with decentralization (Box 2), this could imply a further decline in service quality, additional spending pressures that undermine the recent fiscal adjustment; and a weakening of governance that might weaken the social contract being negotiated. If decentralization is not well implemented, the country could miss an opportunity to enhance and achieve social inclusion.

IV. The IGR Instrument

22. The Institutional and Governance Review (IGR) aims to trace the institutional roots of Bolivia’s erratic government performance and to propose practical alternatives. IGRs assess weaknesses in the public sector manifested by poor regulation, service delivery, or high corruption; and analyze their possible causes, including political economy drivers. Hence, their distinctive feature is to present policy alternatives that seek “best fit” instead of “best practice,” given the constraints in each country context.

23. The Underpinnings of this IGR. The 2000 IGR, entitled “From Patronage to a Professional State: Bolivia Institutional and Governance Review,” provided a series of recommendations that underpin this new Review. The 2000 IGR assessed Bolivia’s public sector organization and operations particularly in the structural areas of financial and human resource management, as well the transparency and accountability in their performance. It found a gap between the “ideal” behavioral patterns prescribed in official norms and the patterns in actual practices. This breach affected budgeting, public expenditure, and human resource management, among others. It also undermined transparency and accountability because, the 2000 IGR concluded, the bureaucracy had been co-opted by the political parties and used as the “currency” for political pacts.

24. As options to overcome this situation, the 2000 IGR suggested: (i) building a consensus for de-politization of the public sector; (ii) introducing greater transparency in civil service management; and (iii) improving central oversight of the public administration for greater operational decentralization and decision-making. Its main proposals are currently being
implemented under the First Institutional Reform Project (PRI-I). Others of these proposals figure in the current decentralization agenda.

25. **Objective of the new Bolivia IGR on decentralization.** This IGR aims to support decision-makers in Bolivia in the implementation of decentralization particularly with regards to departmental governments. Particularly, it provides suggested guidance on how to (i) craft a coherent decentralization strategy; (ii) how to improve the institutional arrangements; and (iii) strengthen the intergovernmental fiscal framework. The policy options (Table 1) are aimed at how to best implement decentralization within a strategic framework. Instead of providing a closed set of recommendations, the report endeavors, to the extent possible, to present different policy alternatives to allow decision-makers to see trade-offs between different approaches. These trade-offs appear to be higher at the regional level as compared to the municipal level. Likewise, the report attempts to present policy alternatives that can be realistically implemented given the incentives prevailing in the Bolivian public sector.

26. **The process is as important as the product.** The IGR endeavors to support the process of discussion among stakeholders of decentralization in Bolivia. To this end, the report was elaborated in close policy discussions with government officials, including a series of workshops on different thematic issues related to decentralization held in La Paz and Washington DC. The report benefited from useful comments and suggestions from representatives of the Vice-Ministry of Decentralization in the Ministry of the Presidency, the Ministry of Finance, the Ministry of Popular Participation (until 2005), the Ministry of Health and Sports, the Ministry of Education, the National Road Agency (SNC), as well as the Decentralization Coordinator for the Constitutional Assembly (UCAC). The dialogue also included field visits to the prefectures of Chuquisaca, La Paz, and Santa Cruz. The team held discussions with civil society, among others, the Comité Cívico de Santa Cruz, and the chamber of industry and commerce (CAINCO) in the same department. A Policy Note on decentralization, summarizing the main recommendations from the IGR was discussed with several government officials in March 2006, in the scope of policy dialogue on behalf of the Bank. These activities reflect Bank's conviction of the need for consensus to facilitate an open dialogue, both politically and technically, and to seek common and useful approaches.

27. **Structure.** The IGR consists of a **Main Report (Volume I)** and a **Volume II** consisting of **Detailed Technical Analysis.** Following this Introduction, Chapter 1 of the Main Report provides an overview of the context in which decentralization in Bolivia is taking place, in terms of actors and interests, the quality of public services, and the fiscal constraints. Chapter 2 provides a detailed analysis of the weaknesses in terms of the decentralization strategy, the institutional arrangements, and fiscal decentralization. Chapter 3 provides the elements for a new decentralization strategy. Chapter 4 presents policy options for the short-term aimed at achieving minimum regional equity in resource distribution. Chapter 5 presents policy options for the medium-term aimed at dividing responsibilities among levels of government and improving efficiency in services. Chapter 6 presents the long-term decentralization strategy aimed at deepening responsibilities of departmental governments, both on the expenditure as well as revenue side. It also establishes the vision of future departmental governments.
<table>
<thead>
<tr>
<th>Fact One:</th>
<th>Fact Two:</th>
<th>Fact Three:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decentralization is driven by the struggle over natural resources.</td>
<td>Weak institutional arrangements:</td>
<td>There is no room to increase public spending.</td>
</tr>
</tbody>
</table>

### Table 1. The Decentralization Strategy

<table>
<thead>
<tr>
<th>Chapter 1</th>
<th>Chapter 2</th>
<th>Chapter 3</th>
<th>Chapter 4</th>
<th>Chapter 5</th>
<th>Chapter 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constraints for Decentralization</td>
<td>Diagnostic</td>
<td>Decentralization Strategy</td>
<td>Policy Options for the Short-term</td>
<td>Policy Options for the Medium-term</td>
<td>Policy Options for the Long-term</td>
</tr>
</tbody>
</table>

**1. Lack of a coherent decentralization strategy:**
- (i) Sequence.
- (ii) Entry points levels of government, not sectors.
- (iii) The nature of regional governments.

**2. Weak institutional arrangements:**
- (i) Lack of institutional mechanisms to discuss and solve conflicts among levels of government.
- (ii) Poor management tools.
- (iii) Resources: Lack of autonomy for allocation of resources.
- (iv) Responsibilities: Overlapping and disjointed responsibilities (education, health, roads).

**3. Inequitable fiscal decentralization**
- (i) Ear-marking of revenue.
- (ii) Transfer of revenue without expenditures.
- (iii) Volatile and uncertain resource flow.
- (iv) High levels of transfer dependence.
- (v) High and increasing regional inequality in transfers.
- (vi) Weak fiscal responsibility and poor management of sub-national debt.

**Institutional Strengthening:**
- (i) SAFCO systems at departmental level; sector-specific systems and requirements (preparatory phase).
- (ii) Resources: Human resource management: wage and career policies.
- (iii) Responsibilities: Service quality indicators for sectors. Monitoring and evaluation.

**Fiscal Decentralization:**
- (i) Transfers: new formula (per capita).
- (ii) Fiscal neutrality: renegotiate hydrocarbon revenue transfer for adoption of expenditures.
- (iii) Fiscal Responsibility: basic rules (including moratorium for departmental debt).

**Institutional Strengthening:**
- (i) Clarify roles of levels of government by separating responsibilities.
- (ii) Adjust expenditure ear-marking.

**Fiscal Decentralization:**
- (i) Gradual introduction of funding formulae in key sectors. For education (per student formula) and health (per capita formula).

**Institutional Strengthening:**
- (i) Responsibilities: Consider transferring new expenditures (educations, roads, health).
- (ii) Strengthen intergovernmental coordination.

**Fiscal Decentralization:**
- (i) Transfers: refine per capita formula with other methods.
- (ii) Eliminate ear-marking of revenue; stabilizing transfers.
- (iii) Taxes for departments: domestic share of ICE, sales tax for gasoline.
- (iv) Consolidate fiscal responsibility: multi-year commitments.

*Source: World Bank.*
CHAPTER 1. THE CONTEXT AND CONSTRAINTS OF REGIONAL DECENTRALIZATION

28. The second phase of decentralization that Bolivia now initiates is taking place within a context that is characterized by three overarching facts: (i) a political economy of interest of actors in which conflicts over natural resources are the driving motivation behind decentralization; (ii) deficient public services across all sectors and regions; (iii) a constrained fiscal environment, that despite the recent improvements, remains fragile and vulnerable to increased spending pressures implied in decentralization, particularly in the take-off period. Each of these stylized facts provides guidelines for the design of a decentralization strategy. Unfortunately, some of these constraints are contradictory. How to manage these trade-offs will figure prominently in the national debate on decentralization.

I. The Driving Forces of Decentralization

29. This section aims to set out some of the main political facts underlying the next decentralization phase. Its objective is to present analytical findings that should be useful for the design of the decentralization strategy, which is presented later in this report.

30. The driving forces behind Bolivia's new decentralization effort are not its needs for service delivery improvements, reduction of regional inequalities or greater fiscal responsibility, despite their importance. They are instead competing pressures for control and distribution of revenues originating from the country's natural resources, particularly revenues from hydrocarbon exploitation and land usage. The issue is particularly strong in the resource-rich regions, which want to keep control over and decision-making about these resources for themselves as much as possible through the decentralization of responsibilities. Conversely, the less endowed regions are likely to want these decisions to be centralized, from which they would expect more equally distributed revenues.

31. Regional decentralization is happening in the context of deepening regional inequality. The deep inter-personal inequalities are well known in Bolivia. More important for the issue of decentralization are inter-regional inequalities. Most departments in the lowlands have experienced economic revivals and growth while the highlands are stagnant. A particularly important phenomenon has been the rise in the Santa Cruz economy, and of those departments that benefit from hydrocarbons production. This has been fueling regionalism. The lowland departments feel that their economic power is not matched with their political power. For these regions, the demand for political decentralization and popular elections is one step into achieving this new equilibrium of economic and political power.

32. A review of the regions' GDP per capita and their growth rates (in constant terms over 1988–2003) demonstrates large differences (Table 2). Santa Cruz's per capita GDP was twice Potosí's level. Regional growth rates are even more unequal. They are positively correlated (although loosely) to GDP per capita, which means that the interregional per capita GDP tends to increase, not to decrease. Bolivia's regional inequality is thus substantial. It implies that the regions' interests have been diverging.

3. In 2002, an estimated 65 percent of the population had insufficient incomes for basic food and non-food expenditures while an estimated 41 percent had too low incomes to obtain food baskets of minimum caloric intake.
Table 2. GDP per capita (2005) and Growth Rates by Region (in percent), 1988–2003

<table>
<thead>
<tr>
<th>Region</th>
<th>GDP per capita (Bolivia=100)</th>
<th>GDP growth rates (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>100</td>
<td>9.8</td>
</tr>
<tr>
<td>Chuquisaca</td>
<td>85</td>
<td>4.6</td>
</tr>
<tr>
<td>La Paz</td>
<td>93</td>
<td>9.3</td>
</tr>
<tr>
<td>Cochabamba</td>
<td>101</td>
<td>6.6</td>
</tr>
<tr>
<td>Oruro</td>
<td>127</td>
<td>-6.6</td>
</tr>
<tr>
<td>Potosí</td>
<td>57</td>
<td>13.8</td>
</tr>
<tr>
<td>Tarija</td>
<td>118</td>
<td>45.9</td>
</tr>
<tr>
<td>Santa Cruz</td>
<td>117</td>
<td>8.0</td>
</tr>
<tr>
<td>Beni</td>
<td>87</td>
<td>16.2</td>
</tr>
<tr>
<td>Pando</td>
<td>137</td>
<td>27.2</td>
</tr>
</tbody>
</table>

**Inequality indicators:**
- Dispersion: 0.24
- 1st decile/10th decile: 1.5

Notes: \( ^a \) growth rates are for the entire period, not per year; \( ^b \) standard error divided by the mean; \( ^c \) first decile divided by 9th decile, approximated here by the ratio of the second highest value divided by the second lowest value.

Source: World Bank, based on data provided by: www.ine.gov.bo

33. **Bolivians remain deeply divided over demands of “regional autonomy.”** A central element of the struggle over dividing the natural resource pie, which has taken the cloak of a demand for greater regional autonomy (“autonomías regionales”), is the proposed withholding by departments of a share of “locally produced revenue.” These proposals are based on the questionable use of information comparing amounts of central or total government taxes collected with a region’s expenditures. Some of the assertions derived from these comparisons are erroneous. Among other factors, saying that a region should retain a certain share of total taxes paid in it confuses local and national taxes. It is inappropriate to equate central government taxes collected in a territory with the central government taxes produced by activities of households and enterprises in that territory.

Figure 1. Survey Results: Demand for Political Decentralization (March 2005)

Source: Encuesta Opinión y Mercado (March-July 2005).

4. For some taxes, like the personal income tax (which does not exist in Bolivia), the two notions might coincide. But they do not for most taxes. It is not impossible to regionalize central government expenditures and taxes meaningfully. But it is methodologically difficult and, in any case, it is not what is presently being done in Bolivia.
34. To some extent because of that confusion, Bolivians are divided about demands for "autonomías regionales." According to surveys, there is widespread popular support for popular elections of the prefecto. This support is large across all regions and social groups (Figure 1). However, citizens are deeply divided over demands for autonomía which many fear is a threat to the very notion of national unity (Figure 2).

**Figure 2. Survey Results in Selected Bolivian Cities: “Will Autonomías Regionales divide the nation?” (March 2005)**

![Survey Results in Selected Bolivian Cities](image)

*Source. Encuesta Opinión y Mercado (March-July 2005).*

35. **Municipalities perceive regional decentralization as a threat to their power.** After all, municipalities have secured a “first-mover advantage” over regional governments in the initial phase of decentralization starting 1994. They were strengthened through the Law of Popular Participation, and are now naturally perceive an increased role of departmental governments as a threat to their resources and political power. They fully recognize that the HL’s changes will give departmental prefects a larger share of public resources. Further, it seems that the municipalities do not consider their representation in department councils to provide an effective tool for resolving inter-governmental differences. As will be explained below, this distributional conflict among regions and municipalities is troublesome and leads to a series of negative consequences.

36. **Some social groups and actors are likely to oppose greater regional autonomy.** Strong unions in the public sector, particularly in health and education, would probably oppose decentralization for fear of losing their bargaining powers. So too might the groups which benefited from the Law of Popular Participation at the municipal level, e.g., the rural Ayllus or the urban Juntas de Vecinos. This implies that future decentralization may not be based on the support of powerful social groups, on which this reform ultimately depends to be successful.

37. **There are no institutional mechanisms to process diverging demands in benefit of a minimum consensus.** Diverging interests are an integral element of any decentralization process. In Bolivia however, decentralization is being implemented without adequate

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5. Problems have already arisen between the Prefectos and Departmental Councils (as the latter’s main function is the definition and approval of regional budgets and investment plans).
mechanisms in place to discuss and resolve conflicts among the different actors involved, particularly between levels of government. This is all the more important as the election of prefectos has a deep impact on the governance system in Bolivia: in absence of a strong Legislative Power, the regional level may constitute the only effective check on the Executive. If no preemptive measures are taken, conflicts on responsibilities, roles, and resources, among different levels of government are likely to increase as the decentralization process unfolds. Recent efforts to establish coordinating mechanisms among levels of government have as of yet not proven effective, thereby creating the risk of dead-lock in the governance system.

38. The different interests of actors involved, along with the lack of institutional mechanisms to resolve conflicts, leads to the following decentralization strategy, that the country is implicitly following.

- **Decentralization proceeds separately between different levels of government.** As a result of diverging interests, the decentralization process proceeds in a disjointed fashion among municipal and regional levels. This leads to a series of negative consequences, since responsibilities cannot be clearly assigned to each level of government. Decentralization does not proceed sector by sector (health, education, roads, for instance), which from a technical point of view, would offer better opportunities for assigning responsibilities.

- **The sequence of decentralization—political decentralization before building basic fiscal and institutional frameworks—is sub-optimal.** The election of the new regional government leaders has enhanced democratic participation in Bolivia. But this will also bring nine new bargainers to the table seeking greater shares of the national resource pool. This will make it more difficult to agree on the size of national public goods, like macroeconomic or fiscal stability. It will also limit the redistribution of resources among regions for better service delivery. Likewise, political decentralization may lead to additional spending pressures in the absence of rules and incentives for fiscal responsibility.

39. **Implications.** The political economy of decentralization has a number of obvious implications: decentralization must be gauged on its capacity to meet the multi-faced demand that exists and also on its capacity not to antagonize those who are cautious about it. Scenarios of decentralization at the regional level cannot ignore municipalities. They must include and discuss possible relationships and conflicts between regions and municipalities, and be assessed in part on their ability to strengthen municipalities. At least a minimum consensus is necessary for decentralization to be successful.

II. The Quality of Public Services: The Supply of Public Services Leaves Much to Be Desired

40. Public services are deficient across all sectors and regions. The many current unmet basic needs in education, health, water supply and housing are unequally distributed among regions. Improvements have been made but much remains to be done, particularly in certain regions. Table 3 shows the substantial horizontal imbalances that exist. Health services in La Paz, for example, are ten times more insufficient than in Santa Cruz and six times more than in Tarija.
Table 3. Unsatisfied Needs Der DeDartment (in aercent). 2001

<table>
<thead>
<tr>
<th>Department</th>
<th>Inadequate Housing Material</th>
<th>Insufficient Housing Space</th>
<th>Inadequate Water and Sewage Services</th>
<th>Inadequate Supply of Energy</th>
<th>Insufficient Education Services</th>
<th>Insufficient Health Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>National average</td>
<td>39.1</td>
<td>70.8</td>
<td>58.0</td>
<td>43.7</td>
<td>52.5</td>
<td>37.9</td>
</tr>
<tr>
<td>Chuquisaca</td>
<td>53.7</td>
<td>72.1</td>
<td>62.2</td>
<td>62.5</td>
<td>70.7</td>
<td>40.4</td>
</tr>
<tr>
<td>La Paz</td>
<td>41.9</td>
<td>66.0</td>
<td>53.2</td>
<td>39.0</td>
<td>49.1</td>
<td>64.9</td>
</tr>
<tr>
<td>Cochabamba</td>
<td>37.3</td>
<td>68.2</td>
<td>55.1</td>
<td>42.2</td>
<td>52.6</td>
<td>28.3</td>
</tr>
<tr>
<td>Oruro</td>
<td>39.2</td>
<td>67.2</td>
<td>65.9</td>
<td>41.8</td>
<td>47.2</td>
<td>58.8</td>
</tr>
<tr>
<td>Potosi</td>
<td>60.3</td>
<td>67.1</td>
<td>71.5</td>
<td>65.0</td>
<td>72.4</td>
<td>59.6</td>
</tr>
<tr>
<td>Tarija</td>
<td>30.4</td>
<td>71.5</td>
<td>45.6</td>
<td>43.1</td>
<td>60.5</td>
<td>14.7</td>
</tr>
<tr>
<td>Santa Cruz</td>
<td>23.0</td>
<td>77.0</td>
<td>55.8</td>
<td>33.9</td>
<td>43.6</td>
<td>6.4</td>
</tr>
<tr>
<td>Beni</td>
<td>63.2</td>
<td>85.0</td>
<td>82.4</td>
<td>64.2</td>
<td>54.6</td>
<td>31.7</td>
</tr>
<tr>
<td>Pando</td>
<td>40.4</td>
<td>80.5</td>
<td>83.6</td>
<td>64.8</td>
<td>61.3</td>
<td>39.3</td>
</tr>
</tbody>
</table>


41. These data are consistent with a detailed analysis in three sectors, namely health, education, and roads, which are the focus of the IGR. These three sectors are critical for social and economic development, yet there are troubling deficiencies in the quality of public service, particularly among the nine different departments (Table 4).

Table 4. Quality of Public Services in Education, Health, and Roads

| Education Sector | • Low and inequitable access to upper primary and secondary education: in contrast with high enrollments for primary education (97 percent), as recent as 2001, net enrollment in upper secondary was only 51 percent.  
|• There are intra-departmental inequalities: within departments and between districts, per student expenditures are unequal.  
|• Teacher distribution among districts is quite poor. Some 9,000 teachers are not needed in the schools in which they work (but they are needed in others). |
| Health Sector | • In indicators such as Infant Mortality Rate (IMR) and Maternal Mortality Rate (MMR), Bolivia occupies the last place in the Latin America region. There are large differences in health indicators within the country, particularly among different departments. According to the post Census 2002 survey maternal mortality was 320 in the Highlands (including La Paz, Potosi and Oruro), 147 in the Valleys (Cochabamba, Chuquisaca and Tarija) and 206 in the Plains (Santa Cruz, Beni and Pando).  
|• In 2001, the percentage of professionally assisted deliveries was 23 percent in the poorer quintile, 53 percent in the following quintile and rose to 89 percent in the richest quintile in Bolivia. At the same time, both the Public Expenditure Review (2004) and the Poverty Assessment (2004) show differences in professional birthing coverage from 60 percent for the non-indigenous population to 37 percent for the indigenous population (year 2001). |
| Roads Sector | • The quality of roads is poor. Paved roads account for only 7 percent of the total road network. Most of these roads belong to the primary network. In international perspective these shares are very low since the average level is 27 percent in the Latin America region.  
|• There are regional inequalities in terms of the quality of road services. While Tarija has 16.2 percent of its roads paved, this share is roughly 2 percent in departments like Potosi or Pando. Even in Santa Cruz, dependent on agro-export industry, has only a tenth of its road network paved. |


42. Implication. The implication of these facts is that decentralization should absolutely contribute to increase efficiency in public service delivery. Improvements have been made in
some sectors, but much remains to be done, particularly in certain regions or zones. This requires a decentralization strategy that is implemented with a view on service improvements, with regional and municipal politicians being accountable for the results they produce in terms of service improvement.

III. The Fiscal Situation: There is No Room for Increased Public Expenditures

43. The new decentralization effort has raised expectations about higher public spending. While today there is macroeconomic stability, increased public expenditures could create a fiscal gap and as a result undermine the economy's ability to remain on a stable footing to generate employment and to provide quality public services. Indeed, in other-country experiences with decentralization, the launching of a decentralization process involving increased public expenditure weakened the overall fiscal sustainability position, disproportionately affecting the poor as the need to adjust arose.6

44. Bolivia's overall projected7 budget deficit dropped to 2.3 percent of GDP in 2005 from 5.5 percent in 2004 (Figure 3). This achievement together faster GDP growth—at close to 4 percent in 2005—have improved the public sector's debt sustainability situation, helping to keep the nominal exchange rate stable, which is key to sustain solvency in a highly dollar indebted public and private sector. But Bolivia's public debt remains high at around 80 percent of GDP and the improvement in the public finances was largely the result of increased fiscal revenue due to higher international price of hydrocarbons and the new Hydrocarbon Law. While this Law promises more revenues (about US$366.5 million in 2006), much of it has already been earmarked. Furthermore, these resources are vulnerable to international price changes.

Figure 3. Domestic and External Debt and Public Balance

![Figure 3. Domestic and External Debt and Public Balance](image)


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6. Annex Table 1 shows the fiscal balances for the national, departmental, and municipal levels separately.
7. Final calculations are expected by end-May 2006.
45. **Implication.** The implication of this fact is that decentralization should by all means be built on fiscal responsibility and should protect the advances in macroeconomic management that already exist. Moving forward, the principle of fiscal neutrality of decentralization—that is, reforms should not result in additional expenditures—should be applied.

IV. Conclusion

46. Each of these stylized facts gives us constraints or guidelines for the design of a decentralization strategy. Unfortunately, some of these constraints are contradictory. Reducing public expenditures is not easy to reconcile with improving public services. Meeting the political demand for more autonomy might not necessarily contribute to better governance. Strengthening municipalities might conflict with creating regions. Increased autonomy might make it more difficult to reduce interregional disparities in terms of service quality and availability of resources. How to manage these trade-offs will figure prominently in the national debate on decentralization.

47. These constraints and trade-offs raise the demand for a specific decentralization strategy:
   - There is need for a strategy that is built on a minimum consensus within an environment of competing incentives and interests.
   - There is need for institutional reforms that contribute to improving services.
   - There is need for fiscal reforms that are compatible with fiscal constraints. At a minimum, they should not worsen the fiscal stance, but improve it through efficiency gains.

48. The following diagnostic aims at providing the elements to achieve this, in terms of strategy, institutional arrangements, and fiscal decentralization.
CHAPTER 2. DECENTRALIZATION STRATEGY, INSTITUTIONAL ARRANGEMENTS, AND FISCAL DECENTRALIZATION

49. This chapter describes and analyzes the three main problems facing decentralization in Bolivia: (i) the inadequate decentralization strategy, (ii) weak institutional arrangements, and (iii) inequitable fiscal decentralization. As will be pointed out, these three problems need to be tackled so that the second phase of decentralization will lead to the desired outcomes: equitative distribution of resources and better services in benefit of more social inclusion. The analysis in this section lays the base for the policy options that will be presented in subsequent chapters.

I. Problem One: Inadequate Decentralization Strategy

50. Bolivia lacks a coherent decentralization strategy for strengthening sub-national governments because of the following factors.

51. **Political reforms launched the process without a previous definition of an adequate institutional and fiscal framework.** While understandable in the country's social context, the primacy of political forces in absence of an adequate rules and incentive framework was unfortunate. Colombia, Peru and Venezuela, among others, were affected by the same dilemma. In so doing, they granted their regional governments more political autonomy before changing their fiscal relationships or expenditure responsibilities. This led to greater spending pressures, weakened fiscal obligations, heightened political cost of own-taxation (and thereby preferences for central government transfers), and overlapping service delivery assignments. Conversely, Chile was one of the few Latin American countries which has introduced institutional arrangements at the sub-national levels in benefit of better services and maintenance of fiscal discipline. These cases clearly demonstrate the benefits of creating and implementing institutional and fiscal frameworks previous to introducing deeper political decentralization.

52. **Bolivia’s decentralization process has not proceeded in an orderly, integrated fashion among different government levels.** Its reforms were enacted separately, as exemplified in its 1994 reforms of the municipalities, which were de-linked from the departmental governments. As pointed out in Box 1 above, the lessons learned from the first phase indicate that the country’s future decentralization will require a more effective delineation of responsibilities among national, departmental and municipal levels. This would help clear the way for achieving the needed greater efficiency in service delivery and accountability.

53. **The nature of regional governments creates constraints for the effective implementation of decentralization.** This is apparent in political, fiscal, and administrative decentralization.

- **Fiscal decentralization.** Regional governments are more transfer dependent due to their lack of own revenue. This requires especially demanding budget controls and fiscal regimes.

- **Administrative (expenditure) decentralization.** Regional governments are also more prone to having overlapping responsibilities vis-à-vis other levels due to their frequent responsibilities for "intermediation" and coordination.

- **Political decentralization.** Regional governments are not as close to their constituents as municipalities, and their policy-making is more "corporate" than "popular" in character. It
will benefit those groups that can organize themselves better at a regional level, which is unlikely the case for local communities.

54. Given the constraints and the nature of the regional level, some elements of Bolivia’s past decentralization strategy are not readily applicable to the second phase with a focus on departments.

II. Problem Two: Weak Institutional Arrangements

II.1 Lack of Institutional Mechanisms to Discuss and Solve Conflicts among Levels of Government

55. As mentioned in Chapter II, diverging interests are an integral element of any decentralization process. In Bolivia however, decentralization is being implemented without adequate mechanisms in place to discuss and resolve conflicts among the different actors involved, particularly between levels of government. New coordination mechanisms are contained in the rules framework that regulates the operation of recently elected prefectos until the Constitutional Assembly defines their final status. However, this rules framework is still incomplete and ambiguous, and it does not serve yet operational purposes. More importantly, recent disputes among levels of government related to resources allocation, the conditions and limits of roles and responsibilities, among others, demonstrate that the preliminary conflict solution mechanisms are not effective and adequate. If no further action is taken, there is increasing risk of dead-lock in the governance system.

II.2 Poor Management Tools at Central and Regional Levels

56. Financial and budget management at national and sub-national levels are deficient, as detailed in the 2004 Public Expenditure Review and the 2005 CFAA (World Bank). There are no adequate systems for financial management, human resources (payroll), or procurement. The implementation of the SAFCO Law is weak, and the processes and systems for its adequate operation are not in place. The deficiencies of these instruments will not allow regional government to provide reliable and transparent financial information to the Central Government. As demonstrated in other countries (Box 3), this is likely to impede the consolidation of decentralization because of the Central Government’s limited confidence about the appropriate uses of funds at regional levels.

57. On the other hand, the processes and systems to monitor and evaluate the delivery of services are practically non-existent. Much basic information in the education, health, and road sectors is presently not available, e.g., details on payroll per primary and secondary health care, and coverage indicators that measure service quality. The implication of these facts is that future decentralization will require improvements in the present levels of capacities for good resource management and service delivery. These institutional weaknesses were already apparent in previous decentralization attempts. In 1999, there was a need to recentralize responsibility for the primary roads network from the prefectures to the national government, as a result of declining service quality.

Box 3. Transparency Underpinning Decentralization

Lack of transparency and limited exchanges of information among different levels of government have been major factors impeding decentralization in many countries. Federal Mexico still has no unified budget classification among the federal level and the states. In Ecuador, disputes among provinces over accurate fiscal and budgetary information have obstructed the creation of consensuses about "provincial autonomy". In Venezuela, poor reporting on transfers has ruled out coherent sub-national policy making and planning. In all countries, the main lesson learned was that good access to and transparent information underpins trust within and among governments.

However, a few countries have made great strides by implementing integrated financial management systems at municipal and regional levels. The lion's share of municipalities in Guatemala and Peru now provide regular, timely budget information through these systems that are integrated with national financial procedures. Argentina's provincial governments are helping their municipalities install such systems. Bolivia should follow other countries and deepen its effort to improve SIGMA (or install a better proven) system in all municipalities and departments for greater transparency.


II.3 Limited Regional Autonomy for the Management of Resources

Departmental governments have inadequate autonomy to manage their resources. They therefore cannot improve productive efficiency (the most efficient combination of inputs to produce outputs)—one of the key advantages of decentralization. Large segments of the funds they receive are ear-marked. This prevents allocative efficiency (the ability to produce services the population most needs). Over the past few years, the new transfers added have prescribed the uses of their resources, which created a complex web of rules. And, to worsen matters, these are neither well-monitored nor properly sanctioned. Therefore (Figure 4):

**Figure 4. Budget Decision-Making Autonomy of Departmental Governments (in percent), 2004**

- Departmental governments can currently only spend 8 percent of all their funds (from transfers and own revenues)\(^9\) in line with their own priorities (Group 1 in Figure 4).


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\(^9\) The sums considered here include resources provided for public sector payrolls. However, the decentralization ratios presented in Table 7 below excluded payroll expenditures.
• More than two thirds of the prefectures’ funds (68 percent) are delegated to them without decision-making autonomy, e.g., the payment of health and education personnel (Group 4 in Figure 4).

• The regions’ autonomies will be reduced in the future since the new HL resources are 100 percent ear-marked.

59. These restrictions enable departmental governments to exercise only marginal control over the inputs they must manage for producing their targeted outputs (public services). This also limits their allocative efficiency; that is, departmental governments have limitations in providing the services the population needs most.

60. Comparable constraints also impede effective human resource management, which mayors and regional governors need to exercise in order to obtain their desired outputs and services. However, a local government, which is formally responsible for delivering health or education services but does not control their personnel, cannot be held entirely accountable for what it fails to produce.

61. In this connection, too, ineffectual arrangements for civil service management can have significant fiscal consequences if their governing rules are unclear. This is particularly important for Bolivia. The share of payroll in the education sector, for instance, amounts to 50.2 percent of total spending. It is less significant in health, whose payroll cost was only 10.1 percent of total expenditures. (Departmental governments, though, can hire additional health personnel with up to 10 percent of the funds they receive for investments).

62. Similarly, it is warrants noting that the ways in which human resources are now managed impedes identifying their costs. One needs to differentiate between personnel costs in, for instance, primary versus secondary education, or primary versus secondary health care. Doing this would help sharpen responsibility assignments and accountabilities: each level of government needs to bear the cost associated with service delivery.


Colombia has a history of cost-based, supply-driven, and rigid transfers for financing public sector staffs. Intergovernmental grants have increased in proportion with salary and benefit increases or expanded payrolls. Its Ley 60, adopted in 1993, increased transfers to local governments under a revenue-sharing system which provided a fixed portion of central government income. This was considered necessary because personnel costs for education and health had risen beyond the bounds of Situado Fiscal transfers. In 1996 both the Situado Fiscal and the Participaciones became insufficient and the center created additional transfers for these needs, initially on a temporary basis. Later they were institutionalized and made permanent, e.g., through the Fondo Educativo Compensatorio. Also, the country’s sub-national government have resorted to varied types of debt when they were not able to pay their personnel.

As a response to the “transfer push”, the constitutional reform in 2001 unified the transfers and set a ceiling on their growths. It remains to be seen whether this reform will successfully eliminate the underlying deficiencies of the human resource funding system.


63. Excessively “rigid” expenditures such as salaries can also have serious fiscal consequences. These could arise with the increasing share and volatility of hydrocarbon earnings in Bolivia’s total revenues. An even “worst-case” situation could develop if the country followed Colombia or others in implementing the kind of dysfunctional arrangements under which
subnational public sector salaries are established at the central level, irrespective of the payment capacity of regional or municipal governments (Box 4).

II.4 Responsibilities are Disjointed and Fragmented

64. In the Bolivian public administration, different levels of government intervene in the production of services in a disjointed fashion (Table 5). In education, for instance, teachers are paid by the central government; they are managed by the departments; their time is controlled by the municipalities; and the districts are responsible for their hirings and firings. With such fragmented decision-making, accountability is diluted, and no single government or service provider is in control.

Table 5. Responsibilities per Level of Government in the Health, Education, and Road Sectors

<table>
<thead>
<tr>
<th>Primary and Secondary</th>
<th>Primary and Secondary</th>
<th>Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>Education</td>
<td></td>
</tr>
<tr>
<td>Central Government</td>
<td>Financing</td>
<td>Finance</td>
</tr>
<tr>
<td></td>
<td>Planning</td>
<td>Planning</td>
</tr>
<tr>
<td>Prefectures</td>
<td>Deconcentrated SEDES:</td>
<td>Deconcentrated SEDUCA:</td>
</tr>
<tr>
<td></td>
<td>payment to health personnel</td>
<td>payment to teachers (payroll)</td>
</tr>
<tr>
<td></td>
<td>(payroll)</td>
<td>Management of teaching personnel.</td>
</tr>
<tr>
<td></td>
<td>Management of health personnel.</td>
<td>Control of norms.</td>
</tr>
<tr>
<td></td>
<td>Control of norms.</td>
<td>Delivery of certificates.</td>
</tr>
<tr>
<td></td>
<td>Infrastructure for secondary and tertiary care (if not transferred to municipalities).</td>
<td></td>
</tr>
<tr>
<td>Municipalities</td>
<td>Infrastructure (Hospitals)</td>
<td>Infrastructure (Schools)</td>
</tr>
</tbody>
</table>


65. Additional factors further complicate the situation. Departmental sector directors fill two—often conflicting—roles. They report to departmental governors but also depend on central government sector ministries. Moreover, departmental budgets are not clearly delineated. Department governments participate in the elaboration and partly also in the execution of a number of ministerial budgets. Each sector has its own logic and pattern of involvement of departments. A substantial part of departmental budgets is, in truth, in the national budget. The road sector budget, for instance, is agreed by each departmental SEPCAM individually with the Ministry of Finance directly, without being coordinated or rationalized with sectoral road policies, or departmental budget policy. The nine SEPCAMs, as autonomous institutions, illustrate the diffused, often confusing roles involved in the execution of departmental budgets. There is a need therefore for a much clearer distinction between national and departmental functions (such as accounting and budgeting) to obtain more adequate accountability across levels of government. This should be considered a prerequisite to the enhancement of the subnational governments' capacities.
III. Problem Three: Inequitable Fiscal Decentralization

III.1 Earmarking of Revenues to Certain Regions

66. Transfers from "regalías" and HL provide ear-marked revenues to hydrocarbon "producing" regions. This eliminates the possibility of their being used for other beneficiaries and purposes, some of which might net higher social and economic returns.

67. Ear-marking has put additional fiscal pressures on the treasury. A provision of Bolivia’s regional pact on hydrocarbon earnings provides that, each time a “producing” department receives a higher share of these revenues, “non-producing” departments have to be compensated with additional treasury funds. But this has further drained scarce treasury funds from non-hydrocarbon sources. For a related reason, the Departmental Compensation Fund has not worked properly, as demonstrated further below.

III.2 Transfer of Revenue Without Expenditures Assignments

68. As noted in the earlier, roughly two-thirds of the additional tax resources to be collected from the HL,\(^{10}\) will be provided to the regions and municipalities. Their distribution, though, will change somewhat over time as follows (Table 6):

- Central Government will keep 36 percent of the tax revenues of the Direct Hydrocarbon Tax (*Impuesto Directo a Hidrocarburos*, IDH) in the first year. This percentage will decline to 32.5 percent in 2007.
- Regional governments will receive 33 percent of IDH’s tax revenues, a share which will remain constant.
- Municipal governments and decentralized institutions (such as universities) will get 24.8 percent and 6.2 percent respectively of the IDH revenues in the first year. These shares will later increase to 27.6 percent and 6.9 percent.

<table>
<thead>
<tr>
<th>Royalties and IDH (US$ millions)</th>
<th>Former Law (First Year, 2006)</th>
<th>New Law (Fourth year and afterwards)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>132.0</td>
<td>208.9</td>
</tr>
<tr>
<td>Regional Government</td>
<td>203.1</td>
<td>326.5</td>
</tr>
<tr>
<td>Municipal Government</td>
<td>119.5</td>
<td>132.9</td>
</tr>
<tr>
<td>Decentralized Institutions</td>
<td>29.9</td>
<td>33.3</td>
</tr>
<tr>
<td>Total</td>
<td>335.1</td>
<td>701.6</td>
</tr>
</tbody>
</table>

*Source: World Bank estimates.*

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10. Technically, the HL eliminates a 31 percent tax on old fields (representing about a fifth of hydrocarbon production), called participaciones, and introduces a 32 percent tax, called IDH, which applies to all hydrocarbon production.
69. In addition, after the HL’s implementation, sub-national governments will carry out 35 percent of public expenditures, up from 27 percent in 2004. These changes mean that Bolivia will become more decentralized in fiscal terms.

70. Significantly at the same time, the HL provides for the transfer of these resources without additional expenditure assignments. In contrast with most Latin American countries, however, the resources made available originate from future revenue streams. From this perspective, the central government does not experience a revenue loss through decentralization (and could even still improve its fiscal position). Still, the additional revenue should be used by sub-national governments for additional expenditures and parallel reduction of central expenditures, but this is not the case. This violates the principle of decentralization by which resources should be transferred with new expenditures and vice versa.

III.3 Volatile and Uncertain Resource Flow

71. A significant share of resources for sub-national governments is based on either volatile or uncertain resources. An increasing share of revenue is from hydrocarbons which is a volatile source; they are volatile in the future because of the uncertainties of future hydrocarbon output, as well as its prices. The Departmental Compensation Fund (analyzed further below) is not working properly. The HIPC funds for municipalities will be phased out in coming years. Moreover, resources from the general revenue sharing pool are sometimes not transferred in cash but in quasi-money instruments (Fiscal Credit Certificates; Certificados de Crédito Fiscal, CCF). This volatile and uncertain resource flow implies two sets of problems.

72. The first is the limited absorptive capacities of sub-national governments to cope with sudden increase in resources. Transfers to both municipalities and departmental governments will increase by 55 percent on average from 2005 to 2006, and much more in the smaller departments (e.g., Pando). These incremental funds will far exceed these governments’ effective spending faculties. This limitation has already been quite evident. Departmental governments actually accumulated funds in 2000-2004. They did not invest the added resources. Neither did the municipalities fully invest their HIPC proceeds, some of which simply went into bank accounts. Unfortunately therefore, these experiences indicate that just providing sub-national governments more resources will not necessarily help to improve their services.

73. Second, it is unclear which additional expenditure responsibilities the sub-national governments might assume in the context of a volatile resource flow. If the added revenues went to meet rigid administrative expenses, this could complicate budget management, and even perhaps obstruct any adjustments needed for fiscal stabilization. This could happen, for example,

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11. While Decree 28421 from October 2005 earmarks the resources to certain sectors as well as foresees the transfer of additional responsibilities in the areas of rural development, employment creation, and public health (brigadas móviles, disease prevention, others) to municipalities and prefectures, it is not clear as of yet whether the central government will stop providing such services, and/or in which jurisdictions such activities were carried out in practice. These two factors largely determine if the measures foreseen in Decree 28421 will contribute to fiscal neutrality of decentralization. Also, the Decree does not clarify responsibilities among departmental governments and municipalities.

12. HIPC funds will be phased out in the coming years.

13. Aggregate fiscal balances for departments are in 2000 (-10 million USD); in 2001 (-5 million USD); in 2002 (-8 million USD); in 2003 (20 million USD); in 2004 (46 million USD). In 2004, the surplus of 45 million USD represents a quarter of their current revenue (Data: Ministry of Finance, 2005).
if the resources were used to cover long-term obligations, such as the wages for newly hired employees contracted for over many years. Volatile revenues could therefore limit the options for new expenditures in sectors with high levels of current spending.

74. The net result of all these factors is the fostering of additional problems of fiscal management and transparency. A staggering resource flow can also undermine the trust among different government levels, which is needed for successful decentralization.

III.4 Vertical Fiscal Imbalances: High Levels of Transfer Dependence

75. As all countries, Bolivia’s levels of government have vertical fiscal imbalances: the own revenue of departments and municipalities is smaller than their expenditures needs (Figure 5). In 2004, municipalities raised 1.8 percent GDP in revenue but their expenditures were 5.5 percent GDP. The departmental governments raised 0.9 percent GDP but their expenditures were 2.5 percent GDP. Intergovernmental transfers—from revenue-sharing and royalties, among others—exist to fill this fiscal gap among revenues and expenditures.

Figure 5. Revenue and Expenditures per Level of Government (in percent GDP) and Vertical Fiscal Imbalances, 2004


76. Municipalities are relatively dependent on transfers. This dependence has been close to 68 percent, and is increasing to over 74 percent in 2006 as a result of the HL (Table 7 below). There are huge variations among urban and rural municipalities, the latter being particularly dependent on transfers. Meanwhile, though, the municipalities have access to own tax revenue (automobile and property taxes)—which they underutilize.

14. This includes donations. The own revenue of prefectures (fees) is merely 0.1 percent of GDP.
77. Departmental governments are even more transfer dependent. Their revenues have relied 96.6 percent on transfers, which will rise to 99 percent in 2006 with the new hydrocarbon funds. In the future, moreover, they could actually obtain larger transfers for decentralized expenditures. This would produce even greater vertical fiscal imbalances, which could be very problematic. Transfers create lines of accountability towards the central government. Also, with the increased volatility of revenue streams because of the higher share of hydrocarbons, departmental governments will become vulnerable to greater financial risk. As mentioned, this in turn could aggravate the possible problem of inflexible uses of the new HL resources.

Table 7. Decentralization Ratios Before and After the Hydrocarbons Law, 2004–2006

<table>
<thead>
<tr>
<th>Regions (prefecturas)</th>
<th>Before (percent, 2004)</th>
<th>After (percent, 2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure decentralization ratio</td>
<td>8.6</td>
<td>13.2</td>
</tr>
<tr>
<td>Tax decentralization ratio</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Transfers dependency ratio</td>
<td>96.6</td>
<td>99.3</td>
</tr>
</tbody>
</table>

Municipalities

| Expenditure decentralization ratio | 18.3 | 21.5 |
| Tax decentralization ratio | 5.4 | 4.5 |
| Transfers dependency ratio | 67.6 | 74.2 |

Sub-national governments

| Expenditure decentralization ratio | 26.9 | 34.7 |
| Tax decentralization ratio | 5.8 | 4.9 |
| Transfers dependency ratio | 66.6 | 73.1 |

Notes: a = expenditures of prefecturas/total public sector expenditures; b = taxes of prefecturas/total taxes of public sector; c = transfers/total resources. Analysis in departmental governments excludes payroll.


III.5 High and Increasing Regional Inequality in Transfers

78. One of the main obstacles to installing an effective decentralization scheme and obtaining greater interregional equality is the current transfer system, particularly as it affects the departments. The existing inequities in resource distribution are a major impediment to achieve social inclusion.

79. The criteria used to allocate between the various regions the total amount of money to be transferred do not serve any of the possible objectives of a transfer system in terms of correcting for horizontal imbalances. Origin of hydrocarbon revenue plays a key role; that is, “producing” departments obtain more. The “non-producing” departments obtain an equal share per region, irrespective of the population or wealth of each region. This implies significant regional inequality in distribution of resources.

80. Transfers are highly unequal across departments in per capita terms, as shown in Table 8 and Figure 6. The La Paz department receives only US$15.8 in transfers per capita, while Tarija receives US$246 per capita, and Pando US$407.2 per capita. The new hydrocarbons law worsens this situation. The changes introduced by the law have an impact upon horizontal disparities among departmental governments. Transfers to departmental governments, which were already very unequal (on a per capita basis), are made even more unequal by the HL. Transfers were counter-redistributive before the new law, and now they are even more counter-redistributive. The same is true for expenditures per capita. Far from reducing interregional disparities in the
country, transfers to departmental governments actually contribute to increase these disparities. Such differences not only fuel regional resentment; they do not contribute to putting Bolivia's departmental governments on an equal footing with regards to the level of public expenditures.

Table 8. Impact of Hydrocarbon Law (HL) on Interregional Transfers and Disparities (in US$ per capita), 2005–2006 (projected)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Chuquisaca</td>
<td>20.7</td>
<td>48.5</td>
</tr>
<tr>
<td>La Paz</td>
<td>9.5</td>
<td>15.8</td>
</tr>
<tr>
<td>Cochabamba</td>
<td>20.1</td>
<td>30.3</td>
</tr>
<tr>
<td>Oruro</td>
<td>22.2</td>
<td>60.0</td>
</tr>
<tr>
<td>Potosi</td>
<td>15.0</td>
<td>35.8</td>
</tr>
<tr>
<td>Tarija</td>
<td>199.2</td>
<td>246.0</td>
</tr>
<tr>
<td>Santa Cruz</td>
<td>18.4</td>
<td>25.7</td>
</tr>
<tr>
<td>Beni</td>
<td>31.0</td>
<td>71.8</td>
</tr>
<tr>
<td>Pando</td>
<td>125.5</td>
<td>407.2</td>
</tr>
</tbody>
</table>

Note: For year 2005, numbers are based on the annual budget. For 2006, numbers are estimates only.

Figure 6. Transfers from Hydrocarbon Law (in USD per capita) and Poverty Criteria (GDP per capita), 2005–2006 (projected)

Note: For year 2005, numbers are based on the annual budget. For 2006, numbers are estimates only.

81. The transfer system for municipalities that existed previous to the approval of the hydrocarbons law does not create horizontal inequities in municipal expenditures. Transfers on

15. Measured among municipalities grouped in each department. The law increases transfers, but does so in a roughly proportional fashion. Municipal transfers per capita, which were largely equal, remain equal. The new HL distributes resources also on a per capita basis.
16. For year 2005, numbers are based on the annual Budget (IEDH + Compensation Fund + Royalties). For 2006, numbers are estimates only (IDH + Compensation Fund + Royalties).
a per capita basis are fairly equitable and do not vary much from one region to the other. This situation is likely to remain so in the future given that hydrocarbons resources are distributed to municipalities on a per capita basis.

82. The increase in horizontal disparities—in a country where these disparities are already very large—can bring a series of negative consequences. It could favor interregional migrations. Some migration may be desirable. But too much too fast will involve very high social and human costs. A valuable social and economic capital in out-migration regions will remain under-utilized. Conversely, in in-migration regions, the pressure on social and economic infrastructure will be much increased. The likely results are under-utilized schools in one place and over-utilized schools in another. Politically, a widening of regional differences will put a heavy burden on the very notion of national unity. Furthermore, the high inequality of transfers does not support the goal of achieving social inclusion. This is unfortunate since departmental governments could play a useful role to achieve higher inclusion.

83. In the meantime, the mechanisms foreseen to reduce inequality among departments have been ineffective. The Departmental Compensation Fund has not worked properly. There have not been sufficient funds to compensate "non-producing" departments. In the Compensation Fund there is an increasing gap between the resources that are needed to compensate, and the resources that are effectively transferred.

III.6 Weak Fiscal Responsibility and Poor Management of Sub-National Debt

84. Ensuring sub-national fiscal stability is another major concern. In 1999, several municipalities could not pay their debt service after the 1994 decentralization process increased their expenditure responsibilities. At the time also, sub-national debt was under-regulated and poorly monitored, and the situation was aggravated by adverse macroeconomic developments. As a result, particularly the most populous municipalities (most of them "capitales de departamento") over borrowed.

85. Faced with this growing problem, the central government intervened in insolvent municipalities in 2000. It set up the "Programa de Readejucación Financiera (PRF)", a fund partially capitalized by revenue-sharing transfers complementing international financial support. The resources mobilized were used to pay suppliers and helped to reschedule the outstanding debt. This marked, for the first time since decentralization was launched, the Central Government's establishment of a tighter framework for municipal finances. This action brought down the aggregate municipal debt without actual write-offs, but debt reduction has not followed in all the municipalities and prefectures. Some sub-national governments have failed to respect their annually set debt targets, including Santa Cruz and Cochabamba, two of the larger municipalities.

86. Today, the total sub-national debt is not fully or precisely known. Also, the size of the departmental and municipal debt stock (roughly 5 percent of GDP) is known to be understated because of unregistered borrowings and suppliers debt. However, data from the system of debt

17. For this analysis, municipalities were grouped within a department. To confirm the above mentioned hypothesis one would need to also know the fiscal capacity of municipalities, but which is unknown. Since the (unknown) municipal tax base per capita is probably a function of GDP per capita, this suggests that tax rates vary greatly from one region to another. For instance, the ratio of municipal taxes to GDP—a proxy of the municipal tax effort—is twice as large in the La Paz department than in the Santa Cruz department.
capacity indicators now in place suggests that the new HL resources should give both
departmental governments and municipalities room to acquire more debt.

87. It bears noting, too, that sub-national borrowing has poor oversight and very limited
transparency. Most municipal debt today is floating debt, particularly from suppliers, which is
admittedly difficult to monitor.

88. The rules for sub-national debt are narrow and fail to encompass fiscal responsibility
rules. It would be important to not focus exclusively on debt service but rather to adopt a wider
fiscal responsibility perspective. For example, once the departmental governments are elected,
their new leaders might conceivably not wish to recognize the debt stock contracted previously.
Although that stock appears to be limited (roughly to 0.5 percent of GDP), its size could increase
rapidly if these governments do not follow responsible fiscal policies. An additional set of fiscal
issues is related to new spending pressures that could arise, particularly during the take-off
periods of further decentralization. Most countries undergoing this process had to cope with
these kinds of pressures that surfaced when their central governments could not readily reduce
their sizes in proportion to the sub-national governments’ assumptions of new tasks. Theoretically also, there could potentially be new regional taxes to restrain excessive sub-
national spending-- but their magnitude is likely to remain limited and therefore alone cannot set
a new incentive framework for responsible fiscal management.

89. Bolivia’s future thus seems particularly vulnerable to suffer some of the typical ills that
afflict decentralizing states. A failure to follow prudent fiscal policies may create negative
externalities on a number of fronts, some of which already materialized in the recent municipal
debt crisis. Such behavior, if unchecked, could enlarge the country’s already existing
“reputational risk” and perhaps even ultimately threaten the stability of its financial system,
creditworthiness and overall macroeconomic order.

IV. Conclusion

90. The second phase of decentralization in Bolivia faces significant challenges to make it a
success. There are three basic problems that need to be addressed.

(i) **There is an inappropriate strategy for the implementation of decentralization.** This
is apparent, among others, in the entry points for decentralization that have been selected
and implemented as well as in the sequence of providing revenue without expenditures.

(ii) **The institutional framework is weak and inefficient.** Departmental governments do
not have sufficient autonomy to manage resources; and responsibilities among levels of
government are disjointed and fragmented. This undermines accountability towards the
citizens.

(iii) **The intergovernmental fiscal framework leads to inequity in resource distribution
and weak fiscal responsibility.** Underlying to this is the ear-marking of revenue; fiscal
pressures generated by current royalty distributions; resources transferred without
expenditure responsibilities; the lack of own revenue on departmental level and high
transfer dependence from the Central Government; inequalities in transfers among
regions; as well as non-transparent management of sub-national debt.
91. There is the risk that the second phase of decentralization will not lead to the desired outcomes if these three problems are not addressed properly. This would have serious consequences: a further decline in service quality; additional fiscal pressures that undermine the recent process of fiscal adjustment; and weakening of governance implied in regional conflict. Taken together, these conditions limit the opportunities to achieve social inclusion as one of the current administration's main policy goals.

92. Taking this into account, the country needs a strategy that establishes a vision of the future role and responsibilities of departmental governments; balances symmetric with asymmetric elements in light of uneven institutional capacities at national and sub-national levels as well as demands for new expenditure responsibilities; lays out a sequence for gradual implementation so that fiscal pressures are kept in check and capacities are not overstretched; builds incentive frameworks for improving services that lead to more accountability; and gradually provides more autonomy in resource management in line with fiscal responsibility rules.

93. This new strategy would need to be substantially different compared to the strategy that was underlying municipal decentralization in the first phase (1994-2004). This implies the following:

- Instead of merely transferring investment expenditures to sub-national levels (which has kept fiscal neutrality of transfers), future decentralization should create joint decisions on current and investment expenditures, in benefit of higher productive efficiency as well as delineation of responsibilities.
- Instead of being mainly transfer-driven, future decentralization should create opportunities for own-revenue generation.
- Instead of fostering participation principally of local communities, future decentralization should create incentives and opportunities for participation of the private sector and business.
CHAPTER 3. THE BUILDING BLOCKS OF A DECENTRALIZATION STRATEGY

94. This chapter lays out the elements and building blocks of a suitable strategy in light of the analysis of decentralization carried out above. The strategy takes into account five elements: (i) the vision of regional governments’ future roles, (ii) asymmetry and symmetry in decentralization, (iii) entry points and sequencing of implementation, (iv) incentive frameworks, and (v) allocative efficiency and fiscal responsibility.

95. For decentralization to be “strategic,” it is useful to consider how best to build an incentive framework conducive to improving services, strengthening accountability and enhancing fiscal responsibility. It may, therefore, be helpful to review the principles for successful decentralization which are now widely recognized and accepted as good guidelines. The three main ones are:

- **Finance should follow functions**: responsibilities should be transferred jointly with resources, and vice versa.
- **Define responsibilities clearly**: each level of government should know what tasks it is responsible for.
- **There should be fiscal neutrality and fiscal responsibility**: national, regional and municipal levels should function within hard budget constraints. Decentralization should not impose additional costs.

I. Developing a Vision of Regional Governments’ Future Roles

96. European and Latin American experiences have been marked by the development of different models for regional decentralization and by varied organizational experiments. As a result, the roles and functions of regional government in unitary countries have become increasingly diversified (Table 9).

Table 9. Principal Roles of Regional Governments

<table>
<thead>
<tr>
<th>Roles</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning</td>
<td>Venezuela (regional planning authorities), Colombia (regional planning authorities), France (regional government; with some executive capacity)</td>
</tr>
<tr>
<td>Political representation of the central government</td>
<td>Spain <em>(Delegado del Gobierno)</em>, Ecuador <em>(Gobernaciones)</em>, Peru <em>(Prefecto)</em></td>
</tr>
<tr>
<td>Agent of the central government for investment coordination</td>
<td>Chile, Ecuador (theoretical role of the <em>Gobernaciones</em>)</td>
</tr>
<tr>
<td>Agent of the central government for direct service provision</td>
<td>Bolivia, Peru <em>(Consejos Transitorios de Administración Regional until 2002)</em></td>
</tr>
<tr>
<td>Elected regional government for direct service provision</td>
<td>Colombia, Ecuador <em>(Prefecturas)</em>, Peru (since 2003), Spain (with regulatory and legislative capacity), France (departments)</td>
</tr>
<tr>
<td>Elected regional government in a federal system</td>
<td>Venezuela (semi-federal), Chile, Argentina, Peru</td>
</tr>
<tr>
<td>Steering regional competitiveness</td>
<td></td>
</tr>
</tbody>
</table>

*Source: World Bank.*
97. These roles can be—and probably should be—envisioned in early stages of the reform. But it is also true, that nobody can foresee the final model of regional government as outcome of reform processes require several decades. Usually, the role of regional government evolves over time and frequent adjustments are made (Figure 7):

**Figure 7. Evolving Roles of Regional Government in Country Cases**

- **Years**
  - 0
  - 10
  - 20
  - 30
  - 40

- **France**
  - 1956: Creation of Regional Planning Authorities
  - 1972: Intergovernmental representation
  - 1986: Election of regions and departments

- **Chile**
  - 1976: Deconcentrated regional government
  - 1992: Municipal representation
  - 2002: Elected regional government?

- **Spain**
  - 1979: Election of new regional government
  - 2000: Discussions for federalization of Spain

- **Colombia**
  - 1991: Election of departmental government
  - 2002: Elimination of Regional Planning Authorities

- **Peru**

*Source: World Bank.*

98. Bolivia’s circumstances warrant its consideration of three functions for its regional governments:

- Planning: which does not necessarily imply management of resources;
• Investment coordination: where regions have resources and autonomy in deciding where and on what these resources are going to be spent;
• Service provision in health, education, roads, or the like.

99. It is useful, therefore, to review the different conditions for success for each of these functions that need to be in place in order to be effective (Table 10). For the present, though, it would appear that Bolivia's prefectures are likely to mainly be service providers, although roles of planning and investment coordination may evolve later on in a complementary fashion.

Table 10. Regional Governments' Conditions of Success

<table>
<thead>
<tr>
<th>Potential Roles</th>
<th>Condition of Success</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regional governments as planning institutions</td>
<td>Planning is complemented with financial incentives.</td>
</tr>
<tr>
<td></td>
<td>Planning and budgeting are integrated.</td>
</tr>
<tr>
<td></td>
<td>Regional Planning contributes to national policies.</td>
</tr>
<tr>
<td></td>
<td>Regional Planning is linked to national planning.</td>
</tr>
<tr>
<td>Regional governments responsible for investment coordination</td>
<td>Regional governments can offer sufficient incentives for other levels of government (or service providers) to coordinate.</td>
</tr>
<tr>
<td></td>
<td>Clear debt service arrangements are in place.</td>
</tr>
<tr>
<td></td>
<td>Transparent rules exist on investment decisions.</td>
</tr>
<tr>
<td>Regional governments as service delivery providers</td>
<td>They have the freedom to decide on needed inputs (budget flexibility).</td>
</tr>
<tr>
<td></td>
<td>They have spending autonomy</td>
</tr>
<tr>
<td></td>
<td>Clear institutional arrangements exist between national and regional levels, e.g., roles of sector directorates in regional governments are clear; a professional civil service regime exists; there are well defined service responsibilities.</td>
</tr>
<tr>
<td></td>
<td>Regional delivery of services is linked to national monitoring and evaluation systems.</td>
</tr>
</tbody>
</table>

*Source*: World Bank.

100. **Assumptions for optimal implementation.** The following are assumptions for achieving the full benefits regarding the future role of regional governments:

• There is open dialogue among participating actors and they are willing to join in at least minimal agreement on the future roles of regional governments.
• Actors are willing to accept some of the opportunity costs of different organizational models.
• There is also accord that the decentralization strategy chosen may be adjusted to meet new circumstances.

**II. Balancing Symmetric and Asymmetric Decentralization**

101. Countries regularly consider the degree of uniformity that should exist among sub-national responsibilities. From a theoretical point of view, the higher the level of uniformity (symmetry), the greater are the levels of coordination and their benefits. However, local capacities and sub-national demands are usually disparate, requiring asymmetric decentralization (under which regions can implement decentralization processes at different depths, scopes and paces).
102. The proposals that have been put forward in Bolivia about regional government’s future responsibilities, as well as the country’s structural conditions, seem to imply that its decentralization is likely to proceed in an asymmetric fashion. Some sectors, like education and health, might define their individual institutional standards for departmental governments that have to be met to be eligible for decentralization (e.g., “certification” in Colombia or Peru). Another factor is that some local opponents of regional decentralization might successfully interfere with its implementation. The Government might therefore decide to negotiate one-to-one deals with individual regions on their adoptions of new responsibilities (as in Spain). Fiscal shortages might impede funds disbursements (as in Ecuador).

103. Under these circumstances, the recommended approach is to balance symmetric with asymmetric elements so as to limit additional costs of coordination implied in an asymmetric decentralization process. This would mean that some areas of responsibility would be identical in all regional governments, while individual regions may adopt additional or different responsibilities in other areas.

104. Assumptions for optimal implementation. We suggest consideration of the following factors for determining the blend of asymmetric and symmetric approaches:

- There are clarity and technical information available to gauge which approach would have positive or adverse effects.
- There are incentives available for proceeding with one or the other approach that can be agreed on and implemented.
- Bargaining schemes can be adopted for lowering transaction costs and providing oversight of institutional arrangements.

III. Entry Points for and Sequencing of Implementation

105. There are no pure models for a vision of a decentralized state. And any decentralization process is, by definition, gradual. Its constituent measures, therefore, have to be appropriately sequenced. To illustrate this, the scenarios described in this report set out phased approaches for decentralization in the health, education and roads sectors.

106. They address how these sectors’ responsibilities can be assigned at national, regional and municipal levels. This is very pertinent because Bolivia’s intergovernmental system is featured by concurrent (or shared) responsibilities that are blurred. This is partly a result of how decentralization was (somewhat unfortunately) implemented in the past. It was a political decision to first decentralize at the municipal level; and only later complete it at departmental levels. (The process was initially perceived as a means of strengthening departmental or municipal levels—but not both simultaneously.) So for future decentralization, it would be essential to employ different entry points and implement them differently. For this purpose, we recommend that the process follow a sector-oriented logic. This would facilitate the assignment of clearer responsibilities at different governmental levels. It should later permit the realization of the potential benefits of more efficient service delivery and greater accountability. This IGR consequently identifies feasible entry points, cites the important conditions that should be present for their usage, and recommends suitable sequencing measures.
107. **Assumptions for optimal implementation.** The following are important factors for selecting an optimal sequence of implementation:

- Actors agree on a vision of decentralization, and commit to its realization. (This would be enhanced by obtaining some “quick wins” early on so that the decentralization process maintains credibility and popular support).
- There is an incentive framework for sector decentralization.
- Decentralization takes place as simultaneously as possible in each region (and symmetrically in the pertinent sectors).
- Intermediate targets are spelled out.
- The Government is prepared to withstand pressures for suboptimal forms of decentralization (in their depths, paces and scopes).

**IV. Building Incentive Frameworks**

108. The political pressures for further decentralization in Bolivia are not necessarily incompatible with the demands for improving public services. A well thought-out strategy can serve both objectives. This can be achieved through establishing “win-win” situations between national and sub-national governments which address mutual interests. For this purpose, the central government could craft bargaining packages that contain the following components of a suitable incentive framework:

- a funding formula,
- service quality indicators that can be regularly, easily monitored, and
- entry points for the transfer of responsibilities.

109. The proposal here is to depart from other Latin American countries’ approaches. These often assumed that it was most important to meet a set of ex-ante conditions which tended to measure the past performances of municipal and regional governments. Instead, we recommend that Bolivia’s decentralization framework be “forward looking”: instead of transferring resources reflecting historic budget allocations, it would be better to transfer funds tied to incentive-based formulae (even if this results in different amounts). It would also be advisable to commit sub-national governments to providing improved services within an accountability framework of checks and balances. Also, instead of adopting “certifications”\(^\text{18}\) of sub-national governments—

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18. Decree no. 28666 of April 5, 2006, establishes a “certification” system for Bolivian departmental governments, without yet defining the technical criteria to be used to assess subnational capacity. As mentioned above, “certifications” of subnational governments have—in the institutional context of many Latin American countries—often not been efficient. The reasons are, among others, the difficulty in finding objective and measurable indicators not only to assess general local government capacity, but also sector-specific capacity that is required to deliver decentralized services in health, education, or roads. Such indicators necessarily measure only past performance, and not future potential of local governments. In addition, there is a high level of credibility and commitment that is needed from central government in refraining from transferring responsibilities to non-eligible subnational governments, in light of regional pressures and from the “bottom-up” to do so. For these reasons, a more suitable approach is to assess minimum institutional capacities based on core systems for more accountability; track performance for given level of service delivery; improve the quality of these services; and start with transfer of those responsibilities that are suitable for a large number of municipalities or regions.
as followed in Peru and Colombia, for instance—it is suggested that emphasis be placed on providing incentives for improved services.

110. At the same time, it is clear that the types of sophisticated decentralizations implemented in Canada, Spain and other European countries that are more results-oriented are not workable without very clearly delineated responsibilities. Unless such conditions are in place, intergovernmental agreements are unlikely to be very effective. Therefore, at the present status of Bolivia’s transition towards a more decentralized state, its possibilities of effectively pursuing results-based arrangements do not appear to be very strong.

111. Assumptions for optimal implementation. The following are important factors for the application of incentive frameworks:

- The central level has sufficient leverage to offer bargaining packages to regional governments that are of mutual interest (e.g., raising taxes at local levels).
- Indicators of successful attainment of service improvement goals can be monitored easily and without the need for a technocratic apparatus.
- Indicators and targets are published.

V. Managing Transitions: Sacrificing Productive and Allocative Efficiency for Greater Fiscal Responsibility

112. Decentralization offers the potential benefit of boosting efficiency. Sub-national governments are, in theory at least, more knowledgeable than central governments about local problems and combining factor inputs at that level (productive efficiency). Also, they are more knowledgeable about services which the population needs most (allocative efficiency). In Bolivia’s transitional status, however, it would be well advised to sacrifice both productive and allocative efficiency in the foreseeable future for more effective expenditure coordination and fiscal responsibility. This implies that, among others:

- There is ear-marking for sub-national expenditures.
- There are fiscal responsibility rules which set ceilings on the hiring of human resources.
- Sub-national debt capacity is assessed by taking into account fungible revenue in light of rigid expenditures, such as debt service and expenses for payroll.

113. Fiscal neutrality of decentralization is another concern. In recent years, Bolivia has had high fiscal deficits, e.g., the aforementioned NFPS deficit of 6.2 percent of GDP in 2004. It is therefore particularly important to consider if near term decentralization could help serve to lower, or at least maintain, the present level of deficit (fiscal neutrality in the strict sense), or to determine if these deficits might instead increase (least desirable outcome). To be sure, there are other, more effective strategies to lower public deficits than decentralization. But if the latter is not implemented along with a related goal of fiscal neutrality, it might derail the Government’s reform program and worsen its macro-economic conditions.

114. On these accounts, sub-national governments need to concentrate on having more transparent revenues and expenditures, and on establishing mechanisms, which could enable them to monitor the fiscal neutrality of their decentralized decisions. The measuring of fiscal neutrality is methodologically challenging, and made difficult for instance by general revenue-
sharing formulae as applied in Bolivia which imply fluctuating transfers according to macro-economic cycles. However, the following indicators could be used to assess the extent to which fiscal neutrality is kept:

(i) **Sector budgets.** Costing exercises demonstrate that the funding for newly devolved responsibilities would be available from current resources.

(ii) **Overall balance of the national, departmental and municipal governments.** It is important to assess the extent to which a given decentralization measure would affect the overall balance of each level. Hence, vertical imbalances for each and among the levels of government would have to be identified.

(iii) **Overall balance of the NFPS.** Although decentralization actions can affect the balances of each of the three government levels, they may still be consistent with overall deficit targets. The scenarios to be followed should therefore be assessed with regard to the overall NFPS balance.

115. **Assumptions for optimal implementation.** The following are important factors to implement a fiscal responsibility framework:

- Prompt actions can be taken to control deficit increases resulting from the new HL.
- Redistribution of funds happens before decentralization takes place in the sectors.
- Elected governors accept a new framework which limits their decision-making autonomy in the combination of inputs to produce services (productive efficiency) as well as the specific services required by the population (allocative efficiency). Fiscal responsibility rules are accepted and applied.
- Ex-ante rules and ex-post conditions for prudent borrowing are in place and constrain lenders and borrowers.
- Sanctions for non-compliance with precautionary fiscal rules can be enforced.
CHAPTER 4. POLICY OPTIONS FOR A SHORT-TERM DECENTRALIZATION SCENARIO

116. This chapter lays out a set of policy options for the short-term. They comprise a set of initial steps that could be given priority and that serve to prepare the terrain to deepen measures in the medium-, and long-term. This chapter first lays out the particular strategy that should be followed. In a second step, it describes the policy options to improve the institutional arrangements; and in a third step, it describes the policy options related to fiscal decentralization. The fourth and final section describes the expected outcome of the short-term decentralization scenario.

I. Decentralization Strategy for the Short-Term: Ensuring Basic Institutional Capacities and Correcting Inequalities

117. An effective decentralization strategy requires that its measures would only be undertaken in the framework of a well supported platform of sequenced political decisions and reforms. A basic political consensus is necessary on the following guiding principles (Box 5).

<table>
<thead>
<tr>
<th>Box 5. The Pre-condition for Successful Decentralization: A Basic Political Consensus</th>
</tr>
</thead>
<tbody>
<tr>
<td>• All participating actors should agree that decentralization measures to be taken and implemented should be responsible and neutral in fiscal terms (e.g. avoiding additional expenditures for decentralization).</td>
</tr>
<tr>
<td>• All participating actors should agree that fiscal arrangements for decentralization, including actions on transfers, would mainly aim at the reduction of horizontal imbalances in the delivery of services. This agreement implies that the current distribution of transfers in equal shares to departments is not necessarily the solution to the problem of poor service quality.</td>
</tr>
<tr>
<td>• All participating actors should agree that current service delivery conditions have to be maintained in the short-term, and need to be improved in the medium- and long-term.</td>
</tr>
</tbody>
</table>


118. Once consensus is reached on these principles, decentralization could be implemented gradually, with different steps to be taken in the short-, medium-, and long-term.

119. In the first phase (Short-Term) the emphasis should be on ensuring basic institutional capacities and correcting inequalities.

• **Institutional:** improve regional management tools. This should encompass financial management, human resources, procurement and monitoring and evaluation, and corresponding systems. The strategy should focus on ensuring adequate basic institutional capacities before giving regional governments or municipalities more revenues or expenditure responsibilities.

• **Fiscal:** (i) improve the distribution of resources with a view on basic equity (per capita formula for transfers); (ii) Basic fiscal responsibility rules.
II. Strengthening Institutions for Decentralization

II.1 Management Tools for Decentralization

120. The SAFCO Law created financial and control systems for public sector management. Some of these systems need to be implemented at regional levels for transparent departmental government management. So too do mechanisms to monitor and evaluate public expenditures and service delivery. In their absence, departmental authorities will not control their own operations; the Central Government and citizens will not be able to assess the use of public funds; and there will remain opportunities for inefficiencies and corruption in public activities.

121. At the departmental level, the implementation of the SAFCO systems is limited. Their fuller operation will require the definition and installation of specific regulatory regimes, implementation of operating processes, and training of responsible officials and staff. In the short-term, these activities should be developed for four basic management systems with the emphases indicated below:

- Planning, to create adequate mechanisms for creating and obtaining agreement on operational plans and budget of the regions. This should help make public investment and service delivery of services more effective and efficient through enabling different levels of Government to coordinate their interventions.
- Financial Management, to upgrade control of and transparency in expenditures. The Central Government financial management system "SIGMA" might be adapted to departmental requirements.
- Procurement, to make the acquisition of goods and services transparent. The CPAR (a report prepared by the World Bank), provides a set of recommendations to improve procurement mechanisms in Bolivia.
- Human Resources, to replicate the good practices in effect at the central level for competitive recruitment and hiring of public employees, and control of their wage bill.
- Monitoring and Evaluation, to establish a set of indicators for service delivery monitoring and methodologies for its evaluation. These will allow the Central and Regional Governments to supervise the quality of the services and generate information to improve the public programs performance and the allocation of resources.

122. These systems need to be in place to allow the Central Government to better supervise uses of public funds and, principally, the efficiency of public service deliveries. Specific monitoring and evaluation methods should be developed for the main services now controlled by the Prefecturas and for those that will be decentralized in the near future. Chile provides good examples of these systems.

II.2 Autonomy for Efficient Allocation of Resources

123. The sub-national governments, particularly the departments, have to have more autonomy for managing their responsibilities. For this purpose, the Central Government should establish a national incentive framework aimed at increasing productive and allocative efficiency at local
levels. When it is installed, local governments could then gradually increase the scopes and depths of their responsibilities. The mechanisms to build an incentive framework are, among others: human resources management; earmarking of expenditures; sector formulae for service delivery; monitoring and evaluation systems; sector bargaining strategies for the transfer of responsibilities; and participatory and control mechanisms. The incentive framework is aimed at raising the interest of departmental government for an efficient allocation of resources, providing transparency in the use of public funds, and creating accountability among levels of government as well as citizens.

124. One particularly important area is human resource management. Useful modifications should include:

- Establishing wage and career policies for sub-national civil servants. These would encompass rules and methods governing their wages and pensions, career management, and decisions on their hiring and firing.
- Having departmental governments trained and provided technical assistance to fulfill their new roles effectively. This should include enabling the sector ministries to exercise stronger oversight. They also need to reinforce their units related to service delivery for functioning in more decentralized environments.

II.3 Creating the Conditions for Better Services: Preparatory Phase of Institutional Strengthening

125. In addition, there are certain sector-specific requirements that should be met at departmental levels prior to any new transfers of expenditures (Table 11).

Table 11. Preparatory Measures for Education, Health, and Road Decentralization

<table>
<thead>
<tr>
<th>Education</th>
<th>Health</th>
<th>Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Train departments on human resource management.</td>
<td>- Train departments on human resource management.</td>
<td>- Develop a national road sector strategy which involves the three levels of government.</td>
</tr>
<tr>
<td>- Prepare inventory (physical assets) for SEDUCAs previous to incorporation into the departmental government structure.</td>
<td>- Prepare inventory (physical assets) for SEDES previous to incorporation into the departmental government structure.</td>
<td>- Define the primary, secondary, and tertiary road network.</td>
</tr>
<tr>
<td>- Complete information on number of teachers per education level (primary/secondary) in each department, and pay levels (including benefits).</td>
<td>- Complete information on number of health personnel per service level (primary/secondary health) in each department, and pay levels (including benefits).</td>
<td>- Full disclosure of accounts of SEPCAMs.</td>
</tr>
<tr>
<td>- Complete information on teacher distribution among and within departments (urban/rural).</td>
<td>- Complete information on health personnel (doctors, nurses) among and within departments (urban/rural).</td>
<td>- Train departments on human resource management.</td>
</tr>
<tr>
<td>- Monitoring arrangements in place: select, discuss, and agree on basic set of indicators to measure service quality; define baseline in each department; define responsibilities in monitoring; define sanctions for</td>
<td>- Monitoring arrangements in place: select, discuss, and agree on basic set of indicators to measure service quality; define baseline in each department; define responsibilities in monitoring; define sanctions for</td>
<td>- Establish pool of public employees who would have to be trained and gradually retired.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Contracting out of all maintenance activities. Train departments on outsourcing strategies and tools.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Monitoring arrangements in place: select, discuss, and agree</td>
</tr>
</tbody>
</table>
monitoring; define sanctions for non-compliance. Improve and disclose the incentives framework for service delivery, especially the use of SUMI on basic set of indicators to measure service quality; define baseline in each department; define responsibilities in monitoring; define sanctions for non-compliance.


126. To these ends, changes are needed for the adoption and monitoring of service quality indicators (Table 12). They are different for the education, health, and roads sectors.

Table 12. Service Quality Indicators in Selected Sectors

<table>
<thead>
<tr>
<th>Education</th>
<th>Health</th>
<th>Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrollment rates</td>
<td>Health coverage indicators: (i) professionally assisted deliveries, (ii) coverage of pentavalente vaccination, and (iii) coverage of fourth Prenatal Care</td>
<td>Quality of primary, secondary, tertiary roads (International Roughness Indicator, IRI).</td>
</tr>
</tbody>
</table>


III. Fiscal Decentralization: A First Package of Measures to Improve Regional Inequality

III.1 Improve Regional Inequity: Redefining the Transfer Formula

127. In the short term, the new HL resources should be targeted on meeting specific expenditure requirements. These should be transferred on the basis of per capita formulas. This would help produce greater departmental revenue equality and contribute to social inclusion. A per capita formula is not only a sufficient proxy for expenditure needs. It is also accepted now in Bolivia as a transparent formula (it has been working for municipalities already). Several other countries in Latin America have often adopted much more complicated, and therefore also less transparent, transfer formulae (Table 13). However, if it facilitates the building of consensus on a new formula in the country, a poverty formula could also be given consideration. Compared to a per capita formula it is less transparent—and it raises the question how much more a poor region gets than the wealthier region—but it is still a valid approach to establish a basic level of equity and compensating for expenditure needs.

Table 13. Transfer Formulae in Selected Country Cases

<table>
<thead>
<tr>
<th>Mexico: Fondo General de Participaciones</th>
<th>45.17 percent distributed to the status on an equal per capita basis.</th>
<th>45.17 percent is allocated on a historical basis, starting with states’ own revenues just before the system started in 1980 and modified gradually by relative tax effort.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colombia: general revenue-sharing (participaciones municipales)</td>
<td>60 percent in proportion to the number of habitants with unsatisfied needs and relative level of poverty.</td>
<td>40 percent according to population, administrative efficiency, and improvement in quality of life.</td>
</tr>
<tr>
<td>Ecuador: 15 percent of general national revenue</td>
<td>70 percent to municipalities. From this share: 10 percent in equal shares; 40 percent population; 50 percent unsatisfied needs.</td>
<td></td>
</tr>
</tbody>
</table>

|---|

### Box 6. Improving Transfer Systems: Timing Reforms is Crucial

From Argentina to Germany, from Peru to Spain, many countries have been, or are in the process of, reforming their transfer systems. However, most were unable to completely overhaul their systems and many reforms failed.

Germany has not been able to adjust its system for over 15 years even though its excessive compensation and redistribution have been long recognized. Neither has Argentina succeeded in revamping the inefficient and opaque revenue-sharing arrangement (the so-called "fiscal labyrinth") adopted in the early 1990s despite the very high transfer reliance of most of its provinces. Colombia also had long appreciated that its 1993 formula was contributing to more fiscal pressures. But it took more than 7 years before its transfers were adjusted for better fiscal controls. Only countries like Canada appear to have been able to win such new fiscal pacts as the 1999 arrangement with its provinces agreeing on fundamental changes to the country's equalization scheme and financing means.

The lessons of these experiences are evident: Try to introduce reforms quickly before there are new beneficiaries of inefficient transfers who could block efficiency-enhancing reforms. Or try to reform transfer systems gradually and only at the margin, as in Colombia and others, for instance, Peru with the new formula for the Canon transfers.

Bolivia would be well advised to introduce speedy changes so that it does not get dragged into the piecemeal reforms that have hampered most other countries of the region. Therefore, the introduction of a per capita formula for the transfers related to the new hydrocarbon revenues would be an important near term policy measure.

### III.2 Fiscal Neutrality: Transfer of Revenue with Expenditures

129. New resources from the HL have been transferred without transferring new responsibilities in a way that would clarify roles among levels of government; and without providing opportunities for fiscal savings for the central government. Although the central government does not experience a revenue loss through decentralization (and could even still improve its fiscal position), the additional revenue should be used by sub-national governments for additional expenditures.

130. In the short term, to further improve Bolivia's fiscal situation, it would be desirable to consider decentralizing new expenditure functions without additional funding, both in departmental governments and municipalities, for example:
Departmental governments could adopt secondary roads expenditures in the amount of US$70 million (in 2006) in return for the hydrocarbon resources revenues (in the amount of US$120 million in 2006) without additional financing.

To compensate for the additional resources received, the at least nine capital municipalities could finance primary health care.

This approach would need the verification that at least minimally acceptable institutional capacities are in place before these expenditures are transferred.

Short of the possibility to transfer additional expenditure responsibilities, there are other options to improve the fiscal balance of the central government. The recent experience of other Latin American countries with regards to fiscal neutrality under decentralization can illustrate some useful options and measures (Box 7).

### Box 7. Achieving Fiscal Neutrality of Decentralization: Alternative Avenues and Strategies

Peru was the first country in Latin America to decentralize in line with the principle of fiscal neutrality. When it embarked on regional decentralization, the country established a one-to-one rule (pari passu). Under it, any new resource transfer to a sub-national government was to be accompanied by a corresponding cut at the central level. This has helped to protect fiscal sustainability and not distort vertical fiscal balances. The issuance of the Law of Fiscal Decentralization (2004), the regulations for the revamped Law of Fiscal Responsibility, and the Law on Accreditation of regional and local governments were designed to balance fiscal transfers and expenditure responsibilities in parallel with the reinforcement of borrowing restrictions and strengthening managerial capacities in service delivery at sub-national levels.

Nicaragua is currently also attempting to apply this principle. Its 2004 increase in revenue-sharing to municipalities from 1 percent to 6 percent is projected to further rise to 10 percent in 2007. Since this would enlarge the fiscal deficit, several options for fiscal neutrality are now being discussed, including:

- (i) all central government agencies would cease activities that are assigned to municipalities but are nonetheless being administered centrally.
- (ii) Instead of receiving transfers, municipalities would be provided vouchers which entitle them to receive investments by central governments in their jurisdictions.
- (iii) New expenditure responsibilities are transferred to municipalities without additional funding.
- (iv) Municipalities would provide counterpart funds for foreign-financed public investment projects in their territories. They would be required to contribute larger shares of project costs than in the past.

These options show clearly that fiscal neutrality for decentralization may not necessarily involve the transfer of expenditure responsibilities—unfortunately often regarded as the only way of achieving it. There are other ways that may provide quicker results, and more effective impacts, for achieving fiscal neutrality.


### III.3 Creating a Fiscal Responsibility Framework

Bolivia has accumulated its own experience with fiscal responsibility at the sub-national level. Therefore, some lessons from the past could be usefully applied. These are that:

- The PRF pioneered some successful incentive measures.
- Sanctions need to be graduated to be credible.
The “20/200” rule system appears to be too lax an instrument for controlling sub-national debt.

Bolivia needs to rely mostly on administrative top-down regulation and oversight for controlling debt.

Mechanisms need to be put in place to clarify debt rules at municipal and departmental levels in order to try to avert the enlargement of their debt problems.

Moving forward, it is useful to assess the experience of other countries facing similar challenges of weak fiscal responsibility (Box 8).

Box 8. The Challenge of Fiscal Responsibility

Bolivia faces similar challenges to other countries whose sub-national governments gained fiscal autonomy without an adequate rules framework and fiscal discipline regime. To address this problem, some countries—including Brazil, Colombia, Peru, Argentina, India, New Zealand, and South Africa—have passed such legislation as fiscal responsibility laws (FRL). Their governments appear to have been motivated by related concerns: (i) an individual country’s aversion to running an excessive deficit; (ii) a group of governments in a single country want to enter into and enforce an agreement that each of them would avoid such deficits. In either situation, the FRL would function as a commitment device—in the first case, across time, to commit future governments; and in the second context, across jurisdictions, to wed governments in a unified policy.

Several features of these laws are of particular relevance for Bolivia:

1. They require transparency through the publication of information about the details of programming and actual implementation of finances throughout the public sector.

2. They restrain sub-national deficits by preventing them in advance and/or by imposing penalties with early effects and supplementing normal curbs on fiscal imprudence, e.g.,
   a. Impositions of the national government on sub-national governments (SNGs).
   b. Impositions of the SNGs themselves for managing their finances, including most importantly following the rules of the national government.

3. They restrain the national government from:
   a. Running unsustainable deficits
   b. Mitigating the consequences of sub-national fiscal excesses.


Taking the international experiences with fiscal responsibility into account, Bolivia should consider adopting a set of rules for sub-national governments within a national policy framework. These should be gradually implemented to give the new rules credibility—whose absence has been a major stumbling block in several other Latin American countries.

For the short-term, the following measures would be helpful, preferably to be implemented for one year at a time:

- Establish a different debt capacity indicator for municipalities that is based on disposable revenue, not total current revenue as is currently the case. This implies taking into account rigid expenditures for human resources and debt service.

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19. The rule “20/200” establishes that a sub-national government cannot use more than 20 percent of its current revenue for debt service, while the debt stock cannot exceed 200 percent of current revenue.
• While the Central Government continues to service departmental debt, the departments’ access to new borrowing should be prohibited until they fully satisfy transparency requirements.

• Sub-national governments should: (i) limit the growth of new hiring and salary increases; (ii) for those governments whose wage bills exceed a prudent percent of revenues, require a salary and hiring freeze until attrition and/or economic growth bring the wage/revenue ratio down to the acceptable range; and (iii) not enter into any new hiring or investment contracts in the last year of a department government’s or municipality’s term of office.

• Require publication of information about the details of government programming and the implementation of funded activities throughout the public sector.

• Link this publication with permissions to borrow (from abroad) and with financial sector regulations that only recognize loans as assets on bank balance sheets if their key information is available publicly.

IV. Expected Outcome of the Short-Term Decentralization Scenario

137. The expected outcome of the short-term decentralization scenario is that there is a basic political consensus in place that would allow the national and departmental levels to focus decentralization on reducing inequities in resource distribution and in improving services. The intergovernmental system would be working in its basic elements: a minimum level of transparency is in place; and there is basic equity in resource distribution from hydrocarbons revenue. These measures would the country allow to focus on clarifying roles and responsibilities and improving service delivery as part of the pending measures for the medium-term decentralization scenario.

138. To achieve the expected outcome, the following conditions should be given consideration and would need to be in place:

• Actors can agree on a basic political consensus regarding the guiding principles of decentralization.

• Actors are willing to introduce basic equality in the distribution of resources.

• The central government is able to credibly commit to and withstand a faster decentralization before basic institutional capacities are created.
CHAPTER 5. POLICY OPTIONS FOR A MEDIUM-TERM DECENTRALIZATION SCENARIO

139. This chapter lays out a set of policy options for the medium-term. Once the initial measures of the short-term scenario are taken, and the intergovernmental system is working in its basic elements—a minimum level of institutional capacities and equity in resource distribution is in place—the country could move on and focus on the division of responsibilities and efficiency in service delivery. This chapter first lays out the particular strategy that should be followed. In a second step, it describes the policy options to improve the institutional arrangements; and in a third step, it describes the policy options related to fiscal decentralization. The fourth and final section describes the expected outcome of the medium-term decentralization scenario.

I. Decentralization Strategy for the Medium-Term: Maintain and Improve the Efficiency of Public Services by Separating Roles and Responsibilities

140. The decentralization strategy for the medium-term is aimed at (i) maintaining, and (ii) increasing the efficiency of public expenditures. Departmental governments and municipalities need to prove that they are capable in maintaining a set of standards for quality of services (that have been defined as part of the preparatory phase); and then also improve them, previous to adopting more responsibilities.

141. For the second phase (medium-term) the essential measures to boost efficiency in departmental governments are the following:

- **Institutional**: (i) separate clearly responsibilities among levels of government; (ii) once basic fiscal responsibility rules are working well, relax ear-marking for higher productive efficiency.

- **Fiscal**: (i) Gradual introduction of funding formula for current services that provide incentives for producing better services; (ii) introduce mechanisms to reduce inter regional inequalities in the services being delivered by regional governments.

II. Institutional Arrangements: Clarify Responsibilities and Provide More Autonomy for Resource Management

II.1 Separation of Roles and Responsibilities

142. Responsibilities among levels of government are disjointed. In light of the experience of other countries (Box 9), over the medium-term, it is essential to clearly separate the roles of national, departmental, and municipal levels. This entails the following areas:

- Clarify the responsibility of departmental agencies like SEPCAM (road sector): either transform it into a deconcentrated agency of a national road agency; or decentralize it in the third phase of decentralization towards departmental governments.

- Clarify roles of ministerial sector directors (health, education, others): nomination by central ministries or by departmental governments (if they are responsible for service delivery).
- Clarify the management of payroll on behalf of departmental governments and match it with sectoral responsibilities (health personnel should only be managed if departmental governments are effectively responsible for providing health services).
- Clarify the budget process: separate national and departmental budgets, so that over the medium-term the prefecturas have a budget that corresponds. Eliminate direct budgetary assignments from the Ministry of Finance to departmental agencies (for instance for SEPCAM).

Box 9. Separation of Responsibilities at the Regional Level: The Latin American Experience

In their coordination of public functions, regional governments often appear to be more prone than municipalities to having overlaps and ambiguity in assigning responsibilities. An often overlooked reason for this is the influence of problems in arrangements for human resource management, budgeting, and appointments of key personnel (like sector directors at the regional level), rather than the contents of laws and regulations.

Regional governments throughout Latin America have had considerable experience with this. The Mexican states and Colombia's departmental governments are responsible for delivering primary education and/or secondary education. However, only a small number of their teachers are in fact hired locally. At the same time, mostly for political reasons, the central governments decide on these teachers' hirings and salary levels, with centrally and locally managed staff operating in parallel. Likewise, Peru's regional governments are responsible for managing payrolls for the national ministries of health and education, even though these responsibilities are not yet decentralized and still under central government control. In Peru the process of appointments of regional sector directors (as in Bolivia) entails shared responsibility between regional governors and the national ministry. In Ecuador, there are both delegated and elected political authorities on the regional level.

It is clear that these and similar arrangements are dysfunctional and undermine accountability. Mayors and governors cannot be held accountable for what they produce in the form of services. Countries have responded with different strategies to these dilemmas. As exemplified by Peru and Ecuador, low performing regional management systems have been superseded. Although overlapping responsibilities and dual authority have been found to be dysfunctional, there have been new councils created in Ecuador and Peru comprised of both delegated and elected authorities (Peru: Consejo de Coordinaciy Regional, 2002; Ecuador: Comit Permanente de Desarrollo Provincial, 1997). Their usefulness is disputed, though, especially as they usually lack political and fiscal incentives to effect coordination. In the absence of the political will in Bolivia to—or the possibility of—reorganizing regional structures, it seems essential to separate responsibilities at regional levels before they are deepened, rather than to try to invent new forms of political representation to address such problems.


II.2 Adjust Expenditure Earmarking

143. It is important to adjust the ear-marking of expenditures. Its rules and regulations are too complex, and its present level seems too high to permit more productive and allocative efficiency to materialize. The recommended corrective measures are the following:

- Eliminate functional ear-marking (current/investment expenditures) and replace it with the fiscal responsibility rules mentioned above that could help limit excessive human resource expenditures, and keep Bolivia within proper overall fiscal deficit parameters.
- Establish sectoral ear-marking according to national and regional priorities (a specific percentage for health, education, roads).
- Once fiscal responsibility rules work well, gradually allow a higher share of departmental resources to be allocated freely. Start by giving 10 percent more room in a given year, up to a 30 percent, so that a maximum of 70 percent of departmental resources is ear-marked.
Departments with quality of services above a national standard are allowed to use resources in those sectors that exhibit lower quality of services.

III. Fiscal Decentralization: Sector Transfers for Funding of Sub-national Expenditures

144. One of Bolivia’s main challenges and opportunities for decentralization is to bring about a change in incentives for better service delivery and correcting inequities. Current levels of funding, and the historic budget allocations are not conducive to accomplishing this goal. Therefore, it is recommended to apply funding mechanisms as explained in Table 14. The proposed mechanism is recommended due to its relative simplicity for implementation. There are other options for funding of sub-national expenditures, which, for instance, would require redistribution among departments. This in turn needs conditions of success that are not present in Bolivia at this point in time, and may even remain unlikely in the long-term.

<table>
<thead>
<tr>
<th>Type of Funding</th>
<th>Explanation</th>
<th>Condition of Success</th>
</tr>
</thead>
</table>
| Transfer same amounts as currently spent by central government but with sector specific transfer formula | A formula is used to set an incentive framework in each sector that is output oriented, not input oriented:  
  - Education: per student formula  
  - Health: per capita formula | Funding formula is simple and clear.  
Funding formula is phased-in gradually so that players accept the new incentive framework; and a stable resource flow is guaranteed.  
Sufficient information is available so that current funding levels can be identified.  
Sufficient information is available to make calculation of new formula (number of students, monitored year by year; population census, and so forth). |

*Source:* World Bank.

IV. Expected Outcome of the Medium-Term Decentralization Scenario

145. The expected outcome of the medium-term decentralization scenario is that levels of government have taken steps to separate roles and responsibilities. Departmental governments would have clear expenditure assignments as a condition of more accountability towards the citizens. There would also be incentives for more efficient service delivery, at the same that departmental governments obtain more autonomy in the use of resources. Departmental governments would demonstrate that they are able to maintain, but also to increase the quality and efficiency of public expenditures. This would allow the country to assign regions additional expenditures, and possibly also tax revenue.

146. To achieve the expected outcome, the following conditions should be given consideration and would need to be in place.

- Departmental governments are willing and able to maintain standards of service delivery and even increase them.
- Indicators for service quality are published.
• The central government has the capacity to monitor departmental governments and to provide technical assistance.
• Fiscal responsibility rules are working well so that ear-marking of expenditures can be relaxed in benefit of higher productive efficiency.
CHAPTER 6. POLICY OPTIONS FOR A LONG-TERM DECENTRALIZATION SCENARIO

This chapter lays out a set of policy options for the long-term. Once the measures of the medium-term scenario are taken and effective—responsibilities among levels of government are better defined and the quality of public services has been maintained and improved—the country could move on and consider deepening the level of responsibilities of departmental governments, both on the expenditures as well as revenue side. This chapter first lays out the particular strategy that should be followed. In a second step, it describes the policy options to improve the institutional arrangements; and in a third step, it describes the policy options related to fiscal decentralization. The fourth and final section describes the expected outcome of the long-term decentralization scenario.

I. Decentralization Strategy for the Long-Term: Deepening Responsibilities of Departmental Governments and Municipalities

Once there has been a successful application of measures proposed in the short- and medium-term, it should be possible to deepen decentralization through giving regional governments and municipalities additional roles and resources. The key measures are:

- **Institutional**: (i) provide additional responsibilities, for instance in the health, education, and road sectors; (ii) strengthen intergovernmental coordination.
- **Fiscal**: (i) refine distribution of resources; (ii) consider providing departments with new own revenue in the form of taxes.

II. Institutional Arrangements: Assignment of Additional Responsibilities and Strengthening Intergovernmental Coordination

II.1 Assigning Additional Responsibilities

Once the required institutional capacities are ensured in all departmental governments, the Government could then consider broadening their responsibilities. In light of the international experience (Box 10), this should be done through the recommended sectoral approach. This would facilitate the rationalization and coordination of responsibilities at the national, regional and municipal levels in an integrated fashion. This process should be guided by well designed and agreed concepts of these future responsibilities (Table 15).
In most Latin American countries, the transfer of responsibilities has proceeded in a piecemeal fashion. Usually, municipal and regional levels have not done this in an integrated manner.

Unfortunately, these approaches have had high costs. While perhaps understandable politically, they have increased needs for coordination and made the assignment of responsibilities more difficult. Colombia suffered this fate after its departmental governments became autonomous in 1991 following its municipalities' decentralization in 1986. Venezuela followed similar strategies during the 1990s. In Ecuador, the demands for "provincial autonomy" in 1999-2000 and requests for the adoption of functions were very disjointed, which led to substantial overlaps in responsibilities. These and other cases showed that inappropriate decentralization can weaken accountability and cause unhealthy competition between different government levels.

Technically, it is best to follow a sector approach in going forward with transfers of responsibilities. Chile did so over more than a decade with its explicit service delivery models involving municipalities. In Ecuador, in 2000 a sector approach was undertaken with framework agreements (convenio marco) set up in four sectors—roads, environment, agriculture and tourism. It was adopted after an assessment of the comparative advantages of the provincial councils vis-à-vis municipalities (although an actual transfer of responsibilities did not happen later). Spain has also followed an explicit sector approach: in health and education, among others. It had intergovernmental committees set up that represented central government ministries and regional governments for the negotiations of transfers.

Bolivia is advised to follow such sector approaches. This will enable it to reap the benefits of greater coordination, clearer assignment of responsibilities and fewer overlaps between regions and municipalities.


**Box 10. Transfer of Responsibilities: The Benefits of a Sector Approach**

Table 15. Future Responsibilities of Departmental Governments in Selected Sectors

<table>
<thead>
<tr>
<th>Education</th>
<th>Health</th>
<th>Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Departmental Governments would have full responsibility to manage primary and secondary education. This entails:</td>
<td>Departmental Governments would be responsible for primary and secondary health care. This entails:</td>
<td>Departmental Governments incorporate SEPCAMs and obtain full responsibility for secondary roads within a national road sector strategy.</td>
</tr>
<tr>
<td>1. deciding when and where to open and close schools; 2. human resource responsibilities (according to options presented above); 3. deciding who will be the director of a school; 4. in-service teacher training; 5. acquiring and distributing textbooks and other pedagogical materials; 6. expanding, reducing, and maintaining school infrastructure (in coordination with municipalities); 7. deciding upon method of service delivery and pedagogical approach. Although not ideal from a perspective of assigning responsibilities, municipalities would continue to provide for school infrastructure.</td>
<td>(i) Network organization: decide how much health facilities a Departamento would have, where they would be placed, of what level of complexity, and under which set of referral rules they should be managed. (ii) Human resources: decision to hire and fire according to national rules (refer to section on human resources above). (iii) Infrastructure provision. Although not ideal from a perspective of assigning responsibilities, municipalities would continue to provide for health infrastructure.</td>
<td></td>
</tr>
</tbody>
</table>

150. To successfully proceed with the recommend sector approach, it would be important that there be an incentive framework governing the departments and sector ministries. These entities should only be eligible to receive new responsibilities and resources if they follow the framework’s policies. This should entail the following:

- There needs to be a formal framework agreement (convenio marco) among all departments and the sector ministry (one agreement per sector).
- To keep transaction costs low, municipalities could sign a convenio marco collectively with the ministries, but grouped within a department.

151. Given the limited institutional capacity at national and sub-national levels, and the volatile resource flow from transfers, the following sequence should be followed:

- first, transfer secondary roads;
- second, transfer responsibilities for health;
- third, transfer responsibilities for education.

152. There could be different treatment for municipal and departmental governments in dealing with primary vs. secondary education, as well as primary vs. secondary health care. Although due to the small scale in many of the rural areas of the country a splitting of these responsibilities is not practical and recommended, it should be given consideration what role capital municipalities could play in assuming these responsibilities in their jurisdiction.

### II.2 Intergovernmental Coordination

153. In the long-term, it is essential to strengthen intergovernmental coordination. The framework agreements mentioned above are only one way for assuring clear responsibilities, as well as improving human resource management. Both should exist as long as the transfer process continues. In the future, institutions should be created to help ensure good coordination of expenditures and policies in each of the sectors. Following Spain’s example (Box 11), national-regional sectoral coordinating bodies could be useful (depending on the expenditures that are transferred).

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**Box 11. Asymmetric Decentralization and the Emergence of Sectoral Coordination: the Case of Spain**

Spain is a good case of balancing well the dynamics of an asymmetric and a sectoral decentralization strategy. Individual regions were given the possibility to adopt a broader range of functions in an asymmetric arrangement; and for each of the sectors involved, such as health and education, intergovernmental committees were set up that represented central government ministries and regional governments in the negotiations of transfers (convenios).

Once the transfer process was completed, participants became aware of the usefulness of this institution. In fact, the sectoral committees still exist and fulfill important functions for intergovernmental coordination. However, there has been criticism that these committees cannot meet on initiative of regional governments. Nonetheless, this arrangement is a good example of how decentralization triggered intergovernmental coordination; and how the center maintained its ability to articulate sectoral policies while keeping costs in check. It may constitute a reference for all countries in which the impetus for reform comes from bottom-up, or individual regions, but have to be kept in line with good national policies.

*Source: World Bank.*
III. Fiscal Decentralization: Improve Distribution and Increase Fiscal Autonomy

III.1 Addressing Horizontal Imbalances: Improving the Distribution of Resources Among Departments

154. Once a new per capita-based transfer system is operative and has contributed to achieving a minimum of inter-departmental equity, it could be considered to refine the methodology and transfer formula. Such refined methodologies however require better information and are often less transparent than the simple per capita formula. Such methodologies include, inter alia:

- weighted indices of relative need;
- per capita (per client) expenditure norms;
- bottom up or physical expenditure norms (representative expenditure approach);
- sector formula (if the approach is to finance different sectors, and not to opt for a general purpose grant).

155. An additional consideration that could be taken into account is that, once there is taxation at the departmental level (discussed below), the formula could change to one which would compensate for relative lack of fiscal capacity (as in Canada, for instance). This opens the possibility of using less complex methodologies that are implied when estimating expenditure needs. The idea of an equal share per region in order to meet fixed costs is also acceptable, provided it remains a small part of the total.

III.2 Elimination of Earmarking of Revenue to Regions and Pooling of Different Resources

156. The total amount of central government transfers to regions and municipalities should be determined in relation to total central government resources, not in relation to royalties. There is nothing about royalties that justifies their ear-marking as a source of intergovernmental transfers. Its use should be eliminated.

157. Pooling of revenue is also a first step to reduce volatility in flow of revenue to regions in particular. In addition to this measure, the country might deliberate on other, explicit mechanisms to stabilize intergovernmental transfers. In doing so, a decision needs to be taken on which level of government would assume the risk of volatility: the national government alone; subnational governments; or whether the risk is shared among both levels. Whatever mechanism is selected, a stabilizing rule—particularly with regards to withholding revenue increases during boom periods—could assist subnational governments in avoiding the boom-bust trap that has afflicted so many countries in Latin America.

158. Designing a good rule requires determining whether the economic shock is a temporary or permanent shock, and whether policy makers will be able to determine the difference. If the income shock is permanent, then by necessity subnational governments will have to adjust downwards their expenditures. To stabilize the permanent shock (or if permanence is not known), it would make sense to follow an intermediate path. One alternative is to implement a moving-average type of transfer rule, not fully protecting the subnationals from the required adjustment, but giving them more time to adjust because of their usually more limited (costly) access to credit compared to the central government. Another alternative would be a set of
individual subnational stabilization funds, so-called “rainy day” funds. Countries in Latin America have experimented with different mechanisms, often as a combination of moving averages, floors, and/or fixed sums (Table 16).

Table 16. Stabilizing Mechanisms for Intergovernmental Transfers in Selected Country Cases

<table>
<thead>
<tr>
<th>Country Cases</th>
<th>Stabilizing Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Between 2003-2005, provinces would start to receive a moving average of the three most recent years shared revenue amounts. In case this moving average were to coincide with recessionary or low growth years, a minimum amount is set: $1.4 billion per month in 2003, $1.44 billion in 2004, and $1.480 billion in 2005. These minimum amounts represent approximately 2.6 to 2.8 percent increase per year in nominal terms.</td>
</tr>
<tr>
<td>Colombia</td>
<td>The country has tried to limit the growth of total transfers. During a transition of 2002-2008, transfers would grow annually at the rate of annual inflation plus 2 percent for 2002-05 and 2.5 percent for 2006-08, thereby creating both a floor and a ceiling. Escape clause for the ceiling: if GDP growth exceeds 4 percent, the ceiling would no longer apply and transfers would increase in proportion to the national revenue growth.</td>
</tr>
<tr>
<td>Ecuador</td>
<td>FODESEC (Fondo de Desarrollo Seccional): transfers can never be lower than in the previous year.</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Oil stabilizing fund</td>
</tr>
</tbody>
</table>


159. It is essential to bear in mind that some of these mechanisms have seriously jeopardized the fiscal position of national governments in certain periods of time, or have had only limited effectiveness. Ecuador, for instance, has been afflicted by the infamous “ratchet effect” by which transfers can never be lower than in the previous year. In Argentina, floors on transfers have contributed to the fiscal stress under which the federal government was in the crisis following the year 2000. In Venezuela, the federal government had only weak discipline in effectively saving funds of the oil stabilization fund and were spent.

160. These country experiences therefore underscore that stabilizing rules for intergovernmental transfers have to be complementary to national and subnational fiscal responsibility rules, budget planning, and debt management. Also, if the national government itself is at the brink of insolvency, or if there are long-term structural imbalances at the subnational level that are being financed by the current system of transfers, then stabilizing transfers may only complicate or even worsen these initial problems. Therefore, before any decision is taken on specific stabilizing mechanisms in Bolivia, the following conditions of success would need to be in place before establishing a stabilizing rule to national-to-subnational transfers (Box 12).

Box 12. Three Pre-conditions for the Stabilization of Intergovernmental Transfers

(i) Subnational governments are credit constrained—rationed in some way out of the market, or subnational governments confront substantially higher cost of borrowing.
(ii) The national government possesses stable access to credit and quality debt management.
(iii) There are no severe structural fiscal imbalances, either within levels of government or across levels of government. In other words, neither individual level of government is facing unsustainable cyclically-adjusted fiscal deficits. In addition, the subnational governments are not spending excessively, with financing by automatic national transfers.

III.3 Reducing Transfer Dependence by Strengthening Own Revenue Bases

161. Strengthening own-revenue bases and diversifying income are important strategies for future decentralization, as the experiences of other Latin American countries have shown. The lack of own revenue bases was a major stumbling block for many regional governments in trying to deepen autonomy. Peru, Colombia, Ecuador and Venezuela have demonstrated that, if regions do not obtain reasonable access to their own sources of revenue, their fiscal dependence on the center will continue to dictate their day-to-day management. Additional advantages of greater dependence on own-revenue include the importance of local politicians “feeling the pain of the marginal tax boliviano they spend.” Then too, local taxation can contribute to more efficient spending, fostering hard budget constraints, and stimulating greater accountability to citizens.

162. It is notable thus that, compared to other countries in the region, regional governments in Bolivia are particularly transfer dependent (Table 17). In the long-term, therefore, providing departmental governments access to own revenue sources would be desirable to reduce their transfer dependence (which is otherwise likely to increase even more).

| Table 17. Transfers and Revenue of Regional Government in Selected Countries (percent) |
|---------------------------------------------|-----------------|-------------------|
| Bolivia (2005)                             | 96.60           | 3.4               |
| Venezuela (2000)                           | 98.39           | 1.61              |
| Colombia (2000)                            | 59.9            | 40.1              |
| Ecuador (1998)                             | 92.8            | 8.8               |
| Peru (2000)                                | 93.8            | 6.2               |
| Spain (2001)                               | 76.69           | 23.31             |


163. The selection of appropriate tax sources for regions is extremely challenging, partly because of competing claims. The national government keeps many taxes for equity reasons just as the municipalities keep others for administrative or efficiency considerations. The central government is considered more to administer revenues from the personal income tax, corporate income tax, and those related to natural resources. Conversely, municipalities are believed to fare better in administering the property tax, the residence-based individual income tax, and payroll taxes levied at the place of employment (when considering the principle of subsidiarity). An additional particular problem for Bolivia is that the regions are relative late-comers to decentralization while the municipalities gained a “first-mover advantage.” They were thereby been granted new tax bases, some of which would be suitable for regional administration.

164. In the face of similar constraints elsewhere, regional governments in several countries have either had very limited own revenue, or have been quite creative, e.g., in some cases, imposing surcharges on national or municipal taxes (Table 18).
Table 18. Country Cases of Regional Government Tax Administration

<table>
<thead>
<tr>
<th>Type of Tax</th>
<th>Country Cases</th>
</tr>
</thead>
</table>
| Property taxes      | • Spain, Ecuador: municipalities administer these; regional governments are allowed to levy a tax on changes in land ownership.  
                    | • France: departments share these taxes with municipalities (which obtain roughly a third of the total), and regional governments are allowed to piggy-back on top of them.  
                    | • Mexico, Argentina: state/provincial taxes with revenue-sharing for municipalities. |
| Personal Income Tax | • Spain (tax is administered by the central government, but regional governments can regulate the regional tax schedule, create their own deductions for individuals and households, non-corporate investments and the application of income—provided these do not affect other taxes levied on any category of income).  
                    | • Mexico  
                    | • Argentina (Impuesto a Ingreso Bruto)                                        |
| Payroll tax         | • Mexico  
                    | • Australia  
                    | • South Africa                                                              |
| Excise Tax          | • Colombia: departments collect 'sin taxes' ("impuestos del vicio") as charges on liquor, beer and tobacco.  
                    | • Spain: regional governments charge taxes on bingo and surcharges on gaming (which are administered by municipalities).  
                    | • Basque country (Spain) specific-status regional government charges excises on manufacturing. |
| Retail Sales Tax    | • USA states  
                    | • Specific-status government of Navarre (Spain); also charges sales taxes on luxury goods. |
| VAT                 | • Brazil  
                    | • Canada (Dual VAT; 5 different VATs).  
                    | • Canary Islands government (Spain) levies an indirect general tax, with a similar structure to that of VAT, albeit with fewer rates and without taxing the retail trade stage. |
| Business Taxes      | • France: departments share these with municipalities (which obtain roughly a third of the total value).  
                    | • Spain: single-province regional governments can set surcharges on the municipal tax on business activities.  
                    | • Basque country (Spain) establishes flexible rates and concessions on the corporate income tax. |
| Automobile registration and annual license taxes | • Colombia: departments administer a vehicle tax.  
                                                             • France: regional governments apply a tax on driving licenses; departmental governments own and administer the yearly automobile tax. |
| Road tolls          | • Interregional highways have been privatized or concessioned in Chile, Colombia, Peru and Ecuador, with several regional governments participating in toll proceeds. |
| Fuel taxes          | • Canada: administered by the federal government and provinces in a tax-sharing arrangement. |


165. In light of this international experience, and given the particular tax structure and conditions present in Bolivia (no personal income tax in place; no functioning tax administration at regional levels; low transparency and poor exchange of fiscal information among levels of government), there are two possible revenue sources that could provide a starting point for regional taxation there:

(i) **Option 1**: the special consumption tax (domestic share);

(ii) **Option 2**: a sales tax on gasoline and diesel fuel.
166. With some tax administration considerations explained below (Table 19), these two taxes would in principle accurately mirror local fiscal capacity, while also not creating adverse effects on equity or efficiency. Given the experience of other countries (e.g., Colombia), they could also constitute suitable regional taxes. They cannot be easily exported from the taxing jurisdictions (contrary to foreign trade taxes, for example). They would not readily or very much influence locational choices (contrary to the corporate income tax, for example). They are not too difficult to administer locally (contrary to the VAT); and they are not used for inter-regional redistributive purposes (contrary to the personal income tax).

Table 19. Options for Regional Taxation in Bolivia

<table>
<thead>
<tr>
<th>Tax Base</th>
<th>Tax Rate</th>
<th>Tax Administration</th>
<th>Appropriation of Tax Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option 1:</td>
<td></td>
<td>Alternatives:</td>
<td></td>
</tr>
<tr>
<td>Domestic share of Special</td>
<td>Regional</td>
<td>a) National with a commission for central government.</td>
<td>Regional</td>
</tr>
<tr>
<td>Consumption Tax (ICE)</td>
<td>Different percentages</td>
<td>b) Regional, revenue collected at the retail level.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>depending on goods.</td>
<td>c) Regional, collected at the producer level.</td>
<td></td>
</tr>
<tr>
<td>Option 2:</td>
<td>Regional</td>
<td>Regional</td>
<td>Regional</td>
</tr>
<tr>
<td>Sales tax on gasoline and</td>
<td>Between zero and 5 percent.</td>
<td>Regional</td>
<td></td>
</tr>
<tr>
<td>diesel fuel</td>
<td>Region can choose the rate.</td>
<td>Alternative: national with a commission for</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>central government.</td>
<td></td>
</tr>
</tbody>
</table>


167. Other possible options of regional revenue include the automobile tax, although that is a municipal tax. Furthermore, on political economy grounds, it seems unlikely that this tax be transferred to regions. The same holds for the property tax.

168. It is essential to bear in mind that the introduction of regional taxation based on the two options suggested above is not fiscally neutral to either level of government. This is of course true for regional governments which would obtain more revenues. This is different for the national government which would experience a revenue loss by transferring the domestic share of the ICE to regions. Municipalities would also be affected due to the decline in revenue-sharing as a result of the changes occurring at the national level. These fiscal impacts need to be carefully assessed prior to granting regions more access to additional revenue (Table 20).

169. Tax decentralization could be combined with expenditure decentralization. This could be aimed at phased transfers of responsibilities in conjunction with increases in own tax revenues and fiscally-neutral (i.e., corresponding expenditure cuts at the national level) transfers. If Bolivia proceeds asymmetrically—that is, not all departments proceed at equal paces and depth—one could first transfer responsibilities in the more fiscally able departments, then extend the process to the others as they improve their fiscal capacities. In any case, this would require the guarantee of sufficient transfers to the less fiscally capable departments to enable them to cover minimal service requirements.

170. Another option is to explicitly condition the transfer of tax authority with expenditure responsibilities. For instance, if a departmental government wants to administer the secondary
roads network, the central government would condition the adoption of this responsibility for the collection of the sales tax on gasoline and diesel fuel (Tax Option 2). This would set an additional incentive to collect taxes. On the other hand, ear-marking of specific taxes to specific expenditures should be avoided.20

Table 20. Regional Taxation and Revenue Net Gain for Departmental Governments (in Million US$), 2006-2010

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 1: Revenue loss to allow dep. to collect dom. ICE</td>
<td>-62.8</td>
<td>-67.3</td>
<td>-71.3</td>
<td>-75.6</td>
<td>-80.2</td>
</tr>
<tr>
<td>Total Net Gain</td>
<td>-62.8</td>
<td>-67.3</td>
<td>-71.3</td>
<td>-75.6</td>
<td>-80.2</td>
</tr>
<tr>
<td>Departmental Government</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 1: Tax collected through domestic ICE</td>
<td>41.9</td>
<td>75.1</td>
<td>79.6</td>
<td>84.5</td>
<td>89.6</td>
</tr>
<tr>
<td>Option 2: Gasoline and Diesel Sales Tax</td>
<td>31.4</td>
<td>33.6</td>
<td>35.6</td>
<td>37.8</td>
<td>40.1</td>
</tr>
<tr>
<td>Total Net Gain</td>
<td>73.3</td>
<td>108.7</td>
<td>115.2</td>
<td>122.3</td>
<td>129.7</td>
</tr>
</tbody>
</table>

Municipalities

| Total Net Gain (Revenue loss in co-participation) | -12.6 | -13.5 | -14.3 | -15.1 | -16.0 |

Note: differences in tax revenue from ICE result from the fact that currently the domestic ICE is administered as a VAT. In case this tax is decentralized to departments, its administration should only be done as a final sales tax.


171. Whatever the final choice is, there are several conditions of success that need to be met for desirable regional taxation:

- The central government is willing to accept revenue shortfalls in revenue due to losses of domestic shares of the ICE.
- Departmental governments are willing to deal with the political cost of new taxation, particularly a sales tax on gasoline (which yields the highest amount of revenue). They would have to have efficient tax administration departments (although in the first instance, the central government could administer regional taxes).
- Municipal governments can bear the temporary shortfalls in co-participation transfers inferred in revenue changes at the central level.

III.4 Consolidating Fiscal Responsibility

172. The country should gradually building up commitment to fiscal responsibility among all levels of government. Over the long-term, the following measures are important:

- Restraint of sub-national deficits by preventing them in advance and/or by imposing extra penalties that take effect quickly, in addition to the normal measures taken to deal with the consequences of fiscal imprudence.

20. Ear-marking is questionable: it reduces the freedom of regional governments in resource allocation, ignores regional specificities (road maintenance may be more costly in some regions, or river transportation may be an option only in certain regions), and implies complicated controls.
Once annual fiscal targets are working well, they can be extended to multi-year bases. These targets could then be mandated in revised fiscal responsibility laws.

IV. Expected Outcome of the Long-Term Decentralization Scenario

173. The expected outcome of the long-term decentralization scenario is that departmental governments have deepened their responsibilities both on the revenue as well as expenditure side. An increasing share of expenditures is financed from own revenue in the form of taxes. This would gradually create more lines of accountability towards the tax-payers and citizens.

174. To achieve the expected outcome, the following conditions should be given consideration and would need to be in place. They are different for central, departmental, and municipal governments.

Central Government:
- Has the capacity to redistribute resources within sectors and among departments previous to transfer of responsibilities (so that decentralization is fiscally neutral).
- Can negotiate transfers of health and education personnel to departmental governments.
- Has the fiscal space to provide additional tax bases or tax revenue for departmental governments.

Departmental governments:
- Can cope with new expenditure responsibilities and have both the institutional as well as absorption capacities to deliver the new sector services.
- Are willing to collect taxes. Effective tax administration can be established.
- Are willing to hire and fire sector personnel.
- Use their own resources to finance sector infrastructure.
- Will have additional funding available in the future, e.g., for secondary education for which improvements are a so-called "unfunded mandate."
- Fill redistributive roles in their jurisdictions (education, above all).
- Clarify their institutional frameworks particularly with regards to the hybrid roles of sector directors, and budgeting.
- Have effective budget constraints in place, especially limits on personnel expenditures.

Municipalities:
- Establish effective coordinating mechanisms for delivery of infrastructure works in the main sectors.
- Accept expanded roles of departmental governments in servicing key sectors.

V. Vision of Future Departmental Governments

175. The implementation of the policy options in the short-, medium-, and long-term should contribute to a strengthening of departmental governments. Decentralization represents an opportunity to achieve social inclusion. Successfully strengthening regional governments for these purposes could be very salutary.
In line with the above, the following are the expected outcomes as a result of the policy options laid out in this Report.

- There are mechanisms in place to process conflicts among levels of government in benefit of better governance. There would be a minimum level of transparency and flow of information that would allow all actors to constantly revise and adjust the decentralization strategy in light of new circumstances.
- There is a minimum level of horizontal equity in resource distribution from hydrocarbons revenue, which would lead to more equitable spending.
- Responsibilities of levels of government would better separated. The different sectors would have coordinating mechanisms in place that make overlaps in responsibilities transparent.
- There would be more autonomy in the use of resources, which in turn would allow departments to use inputs more efficiently. Citizens would have the ability to monitor the quality of public services at the departmental level.
- Departmental governments would be more accountable to the citizens and fax-payers.
## Annex Table A.1. Balances per Level of Government

### Central Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Revenue</th>
<th>Tax Revenue</th>
<th>Non Tax Revenue</th>
<th>Capital Revenues</th>
<th>Non Capital Revenues</th>
<th>Overall Balance of CG</th>
<th>Overall Balance of DG</th>
<th>Overall Balance of MG</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>24.7</td>
<td>19.4</td>
<td>22.8</td>
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<td>32.3</td>
<td>31.8</td>
<td>30.1</td>
<td>29.2</td>
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<td>24.6</td>
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<td>25.9</td>
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### Departmental Government

<table>
<thead>
<tr>
<th>Year</th>
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<th>Tax Revenue</th>
<th>Non Tax Revenue</th>
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<td>35.3</td>
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</table>

### Municipal Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Revenue</th>
<th>Tax Revenue</th>
<th>Non Tax Revenue</th>
<th>Capital Revenues</th>
<th>Non Capital Revenues</th>
<th>Overall Balance of CG</th>
<th>Overall Balance of DG</th>
<th>Overall Balance of MG</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>24.7</td>
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<td>31.8</td>
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<td>27.7</td>
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<td>2007</td>
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<td>35.3</td>
<td>33.5</td>
<td>33.5</td>
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</tr>
</tbody>
</table>

### Capital Revenues

- **Public enterprise operating balance**: 0.1
- **Social Security**: -4.3
- **Overall Balance of NFFS**: -3.8
- **Central Bank operating balance**: 0.3
- **Overall Balance of CPS**: -4.6
- **NFFS debt stock**: 27.2

### Notes

- Departments and Municipalities: Assume a balanced budget.
- Revenues in line with IMF macro projections (7/14/06)

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**Table Footnotes**

- Departments and Municipalities: Assume a balanced budget.
- Revenues in line with IMF macro projections (7/14/06)

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