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**DECENTRALIZATION AND ACCOUNTABILITY
OF THE PUBLIC SECTOR**

Edited by
Shahid Javed Burki
Guillermo E. Perry

with
Florence Eid
Maria E. Freire
Victor Vergara
Steven Webb

PROCEEDINGS OF A CONFERENCE HELD IN **VALDIVIA,**
CHILE

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Contents

I. Introduction	1
From Globalization to Localization, by Shahid Javed Burki	3
Overview and Political Origins of Decentralization in LAC	
The Political Context of Decentralization in Latin America, by Fernando Rojas	9
The Politics of Decentralization in Latin America, by Stephan Haggard	33
Comment, by Josep M. Colomer	45
II. Framework for Fiscal Federalism	51
Making Local Governments Accountable to Average People in Cities and Villages— Challenges and Next Steps in Latin America	
The Participation-Accountability Nexus and Decentralization in Latin America, by Ramón Borges-Méndez and Victor M. Vergara	55
Comment, by Raúl Pont	79
Making Decentralization Compatible with Macroeconomic Stability	
Macroeconomic Management in Decentralized Democracies: The Quest for Hard Budget Constraints in Latin America, by William Dillinger, Guillermo Perry, and Steven B. Webb	85
Comment, by Claudio Loser	107
Transfers and Incentives—International Experience	
Transfers and Incentives in Intergovernmental Fiscal Relations, by Richard M. Bird	111
An ‘Incomplete-Contracts’ Approach to Intergovernmental Transfer Systems in Latin America, by Sebastián M. Saiegh and Mariano Tommasi	127
Governance and Incentives in the Public Hospital Sector, by Florence Eid and Pere Ibern	145
Comment, by Alberto Díaz Cayeros	167
Equity and Decentralization	
Equity and the Decentralization of Social Services, by Emmanuel Jimenez	173
Comment, by Josefina Stubbs	189

III. Sectoral Issues	199
Education	
Education Decentralization in Latin America: The Effects on the Quality of Schooling, <i>by Donald R. Winkler and Alec Ian Gershberg</i>	203
Health	
Decentralization in the Health Sector: The Spanish Example, by Josep María Via i Redons	229
Decentralization of Health Services in Latin American Countries: Issues and Some Lessons, <i>by Tarsicio Castañeda, Girindre Beeharry, and Charles Griffin</i>	249
Environment	
Decentralized Environmental Management, by Sergio Margulis	273
Roads	
Effective Decentralization of Roads: Lessons from the Latin American Experience, by Jeffery Gutman	293
Local Sanitation	
Decentralization and Municipal Solid Waste Management: Lessons from a Decade of World Bank Lending, by Carl R. Bartone	307
IV. Local Financing and Management Capacity	315
Recent Developments in Subnational Tax Regimes	
Subnational Revenues: Realities and Prospects, by Richard M. Bird	319
Subnational VATs	
Subnational Taxation and Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution, by Ricardo Varsano	339
Comment, by Horacio L. P. Piffano	357
Local Property Tax	
Local Taxes: Lessons Learned on the Implementation of Real Property Tax, by Julio Roberto Piza	363
Credit Access	
Subnational Governments and Credit Markets: Selected Cases, by Maria E. Freire, Marcela Huertas, and Benjamin Darche	375
Financial Resources of European Local Governments: Budgetary Structures and Borrowings, by Marie-Alice Lallemand Flucher	395
Capacity for Local Accountability	
About Transparency in Local Management, by Mario Rosales	409
Comment, by Gonzalo Darquea Sevilla	413
Comment, by José Roberto Rodrigues Afonso	419

V. Closing Session	423
Closing Panel: Challenges of Decentralization: Accountability, Efficiency, Equity, and Financial Soundness	425
José Antonio Ocampo	425
Joaquín Vial	427
Santiago Levy	429
Guillermo Perry	431
Raul Troncoso Castillo	432

I. Introduction

From Globalization to Localization

S H A H I D J A V E D B U R K I

It gives me great pleasure to participate in the opening session of the Annual World Bank Conference on Development in the Latin American and Caribbean (LAC) Region. This conference is now generally referred to as ABCD-LAC. This is the fifth time we are meeting. The series began in 1995 at Rio de Janeiro, when we focused on the adjustment policies in the region. Since then we have met in Bogota, Colombia, to talk about poverty—particularly poverty in the countryside—in Montevideo, Uruguay, to talk about trade and open regionalism, and in El Salvador to discuss the importance of institutional reforms—in particular the reform of the financial sector. Today, we will talk about decentralization and the need to bring government closer to the people in a global economic environment that is changing rapidly for much of the developing world.

The idea of focusing on this issue for our annual conference and to hold it in Valdivia—to hold it in a regional center rather than in the capital city—was born three years ago in a discussion I had with Eduardo Aninat. It is a testimony to his wisdom and experience that in 1996, when we first discussed the idea behind this conference, Minister Aninat saw the importance of localization in a rapidly globalizing world. We will discuss today the subject of localization—or decentralization—from several different perspectives. But as I will suggest in a few minutes, the enormous opportunities offered by globalization can

only be realized by the developing world if it focuses attention on the power of decentralization—of getting people involved in their own development and of defining their own future.

The next conference—the sixth of this series—will be held in June 2000 in Washington, D.C. and will address the broad subject of Latin America and the Caribbean in the 21st century. The first ABCD-LAC of the 21st century will be inaugurated by my successor, David de Ferranti, who takes over from me as the Regional Vice President of the Latin America and Caribbean Region on July 1. I am extremely happy that I am handing over the leadership of the World Bank LAC Region to David, not only because he has been a friend for many years, but because he brings

with him a rich experience in development. David has a high level of concern for social development and a considerable amount of knowledge of the region. I could not have hoped for a better successor, and I wish him well in his assignment.

In the few minutes I have been given in this opening session, I would like to focus the attention of this large audience on two important subjects: a rapidly changing global economy, and my concern, shared by many, that the dynamic that globalization is unleashing may cause the widening of income disparities among nations, among different groups of people within countries and among people belonging to different age cohorts. What these concerns have to do with the main subject of the conference—

Shahid Javed Burki was the World Bank's Regional Vice President for Latin American and the Caribbean from January 1994 to June 1999.

moving beyond the center and decentralizing the state—should soon become apparent.

A great deal has been written in recent weeks and months about the state of the global economy and how the developing world is being affected by the rapid-fire changes that are occurring all around us. From all this one is able to form an impression about the common and widely shared view of the global economy and its likely evolution over time. Let me call it the popular—or, for short, the “pop” view. This view contains a number of strands. Let me mention four of these. First, many people believe that the process of development that is commonly referred to as globalization is making a small number of very large corporations exceedingly powerful, with their influence being exercised not only in one country but across the globe. A few global banks, a few global oil companies, a few combinations of airlines, one producer of software, and one manufacturer of micro-chips dominate their respective sectors of the economy. Second, it is believed that the growth in the economic power of these entities has reduced the authority of governments. Governments are seen now as confining their energies to exhortation—as they did in the G-8 summit in Cologne on June 20—rather than playing an effective role in erecting a new global economic and financial order. Third, it is felt that a very large number of countries are being left so far behind in the race to provide their citizens with basic needs that they may have been condemned permanently to a state of perpetual impoverishment. In fact it is suggested that it is no longer appropriate to call these countries “developing,” for they have not seen any development for several decades, and that a better description of their condition would be to call them “perpetually weakening economies.” Fourth, some people fear that these unfortunate developments are producing a backlash that may force governments toward negative action—to force them to adopt policies that may seem to ameliorate the situation of those who are disadvantaged over the short term but, in fact, would do long-term damage to them.

There is some truth in all these assertions—some strength in these strands of argument. However, it would be very dangerous to weave an entirely new fabric of policy reform from these strands. Such an attempt would set back all citizens of the world—including those who are being left behind by the rapidly globalizing world. It is important, therefore, to do three things: one, to under-

stand the full meaning of the process of globalization; two, to understand the implications of globalization for different parts of the world; and three, to see how moving beyond the center and decentralizing the state would help all countries to draw benefits from the changes that are occurring all around us. The real challenge for the developing world is to turn the dynamic of globalization in favor of its citizens.

Let us first understand what is meant by globalization. It is a phrase that we generally apply to the movement of large amounts of capital, to a greater exchange of goods and commodities among the world’s nations, to a greater voluntary movement of people across established frontiers, and to a greater integration of global output. But it is not always realized that not all of this is new. Some of it has happened before, in fact to a greater degree if we think in proportional rather than absolute terms. It is not well-known that net financial flows were a larger share of world savings before World War I than they were in the mid-1990s. It is also not well-known that world trade as a proportion of world output was higher in 1913 than in 1975. For me what is important about globalization is the speed with which information flows, and it is this—and two other aspects of change—that will truly revolutionize and globalize the economy.

Apart from the flow of information, the other profound changes are in the areas of demography and the role of the state. It is the first time in human history that large parts of the world are going through a period of demographic transition that is producing natural declines in national populations. Populations are declining in large areas of the industrial world not because of plague and pestilence but because of falls in fertility.

There are now 400 million active workers in the industrial world; in four decades their number will decline to 300 million. I have seen at least one analysis according to which Japan’s population will decline from 120 million to 65 million in about sixty years. Will the industrial world be able to sustain economic activity at its present level—let alone at an increased level—with this decline in the workforce? The answer is no. At the same time Europe and Japan—unlike, for a variety of complex reasons, the United States—will not permit compensating inward migration. The only way out for them will be to make use of the abundant labor in the developing world. This development alone will bring

about a much greater integration of the global economic system.

The other change of great consequence is the redefinition in the role of the state. Over the last two decades—particularly since the time of Ronald Reagan and Margaret Thatcher—the state has tended to reduce its risk-bearing responsibility. It is not prepared to provide as much economic protection to its people and to private institutions as it did before. The response to this dramatic change in political philosophy—the move from a caring state to a state that watches from some distance—has come quickly and will lay the ground for relations among nations. Individuals have begun to plan to care for themselves, and institutions have developed the means to help individuals in this quest. The mergers and acquisitions that are leading to the emergence of large global corporations are also in part a response to deal with risks. Let me provide a few numbers to illustrate the first point.

Over the last six years, from 1993 to 1999, the total amount of assets being managed by pension funds in the United States alone increased to nearly \$7 trillion. Some 14 percent, or close to a trillion dollars, has been placed abroad. In the next five years, the size of the pension funds will more than double in the United States, and a substantial portion will be invested abroad. Of this \$2.6 trillion, more than a third may go to the developing world—to the part of the developing world that equips itself to receive it.

This is where demography and the role of the state once again enter the picture. A large part of this enormous resource will go to the countries that are able to educate and train their workers to provide the services the aging population in the industrial countries will increasingly need. The large First World corporations will play the role of intermediaries between those who need services and those who are able to provide them. In searching for the locations that can provide these services, these corporations will have highly specific requirements—the quality of

human resources available, the speed with which the needed services can be provided, the ability to research and improve the products being produced. In order to facilitate all this, governments will need to come close to the people—to move beyond the center and toward both near and distant localities. Globalization will provide benefits to the developing world only if it is coupled with localization.

This last point is also my concluding point, and to underscore it I need to point only to the developments that have already begun to occur in the industrial world. The move from manufacturing to services, from factories that transformed commodities into products to enterprises that process information and improve technology, has already produced sea-changes in the world's more mature economies. Local governments are active in developing corridors to attract these new industries. This is as true of the areas surrounding Dulles Airport near Washington, D.C., as along Route 28 near Boston. The same developments will need to occur in the developing world. Greater authority and command over resources will have to be given to local governments to help them take advantage of globalization. In localization, therefore, lie the seeds of change that could occur in the developing world—and provide benefit to all citizens.

These and many related issues will be discussed in the sessions that will be held as a part of this conference. I am confident that our deliberations in the next two days will provide us with the knowledge to use localization to turn globalization into an asset rather than a liability, to stop income disparities from widening, and to involve billions of people all over the world as active participants in bringing about positive change. These discussions should help to mobilize the forces of globalization in favor of the billions of people who live in the world's developing countries.

I thank you for giving me the opportunity to open this conference on decentralization.

Overview and Political Origins of Decentralization in LAC

The Political Context of Decentralization in Latin America

Accounting for the Particular Demands of Decentralization in the Region

FERNANDO ROJAS

Summary

The recent wave of decentralizations all over Latin America remains a paradox. Why would deeply rooted, well-established presidential regimes decentralize?¹ Although the particular answer to this question varies from country to country, the common denominator across the LAC region² is that national governments have faced a great deal of pressure—primarily political pressure—to do so. Decentralization in Latin America did not originate in a centrally organized fiscal rationale. In adopting decentralization from the top down, Latin American presidential regimes were in most cases reactive, not proactive.

The fact that Latin America did not embark on decentralization for the sake of fiscal decentralization has shaped the particular features of fiscal decentralization in the region. Had decentralization been the result of a technically inspired decision by national governments, intergovernmental fiscal arrangements likely would have been the result of a phased-in, cohesive strategy of devolution of revenues and responsibilities to sub-national levels. The economic theory behind reallocation of revenues and responsibilities—for the most part constructed over decades of experience in more developed countries—might have found one more particular application south of the Rio Grande. And the national ministries and secretaries of finance would have taken an early lead and would have emerged as the champions of decentralization processes everywhere.

What actually happened in most countries is that national governments were under pressure to adopt decentralization hurriedly. The impact of symbolic, often flamboyant constitutional and legal reforms took precedence over the more mundane concerns of implementation and administration of radical reforms. Carefully drafted and heavily publicized rules remain written but largely unapplied—which brings to decentralization the frustrations of the centuries-old gap between law-in-books and law-in-practice. When presidents and the ministries of finance became fully aware of the implications of decentralization, it often was already too late to bring the design of decen-

tralization back to square one and restart the process from scratch. The very basic pillars of quasi-monarchic presidential regimes were shaken, and there was no structure ready to support the new decentralized state.

What followed after the inaugural celebration of decentralization reforms was a mix of veiled resistance and gradual awakening to the fiscal and administrative demands of decentralization. The moving train of decentralization had to make—and still has to make—frequent stops and take long detours to bring national political parties and finance and sector ministries on board. The painstaking process of balancing political and administrative reality with the new

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redistribution of power forced by decentralization has produced a curious hybrid of “delegated decentralization,” the confusing meeting point of the French and the Australian forms of the state. In the end, intergovernmental monitoring and coordination took precedence over subnational governmental autonomy and individual accountability. Trust-building among recently declared equal partners became the first priority of decentralization. The usual prerequisites of information, reporting, evaluation, and disclosure had to be identified as the intermediate goals of decentralization. Implementing decentralization in Latin America became a back-and-forth movement from the foundations to the 20th floor. The dominant direction at this point is one of a consensus-building process on how decentralization should look like rather than one that is effectively implementing reform.

Based upon fragile social, political, fiscal, and financial conditions, the initial impetus of Latin American decentralization had to be slowed down. Crude reality has begun to demonstrate that piggybacking on national tax revenues might be more expedient than ceaselessly digging into adequate excises for regional taxes or insisting on the property tax as the overwhelming source of tax revenues for municipalities. After some early attempts to reach strict separation of sector responsibilities, practically all countries have kept some review, monitoring, and approval of decentralized services at the national level. Automatic, freely disposable general revenue sharing is being increasingly complemented with earmarked grants, matching grant programs for territorial equalization, poverty alleviation, and other national priorities that are also relevant to subnational governments. The slow developments of capital markets in the region has tamed the initial push for free subnational access to capital markets. Ex-ante controls and ex-post sanctions are being reinforced.

As the idea of fiscal discipline becomes paramount in every decentralization process, intergovernmental tax harmonization, expenditure agreements, and national-level interference in subnational governments have become more important than separation. The search for stakeholders’ ownership of benefits and responsibilities led to an emphasis on institutional incentives capable of elevating efficiency in allocation and production.

Institutional developments suitable to coordinated decentralization are presently the priority everywhere in the region. Although the frontiers of individual account-

ability have been partially blurred by shared responsibilities, adequate institutional developments are being reintroduced to reconcile intergovernmental coordination and clear individual accountability at each level of government. The new web of intergovernmental and inter-sectoral connections is being wired in such a way that it is possible to trace back individual responsibilities. The more the ministries of finance get involved in fine tuning and monitoring decentralization, the more they become aware of the need to complement macro-fiscal policies with effective institutional arrangements.

The agenda for the coming years should be based upon an empirically grounded starting point—not a theoretical one. The short-term target should be inter-sectoral and intergovernmental trust-building and expanding civil society participation. This means the emphasis should be on development of common progress indicators, disclosure and dissemination of information, shared auditing, and evaluation. Autonomy may be partially sacrificed as long as efficiency and accountability are enhanced. Separation may grow in the medium term, on the basis of more market development and stronger regional and local government institutions and citizens’ control.

I. Why Is Decentralization Occurring?

The ideas that gradually led to decentralization in LAC began to be developed in the mid-1970s as a reaction to growing fiscal deficits and increasing awareness of rigidities and inefficiencies at the central level of government.³ Although many of the countries of the region were still under dictatorships and politically unstable—and several countries were going through periods of internal turmoil or civil wars—it was hard to anticipate at that time that the forces that would incline the balance toward decentralization in the 1980s and 1990s would be primarily political in nature. The return to democracy in Brazil (1980s) and Paraguay (1990s); the internal peace processes of Colombia (1986), Nicaragua (early 1990s), and Guatemala (1996); the multiplication and redistribution of the centers of political power in Venezuela (1988); the reorganization of grass-root and other civil society organizations along territorial lines in Bolivia (1993-96) or the strengthening of the multiparty system and the consolidation of the opposition in El Salvador (1990s) and Mexico (1989 onward)—all these are just some examples of the political origins of decentralization in LAC. As a matter of fact, the politically

driven shift toward decentralization overlapped with the centralizing economic measures adopted all over to cope with the regional economic crisis of the 1980s.

Although LAC countries have often invoked fiscal problems at the time of adopting decentralization policies, very few countries in the region have primarily decentralized as a rational, technocratic solution to a fiscal problem. Chile—and to a lesser extent Argentina—appear to be the only LAC countries that embraced decentralization with the main purpose of enhancing public-expenditure efficiency and strengthening public-sector management capacity.⁴ Yet even Chile's comparatively slow pace toward decentralization⁵ was initially determined by political reasons associated with the military regime's caution toward or aversion to decentralization. Indeed, Chile began its long march toward decentralization with some timid deconcentration measures during the years of dictatorship. And it has kept on gradually building capacity at the subnational levels⁶ as well as introducing mechanisms for intergovernmental coordination since the return to democracy in the late 1980s.⁷

Besides internal political dynamics, external pressure also helped propel decentralization in LAC. Foreign development agencies and aid programs have contributed to spreading the word of decentralization all over LAC. The specific purposes and particular emphasis behind the decentralization proposals of external agencies have been as varied as the reasons behind decentralization in each country. Some agencies saw decentralization as a means to alleviate fiscal pressure upon central governments.⁸ Participa-

tory democracy has been a priority for other agencies and programs, especially those that had already been funneling resources to communities and non-governmental organizations. Still others emphasized the potential of decentralization for poverty alleviation schemes or compensatory goals.⁹ Some external programs have promoted decentralization as a way to cope with the politically determined instability of government personnel or to reduce the levels of corruption at the national level. This group of programs expected to raise the level of professionalism and strengthen management and administrative capacity at supposedly clientele-free subnational levels. A few have advocated decentralization with the purpose of strengthening capacity in a given sector (i.e., health, agriculture, environmental protection) or reaching inter-sectoral goals (regional development, local competitiveness).

II. Politically Driven Decentralization Challenged Fiscal Stability and Threatened the Hegemony of Traditional Politics

Although political factors have varied from country to country, all national governments have been under pressure to decentralize. National political parties and national governments bowed to these pressures and often assumed decentralization as a flag of their own. Most countries hurriedly enacted constitutional and legal reforms. Following the legal-positivist tradition, they concentrated their initial efforts toward decentralization on top-down legal reform. They paid little attention to experimenting, testing, adjusting, and replicating as means to ensure the applicability and sustainability of the reforms.¹¹ Formal distribution of revenues and expenditure responsibilities took precedent over effective implementation and efficiency in service delivery.

Moreover, powerful incentives were not granted for additional fiscal effort, nor were dynamic sources of revenue transferred to subnational governments. Expenditure responsibilities were transferred overnight, as if both national and subnational governments could quickly adjust to their new sector roles. The principle of fiscal autonomy liberated subnational access to capital markets in spite of the fact that neither national governments nor capital markets were prepared to let subnational governments default. Top-down technical assistance was initially deemed essential to management and administrative strengthening of lower levels of government. It took years

Nicaragua

Today's Nicaragua is an example of externally inspired decentralization reform. The Nicaraguan social investment fund (FISE), the Ministry of Education, the Ministry of Health, and the Ministry of Agriculture—each has developed its own particular sector model of deconcentration and decentralization.¹⁰ Because no general legal and institutional framework is in place, the four models of decentralization send different signals to communities and local governments. At the same time, other ministries keep operating and spending on a highly centralized basis. As a result, intersectoral coordination is practically impossible.

before governments and external agencies refocused on implementation or realized that learning-by-doing, dissemination of best practices, and horizontal exchanges among subnational governments were probably more effective ways to strengthen regional and local governments.¹²

The political benefits of flamboyant constitutional and legal reforms took precedence over the more mundane concerns of implementation and administration of these radical reforms. In most cases, reforms did not take into account the existing fiscal or political constraints. When Ministries of Finance or Hacienda took notice of the implications of decentralization measures, it was often too late to restart the decentralization process from scratch. The very basic pillars of quasi-monarchic presidential regimes were shaken when there was no structure ready to support the new decentralized state. Thus, all these rules, drafted so carefully and publicized so heavily, remain on the books but are largely unapplied—with the result that decentralization experiences the frustrations of the old colonial tradition, *se obedece pero no se cumple* (roughly translated, “laws are obeyed but not effectively implemented,” as often practiced by Spanish administrators in the colonies with respect to rules issued by the crown).

The implications of decentralization not only surprised national governments, they also brought about a radical challenge to the traditional way of doing politics in LAC. To a large extent, presidential regimes and pyramidal, clientele-driven political parties were caught off guard by this challenge. The extension of elections to subnational levels and the widening and intensification of relations between subnational governments and communities are examples of the ways decentralization has reinforced democratization.

Until the end of the 1970s, in most LAC countries mayors were appointed, either by the president or by the corresponding regional government. By the mid-1990s virtually all LAC countries had elected mayors, though some mayors are not directly elected through universal vote.¹³ This is not the case with the heads of intermediate governments (generally known as governors, but called *prefectos* in Bolivia and *intendentes* in Chile); they are still presidentially appointed in some countries, including Chile, Bolivia, Ecuador, and Guatemala.¹⁴ This difference between the method of selecting mayors and governors is in tune with the institutional tradition of citizens’ participation in local affairs, which goes back to colonial times, and with the

post-independence tradition of intermediate governments that act primarily as delegates of the national government for purposes of internal political control.¹⁵

Decentralization reinforced the ongoing revival of civil society all over Latin America. In turn, bottom-up approaches to government have strengthened governance and have made decentralization more sustainable. Indeed, participation has transformed subnational levels of government in many ways:

- The old Spanish *cabildos* that were at the core of community life during colonial times are being revitalized and adjusted to modern times. Some countries have recently stimulated the recovery of the tradition of the *cabildos abiertos* by ensuring their binding force on the allocation of resources at the local level.¹⁶ In some other cases the *cabildos* have been re-introduced by the initiative of recently elected mayors and other local political leaders. In the latter case the *cabildos* tend to be short-lived, their life span depending on the continuity and of the particular leader or the political group that fostered the *cabildos* in the first place.¹⁷ Evaluations of recent experiences with the *cabildos* indicate that they are not adequate to confront citizens’ priorities with scarce public resources; neither are the *cabildos* free from arbitrariness in the selection of people’s priorities.¹⁸
- Many city governments and a few regional governments are trying decentralization or division of regions and municipalities into smaller budget and administrative units to allow for more participation in the allocation of local budget resources—particularly investment resources.¹⁹ Perhaps the most consolidated partition of both city and budget—and one that has become customary practice over the last decade—is the Participatory Budget of Porto Alegre, Brazil. Yet practically all large LAC metropolises have by now introduced some form of subdivision of the urban area and are now utilizing this partition to consult residents’ preferences on expenditure allocation and making people confront their expectations with limited available resources. Some cities have used budget subdivisions to stimulate fiscal effort by linking the subdivision revenues with localized public services.
- Bolivia’s Law on Popular Participation created the Territorial Grass-Root Organizations (*Organizaciones*

Territoriales de Base), OTBs, and the Vigilance Committees (*Comités de Vigilancia*) with a view to promote, organize, and strengthen civil society's participation in planning, budgeting, and control at the local level. Indeed, the OTBs capitalize on the tradition of a plethora of local grass-root organizations²⁰ that local leaders have kept alive since colonial times for purposes of health, education, park maintenance, or street paving.

- Micro-regional participatory planning (or planning at the sub-municipal level) is being introduced as part of the ongoing reform of social investment funds (commonly known as the FIS) throughout LAC. When micro-regional planning is combined with simplification of the project cycle, matching-funds requirements, and clearly predefined national resources per planning unit, the reformed FIS seem ripe for institutionalization as part of a larger, decentralization scheme of intergovernmental fiscal relations.

Since participation has been more evident at the community and municipal levels, the municipal level of government is at the crux of all the tension between the participatory and the clientele forms of doing politics. This tension expresses in at least three different ways:

1. **The conflict between the local government's response to its local electorate and its response to the demands of the central government and the national political parties for mutual political support and fiscal deference.** This balance often dominates local policy options in the areas of human-resource development and streamlining the local administration, and it includes the often tense relationship between the mayor and the local administration, on the one hand, and the elected members of the city council—who primarily tend to follow party guidelines.²¹
2. **The balance between planning and budgeting autonomy, and coordination with both civil society and higher levels of government, including regional governments and municipal (sub-regional) associations.**²² This type of tension also includes local government participation in alliances or partnerships with communities and the private

sector as well as the search for local competitiveness in a globalized economy. Keeping the proper balance between taxes, prices, and voluntary contributions is also part of this tension.

3. **The balance between the urban centers and the rural periphery within each municipal jurisdiction.**

The institutional context (including intergovernmental fiscal relations) in which municipalities operate, plus the position of a local government on each of the conflicts cited above, determine the specific degree of autonomy of each municipal government vis-à-vis local pressure groups and political coalitions, the central government, and national political parties.²³

The tension between the two competing forms of doing politics (national top-down, subnational bottom-up) has also made it difficult to unequivocally define the role of the regional level in recently decentralized countries. In unitary countries in particular, the regional level has remained the subject of much hesitation and variation throughout LAC since decentralization first started. Regions were at the core of many *caudillo* turf-battles that led to frequent internal civil wars during the immediate post-independence period in most of LAC. With unification and increasing centralization in the late 19th and early 20th centuries, regions were transformed into branches of the unitary government's political machinery, with few service-delivery responsibilities other than police and army bases, some regional planning, and deconcentrated functions in the social sectors. Even two of the four LAC countries that opted for federalism gradually reduced the role of the states to deconcentrated arms of the federal level.²⁴ As the movement toward decentralization demanded more intergovernmental coordination, higher subnational autonomy, and closer supervision of local governments, the role, the resources, and the relative autonomy of regional governments were brought back to the agenda of critical state reform issues during the last decades of the 20th century.

Although most LAC countries have focused on municipalities as the target level for devolution of state resources and responsibilities, the four federal countries of the region have given some more weight to the intermediate level.²⁵ Chile is the only unitary country in the region that has maintained the regions as the pivotal level of decentraliza-

tion; yet even Chile is gradually expanding deconcentration and decentralization to the local level. Bolivia and Peru tried the regional approach for a few years during the 1980s. Peru practically abandoned decentralization policies for most of the 1990s during the Fujimori administrations. After focusing on the local level and grass-root organizations, Bolivia revived the departments in 1996, but essentially limited their role to branches of the national government. Therefore, the Bolivian prefectos (heads of departmental governments) are appointed by the president of the country and are highly subject to national political pressures.²⁶ During the 1980s Guatemala combined the police and military functions of departments with their role as a link in the top-down chain of planning that was supposed to go from the central to the local governments. With the peace accords of 1996, Guatemala decentralized primarily to the local level; it kept the intermediate levels of government primarily for planning coordination. After largely ignoring the intermediate level of government, the Colombian Constitution of 1991 partially revived the intermediate level as the missing link of decentralization.

By and large, all countries seem to agree on the potential of regional governments as the necessary link between the national and the local levels for planning, budgeting, and personnel sector coordination.³⁰ There is also an implicit agreement as to the subsidiary role of intermediate governments when local governments are incapable of assuming their responsibilities. However, municipal gov-

ernments see the enhancement of the intermediate level as a threat to their autonomy because regional governments traditionally have been used for the control of local politics by the national level through handing out fiscal privileges and political favors. The fiscal and political dependence of the intermediate level of government accounts for policies or practices of clientele appointments and personnel instability as regional politicians and governments have to reciprocate the protection and fiscal deference provided by politicians and administrators at the national level. Indeed, one of the challenges of decentralization in Latin America is precisely the transformation of the regional level, from primarily police control and political maneuvering into planning, monitoring, and service-delivery units of government that are responsive to regional constituencies. Even federal Venezuela only recently began to have elected—rather than centrally appointed—governors. Similarly, Mexican governors—who had been in practice delegates of the president for most of the 20th century—are becoming more independent as a result of growing political pluralism and inter-party competition.

In sum, decentralization threatened traditional political parties and their top-down, clientele-driven way of doing politics. Decentralization also challenged the quasi-monopoly power of the president and even raised eyebrows among the technocrats at the ministries of finance. Subnational levels became the scenario of competition among different styles of politics and decision-making. To a

Colombia's Experience

The recent evolution of the role and hierarchy of Colombia's departments is a good example of the ambivalence of most LAC countries with respect to the intermediate level of government. As a medium-size country, Colombia reflects most of the pros and cons of the revival of the regional level in both larger and smaller LAC countries.

Colombia's 1986 laws on decentralization focused on the local level and practically ignored the regional level of government (departments). The 1991 Constitution recovered the role of departments for delegation and deconcentration of central-government responsibilities while at the same time expanding departments' own functions and strengthening their specific role as the bridge between national and local governments. However, the 1991 Constitution preserved local autonomy and stopped short of confirming the traditional hierarchical role of departments over municipalities.

As in the case of federal countries and a few unitary countries in LAC,²⁷ governors are elected through universal vote. As a result of all the above, Colombia's intermediate level of government is ambivalent in a double sense: (1) governors are at the same time agents of the president (central government) and independently elected leaders of the regions;²⁸ and (2) departments have both a subsidiary role as well as a role in the coordination and strengthening of municipalities, sometimes on behalf of the central government, sometimes as a function of their own.²⁹

greater or a lesser extent, national politics has managed to triumph at some subnational levels, in some of the countries of the region. On the other hand, the paramount idea of fiscal discipline is incrementally penetrating subnational levels, and some subnational governments have fully incorporated fiscal discipline into their basic tenets.

III. Veiled Resistance to Decentralization and the Slowdown of Its Implementation

National-level technocrats, presidential regimes, and national political parties have been reacting to the initial design of decentralization with a view to regain control of the process. Technocrats have sought to partially redress decentralization in order to re-establish fiscal discipline and efficiency. By monitoring subnational public expenditure, redesigning fiscal incentives and tax harmonization, controlling credit, and fine-tuning transfers, national ministries are currently seeking to correct the initial equating of decentralization with straight devolution and separation of levels of government. They have also become more aware of the need to strengthen institutional capacity at subnational levels in order to ensure intergovernmental coordination, and they are slowly adjusting to their new regulatory and monitoring role.

The national ministries are finding refuge in intergovernmental coordination, delegation, and deconcentration as intermediate phases of the process of decentralization. At the same time, intergovernmental coordination is taking secrecy, monopoly of information, and discretionary powers away from them. The tension between the search for intergovernmental coordination, on the one hand, and the resistance of the national government to give away their secrecy powers, on the other, is best exemplified by the continuous—and so far failed—search for an independent technical unit for monitoring and fostering decentralization.³¹ Attempts to establish horizontal coordination such as inter-secretary agreements at the national level or conferences of governors, mayors, or finance secretaries at the subnational level have generally failed in Latin America. Vertically imposed coordination may be more effective at times; however, it is generally counter-productive to stimulate sector or subnational initiatives or to ensure sustainability.

The Venezuelan Presidential Commission for the Reform of the State (*Comisión Presidencial para la Reforma del Estado*, COPRE) has been one of the most successful—

though short-lived—attempts to strengthen sector coordination at the national level with a view to supporting decentralization. In addition to the president of the country or his delegate, the commission included the key sector ministries for decentralization (finance, planning, interior, social sector). A few governors often participated in the commission's activities on behalf of the states. In addition, COPRE had a regional office in every state, headed by the governor of the state, with the national COPRE and the sector ministries participating. Through this mechanism, the governor was made in practice the coordinator of deconcentrated agencies and overall public expenditure at the state level.³²

COPRE was tasked with the responsibility for ensuring implementation of the Decentralization Law. It monitored transfers of revenue and expenditure responsibilities, evaluated and strengthened state's capacity to assume new responsibilities, designed and exchanged accounting and reporting systems, proposed legal and constitutional reforms, and developed progress indicators for the decentralization process as a whole. Presidential authority

Lessons Learned

The main lessons that can be drawn from the region's experience with the creation of special technical units for transparent and coordinated decentralization are:

(1) Presidential commissions are hardly sustainable, as they depend heavily on the support of the president who created them in the first place.

(2) Besides inter-sectoral representation, presidential commissions or committees need the active commitment of finance and planning agencies. They also need a strong linkage with regional authorities, especially when governors play a significant coordinating role for deconcentrated federal agencies. Sustainable coordination requires appropriation by regional—even local—agents.

(3) Horizontal coordination among a few agents located at the same level of government (and the same hierarchical level) may prepare the ground for multi-government coordination. Vertically imposed coordination is not usually sustainable in the medium or long term.

backed COPRE's inter-sectoral coordinating efforts. Investment planning in the states was articulated between COPRE, the ministry of planning (CORIDIPLAN), and sector ministries. The planning exercise at the federal level took into account the inputs and initiatives coming from the states via the regional COPREs and deconcentrated units of sector ministries.

Because the commission's effectiveness depended on the continuous and vigilant support of the president, both the commission and the process of decentralization suffered when the COPRE no longer had presidential support to foster and monitor decentralization.

Presidential regimes and national political parties have also attempted to keep their dominance in spite of decentralization. A quick review of a few countries may help illustrate the many ways the national level has attempted to re-appropriate their privileged command—with more or less success across the region.

During the 1990s Bolivia introduced laws and constitutional amendments that entitle Congress and political parties to exercise political and technical control over local mayors and council members:

- All candidates to elected local offices have to be affiliated with a political party that operates at the national level
- Mayors are elected by the local council, out of the council members. These indirectly appointed mayors may be removed by the council after their first year in office if the council does not deem the mayor's per-

formance to be satisfactory.³³ As a result, mayors' tenure in office is dependent on the stability of political coalitions at both the national and the local level.³⁴

- The Senate may suspend central-government transfers to municipalities that do not comply with legal guidelines on minimum investment quotas out of total local spending.³⁵

Bolivia is a rather extreme case, as most countries formally protect the independence of mayors by restraining the national government or the legislature from dismissing mayors at will. However, even countries that have not adopted Bolivia-like provisions have maintained significant influence of national politics over local decisions in practice. Some examples:

- Colombia has a system that allows the election of mayors who are not affiliated with a political party—even locally based political parties. Not only does the system tolerate independence from the national government or national political parties, but it also allows all sorts of coalitions between politically affiliated candidates and non-affiliated candidates or council members. Yet mayors who may be categorized as relatively independent from the two major political parties amount to only 10 percent of Colombia's 1,050 municipalities. The picture for departmental (intermediate level of government) governors is one of even greater links between departments and national politics.³⁶

Maintaining Influence in Brazil, Colombia, and Venezuela

The 1988 Brazilian Constitution mandates a strict separation of resources and responsibilities among levels of government. Yet the federal government may ordinarily resort to budget allocation, discretionary fiscal transfers, and service and investment contracts to ensure the support of members of parliament and their constituencies regardless of their political affiliation. The more powerful a politician and the more critical his or her influence is on a key policy decision, the higher the transfers or the more significant the decisions the federal government must make to strengthen his or her political career.

In 1991 Colombia passed a constitutional reform that prohibited the traditional form of politically oriented discretionary transfers, known as *auxilios regionales*. Subsequent laws made this sort of transfer a crime punishable by prison and fines. Soon the *auxilios* reappeared under the form of privileged parliamentary influence on the allocation of the rural, urban, and social special investment funds administered from the direction of the central planning agency.

Venezuela's 1988 Organic Law on Decentralization sought to restrain discretionary transfers granted by the federal government by establishing mechanisms to combine and coordinate these transfers with the new formula-driven transfers. Yet discretionary transfers remain largely uncontrolled a decade later.

- Until recently Mexico's system ensured that all governors belonged to the ruling federal party. With the growing role of party pluralism and political opposition, candidates of other political parties are increasingly being elected. Yet all elected governors have so far been affiliated with one of the three political parties that have dominated national politics since the latter part of the 1980s.
- Politically oriented discretionary transfers³⁷ have proved harder to kill than initially anticipated. Indeed, the more they are chased, the more veiled and sophisticated these transfers have become.

Presidentialism has also contributed to the maintenance of the political influence of the national level over subnational governments. Even after decentralization, presidents are frequently in a position to influence the territorial allocation of resources, thereby enhancing or risking political careers that start at the local or regional level.³⁸

Political parties have abandoned their ideological principles and class affiliation and have evolved toward multi-class, corporatist types of loose coalitions of unstable members with divergent interests. The relative weakness of the political parties comes at a bad time for national governments, as the erosion of party ideologies, party platforms, and party loyalties has meant that presidents have a fragile support from their own parties at the same time decentralization is threatening the concentration of power at the presidency. On the other hand, the erosion of political parties has also meant that LAC presidents, having privileged influence on the detailed allocation of fiscal resources as well as marked influence on the legislature and the legislative process, may buy off the occasional support of individual members of Congress or their constituencies all the way to the regional and local levels. Strong presidential regimes are capable of maintaining clientele ties with legislators and national political parties that branch out to intermediate and lower levels government, thereby reproducing central influence over local budgets and personnel management even after a period of marked decentralization. A series of subtle institutional links create a relation of reciprocity between strong presidential systems with weak political support, debilitated political parties, increasing local and regional political significance, and growing national visibility of individual political careers at the local and regional levels. Loose relations of reciprocity, though unstable and volatile in terms of the individuals that form

a supporting coalition at each point in time, have the capacity to reconstitute the influence of the national level over subnational governments during the present phase of state decentralization. Therefore, while few countries have rules that allow for national political influence on the subnational levels, most national governments and country-based political parties maintain in practice (often *de facto*) significant influence over local and regional politics and manage to exercise indirect control over local budgets and personnel management.

From the point of view of the very short-term interest of national governments in maintaining political control and promoting their own legislative agendas, large presidential powers, fragmented political parties, lack of political discipline in Congress, and weak opposition are good—even when all these factors also imply weak or unstable political support from the president's own political party or government coalition. The long-term effect, however, is a perverse one, because presidents further debilitate the fortresses of political parties and the legitimacy of the system of representation at the national level. Above all, presidential clientele practices debilitate the long-term capacity of governments to effectively introduce state reform, rationalize human resources management within the public sector, cut budget deficits, combat political and bureaucratic rents, and reduce corruption and public-sector inefficiencies.

Brazil provides a clear-cut example of the way national governments pursue their short-term interest by courting subnational governments under conditions of fragile parliamentary support.³⁹ Brazil's federal government is seriously committed to macroeconomic stability. At the subnational level Brazil has probably one of the richest wells of creative government experiences in mobilizing regional and local resources and improving effectiveness and efficiency in service delivery. Yet parliamentary support for the federal government is fragile as a result of the erosion of political parties at the national level. In view of this fragility, the federal government resorts to every discretionary power it may have access to in order to gain political support in Congress and guarantee approval of the government's legislative agenda. Since both Congress and political parties are heavily fragmented in Brazil, the federal government seeks to negotiate individual support by giving members of Congress and political leaders federal spending that benefits individual constituencies—thereby elevating the merits of individual politicians and reinforcing

ing their political careers. The federal government, as well as members of the federal parliament, court influential local and regional governments and political leaders to ensure their support. Clientele relations are developed between the federal government and Congress, on the one hand, and subnational governments, on the other.

Reciprocal political dependency along clientele lines—though useful for ensuring otherwise elusive political support for the president's legislative agenda—has restrained the capacity of the federal government to push constitutional and legislative reforms. This is particularly true of policies that—though a top priority for today's Brazil—may not have the support of influential political leaders at the federal, regional, or local levels. This was the case for the larger part of the 1990s with the federal government's proposal for state reform, with policies aimed at reducing the public deficit, and with proposals to effectively restrain state and local debt or prevent the federal government from rescuing over-indebted subnational governments. On the other hand, federal intervention in state and local affairs curtails subnational autonomy, as it may be necessary to effectively mobilize additional resources and elevate efficiency in allocation and production.

Keeping reciprocal relations of a clientele type with the central government and national political parties also may be in the short-term interest of mayors, governors, council members, and regional assemblies that base their political leadership on privileged access to the halls of national politics. If national politics is still largely influential at the subnational levels, the reverse is gradually becoming true: The influence of regional and local governments upon national politics and the national government is growing with decentralization. As regional and local governments mature as powerful fiscal and overall economic forces, central governments and Congress alike are becoming more dependent on subnational political support.

The new avenues of subnational influence on the national level are not restricted to the capacity of subnational political leaders to articulate demands on behalf of their territories and receive the support for their individual demands at the national level—as this form of territorial advocacy predates the times of LAC decentralization, often along the lines of political-clientele reciprocity.⁴⁰ The more fiscally and politically important subnational levels are, the larger the number of presidents, cabinet ministers, or members of parliament who have previously

participated in subnational governments.⁴¹ Yet the real test for the expected growing influence of the new subnational politics brought about by decentralization is the extent to which politically disparate regional interests effectively gain power separate from—or even at the expense of—national political parties and politicians at the center.⁴² An alternative test for the relative political autonomy of subnational governments is the extent to which local and regional leaders develop their own support bases independently from the favors and the support of the national-level or local leaders' reciprocal support for national politicians.

IV. The End Result: Delegated or Deconcentrated Decentralization

The combination of opposing forces has led to a hybrid type of decentralization. Since the invisible forces for quick, complete decentralization collide with the resistance of national governments and national political parties, the result is controlled, monitored decentralization. A number of countries have called decentralization what should be more appropriately characterized as deconcentration or mere delegation. A few others, while explicitly typifying their models as controlled decentralization, propose deconcentration as the first step of a phased-in process of decentralization. Still others admit that the development of markets and government institutions—particularly institutions at subnational levels—call for a closer intervention of national governments in the form of monitoring, evaluation, and centrally guided allocation of resources. Whatever the case may be, the truth is that Latin America is demanding the development of institutions capable of implementing decentralization in the region. The initial euphoria with complete or semi-complete separation of revenues and responsibilities has yielded to intergovernmental actions geared to fiscal discipline, efficiency, and sustainable decentralization.

Decentralization in LAC frequently took off as a redistribution of both revenues and expenditure responsibilities. Soon countries learned that it was hard to balance revenues and responsibilities for a single jurisdiction, let alone the entire country. Even some of the countries that combined in a single law or constitutional reform the core of the fiscal reform of decentralization incurred some disproportion between new revenues and responsibilities or a time gap in favor of revenue redistribution.

Revenues vs. Expenditures

The 1986 Colombian laws on fiscal decentralization were more quickly and more effectively implemented on the revenue side than on the expenditure side of the fiscal pie. The same may be said of the 1988 Brazilian Constitution. The fiscal component of the Bolivian Law of Popular Participation (1993) contains primarily a change in the formula for redistribution of fiscal transfers among municipalities but no new, clear responsibilities are effectively imposed on those municipalities that benefit from the law. The 1997 Salvadoran decision to substantially raise revenue transfers to 6 percent of current national income did not clearly and effectively add responsibilities to municipalities. The same is true for the recent Ecuadorian law that established general revenue sharing of 12 percent for municipalities.

The initial prevalence of automatic, freely disposable transfers of revenues in most LAC countries raised eyebrows among fiscal authorities, as it was deemed to create additional fiscal pressure and introduce further budget rigidities without clear connection with expenditure responsibilities or improvements in service delivery at subnational levels. Two reasons seem to account for the preference given to the revenue side of the fiscal equation during decentralization in LAC. Each one of these reasons has imprinted a particular imbalance on fiscal decentralization in most LAC countries:

- **Governments need to ensure credibility and mobilize political support for the enactment of decentralization in the first place.** After decades of centralization, national governments deemed it essential to guarantee transfer of revenues⁴³ by enshrining them in the constitution or introducing clear, inescapable formulas and timetables for unconditional transfers of the general revenue-sharing type.⁴⁴ Indeed, the only usual restriction on this type of transfer has been the request for the allocation of a certain percentage of either the transfers or total regional or local income to investment purposes. In most cases, unconditional transfers have been given as collateral for additional subnational debt (primarily domestic debt), which further enhances the fiscal capacity of

regional and local governments.⁴⁵ Just a few countries attached strings to the transfers from the very beginning or subjected revenue transfers to negotiations with the national level as to the specific sector responsibilities transferred to the subnational level and the particular way the new subnational responsibilities should be complied with.⁴⁶ Indeed, most countries only discovered the virtues of conditional transfers or earmarked transfers at a later point in the path toward decentralization.⁴⁷ As a result, it has only been recently, toward the latter part of the 1990s, that a consensus is emerging throughout LAC as to the advantages of complementing general revenue transfers with conditional, earmarked transfers.⁴⁸

- **Many national governments have been neither prepared nor willing to relinquish the responsibilities of those sector ministries that are being decentralized.** This is particularly true of the huge social sector ministries (education, health) and infrastructure ministries (roads, ports, communications) that control the largest payrolls in the country⁴⁹ and are union-dominated. Resistance and rigidities at the national level have nullified or minimized most attempts to reduce national expenditures in the social and infrastructure sectors that countries are decentralizing. Obstacles at the national level have consequently invalidated the implicit assumptions about fiscal decentralization equilibrium that dominated early decentralization schemes in LAC: (1) that transfers of revenues and expenditure responsibilities to lower levels of government would be accompanied by corresponding downsizing and budget cuts at the national level; and (2) that changes in the intergovernmental distribution of responsibilities would lead to changes in the size of each level of government as a proportion of GDP.⁵⁰ Under these circumstances, not only does the inertia in public spending remain with the central governments—and decentralization necessarily implies more pressure upon the fiscal balance than had originally been anticipated—but redistribution of responsibilities is plagued with confusion and lack of clear accountability, as has happened in Brazil, Colombia, Mexico, and Venezuela.⁵¹

The initial two assumptions underlying the preservation of fiscal equilibrium under decentralization were based on one or both of these two premises:

- Decentralization may be a zero-sum fiscal game—i.e., additional transfers would be compensated by proportional reductions in central-government spending. This premise is based in turn on the implicit assumption that decentralization does not involve new production factors or technological innovations, nor are there administrative frictions or other reorganizational costs inescapably attached to the process.
- Decentralization may raise the effective tax rate for the entire public sector (all levels of government) in order to compensate for any additional revenue needs. This premise is particularly addressed to tax efforts at subnational levels—i.e., to the sources of revenue that are managed and controlled at regional and local levels.

Early decentralization processes, as characterized by Brazil and Colombia during the late 1980s, did not take into account the transitional cost of decentralization⁵² nor the huge overhaul of the central government that is required to adjust the role of the national level to planning, regulating, stimulating, monitoring, and evaluating. Indeed, the initial neglect for the new regulatory function over responsibilities being transferred to lower levels of government led to the attempts of subnational and decentralized agencies to regulate themselves.⁵³ These attempts further complicated the already confusing panorama of distribution of expenditure responsibilities among levels of government. Fortunately, at the turn of the century most LAC countries have begun to clearly differentiate the func-

Colombia's Regulatory Evolution

Colombia is one of the LAC countries with a more developed regulatory system at the national level. Yet most of this system evolved *after* the initial waves of decentralization and privatization made evident the need to create, at the national level, new institutions capable of monitoring, evaluating, and regulating service delivery by private corporations and subnational governments. There are presently three regulatory commissions (energy, water, communications) and three special supervisory agencies (health, ports, public utilities). Dozens of laws prescribe the way the new regulatory and supervision functions must be performed.

tions of planning, financing and incentives, service delivery, regulation, supervision, evaluation, and control, and they are specializing the roles of each government level accordingly.

It was also assumed in LAC, during the early days of redistribution of expenditure responsibilities, that subnational governments would replicate the way public services were previously delivered at the national level. Therefore, revenue transfers for a given responsibility were often estimated using the same cost structure of a given service at the national level.⁵⁴ It took nearly 10 years of immensely creative practices by subnational governments and hundreds of studies on local government innovation to demonstrate that (1) as subnational levels have access to more diversified resources (particularly citizens' participation and community labor, but also capital and technology), they are ordinarily in a position to combine factors of production in a more complex yet flexible manner than the national government; and (2) subnational governments may produce services that were not previously delivered at all.⁵⁵

The growing realization of the potential of both the availability of additional resources and new forms of service delivery at subnational levels has transformed the initial approach to decentralization in at least five respects:

1. Rather than prescribing uniform rules on the functions or responsibilities of subnational governments, national governments are now more inclined to stimulate subnational governments to develop differentiated approaches of their own for the achievement of negotiated goals. In turn, reporting and performance requirements are tailored to the potential resources identified at each subnational jurisdiction.
2. Testing, through experiments and pilot projects, is now widely accepted as the most effective means of identifying potentials at lower levels of government, designing adequate incentives, and determining adjustments for replication.⁵⁶
3. Focalized incentives and specific regulations for new institutional arrangements are gradually superseding standardized models of decentralization generally applicable to all services. Some of the most successful decentralized programs in LAC have been sector-specific, tailor-made for the particular social capital

Different Approaches to Redistribution of Responsibilities

The clearest examples of the negotiated approach to redistribution of expenditure responsibilities are the Chilean yearly agreements on regional investment, signed between the central government and each regional government. Each region sets its own goals, and fiscal transfers are adjusted to a carefully detailed investment program that may cover more than one sector.

Venezuela required sector negotiations for the transfer of the most significant responsibilities from the federal government to the states. When an individual state believes it is ready to assume a given sector, it negotiates with the corresponding sector-ministry at the national level; this agreement between the two levels of government has to be blessed by the national Congress. Differing from Chile, the Venezuelan negotiations are one event that defines once and for all the transfer of most sector responsibilities to the subnational level. Although revenue transfers are adjusted to the responsibilities effectively assumed by each level, the comprehensive nature of the negotiations has made the Venezuelan process of decentralization a slow, painstaking one.

After attempting the abrupt transfer of health and education services to the local level in 1986, the 1993 Colombian Law on Resources and Responsibilities (*Recursos y Competencias*) made these transfers a concerted process between the three levels of government. When a regional government has complied with carefully detailed prerequisites, it may come to the central government to request the effective transfer of a sector responsibility in what is known as the process of "certification." "Certified" regional governments "certify" in turn their own local governments on an individual basis.

Examples of Testing

Legal and cultural barriers have been obstacles to the application of scientific management for the effective distribution of responsibilities among levels of government in LAC. Both the civil code legal tradition and an extreme version of Weber's formal rationality have conspired to resist experimenting, adjusting, and replicating as a means of allocating responsibilities on the basis of each level's comparative advantage. After failing to effectively distribute responsibilities on the basis of uniform, across-the-board decisions, countries are now testing the real capabilities of subnational governments as well as the flexibility of the national level to adjust to differentiated degrees of function and revenue transfers.

With a view to ensuring sustainability, the social investment funds of El Salvador, Honduras, and Nicaragua are deliberately testing incentives and mechanisms for participatory investment planning and maintenance of infrastructure. Because these incentives and mechanisms are geared toward mobilizing the willingness of governments and civil society to cofinance and comanage at the local level, they have to be continuously adjusted to the real fiscal capacity and social capital of each particular jurisdiction.

Since 1997, eight federal Mexican secretaries have experimented with inter-institutional and intergovernmental coordination mechanisms for planning and budgeting at selected regional and local levels. If positive, this experiment will be extended to other areas of the country, and recommendations eventually will be translated into law reform proposals.

In 1997-98 the Paraguayan Ministry of Health experimented in four municipalities with a model for deconcentration and decentralization to the local level.

or available resources at a particular locality or region. The EDUCO program in El Salvador's war-torn regions is an example of the capacity of adequately designed incentives to mobilize scarce human resources and ensure sustainability through civil society's participation. Similarly, the PRODEL program in the war-torn northwest region of Nicaragua illustrates the capacity of focalized incentives and reliable institutional arrangements to bring together local governments and communities for purposes of urban infrastructure and micro-credit. Particular contractual arrangements between the state of Merida and Venezuela's federal government have carefully regulated the state provision of educational services under goal commitments that have mobilized the support of teachers and families and have raised both the coverage and the quality of education in the state.

4. Intergovernmental coordination for planning, budgeting, cofinancing, and action is growing as a result of the expansion of negotiated arrangements between the central governments and subnational governments. Rather than having separate sector responsibilities, levels of government realize they must harmonize investment planning and projects in order to enhance the effectiveness and efficiency of public-sector interventions. As the role of central-government incentives and regulations has become more critical,

it is essential that the national government knows the priority interests of communities, capital, and subnational governments. As bottom-up integral planning is superseding top-down sector planning, public-sector intervention becomes more demand-oriented, and inter-sectoral harmonization becomes more critical. Mayors and governors must have a clear idea of the horizons of public-sector expenditure and state intervention by all levels and sectors of government. Otherwise, subnational governments will not be able to bring initiatives to the attention of agencies that have only a partial (sector) or too-distant (central) view of the territory.

5. As national governments realize the comparative advantage of having subnational governments identify priority needs and alternative ways of producing services, there is a growing pressure to substitute jointly designed programs for centrally designed technical assistance programs, emphasizing coordination and capitalization of best practices at the subnational level. Still today, central government agencies affected by the process of decentralization tend to maintain traditional training and technical programs that focus on national laws and central regulations.⁵⁸ As widely practiced during the early days of decentralization in LAC, traditional technical assistance programs include accounting, planning, budgeting, procurement, and project supervision—the

Strategic Participatory Planning

Strategic participatory planning of global scope is becoming a common feature of large metropolitan areas and more advanced regions of LAC, as illustrated by the recent examples of Rio de Janeiro and Porto Alegre (Brazil); Mexico City; Mendoza (Argentina); Bogota, Cali, and the region of the Valle de Aburrá (Colombia); Valparaiso and the entire Region IV in Chile; etc.⁵⁷

São Paulo's plan to expand its rapid transit system and Cali's plan to construct a metro both require the conjunction of central regulation (including restrictions on property rights), public-private capital financing, and beneficiaries' contributions.

Urban development plans of Mexico City and the state of Mexico (for relocation, water distribution, and reservation of certain areas) call for the coordinated effort of several federal secretaries (Agriculture, Transport and Communication, Environment, Social Development, Agrarian Reform), the Federal District, and the five states that surround the District.

The 1997 participatory, comprehensive vision of Medellin and the Valle de Aburrá in Colombia includes projects that call for the collaboration of national, regional, and local agencies.

way these operations are carried out at the central level.⁵⁹ With the growing pressure to move toward inter-sectoral and intergovernmental coordination, all levels of government (including the national government) have to adjust to new roles and responsibilities. Traditional models of top-down technical assistance and training are being replaced by workshops and experiments to jointly find new ways of doing things together through harmonization of intergovernmental roles and practices.⁶⁰ As a result, two models of training and technical assistance are presently competing throughout LAC: One leads subnational governments to follow the traditional practices of the central governments prior to decentralization; the other one calls for a learning-by-doing, workshop-type of training among all levels of government.^{61, 62}

Urban and regional planning, construction and maintenance of urban infrastructure, traffic regulation, and concessions or otherwise regulating the access to public areas and sources of water were already in the hands of local and regional governments—particularly in predominantly urban municipalities—before the current wave of decentralization. As a general rule, deconcentration and decentralization of expenditure responsibilities have included health, education, potable water, wastewater disposal, and solid garbage disposal. Other public-sector responsibilities that are often transferred to the states are low-income housing, environmental clean-up, protection of reserved areas and water sources, construction or maintenance of local or regional roads, and police services. Yet local and regional governments were already playing some de facto role in most of these services, even before they were transferred.⁶³ As decentralization has intensified the pressure on subnational governments for service delivery at local and regional levels, the creativity of subnational governments has added confusion about which level is accountable for what elements of a public good or public service.

Since constitutions and laws ordinarily charge mayors and governors with overseeing all matters relevant to the social and economic life of their jurisdictions, as well as promoting social and economic development, subnational governments are entitled to take initiatives to expand or improve service delivery, unless explicitly prohibited by

Education

The education sector presents a typical case of local and regional initiatives that add confusion to the division of labor and dilute accountability by level of government. Although education has been generally structured as a deconcentrated service, with local and regional delegates covering the entire country, the truth is that local and regional governments were already paying for or providing incentives to some teachers, building or maintaining schools, mobilizing communities and private enterprise to contribute with educational equipment, organizing parents' committees, etc. All these initiatives have intensified with the increasing autonomy of subnational governments, regardless of the actual phase of decentralization of education or the specific level of government that is being allocated primary responsibility for the service.

law. However, subnational expenditures in services that do not fall explicitly within the realm of local or regional responsibilities are rarely made explicit in the budgets of subnational governments. As a result, local and regional governments know best what are the real expenditure responsibilities and what is the most effective service delivery. Indeed, realization of the incomplete coverage of their data bases is moving central agencies either to charge regional governments with data collection tasks or to request data from local and regional governments by themselves in order to complement the information collected by their field offices. Yet the incentives for regular data collection and submission to a common data bank have not been generally developed.

In terms of revenues, decentralization accelerated the ongoing processes of simplification of the tax structure.⁶⁴ Recent studies on the role of local governments in the reduction of transaction costs and the creation of competitive environments have reinforced the purely fiscal rationale that has moved some of the largest countries to simplify local tax structures.⁶⁵ Decentralization has also contributed to the modernization of the old *patente de industria y comercio*, or levy on every industry or commercial establishment.⁶⁶ When decentralization put some pressure on additional tax effort at the local level, the *patente* pro-

vided an easy way out as municipalities did not have to go into all the political and administrative costs of administering the property tax. Because the relative price distortions introduced by the tax do not seem to bother too much the economic agents, and because national governments were anxious to see increases in local tax revenues,⁶⁷ this anti-technical type of tax has gained popularity and is spreading all over LAC. In turn, the modernization of the *patente* is presently calling for some sort of piggybacking on the national sales tax or further harmonizing the *patente* with the national sales tax.

As decentralization has increased the diversity of the region's own sources of income, LAC countries are still searching for a proper tax base for the intermediate level of government.⁶⁸ Even federal countries such as Brazil are still looking for a technically adequate solution to the problem of appropriate tax sources for the state level. While most countries that apply taxes at the regional level have resorted to excises on gasoline—or surcharges on gasoline and other fuels—or on vehicles, tobacco, alcohol, or lottery games,⁶⁹ Brazil tried to apply the VAT at the regional level.⁷⁰

Taken altogether, the reform of local and regional sources of revenue after decentralization indicates that governments at all levels are trying to increase subnational revenues with the least political, technical, and administrative costs. Enhanced local and regional autonomy has led to increments in subnational tax revenues when relatively dynamic sources of revenue have been put in the hands of subnational governments. The available—if scarce—evidence indicates that simplifying the revenue structure, reducing or eliminating the degree of central control over the rates and the administration of subnational sources of revenue that can be administered in the territories, and stimulating local governments to eliminate exemptions and unnecessary tax incentives can only take subnational governments so far in the right direction.⁷¹ Piggybacking or otherwise sharing the proceeds of the most dynamic, national taxes on sales and income have to be introduced to substantially elevate regional tax effort as demanded by decentralization.

Decentralization in LAC has been based upon the premise that no local or regional government with substantial expenditure responsibilities can be self-financed. The technical limitations of subnational sources of revenue, combined with the fact that the national government keeps

the most dynamic sources of revenue for itself—or that these most dynamic revenue sources fit the national level better—have moved all countries to make additional fiscal transfers when devolving or transferring responsibilities to lower levels of government. Although formula-driven, general revenue sharing transfers became prevalent during the early years of decentralization, it soon was evident that national governments had kept some way to resort to discretionary or extraordinary transfers, usually of an earmarked type. Moreover, these extraordinary transfers were often used to bail out over-indebted subnational governments. The present challenge is to effectively complement freely disposable and earmarked transfers in such a way that most or all transfers are formula-driven and allocated in transparent, disclosed ways.

The slow developments of capital markets in the region has tamed the initial push for free subnational access to capital markets. Ex-ante controls and ex-post sanctions are presently being reinforced throughout the region.

V. Conclusions

Two opposite styles of executive-legislative relations and national-subnational relations are silently competing with each other in contemporary LAC. As presidential systems do not seem to bend to parliamentary systems—not even on an experimental basis—decentralization in LAC has to coexist with strong presidential systems.⁷² Effective implementation of decentralization seems to require a transitional phase of cooperation and coordination between strong presidential systems and new centers of power at the subnational level. Coordination should be used as a trust-building tool to stimulate higher levels of government to transfer responsibilities to lower levels. As national ministries and subnational governments develop uniform accounting, reporting, and monitoring, they develop confidence in their peers' capacity to act with the same competence as if they were acting by themselves.

Moreover, intergovernmental coordination should be shaped in such a way that it does not appear to threaten the ministry of finance's legitimate concern with the primacy of economic stability. At the same time, the new linkages between the national and subnational levels should protect subnational autonomy from party-clientele, top-down relations. The solution to this three-facets riddle seems to lie in strengthening trust-building among levels of government via transparency and enhanced accountability. Reli-

able joint (that is, intergovernmental) or national-level monitoring and evaluation are necessary.

As exemplified by the bill on subnational fiscal discipline recently submitted by the federal government to the Brazilian Congress, there is growing acceptance of national-government interference when it is strictly geared to ensure transparency and accountability through intergovernmental collaboration. More than delegation and deconcentration, the present agenda calls for clearer accountability in a context of intergovernmental collaboration. Trust-building between sectors and across levels of government also needs (1) specification of formulas and eligibility criteria for transfers, (2) focusing of fiscal incentives of regional and local governments on dynamic and efficient sources of taxation, (3) coordination and negotiation of expenditure responsibilities under flexible arrangements according to fiscal capacity, and (4) clear signals on the whole system of incentives and conditions, so that subnational governments may know better their own production possibilities as well as the possibilities for their own territory.

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Endnotes

1. As I will illustrate below, decentralization in LAC has different meanings and manifestations, depending on the country—often the region of the country—and the time under consideration. While some countries have essentially understood decentralization as the transfer of resources and responsibilities from the national level to lower levels of government, others have enshrined civil society participation (Bolivia), administrative effectiveness (Chile), or intergovernmental coordination through deconcentration and mere delegation (Mexico) as the ruling principle of decentralization. Therefore, what is called decentralization in LAC may really be just policy decisions and actions taken under the rubric of decentralization rather than decentralization per se.

2. As referred to in this paper, "the region" or "LAC" means Latin America. This region encompasses a wide diversity of countries in terms of area, population, territorial divisions, levels of government, types of states (federal, unitary), economic structures, levels of development, competitive advantages, social capital at local and regional levels, and fiscal and administrative capacity. Divergences notwithstanding, most these countries have a common heritage of legal, judicial, and administrative institutions, as well as a tradition of powerful central or federal governments. Most of these countries also share, to a greater or lesser degree, deeply rooted practices of clientele relations that consist of political and economic reciprocity primarily based upon privileged access to public resources and policy measures. Furthermore, corruption indicators remain relatively high for many countries in the region. Other recent trends that allow some common treatment of the LAC countries as a region are: (i) democratic governments as characterized by multiparty elections and a growing alertness to human rights; (ii) strong presidential regimes; (iii) increasing fragmentation of political parties and vanishing party

loyalties; (iv) recent respect for and observance of fiscal, monetary, and trade fundamentals; (v) the changing role of the state in regard to privatization and citizens' participation; (vi) shift from appointed to elected mayors or governors; (vii) decentralization itself; (viii) rising indicators of urbanization including urban crime and violence. Last but not least, most these countries are now experimenting with four models of service delivery at local and regional levels: modernization of central government services, privatization, decentralization, and public-private alliances.

3. An example of the pioneer studies undertaken in the region toward the end of the seventies is the report produced by the Colombian Presidential Commission on intergovernmental fiscal relations (Bird 1981).

4. Neither restoring fiscal equilibrium nor primary political reasons have been behind Chile's decentralization.

5. The relative fiscal size of the Chilean subnational governments (as a percentage of GNP or total public income or expenditures) is still considerably lower than the fiscal size of regional or local governments in other LAC countries, particularly those countries with economies larger than or about the same size as Chile.

6. It has done this primarily at the regional level (Intendencias in Chile), slowly reaching the local (municipal) level.

7. Costa Rica, the only country in LAC other than Chile that ranks well below the rest of the region in the international scales of corruption indicators, is the only Latin American country that has neither attempted decentralization nor introduced a strategy to this effect. Peru is not presently engaging in some sort of decentralization, but Peru attempted decentralization—primarily along regional lines—before the 1990s.

8. Their expectations gradually faded out as it became evident that the transition to a decentralized state implied additional spending in the short term. Besides, some subnational governments were not as fiscally disciplined as originally anticipated.

9. They were based upon the assumption that targeting and monitoring subsidies would be achieved more effectively at decentralized levels. Or they expected to introduce changes in the distribution formula for fiscal transfers that would benefit the most backward or rural regions of the countries.

10. By definition, deconcentration and decentralization are similar, but they have important different connotations. The French-inspired concept of deconcentration corresponds to relocation of higher levels of government into smaller subnational territorial units. Although deconcentration brings government closer to the people, competence and responsibility remain with the higher level of government. By contrast, decentralization implies the transfer of competence and responsibility to lower levels of government.

11. Argentina, Bolivia, Brazil, Colombia, Venezuela, and—more recently—Ecuador have adopted general legal and constitutional frameworks, with division of resources and responsibilities usually complemented by specific sector and territorial laws. Uruguay has also adopted a relatively cohesive and comprehensive decentralization policy, adjusted to the relatively small size of the country both in area and population. Smaller Belize has also redistributed resources between the central level and Belize City. Chile and Honduras keep gradually building the structure of decentralization by adding policies and instruments over time. Mexico has a 20-year-old law for fiscal coordination that is short of a clear rule on distribution of revenues and responsibilities among relatively independent levels of government. The Guatemalan Peace Accords (1996) have a blueprint for decentralization that has not been transformed into a state policy. El Salvador, Nicaragua, Panama, and Paraguay pay lip service to decentralization while only adopting scattered and diverse sector policies. Costa Rica and Peru still debate whether to follow the regional decentralization trends.

12. See World Bank (1995).

13. Bolivia has indirect election of mayors; a directly elected local council that elects the mayor. Nicaragua had a similar indirect election until recently and now has direct election of mayors.

14. Nicaragua is presently entertaining a proposal to introduce prefectos appointed by the president.

15. Argentina and Brazil are only partial exceptions to this general rule, as their intermediate governments have traditionally had some more significant responsibilities. Yet even in these two countries the intermediate level of government primarily played a police role during the years of dictatorship.

16. El Salvador has attempted to institutionalize the *Cabildos Abiertos* since the late 1980s. The Honduran Social Investment Fund (Fondo Hondureño de Inversión Social, FHIS) introduced in 1998 the *cabildos abiertos* as a means to do participatory planning at each municipality for the identification of priorities that fall within the FHIS menu of investment projects in infrastructure and social expenditure.

17. This was the case in Cartagena (1988) and Cali in Colombia (1992-98). The Cali experience with the *cabildos* was gradually subsumed within and further institutionalized through the decentralization of the city administration in 20 territorial units (known as the CALIs) for planning, budgeting and service delivery. The Mesas de Concertación de Córdoba, Argentina, during the early part of the 1980s, are another example of short-lived *cabildo*-like civil society participation that depended on the support of local and regional governments.

18. Evaluations of the *cabildos* experience of post-civil war Salvador indicate that mayors and local politicians made their voices

prevail in the open town meetings, above those of ordinary citizens. The 1998 Honduran experience with *cabildos abiertos* for investment planning, in connection with the allocation of resources of the Social Investment Fund, bypassed the elected councils. As a result some mayors and councils posed resistance to this attempt to reintroduce participatory democracy. Contrary to Honduras, the experience of the Social Investment Fund of Nicaragua with participatory planning for the maintenance of social infrastructure explicitly consults both mayors and elected councils. The Cartagena (Colombia) experience of 1987-89 with the *cabildos abiertos* was short-lived and led to frustration of people's expectations and discontinuity in planning.

19. The list includes, among others, the metropolitan areas of Santiago de Chile and Lima (Peru); Porto Alegre, Recife, Rio de Janeiro, and São Paulo (Brazil); Bogota and Cali (Colombia); Caracas (Venezuela); and the Province of Mendoza in Argentina.

20. Often called *patronato*, *juntas de acción comunal*, *comités cívicos*, *comités de barrio*, or, more broadly, *organizaciones de base*.

21. Manifestations of the latter tension vary from country to country, primarily as a function of the institutional framework within which both the municipal administration and the local council operate.

22. Municipal associations and special districts have grown at an accelerated pace since the adoption of decentralization policies. Confronted by the need to improve service delivery by themselves and strengthen their own management and administrative capacity, municipalities have joined resources with one another.

Smaller municipalities tend to associate themselves in order to strengthen their management and administrative capacities or to take advantage of potential economies of scale. Associations among larger municipalities—particularly in big metropolitan areas—are primarily driven by coordination and innovation purposes. The huge metropolitan area of Mexico City has five different jurisdictions. With the growing political autonomy of both the states and the Federal District, these jurisdictions have begun to take initiatives to coordinate urban policies regarding land markets, urban infrastructure utilization, new development areas, population density, internal migration policies, etc.

Seven municipalities of the metropolitan São Paulo are developing new urban policies and instruments for the rationalization of the use of land, urban infrastructure, and air space as well as capturing increases in land values.

23. The institutional context varies from country to country and from municipalities of higher category to municipalities of lower categories. Because decentralization is a relatively new development in LAC, most countries are still hesitant about the stability of mayors and council members, the stability and compensation of techni-

cal staff, the role (if any) of auxiliary mayors, the limitation or prohibition of re-election, the binding force of planning over time, etc.

24. Argentina and Brazil always kept regional governments (provinces in Argentina, states in Brazil) more independent than states in Mexico and Venezuela. Therefore, decentralization in Argentina and Brazil did not mean institutional change as radical as in Mexico and Venezuela. On the other hand, the tradition of higher fiscal independence of the Argentinean and Brazilian states was the basis upon which states went beyond their indebtedness capacity and created significant fiscal imbalances during the 1980s and '90s. Mexico and Venezuela keep state indebtedness very much under federal control.

25. Called states in Brazil, Mexico, and Venezuela; provinces in Argentina.

26. Internal political battles within the central government coalition have become particularly acute at the level of the Bolivian *prefecturas*. As a result of paralyzing turf struggles and institutional confusion about the real role of the intermediate level of government, the Bolivian *prefecturas* substantially underspent their budgets during 1998.

27. Paraguay, Uruguay.

28. In spite of being a federal country, Venezuela has also kept the double role for governors.

29. The ambivalent role of departments has often been used as a leverage during the transition from centralization to decentralization. In the case of the decentralization of education, for instance, departments have to fulfill some requirements and demonstrate that they are both capable of and willing to assume some educational functions before responsibilities are actually transferred to them. At the same time, departments have to monitor the capacity and the willingness of municipalities before they further transfer educational responsibilities to the local level. This two-stage process is known as the process of "certification," as departments have to be "certified" by the national government before they themselves "certify" a given municipality within their jurisdiction.

30. See, for instance, F. Rojas (1994b).

31. It is also exemplified by the continuous blame on subnational governments for corruption and inefficiency. In fact, no country in the region has been able to demonstrate that either corruption or inefficiency has a higher incidence at subnational than at national level.

32. Decentralization in Venezuela is practically limited to the state level.

33. This primarily political mechanism is known in Bolivia as the *censura constructiva*.

34. Nearly 10 percent of Bolivia's roughly 330 mayors have been removed from office during the last two years. According to political

observers, national-level coalitions have been influential in the removal of mayors of large and intermediate cities (the mayor of the city capital, La Paz, among them), while removal of mayors of small municipalities has been primarily due to local politics and/or poor performance. Bolivia has been preparing a new Municipal Law during the last few years. As announced, the new bill reforms the local electoral system by restricting mayoral candidates to those two or three council members that receive the highest vote at the time of the election.

35. So far this provision has only been applied in a few cases, and the sanction has been raised once local governments comply with the required quotas.

36. As it is also the case in other LAC countries (including federal Venezuela), regional investment and development plans must harmonize with the national development plan, and local development plans have to be in conformity with both national and regional plans. Strict enforcement of this pyramidal planning is rarely attempted. Besides, Colombian laws require that all mayors and governors comply with their own government plan as of the time they were elected. Those who deviate from their plans at the time of the election may be removed from office if a substantial number of voters express their will for their dismissal. Although government plans are usually vague—and unexpected circumstances may always justify adjustment to the original plans—political coalitions and the mass media have occasionally attempted to make use of this provision. Significantly, three of those attempts have been tried against the mayor in the capital city of Bogotá—so far without success.

37. These transfers have often led to confrontation between the Ministry of Finance—responsible for fiscal policy and the administration of fiscal transfers—and the Ministry of the Interior or the Ministry of the Presidency—usually responsible for the process of decentralization as a whole, as it is or has been the case at times in Bolivia, Chile, Colombia, Paraguay, and Venezuela. Countries have attempted to resolve this tension between the fiscal and the political side of the government by elevating the responsibility of the process to a commission of cabinet ministers (as in the case of the *Comisión Presidencial para la Reforma del Estado*, COPRE, in Venezuela, 1988-1993, or in the case of the 1998 Bolivian commission for decentralization, headed by the country's vice-president) by transferring in practice the leading role of this process to the Ministry of Finance (Chile in 1998, Paraguay in 1996) or the National Planning Department (Colombia, Venezuela), by appointing a parliamentary commission for decentralization (Paraguay in 1995), or by creating a special Ministry for Decentralization (Venezuela in 1995). Other countries have added this responsibility to presidential commissions in charge of state modernization (Guatemala, Honduras, Nicaragua).

Besides the tension between the Ministry of Finance and the agency responsible for the overall coordination of the process of decentralization, there is usually a tension between the sector ministries and the Ministry of Finance. While the latter seeks to add all transfers and convey clear, aggregate rules and incentives to lower levels of government, sector ministries such as Educación or Salud ordinarily try to develop their own sector-specific model of decentralization and design their own fiscal transfers.

38. As in the case of Brazil, most LAC countries inherited some of the strong presidential features of the Fifth French Republic. Most LAC presidents may temporarily legislate by themselves. They also have wide veto power of legislative decisions and exclusive legislative initiative on most key fiscal and economic laws. (S. Mainwaring 1997, M. Cavarozzi 1997).

39. Many other countries in the region share the same basic characteristics of the Brazilian example, namely:

- A high number of often fragmented political parties, as in the cases of Bolivia, Ecuador, and Venezuela. Mexico's one-party structure is today a multiparty system—and possible additional fissures are occurring within each one of the three main parties. The two traditional political parties of Colombia have been significantly split for more than 20 years. The same may be applied to Argentina and Paraguay during these countries' post-dictatorship years.
- Coalition governments.
- Lack of party discipline, both within the government coalition and within the opposition.
- Unstable government coalitions, as exemplified by Ecuador, Venezuela, and Paraguay during the last part of the century.
- Strong presidential powers everywhere throughout LAC.
- Governments' buying off the support of small groups or individuals in Congress and extending buying-off actions to subnational levels seen as an acceptable political practice.
- Growing fiscal and political influence of subnational governments, making them critically important for national-level politicians.

40. Politicians at the national level have traditionally ensured the support of their territorial bases by controlling and funneling discretionary budget transfers for local and regional development. These transfers have been either coordinated or directly administered by the Ministry of the Interior because this ministry is primarily responsible for articulating parliamentary support for the president. Besides, this same ministry is either formally responsible for coordinating the process of decentralization (as has been the case at times in Bolivia, Chile, Colombia, and Honduras), or remains a significant player in the decentralization process when no

single authority has been designated to coordinate decentralization (as in Mexico), or some other national agency is primarily responsible for decentralization (as in the cases of Guatemala and Venezuela).

41. To mention but a few recent examples, by the end of 1998 the president of Argentina had been a former provincial (state) governor while the vice president of Colombia had also been governor of the department he was born in. In the same year, the presidents of Colombia, Ecuador, El Salvador, Guatemala, and Nicaragua had all been mayors of the capital of their countries. By the same time it has been widely speculated that Cuathemoc Cardenas, then mayor of Mexico D.F. will enter the race as a presidential candidate for the 2000 elections. In the 1998 presidential campaign in Venezuela, one of the strongest candidates based his merits on his performance and achievements as the governor of the medium-size state of Carabobo. This candidate partially focused his political platform around decentralization issues. Furthermore, one of the most powerful arguments for the approval of Venezuela's 1988 Organic Law on Decentralization was precisely the fact that the political system was in need of adding a few steps to the ladder leading to Congress and the presidency. As young provincial political leaders found little incentive to remain in their regions, they moved to Caracas where they found it very difficult to access political offices that were already crowded out by more traditional political leaders.

42. If one assumes that the distribution of political power in the country is a zero-sum game, then the growth in political power in the regions would mean a reduction in political power at the center. However, decentralization may be seen as a process that enhances the legitimization of the political system and creates additional sources of political power.

43. More rarely sources of revenue.

44. Most countries opted for a percentage of the national government's current income. Mexico and Paraguay redistribute shares of broad-base national taxes, as did Colombia—out of the value added tax—between 1986 and 1991.

45. In the case of the Mexican states, fiscal transfers have been the only type of collateral given to domestic creditors.

46. Chile is the country that has resorted the most to negotiations and carefully transferred responsibilities followed by monitoring indicators. Venezuela's 1988 decentralization law chose a combination of an increase in the general revenue transfers plus negotiated transfers conditioned to the states' effective assumption of sector responsibilities. Paraguay has also resorted to conditional, negotiated transfers. In all these cases, decentralization of expenditure responsibilities has followed a slower pace than in countries that opted for straight redistribution of revenues and responsibilities.

47. For instance, it took Colombia nearly six years to discover the need to regulate and phase in the transfer of expenditure responsibilities in the social sector. After an outright transfer of revenues and responsibilities in 1986, Colombia adopted the method of "certification" to effectively transfer revenues and responsibilities in health and education on a case-by-case basis.

48. Automatic, unconditional transfers would serve compensatory purposes and would ensure minimum management and administrative capacity to cope with new responsibilities while conditional transfers would help ensure effectiveness and efficiency as well as sustainability in service delivery.

49. Ordinarily followed by defense and justice ministries.

50. Data for Colombia show that for the first 10 years of decentralization (1985-1994) both national and subnational government spending grew as a share of GDP after the size of the national government expenditures had been adjusted for intergovernmental transfers (R. Bird and A. Fiszbein 1996). While the biggest chunk of fiscal transfers is earmarked to the social sector, there has been little reduction in direct central government spending for this sector. At the same time, other sectors—particularly defense, social security, and administration of justice—have been growing at a rapid pace as a proportion of total national budget.

51. As P. L. Barros and V. L. Cabral (1995) have shown for Brazil.

52. This explains why the Ministry of Finance was initially left out of the process of implementing decentralization. When it became evident that decentralization had some fiscal costs—and some symptoms appeared as the capacity of fiscally autonomous subnational governments to create fiscal imbalances—the Ministries of Finance quickly got back in the picture.

53. For an account of the vacuum initially left by the central government in Colombia, see Bird and Fiszbein (1996), for Brazil, Barros and Cabral (1995). Examples of subnational governments' attempting to fill the vacuum left by the national government in regulation or incentives are still going on in LAC. This is, for instance, the case with the water service in Paraguay 1996-98, where both the specialized national agency and the municipalities are still trying to develop regulations of their own for the water services they themselves provided.

54. This was the case with the preparation and application of the 1993 Law 60 on revenues and responsibilities of subnational levels of government. The same assumption inspired the Organic Law of Decentralization in Venezuela, which practically froze the level of transfers for individual sector responsibilities to the same amount of money being spent by the national government at the time of the transfer.

55. Multilateral and bilateral programs as well as university research programs have made a significant contribution to documenting innovative experiences in LAC. For an example of World Bank support to this effect, see Fuhr and Campbell (1994). The program *Innovations in Local Government*, sponsored by the Ford Foundation and initially focused in the United States (Kennedy School of Government at Harvard University) and The Philippines, has now been extended to Brazil. The IDB has also documented good local and regional practices, primarily through the work of the Instituto de Desarrollo Social, or INDES. Bilateral cooperation (USAID, KFW, GTZ, DES, CIDA, SIDA, Friedrich Ebert Foundation, Konrad Adenauer, Friedrich Naumann, etc.) has both supported and documented new institutional arrangements and creative forms of service delivery at regional and local levels throughout the region. Similarly, the growing number of horizontal exchanges among mayors, governors and members of local or regional assemblies is offering new forums for discussion of unprecedented experiences, where LAC local and regional actors often encounter their peers from other regions of the world.

56. Some LAC countries (Chile, El Salvador, Mexico, Nicaragua, Paraguay, Peru) have adopted and implemented decentralization as a sector-by-sector, gradual, piecemeal process that does not require a comprehensive legal or institutional frame of reference. On the other hand, Bolivia, Brazil, Colombia, and Venezuela have proceeded on the basis of comprehensive strategies, often elevated to the rank of each country's constitution. Mexico adopted a Law of Fiscal Coordination that does not deal with some of the key institutional issues of decentralization. Guatemala included guidelines for decentralization as part of the Peace Accords of the 1990s.

57. The experience of Barcelona, Spain, with participatory planning and comprehensive views of the city and Cataluna, plus local and regional studies on competitiveness, have inspired the subnational search for mission, identity, and long-term development goals throughout LAC.

58. The ongoing (1998) Mexico program brings technical assistance, hardware, and software to states and local government with a view to applying the same federal rules and criteria for accounting, budgeting, and monitoring at all levels of government.

59. This was, for instance, the most basic component of the Colombian program for institutional development of municipalities from 1988 through 1992.

60. Collection of information on good practices, business school-type case studies, dissemination, and replication are becoming the main core of the new activities of the municipal development institutes that have existed throughout Latin America since the late 1960s. This is, for instance, the reorientation of FUNDACOMUN in Venezuela since the

early 1990s. IBAM (Brazil) has also partially followed this general way to restructure. Colombia's INSFOPAL disappeared with the 1986 decentralization reform, while the equivalent institutes in Bolivia and Peru have gradually vanished since the late '80s.

61. This is one more manifestation of the collision and competition between two styles of government, as elaborated on in the first part of this paper. It is true that the design of intergovernmental transfers may help stimulate intergovernmental and inter-sectoral coordination. Institutional arrangements such as inter-sectoral or intergovernmental contracts, technical consultative committees (as in Bolivia), presidential commissions (as in Nicaragua and Venezuela), or simple *ventanillas únicas* (as in Bolivia) may also help overcome the barriers posed by the traditional hierarchical role of the national level or the turf battles among ministries and other central-government agencies. Yet no institutional arrangement at the national level may effectively fill the gap created by insufficient commitment to coordination at subnational levels.

62. Having been created as parallel institutions to central-government ministries, social investment and emergency funds are beginning to play a flexible, inter-sectoral and intergovernmental coordinating role, particularly in smaller countries, where the funds are a significant source of public-sector investment (Bolivia, El Salvador, Guatemala, Honduras, Nicaragua). On the contrary, ministries tend to be more resistant to coordination—particularly coordination from the bottom-up—as ministerial posts are distributed in accordance with political parties or party fractions. Ministries, especially sector ministries, are also characterized by a long entrenched bureaucratic inertia.

63. Local governments in relatively poor countries like Nicaragua or Paraguay have been building and maintaining schools long before the current attempts to deconcentrate and decentralize education in these countries. A rough estimate of local government's own yearly contribution to education in Nicaragua indicates that it might be as high as 18 percent of the cost of schools being built or restored in the country. Colombia's local and regional governments had schools of their own and paid their own teachers before education was centralized in the 1960s. Regional-level departments like Antioquia and Valle and many large and intermediate cities are still paying their own teachers or providing incentives to teachers over and above the national transfer for education.

64. Some countries keep long lists of taxes and fees but municipalities effectively administer a few of them. This is, for instance, the case in Venezuela.

65. Colombia began the process of simplification in 1968 (Law 33), then accentuated simplification at subnational levels in 1983 (Law 14).

66. During the early 1990s, a GTZ cooperation program for Venezuela experimented and proposed a reform of the *patente* that has been gradually adopted by most Venezuelan municipalities. Colombia uniformly reformed the *patente* for all municipalities, as part of the tax reform of 1983.

67. From being an obsolete tax until 1983, the *patente* soon became the largest source of tax revenues for Colombian municipalities.

68. As a unitary country, Colombian departments do not have revenue sources of their own. However, for most practical purposes, excises on lotteries, liquor and tobacco—although established at the national level and delegated by the nation to the departments—are administered as resources of their own.

69. In federal Venezuela, the states have not had any significant source of revenue before the 1988 Law on decentralization. Even the law authorized only very limited sources of revenue, primarily excises and tolls for the use of roads, seaports and airports which are very unequally distributed in the territory.

70. Brazil's exclusive experiment with the application of the VAT at both the federal and the state levels introduced so many complications that the standard recommendation has been the abolition of the states' VAT, the strengthening of the federal VAT and the application of a distribution formula for the federal VAT among states, perhaps similar to the distribution formula for part of the VAT proceeds currently applied in Mexico. More recently, experts have re-visited the Brazilian experiment and are

more optimistic about the potential piggy-backing on the federal VAT.

71. Colombia's 1983 tax reform of local and regional taxes simplified the tax structure and increased the command of subnational governments over their main sources of revenue. This reform produced quick and measurable increases in local and regional tax revenues. The 1986 decentralization reform made significant transfers of revenues and responsibilities to state and local governments. This reform included incentives for local tax efforts in the formula of distributing transfers among municipalities. The 1993 reform also included incentives for additional tax efforts that corrected some of the most obvious technical distortions of the 1986 incentives. Neither the 1986 nor the 1993 incentives for additional tax efforts have produced any significant results.

72. As political architects become more aware of the combined effect of powerful presidential systems and declining political parties, there is a natural tendency to further regulate political parties and electoral systems. There is also a growing current throughout LAC that restricts the theoretical advantages of presidentialism to two-party systems. This same current is beginning to argue in favor of parliamentary systems when there are more than two parties, specially if the parties lack internal discipline and distinctive political cohesion. However, no country in Latin America seems to satisfy the essential conditions for effective parliamentary government at this time. Even Brazil's experiment with parliamentary government during the early 1960s was in practice a mixed, presidential-parliamentary system.

The Politics of Decentralization in Latin America

STEPHAN HAGGARD

The potential gains from decentralizing government are numerous. Recent literature highlights not only improvements in allocation efficiency stressed by early theorists of fiscal federalism (Oates 1972) but dynamic effects on growth and various political advantages as well, including increased participation and enhanced autonomy for minority groups.

As experience accumulates, however, it is clear that this promise is not always realized and that a number of experiments in decentralization have gone wrong, sometimes radically so (Prud'homme 1995). If we focus on the assignment problem—the task of allocating expenditures and revenues to the appropriate level of government—it is possible to find cases where expenditure responsibilities are transferred ahead of revenue-raising powers as well as precisely the opposite: cases where resources are transferred without corresponding responsibilities. A common complaint about decentralization is that the assignment of policy responsibilities lacks clarity, resulting in duplication of effort, and deteriorating quality of service.

The fiscal consequences of decentralization have not always been benign either. Provincial governments in some federal systems have run unsustainable budget deficits financed either by transfers from the federal government or by borrowing. Subnational borrowing presents particular problems. Both Argentina and Brazil experienced subnational debt crises that complicated the central government's fiscal and monetary policy.

Critics of decentralization have also underscored the possibility of an increase in regional disparities. One function of government is to redistribute income among jurisdictions. To the extent that taxing and spending decisions are delegated to lower levels of government, this capacity is diminished. Equally common are patterns of resource flows and transfers that do not correspond to any economic or distributive logic, such as the ability of capital cities or favored provinces to capture a disproportionate share of the budget.

Finally, studies of the decentralization of service provision have provided examples where state and municipal

governments are poorly equipped to handle the responsibilities delegated to them. Despite these weaknesses, local governments have also on occasion blocked the devolution of authority to service providers, such as school principals and hospital administrators. In some cases, these failures are connected with outright corruption and fraud.

These findings do not necessarily imply that we should be skeptical about decentralization. However, they have generated a second generation of literature that pays less attention to the static gains from decentralization and greater attention to getting *incentives* right among different

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levels of government. Exemplary of this new approach is Barry Weingast's (1995) theory of "market preserving federalism." Building on Tiebout (1956), Weingast argues that the most important effects of decentralization are dynamic; it induces policy experiments and competition among jurisdictions that improve the quality of governance. But Weingast's market-preserving federalism only has growth-enhancing effects under a series of highly restrictive conditions that are ultimately political in nature:

- Subnational governments have primary authority over the economy within their jurisdictions.
- The national government has the authority to police the common market and to ensure the mobility of the goods and factors across jurisdictions.
- Revenue sharing is limited and borrowing is constrained, so that all governments face hard budget constraints.
- The allocation of authority and responsibility enjoys some credibility, so that it cannot be altered either by the national government or through subnational pressures. Both levels of government must be able to credibly commit to the intergovernmental bargain.

A similar set of incentive-based arguments have been made in discussions of the conditions for maintaining fiscal stability in a decentralized system (Dillinger and Webb 1999). Overall fiscal balance is more likely if:

- Subnational governments are required to raise their own revenue.
- The government can delegate functions to subnational governments to go along with the delegation of revenue sources.
- The central government controls subnational borrowing *ex ante*.
- The central government commits not to bail out subnational governments and imposes losses on creditors in the case of default by subnational governments.
- The central bank is autonomous and has a strong anti-inflation mandate.

We have made somewhat less progress in understanding how to structure incentives to ensure efficient service delivery, but some tentative conclusions about the role of incentives are emerging here as well (Litvack, Ahmad, and Bird 1998):

- Information on the cost of public services, on procurement, and on public attitudes about service quality, including from the media and independent surveys, enhances political accountability to local preferences.

- Competition among service providers (as well as among jurisdictions) can enhance the efficiency of service.
- Participatory budgeting, community participation, and engagement of NGOs can provide additional checks on government.

These approaches to decentralization mark an important advance in that they specify the conditions for achieving improvements in economic performance and the quality of service delivery. However, they do not address the more fundamental question of how such bargains are struck and why they would be credible.

To answer this question, the analysis of decentralization must explicitly take into account the incentives facing politicians and bureaucrats. Why would politicians and bureaucrats delegate authority to lower levels of government? What interests do subnational politicians have in the design of fiscal institutions? How do political incentives influence—and sometimes distort—the design of decentralization?

This paper considers these questions in three steps. The most basic question is why executives at the center might choose to decentralize in the first place. What is their political, as well as economic, calculus? Second, legislators and governors are also central to the intergovernmental bargain: How does the relationship between politicians at different levels of government influence decentralization? In closing, I consider the stability of these bargains, and some of the conditions that might lead to a reconsideration or reversal of decentralization, including particular subnational fiscal or political crises. Although I focus overwhelmingly on relations between the center and state or provincial governments, many of the lessons drawn can be extended to the municipal level as well.

Throughout, I emphasize two major points. First, getting decentralization right is not simply a technical or administrative problem, but a more fundamental political and institutional one. Second, decentralization is an ongoing process. Even in long-standing federal systems like the United States and Canada, the federal bargain is subject to continual reassessment.

I. Politics at the Center: Incentives of National Executives

In a recent analysis of the politics of federalism, Inman and Rubinfeld (1997) state clearly the implicit political model

undergirding the long literature on fiscal federalism: “The principle of economic federalism prefers the most decentralized structure of government capable of internalizing all economic externalities subject to the constitutional constraint that all central government policies be decided by an elected or appointed ‘central planner.’” The goal of efficiency is to the forefront, and it is assumed that this elected planner gains politically from being responsive to aggregate social welfare, in the form of the median voter.

We know that this commitment to fiscal federalism does not fit the long sweep of Latin American history, which has experienced centralization under strong political leaders, beginning with the initial nation-building phase and including the authoritarian governments of the post-war period. Yet the current triumph of democracy, and the preference for presidential constitutions, raises the question of the conditions under which executives do see decentralization in their political interest. Recent experience of Latin America suggests that presidents do frequently initiate decentralization. However, it is important to underline two qualifications: Their motives are not necessarily dominated by efficiency calculations; and there are often good political reasons why executives may *resist* decentralization. We consider each of these contradictory forces in turn.

What political calculations lead presidents to decentralize? Perhaps the most important force behind the recent push to decentralize is the return of democratic governance itself. In a number of countries in Latin America, democratization resulted in a return to earlier constitutions with federal provisions; Argentina provides an example. Prior to the transition to democratic rule, authoritarian governments devolved some government functions to appointed officials at lower levels of government. With the introduction of electoral democracy at the subnational level, it is quite natural for these elected governments to assume the transferred functions.

Where systems have not previously been federal, as in Bolivia, the move toward democracy provides opportunities for *potential* politicians and interest groups to lobby for greater autonomy for subnational governments. In some countries, indigenous peoples have also exploited the democratic opening to push for a different conception of autonomy based on ethnic or tribal grounds; the recent referendum in Guatemala provides an example. But in all cases, once democracy is extended to the region, state/province, or municipality, elected officials will

become lobbyists for greater powers, responsibilities, and transfers. Presidents can reap at least one-time political gains by playing the role of reformer and accommodating these demands.

In addition to the effects of democratization, pressures for decentralization can arise from a second source: disaffection with the political status quo within existing democratic or semi-democratic governments. In Colombia, Venezuela, and Mexico, politics at the center has long been dominated by either a duopoly or monopoly of political parties. Barriers to entry at the center were extremely high, in part because the dominant parties had an interest in limiting political competition. The result of this political structure was voter apathy, alienation from politics, or radicalism.

Decentralization arose in such systems from the following political dynamic: The president sought to counter growing political alienation by introducing decentralizing political changes (Betancur’s initiatives in Colombia provide an example). Opposition groups exploited the fact that barriers to political entry were lower at the provincial and municipal level, and they actively contested elections. (In Mexico, increasing competition at the state and municipal level has been one of the central forces behind that country’s gradual democratization over the last decade.) As political competition increased at the subnational level, presidents had an interest in supporting their co-partisans at lower levels of government; one way of doing that was by providing them more resources and powers.

A third political motive for decentralizing has to do with the effort to reach settlements to civil wars or to assuage separatist or guerilla movements; this motive has been important in several Central American countries and more recently in Colombia. We will not dwell on this problem extensively, except to note that the history of this solution to deeply divided countries is not promising (Lake and Rothchild 1999). It appears that there is a tendency for central governments either to increase their power at the expense of regions (as happened in Peru in the course of the government’s efforts to defeat the Sendero Luminoso) or for regions to favor full political autonomy or secession, as happened in the former Yugoslavia, the former Soviet Union, and Ethiopia/Eritrea.

What is most notable about these three motives for decentralization—democratization, increasing participation, and accommodating separatist forces—is that the

political gains from them for presidents are transitory in nature. Once decentralization takes place, subsequent presidents do not necessarily gain from it. Moreover, the political gains from greater decentralization are offset by two other considerations: loss of control over resources and principal-agent problems (Garman, Haggard, and Willis 1999).

First, decentralization by definition implies that the center, and specifically the executive, loses some control over resources. The political implications of this loss can be seen if we focus on the redistributive rather than efficiency effects of federal arrangements. The redistribution of resources across jurisdictions is one of the main functions of a central government. Stripping resources from the center diminishes its power to perform that function. However, centralized control over resources also has political implications: It permits the president to equalize the distribution of goods and services not on the basis of need (as the normative theory of fiscal federalism would require) but in order to target politically salient constituencies.

This observation helps explain the apparently anomalous distribution of transfers and other resources across jurisdictions (Kraemer 1997). In one of the most thorough of these exercises, Daniel Treisman (1998) shows how net transfers to subnational governments in Russia did not reflect predictors of social need but indicators of regional discontent and credible resolve to threaten the constitutional order. Similar findings about the influence of political calculations on spending patterns across regions are emerging in Latin America, although the precise nature of the models differ in important ways. In Mexico, Molinar and Weldon (1994) have shown how the allocation of PRONASOL resources, a centralized anti-poverty program, was biased toward districts where the opposition had shown recent electoral gains. In Peru, Graham and Kane (1998) show a similar political dynamic at work: The Fujimori administration redirected discretionary spending to regions where he lost in the 1993 referendum, although this pattern was not consistent. In Argentina, by contrast, the Menem administration sought support by directing spending to provinces with low population, and thus high representation per capita (Gibson 1997).

The problem of loss of control over resources is equally acute, if not more so, for bureaucratic actors. If decentralization is not to lead to an increase in the size of all government, it implies some shrinkage of the budgets, powers,

and responsibilities of central-government agencies. Finance ministries, in particular, are attuned to the potential fiscal costs of decentralization and are concerned that it be designed to minimize these costs. But these concerns are not necessarily shared by sector ministries, who have an interest in maintaining resources and control and designing sector-specific models of decentralization and intergovernmental transfers (Rojas 1998).

A second problem that executives face in transferring expenditure responsibilities, budgetary resources, or even taxing powers to lower levels is the creation of principal-agent and contracting problems (Seabright 1994). If functions and powers are transferred, how can the president guarantee that his objectives will be carried out? Although contracts can be written to induce officials at lower levels of government to reveal information, decentralization inevitably raises problems of monitoring and incomplete contracts. In Chile, concerns about the capabilities of lower-level governments have been one of the major factors slowing the pace of decentralization.

In sum, while the president may be able to realize some political gains from decentralization, these may be partly offset by both political and agency losses. These calculations help explain some features of the decentralization process that we witness, including:

- the continuing tendency to guard resources at the center, as well as the effort to maintain a discretionary component in intergovernmental fiscal transfers;
- greater willingness to transfer responsibilities than the resources to meet them;
- lack of clarity in the definition of responsibilities across levels of government, as executives and ministries seek to maintain responsibilities, budgets, and oversight;
- efforts to control the application of funds in order to reduce agency loss, including through such devices as earmarking and matching transfers;
- political conflicts over which ministry or agencies will oversee the design and implementation of the decentralization process (Rojas 1998).

II. Incentives Facing Governors

The distinctive feature of presidential constitutions is that they are built on a system of checks and balances; even strong presidents cannot make policy without support of

the legislature. Federalism introduces an additional check. States and provinces are guaranteed some areas of policy autonomy, even where their choices are subject to some regulatory or other oversight by the center. Thus, to comprehend the politics of decentralization, it is necessary to consider the political interests of legislators and subnational politicians (and even *potential* subnational politicians) and the political interactions among them.¹

If we focus solely on the efficiency gains from decentralization, governors should also benefit politically from a level and structure of decentralization in which state governments have a comparative advantage in providing the bundle of services assigned to it, and the resources adequate to provide those services.

However, as Migue (1997) has pointed out, national and subnational governments also compete with one another for votes by supplying different bundles of policies. Such interjurisdictional conflict might help explain a number of problems we observe in the decentralization process, including excessive supply of services, intrusion of federal governments into the affairs of states, and the overexpansion of central governments.

In designing intergovernmental relations, there are also a number of specific points on which the interests of executives and governors are likely to conflict:

- If governors could be assured of secure transfers to meet their policy responsibilities, they might well prefer such transfers to raising their own taxes.
- Governors' estimates of resource needs are likely to exceed those of the central government.
- Governors will favor fixed formulas for transfers that specify in advance both the total pool of resources and their distribution across jurisdictions; in short, governors will prefer to tie the hands of the central government.
- To enhance their flexibility, governors will prefer transfers that are not encumbered by conditions or earmarking and thus will grant them greater discretion.

What determines the bargaining relationship between central and subnational governments? An important political factor is the relationship of accountability between the two (Riker 1975; Garman, Haggard, and Willis 1999). We can see these relationships more clearly by introducing the critical role of political parties. When the president and governors belong to opposite parties—a situation that

might be called “vertically divided government”—then the problems we have outlined are more acute. The president will be reluctant to transfer resources to opponents and will face more daunting principal-agent problems in monitoring the governors. Conversely, governors are more likely to resist presidential discretion and control over resource use.²

If presidents and governors are from the same party, the distribution of powers and resources will depend on the political relationship between the two. Consider two extremes. In one case, the party is purely hierarchical; the president effectively nominates the governor and determines his future career trajectory through a variety of mechanisms, ranging from control over nominations and campaign finance, to non-elective appointments in the case of electoral failure. Under these circumstances, we would expect the governors to align themselves closely with the president. The system would tend in equilibrium toward a higher level of central control. Mexico before the 1990s was an extreme example.

By contrast, imagine a political system in which governors have a strong influence on the nomination and election of the president, or have a voice in his ability to secure legislative support; Brazil provides the archetypal case. In that instance, we would expect the president to be attentive to the interests of the governors, including decentralization.

III. Incentives of Legislators

National level legislators provide the crucial political link between lower-level political jurisdictions and the central government. In about half of the countries in the region, political decentralization was a constitutional issue. But even in these instances legislatures played a role; for example, in Brazil and Chile, the sitting legislature served as a constitutional convention. In the remaining countries, decentralizing initiatives were passed as ordinary legislation. Legislatures also play an important role in the crafting of the “fiscal pacts” that decide the formulas through which resources are going to be transferred, as well as the design of various sectoral initiatives.

Many features of legislative behavior are likely to be important for how decentralizing initiatives are crafted (Inman and Rubinfeld 1997), but I focus here on the role of political parties in passing policy and forming links between levels of government. Under divided government

(i.e., where the president's party does not have a majority in the legislature), legislators will seek to craft decentralization to check the discretionary powers of the president and to channel resources in ways that favor their co-partisans at the subnational level. The most egregious, and destructive, example of this dynamic occurred during the late Alfonsín period, when opposition and regional parties combined to blackmail the government for greater resource transfers (Haggard and Kaufman 1995, Chapter 6).

Yet even where a single party controls both branches of government, legislators might prefer to maintain central-government control and discretion, but vest it in the legislature. But how they behave will depend on the lines of authority and accountability within the ruling party itself. Where parties are disciplined, we would expect outcomes closer to the ideal point of the president and/or party leadership. When legislators are dependent on politicians at the state level, they will be pulled toward the preferences of the governors.

Various features of the political system, including electoral laws that encourage either party- or candidate-centered voting, create or dissipate party discipline.³ Control over campaign finances or career opportunities once politicians leave elective office also influence candidate incentives. However, much is captured by the simple indicator of who controls nominations. Does the party leadership (often headed by the president) or do subnational leaders control nominations of candidates for national office? Where subnational political leaders have strong influence over the nomination of the president and legislators, and thus on the ability of presidents to form legislative coalitions, we would expect to see patterns of decentralization that conform more closely to the interests of governors (and, in some cases, of mayors and local governments). By contrast, in systems in which central-party leaders wield influence, we would expect presidents to retain greater discretion and for decentralization to take place in ways that maintain the central government's influence.

IV. The Politics of Decentralization: Case Studies

To illustrate the way in which these political factors influence the process of decentralization, I focus here on five Latin American countries that are highly decentralized in political terms—i.e., in which there are open electoral contests for both governors and mayors—Argentina, Brazil,

Colombia, Mexico, and Venezuela. In Colombia and Venezuela, the impetus for decentralization came from the federal executive as a result of civil unrest and declining support for the dominant parties. In Brazil and Argentina pressures for decentralization stemmed primarily from governors demanding greater fiscal revenues after the reintroduction of democratic rule. In Mexico, a more gradual process of democratization has generated increasing pressures for decentralization.

There are some striking differences among these cases. While there is no one simple measure of the extent of decentralization, one table captures a number of salient differences in a parsimonious way. Table 1 outlines the share of expenditure and revenues at each level of government and how it changed between the early 1980s and early 1990s. As can be seen, Argentina and particularly Brazil are substantially more decentralized, particularly with respect to the locus of spending, than are the other three countries; moreover, they decentralized even more during this period. Venezuela and Mexico stand at the other extreme, with Mexico's witnessing a quite substantial devolution of spending responsibilities in recent years. Colombia stands roughly between the two, but in recent years has been moving closer to the Argentine and Brazilian pattern.

In the following brief sketches, I outline how the political incentives facing presidents, governors, and legislators have interacted to produce distinctive national fiscal bargains.

Colombia and Venezuela

Colombia and Venezuela yield an ideal country comparison because they share a number of features that separate them from our other cases. The impetus for fiscal decentralization in both countries originated from the federal executive and occurred in conjunction with the implementation of political decentralization. In both cases, presidents allowed direct elections for governor and mayors during the late 1980s and proposed modest fiscal decentralization as a way of countering challenges to the president's party. These political challenges, and the impetus to decentralize, came after a prolonged period of democratic rule in which two dominant parties alternated power at the national level, but there was increasing voter disaffection with the major parties.

TABLE 1
Revenue and Taxes by Level of Government

COUNTRIES	SHARE OF TOTAL GOVERNMENT TAX REVENUE COLLECTED BY LEVEL OF GOVERNMENT		SHARE OF TOTAL GOVERNMENT EXPENDITURE BY LEVEL OF GOVERNMENT	
Argentina	1983	1992	1980-84	1990-94
Central	79.3	80.0	63	54
Subnational	20.7	20.0	37	46
Brazil	1975	1995	1980-84	1990-94
Central	73.7	66	74	45
Subnational	26.3	34	26	55
Colombia	1980	1994	1980	1994
Central	82.2	80.1	72.8	66
Subnational	17.8	19.9	23.2	34
Venezuela	1980	1989	1980	1989
Central	95.8	96.9	76.0	77.7
Subnational	4.1	3.2	24.0	22.2
Mexico	1982	1994	1980-84	1990-94
Central	90.7	82.7	81	71
Subnational	9.3	17.3	19	29

Source: Garman, Haggard, and Willis (1999)

Despite these similarities, the two countries diverge on the extent to which they transferred revenue and spending powers to state and local governments. In Venezuela, the legislature adopted a modest fiscal transfer to state and municipal governments with significant central control over its uses (Knoop 1994). In Colombia, legislators adopted a more aggressive transfer of responsibilities, taxing, and spending powers to regional and municipal governments. Fiscal transfers were also higher (Bird 1990; Dillinger and Webb 1999). These divergent outcomes can be traced directly to the incentives facing legislators.

Political power in Venezuela has been highly centralized since the inception of democratic rule in 1961 with national party leaders within Venezuela's two dominant parties (Acción Democrática and COPEI) wielding tremendous influence over their respective party members. Prior to 1993 voters chose between closed party lists, with the rank order of candidates determined by national party leaders. Electoral reform in 1993 mandated that half the Chamber of Deputies be elected by single-member districts; nonetheless, national party leaders continued to control nominations for the remainder of seats up for election.

The relatively prominent position held by national party leaders had the effect of limiting pressures to decentralize prior to political decentralization. Responding to large public discontent, a fiscal crisis, and growing pres-

ures from within his party, President Jaime Lusinchi (1984-89) created a reform commission in 1984 that paved the way for the introduction of direct elections for mayors and governors in 1989.⁴ In the first legislative session after the introduction of direct elections, legislators gave state and municipal governments a greater share of federal revenue. Yet while transferring additional revenue to state and municipal governments, the law re-enforced central control over subnational finances. The law not only explicitly stated that governors were "agents" of the president, but also granted the Senate authority to remove any governor by a two-thirds vote. The transfer of further revenue and functional responsibilities had to be initiated by the president or state governors, and approved by two-thirds of the Congress and a simple majority in the state legislative assemblies. The Congress, however, has been very reluctant to transfer any functions because of their close ties to centralized public-sector unions (Knoop 1994).

Venezuela's more timid decentralization stands in contrast to reforms enacted in Colombia. Much like Venezuela, the impetus for the introduction of fiscal and political decentralization in Colombia came from the federal executive, in this case to initiate a peace process with a growing guerrilla movement. Conservative President Belisario Bontacur (1982-86) successfully introduced the popular election of mayors for 1989 and transferred a large share of fed-

eral revenue to subnational governments during his administration. The transfer of fiscal revenue was initially undertaken with significant earmarking, and the law also gave the president extraordinary authority to issue decrees reassigning to local governments specific functions previously carried out by the federal government.

Of the two sets of reforms implemented by Bentacur, the introduction of direct elections for mayor had the greatest impact. Unlike Venezuela, which has a centralized party organization, Colombia's candidate selection within both the Liberal and Conservative Parties is decentralized. Colombia employs a closed-list electoral system, but each party is allowed to run multiple lists at the department level, and regional party bosses within each party determine the rank order of their respective lists. Under such a highly decentralized party organization, the introduction of direct elections for mayors had a powerful impact. Legislators initially opposed to measures introduced by Bentacur now depended on mayors to a much greater extent than their legislative counterparts in Venezuela. Locally elected officials rapidly assumed an important role in drafting regional district lists and ensuring the success of legislative campaigns.

The newfound political weight of subnational politicians became evident in the Constitutional Convention of 1991. Responding to popular pressures and a continued guerrilla insurgency, Liberal President Virgilio Barco (1986-1990) used his state-of-siege powers to call a referendum on whether to reform the constitution through a National Constituent Assembly. The referendum passed, and elections for the Constituent Assembly were held in 1990. The 70 members for the Constituent Assembly were elected in a single national district instead of from multiple lists within districts. The changed electoral rule gave non-traditional parties, such as the M-19 Democratic Alliance that consisted of former members of the guerrilla movement, the opportunity to cultivate a broader cross-regional constituency. Candidates from the traditional Liberal and Social Conservative Party who won their seats in the Assembly were now beholden to recently elected mayors (Medellín Torres 1992).

Both opposition and traditional politicians had a greater interest in implementing more expansive decentralization measures. In addition to introducing direct elections for governors at the provincial level, the new constitution devolved significant financial autonomy to provinces and

municipalities. Both received greater taxing authority, a substantial increase in their share of federal taxes, and the authority to issue their own debt and borrow abroad. Department and municipal governments were further guaranteed that expenditure responsibilities would not be devolved without the prior allocation of additional resources, a practice that had occurred during the 1980s.

In sum, the national executive in both Colombia and Venezuela responded to growing political alienation by initiating decentralizing initiatives. Both introduced direct elections for subnational executive posts. In Colombia, elected mayors and eventually governors wielded influence over national legislators because they operated under a party system where regional leaders already exerted tremendous influence over national legislators within their respective parties. Under such a system, locally elected officials became important players in the success of a legislator running on a district party list. In Venezuela, by contrast, a centralized party organization placed greater limits over the ability of subnational politicians to exert influence over national legislators. Legislative careers to a large extent remained tied to national party leaders; thus, the relative weight exerted by locally elected officials was diminished compared with Colombia.

Brazil-Argentina

Brazil and Argentina provide a useful comparison because of history, a shared formal federal structure, and the common impetus to decentralization under a transition to democracy. Both countries have federal constitutional structures that date to the 19th century, although Brazil was always more decentralized than Argentina. Direct elections for mayors and governors were introduced in Brazil and Argentina during the early 1980s as a component of the transition to democratic rule.

Despite these similarities, decentralization has progressed to a much greater extent in Brazil than in Argentina. Throughout the first half of the 1980s state and municipal governments in Brazil received significant increases over their constitutionally mandated shares of federal revenue and secured greater debt limits and favorable federal refinancing of existing subnational debt. In Argentina, regional parties were able to blackmail the center under the Alfonsín government, resulting in massive transfers to the states through discretionary federal transfers meant to overcome provincial budgetary shortfalls

(Dillinger and Webb 1999). But federal legislators were unable to agree upon a new revenue-sharing agreement during most of the 1980s, leaving provincial and municipal governments with uncertain financing for the responsibilities delegated to them under military rule. A new revenue-sharing agreement was enacted under the constitutional reforms of 1994, yet the federal government was able to insure that this agreement did not threaten federal finances.

Brazil's more extensive transfer of revenue to subnational governments reflects the significant ties that exist between state and local officials and federal legislators. The Organic Law of Political Parties, originally drafted during military rule, mandated parties to hold municipal, state, and national party conventions in which each delegate was chosen by the lower level. Federal legislators were thus nominated in state party conventions, and presidential candidates in the national convention. Such a structure allowed mayors and governors to yield significant influence over the selection of candidates within their own parties due to their comparative advantage of distributing patronage in local and state conventions. In addition to selection rules within parties, Brazil's open-list proportional-representation electoral rule reinforced ties between federal legislators and subnational politicians. With a strong incentive to cultivate a personal vote, mayors and governors often aided federal legislators in fostering a following within specific geographic regions.

With such strong ties developed between federal legislators and subnational politicians, legislators enacted a series of measures that increased subnational financial autonomy, at times to the detriment of federal finances. First, legislators buttressed subnational revenue by expanding their taxing prerogative and by transferring increasing shares of federal taxes to subnational governments with few restrictions over their use. The transfer of revenue culminated in the new Constitution of 1988, which was drafted by sitting federal legislators elected in 1986. While transferring significant revenue to subnational governments, the new constitution was ambiguous about the distribution of functional assignments, thus leaving the federal government with responsibility for many of the same services as before but with fewer resources. Second, federal legislators continually extended subnational debt limits and refinanced the existing stock of state and municipal debt through bailouts at low and fixed interest rates.

Fiscal crisis has led to some reversals of this decentralizing trend, as we will see. But there can be little doubt that the extent of decentralization in Brazil has been tremendous.

Decentralization in Argentina demonstrates the extent to which the partisan makeup of the executive and legislative branches affects subnational finances. The first democratic administration of Raúl Alfonsín (1983-89) was characterized by divided government; the president's Radical Party held a majority in the House while the opposition Peronists (PJ) held a majority in the Senate. Prior to 1994 all senators were chosen directly by provincial governments, thus providing these governments, primarily held by the Peronists, an effective check against Alfonsín's Radical government. The primary consequence was the inability of the federal government to legislate a new Revenue-Sharing Law between federal and provincial governments. In the absence of federal revenue-sharing, the Treasury distributed discretionary grants in order to compensate for provincial budget shortfalls. Provincial governments, therefore, had the incentive to engage in a competitive bidding process and blackmail the federal government by running up larger budget deficits in order to receive a greater share of federal funds (Sanguinetti 1994). Such blackmail succeeded because a Peronist majority in the Senate could threaten the passage of legislation favored by the Alfonsín administration.

A new Revenue-Sharing Law was only passed in 1987 after the Peronists assumed the majority of seats in the lower house. The new law increased the provincial share of federal revenue, yet the monitoring of provincial accounts by the central bank was tightened. Under Carlos Menem's administration (1990-99), unified government permitted new intergovernmental fiscal bargains. Menem rose within his own Peronist party in a "federalist" coalition, and once in office provided financial relief to provincial governments in 1991 and further supported constitutional reforms in 1994 that guaranteed provinces an even greater share of federal revenue. Such favorable agreements, however, were enacted in exchange for provincial spending limits, for earmarking the use of transferred funds, and upon transferring higher education to the provinces. The government also prohibited subnational bailouts and devised institutional arrangements through the Banco de la Nación that allowed the central government to tap provincial revenues directly. These restraints became operative after the "Tequila Crisis"

of 1994-95 and forces provinces to adjust (Dillinger, Perry, and Webb, p. 85 in this volume).

The policy of transferring revenue to provincial governments only on the condition that such transfers not compromise federal fiscal goals stands in stark contrast with the pattern in Brazil. This difference derives in great measure from the fact that legislative incentives in Argentina are more "national." Governors and regional party leaders exert influence over the composition of candidate lists for the federal legislature, but national party leaders in both the Peronist and Radical Party can exercise veto power over the makeup of the lists generated by provincial party commissions. Furthermore, Argentina's closed-list proportional-representation electoral rule reduces the incentives for legislators to cultivate a personal vote and thus creates greater opportunities for legislators to pursue a career independent of provincial interests. While clearly representing provincial interests to some extent, legislators in Argentina cannot be characterized as de facto "delegates" for subnational interests.

Mexico

Mexico does not fit neatly into either of the patterns just reviewed, but nonetheless provides useful insights on the effect of party organization on the decentralization process. Despite a formal federal structure and history of regional political organization, the Mexican system has been one of the most centralized in Latin America. The ruling Partido Revolucionario Institucional (PRI) has until recently not only dominated elected offices at all levels of government, but also provided the sitting president unparalleled influence over Mexico's political system. As a result, Mexico's political system has yielded an executive-dominant pattern of decentralization. However, the recent success of opposition parties in the federal legislature and in subnational elections has begun to change the system in ways we would predict.

Mexico's decentralization during the 1980s and early 1990s was dominated by the executive. With substantial influence over the career paths of members of his own party, decentralization initiatives originated from the president's Cabinet and were crafted to buttress executive political clout (Rodriguez 1997). State and municipal governments received federal funds through two primary mechanisms: revenue-sharing laws that specified a fixed quota of federal taxes to be distributed to subnational gov-

ernments,⁵ and discretionary federal investment programs executed in conjunction with state and municipal authorities. There is substantial debate over the extent to which Mexico's revenue-sharing laws, or *participaciones*, have been manipulated for political ends (by determining the formula for the distribution of funds), but the control of discretionary investment programs clearly has been turned to political ends.

Under the de la Madrid administration (1982-88) several federal development programs executed in conjunction with subnational governments were consolidated into one regular budget line called the Desarrollo Regional, or Ramo XXVI, later Ramo XXXIII. Funds destined to state and municipal governments through this mechanism were substantial, and until recently outpaced funds originating from *participaciones*. Formulas specified the allocation of these funds, but the money was allocated in line with federal priorities.

Other programs involved greater executive discretion. The one that has received the most attention because of its sheer size has undoubtedly been the anti-poverty program instituted by the Salinas administration under the title Programa Nacional de Solidaridad (PRONASOL or Solidaridade). The president determined the program's overall budget, negotiated individual contracts with states, and in some cases created bureaucratic organizations parallel to state and municipal governments that circumvented the power of existing governors and mayors. The program not only served to garner support for the president in low-income communities, but also reduced Salinas's dependence upon the traditional party hierarchy.

Despite the control the government exercised over the use of Ramo XXVI/Ramo XXXIII funds and the discretion the president enjoyed with respect to other programs, the recent success of opposition parties in municipal, state, and federal legislative races is undermining Mexico's previous pattern of relations between the center and subnational governments. Much of the discretion held by the president over the allocation of investment programs derived from de facto delegated authority from PRI legislators who owed their allegiance to the president. With the PRI no longer holding a majority in Mexico's lower house, the federal executive can no longer count upon easy passage of its budget proposals, and federal legislators are becoming increasingly responsive to pressures from politicians at the state and local level, including opposition governors and mayors.

As we would predict, there have been further efforts to increase the relative share of *participaciones* in relation to investment programs under the Ramo XXXIII mechanism. More generally, control of resources is gradually shifting from the center to both states and municipalities. For example, in 1997 Mexico had three major transfer programs; in the 1999 budget there were 10. The federal government still exercises control over many of these funds, but the expansion of transfers clearly reflects a newfound interest in catering to subnational interests.

V. Conclusions

This paper began by noting that political calculations have shaped the timing, scope and design of decentralizing initiatives. I noted three political forces—democratization, political pressures to break dominant party control, and the management of secessionist pressures—that have pushed executives toward decentralization. Against these and other economic pressures, however, have weighed concerns about principal-agent problems and loss of political control.

Despite different sources of pressure for decentralization, we have argued that lines of political accountability, in particular the internal organization of parties, play a critical role in determining the bargaining relationship among executives, governors, and legislators that shapes fiscal outcomes.

After an initial flurry of enthusiasm, recent monographic work on decentralization has been somewhat more cautious about its benefits for democratic accountability, coherent fiscal policy, and public-sector efficiency. Decentralization not only has the potential to threaten the integrity of government finances by loosening the hard-budget constraints on state and local governments, but can also create additional inefficiencies if subnational governments lack technical and administrative capacity or face perverse incentives over the delivery of public services.

These pitfalls are not simply a result of weak institutional capacity, but may reside in more profound institutional problems, perverse incentives, and strategic bargaining between levels of government, bargaining which is in turn related to features of the political system.

Since a number of the problems that can arise from intergovernmental bargaining have been outlined, I conclude by raising briefly two issues that require further

research. First, the processes we have described cannot continue without limit. Just as the accumulated costs of centralization contributed to the political pressures we are now seeing for decentralization, so it is also the case that the perils of decentralization will generate their own backlash. Brazil presents an important example. The current administration of Fernando Henrique Cardoso has attempted to curtail recurrent state and municipal fiscal deficits through conditioning federal bailouts on the privatization of state-level government-owned enterprises and increased subnational borrowing restrictions. The federal government has also tried to induce subnational governments to increase their spending in areas of joint responsibility. Whether these efforts will succeed or hold remains to be seen, but they underline the broader point that intergovernmental fiscal bargains are not fixed, but shift over time and might well shift selectively toward greater centralization of some functions in the future.

Finally, I close with an interesting endogeneity problem. For the purpose of the analysis here, I have drawn a sharp causal line, arguing that parties and lines of political accountability drive intergovernmental fiscal bargains. However, it may also be the case that over time, fiscally decentralized states produce political parties that are organized along subnational lines. In order to fully test this possibility, future research should consider the historical evolution of intergovernmental relations over the longer run. The answers will speak not only to the fiscal questions that have been our focus here, but to the question of decentralization as a component of the larger process of increasing participation and democratization.

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Endnotes

1. For purposes of this analysis, I omit discussion of the additional complexities that arise from consideration of the interests of, and incentives facing, elected mayors and municipal leaders.
2. Vertically divided government may produce one salutary effect, however. Political uncertainty about transfers from the center could induce opposition governors to raise their own revenues; there is some evidence of this from Mexico.
3. In the most comprehensive analysis of the issue, Carey and Shugart (1995) identify four factors that determine these electoral incentives: party control over nominations; the existence of vote-pooling; whether voters are allowed to cast only a single vote for a party, multiple votes, or a single vote for a candidate; and the size of the district.
4. Comisión Presidencial para la Reforma del Estado (COPRE).
5. We are referring to funds established under the Ley de Coordinación Fiscal which mandates the federal government to allocate revenue to states through three separate funds: the Fondo General de Participaciones (FGP), the Fondo Financiero Complementario (FCP), and the Fondo de Fomento Municipal (FFM). The FGP is the largest and more commonly known as *participaciones*.

Comment

J O S E P M . C O L O M E R

Stephan Haggard's and Fernando Rojas' papers raise a number of crucial questions regarding the political conditions and the effects of decentralization. I will comment briefly on five of them: 1) The origins of decentralization; 2) the social efficiency of schemes of decentralization in comparison with unitary states; 3) the division of powers between the central government and noncentral units; 4) the institutions of a politically divided government; and 5) the institutions of intergovernmental cooperation. In these comments I will try to put the analysis of decentralization in Latin America in a broader perspective.

Origins

Regarding the political origins of decentralization, I have only a brief remark. The basic political motives for decentralization that are identified in the two papers—democratization, increasing participation, and emerging regional movements—have a common characteristic: They challenge the incumbent rulers. Decentralization is not only a response to these challenges, but it is also a mechanism to reduce the concentration of power and to diffuse power among differentiated actors.

Social Efficiency

Decentralization, thus, produces a relatively high number of “winners,” which is roughly equivalent to saying that, with decentralization, a high number of citizens can satisfy their political preferences at some level of government. Adopting a criterion of efficiency that is widely used in the social sciences, we can say that the higher the number of citizens satisfying their preferences, the higher the social utility of the corresponding institutional framework. Therefore, decentralized institutions can be considered to be more socially efficient than unitary states if the distribution of voters' preferences is sufficiently varied across the territory—that is, if

there appear to be a sufficient number of regional or local majorities that are national minorities. In unitary states, only those citizens whose preferences coincide with the overall majority obtain satisfaction. In contrast, in vertically divided government the national losers are compensated by becoming partial winners at the regional or local level. In two- or three-level elections, the number of total losers is likely to be smaller than in a single-level election.

The total amount of political satisfaction or social utility produced by vertically divided government depends on the importance given by the voters to the different issues associated with each governmental level. But the number of

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issues on which the voters can satisfy their preferences is never lower than under a unified government. As a simplification and adaptation of the mathematical proof provided by Roland Pennock (1959), Table 1 shows an example of the different amounts of social utility that can be obtained by a unitary decision and by decentralized decisions in a situation in which a large-scale (that is, national) minority is a majority at some smaller scale (regional). In comparison with a single, absolute winner in the unitary framework, different winners in different regions in the decentralized framework can produce higher amounts of social utility.

Division of Powers

The analysis presented in Stephan Haggard's paper shows an increasing degree of financial decentralization in Latin American countries in the last two decades. I have been able to produce a comparative table with data on revenue and expenditure decentralization in 14 decentralized countries in the most recent year available. I include data for five previously considered decentralized Latin American countries that share the institutional characteristic of having presidential regimes (Argentina, Brazil, Colombia, Mexico, and

TABLE 1

Social Utility in Unitary and Decentralized Governments

REGIONS	PARTIES	
	LEFT	RIGHT
A:	60	40
B:	60	40
C:	40	60
Unitary (national winners)	160	140
Decentralized (regional winners): 60+60+60 = 180		

Note: Numbers are voters at every region (A, B, C) and at national level. Underlined numbers represent winners with different institutional formulas.

Venezuela) as well as for four "Anglo" countries that also have some common traditional institutional features, basically a two-party system (the United States, Canada, Australia, and India) and five continental European countries, also with some other common institutional features, namely parliamentary regimes with multiparty systems (Germany, Austria, Switzerland, Sweden, and Spain).

As can be seen in Table 2, in spite of the recent processes of increasing decentralization previously remarked in the

TABLE 2

Financial Decentralization in Decentralized Countries

CENTRAL GOVERNMENT SHARE OF TOTAL TAX REVENUE				CENTRAL GOVERNMENT SHARE OF TOTAL EXPENDITURE				
LATIN	ANGLO		EUROPE	LATIN	ANGLO		EUROPE	
	Canada	53			Canada	42		
				Argentina	54	U.S.	53	
						India	54	
						Spain	59	
	India	63	Switzerland	64	Australia	60	Germany	60
	U.S.	66					Sweden	65
			Sweden	68	Brazil	66		
			Germany	73	Colombia	66		
			Spain	75	Mexico	71	Austria	69
	Australia	77			Venezuela	78		
Argentina			Austria	80				
Colombia								
Mexico								
Venezuela								

Note: The numbers are the percentage of total tax revenue or total expenditure in the hands of the central government. The countries at the top of the table are more decentralized than those at the bottom; the distances suggest the amount of percentage differences.

Sources: Author's calculations with data in International Monetary Fund, *Government Finance Statistics Yearbook* (Washington, D.C. 1997), for the most recent year available: Australia 1996, Austria 1995, Brazil 1993, Canada 1993, Germany 1996, India 1994, Mexico 1994, Sweden 1996, Switzerland 1995, and the United States 1995; Ministry of Public Administrations for Spain 1998; Stephen Haggard (1999) for Argentina 1990-94, Colombia 1994, and Venezuela 1989.

papers, most Latin American countries still lag behind most of the other decentralized countries mentioned. Regarding decentralization of tax revenue, only Brazil has reached a level that may be comparable to federal states in other parts of the world. Regarding decentralization of government expenditure, only Argentina has reached such a comparable level. These differences may be produced by different lengths of stable democratic regimes in the different sets of countries considered, since it is in the democratic context that decentralization advances. The implication is that further decentralization should be expected in Latin American countries as democracy will endure, because the corresponding political demands in favor of more decentralization and intergovernmental bargaining will ensue.

Vertically Divided Government

Legal and financial decentralization is effective when there is political decentralization, which is to say when different political parties promoting different policies have power in the central and regional governments. Vertically divided government can be measured by the proportion of regional chief executives whose party is not in national government.

Empirical evidence shows that there is one institutional rule that is crucial to produce high frequency of vertically divided government: Nonconcurrent elections for the central and regional governments. Data for the period 1945-95 presented in Table 3 show that the vertical division of government between different parties is greater in federal countries with nonconcurrent, staggered elections

for regional governments than in those with concurrent elections for central and regional offices or in those with separate but simultaneous regional elections. About half of the regions, on average, are ruled by a party that does not rule the central government in countries with nonconcurrent, staggered regional elections, while less than one-third of the regions are outside of control of the central government's party in countries with concurrent elections.

Similar effects can be observed within the United States, where, in the period 1945-95, fewer than one-third of state elections were concurrent with presidential elections (242 out of 761 state elections). The analysis of the figures shows increasing proportions of split-ticket voting, both in concurrent and in nonconcurrent elections. Yet the average proportion of winning governors from the party not holding the presidency is higher in state elections that are not concurrent with a presidential election than in those that are concurrent (62 vs. 41 percent, respectively). This is also due to institutional changes in a number of states, in which two-year gubernatorial terms (which produced concurrent elections half of the time) have been replaced with four-year terms, usually scheduled for non-presidential election years (author's own calculation).

Another variant exists in regionalized countries with nonconcurrent elections, such as Spain and Italy, where those regions holding staggered elections have higher proportions of presidents from parties not in central government than those regions that hold elections simultaneously, as shown in Table 3 (Colomer 1996, 1998).

TABLE 3

Vertically Divided Government (1945-95)

CONCURRENT			NONCONCURRENT, STAGGERED		
Argentina (1946-73)	-120	12	Argentina (1983)	-96	60
Brazil (1947-50)	-52	55	Brazil (1954)	-182	55
India (1952-67)	-100	23	India (1971)	-150	33
			Canada	-154	61
			Germany	-106	50
			Australia		50
			Austria	-120	31
PARTLY CONCURRENT			NONCONCURRENT		
United States	-761	55	Spain	-69	48
- nonconcurrent	-519	62	- staggered	-17	83
- concurrent	-242	41	- simultaneous	-52	37

Note: The figures are proportion of regions with a chief executive whose party is not in central government. The subindices are the number of regional elections in the period 1945-95. Source: Author's calculations with data from Balestra and Ossoona (1983), Cantón's (1973), Chatterjee (1997), Feigert (1989), Fisher (1990), Fleisher (1986), Jaensch and Teichmann (1988), Jones (1997), Kallenbach (1977), Ritter and Niehuss (1987), Thaysen (1994), Tribunal Superior Eleitoral (1950), Zadi Zaidi (1976-), *The Book of the States*. (Lexington, KY: Council of State Governments), Congressional Quarterly's Guide to U.S. Elections, Europa Yearbook.

This institutional “law” is confirmed in several federal countries, including Argentina and Brazil (as well as India), in which concurrent regional elections in previous periods were recently replaced with staggered elections, with the effect of increasing the proportions of regional governments ruled by a party that was not in central government. It seems, thus, that Latin American decentralized countries are also following this path toward increasingly frequent divided government between the center and non-central units.

Divided Bicameralism

Finally, in order to obtain the expected effects of high social utility previously mentioned, the observed evolution toward increasing division of powers and more frequent divided government should be paralleled with effective mechanisms of intergovernmental cooperation. A crucial institutional element of cooperation between the central government and the regional governments in federal states is the upper chamber of territorial representation.

The upper chamber can only play this role of promoting cooperation in inter-institutional relations if it has both a differentiated political majority from the lower chamber and significant legislative powers. These conditions of symmetric bicameralism usually require either the indirect election of the chamber by the regional governments or parliaments, as in Germany, India, and Russia, or differentiated regional districts and nonconcurrent popular elections able to produce winners different from those in the lower chamber, as in Argentina, Brazil, Venezuela, as well as in Australia, Switzerland, and the United States. Legislative disagreements between the two chambers can be solved through negotiations among delegates of the two chambers in a conference committee, as in Germany, Switzerland, and the United States, or by a decision of the two chambers in a joint session, as in Australia, India, Venezuela, and, for some issues, Brazil (Tsebelis and Money 1997).

A symmetric bicameralism with sufficient mechanisms of cooperation can have effects similar to those of inclusive decision rules. Requiring the concurrence of two different majorities to make a decision is like requiring a super-majority. Even if each of the chambers makes decisions by simple majority rule, joint decisions by two politically differentiated chambers will be negotiated or be found around moderate, intermediate alternatives. These will likely be supported by an inclusive majority, thus giv-

ing satisfaction to larger numbers of citizens than a single-chamber decision would (Riker 1992a, 1992b).

In short, both a politically divided government and institutions of intergovernmental cooperation are necessary conditions of a socially efficient decentralization.

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II. Framework for Fiscal Federalism

Making
Local Governments
Accountable to Average
People in Cities and
Villages—
Challenges and
Next Steps in
Latin America

The Participation-Accountability Nexus and Decentralization in Latin America

R A M Ó N B O R G E S - M É N D E Z A N D V I C T O R M . V E R G A R A

Introduction

Recognizing and deepening of the participation-accountability nexus in government administration represents a change in the principles that guide social contracts among individuals, communities, and institutions. In Latin America, with the restructuring of the state (and its relationship with civil society and the market), we have embarked upon redefining the bases of these contracts. For many citizens, however, the benefits of these contracts are still almost mirages when compared with more earthly problems like hunger, poverty, discrimination, and abuses of power in administering society's resources. How did the participation-accountability nexus develop in Latin America? What do we need to know about the nexus to make it an effective component of government policies? To answer these questions, we have examined a wide range of political, economic, social, and cultural processes in the region that have affected the relationships between civil society, the state, and the market over the last 30 or 40 years.

Undoubtedly, this reflection leaves many loose ends and has an interpretative tone, even though it draws upon empirical sources from different disciplines that document the ample experimentation—with both good and bad results—taking place in governmental management at the subnational level. For example, as to the general problem of how to delimit “local” space, the point of reference is urban and not rural, although

we do make sporadic references to the rural theme. This is an important limitation, as well as the superficial treatment given to the topics of economic globalization and internationalization, which indubitably are playing an important role in the construction of local political and economic spaces. The same can be said with respect to the lax treatment given to such profound processes as juridical, constitutional, and administrative changes that are taking place in the specific countries of the region, and that certainly have an important effect on the manner in which the participation-accountability nexus has been defined. The examination does not rest on a taxonomic or a cataloguing

exercise. The objective of this reflection is to open an interpretative window that looks inside the local environment, and to provoke—often on the edge of subjectivity—a debate regarding practical topics that have profound ethical-moral dimensions.

The paper consists of three parts. The first part is a historical overview of how the participation-accountability nexus was established in Latin America. Historically, between the 1960s and the present, the concepts and conditions for participation and the idea of accountability have changed dramatically. The objective of this exercise is to show the conditions and forces that have been con-

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solidating the nexus as a means of promoting good government, particularly at the local level. Within this time span, participation is redefined as sociopolitical activation, and as a variety of actions directly related with democratic governmental administration and with satisfying the needs of citizens. Accountability makes the transition from a simple, passive principle of political representation to an active principle that guides processes (vertical and horizontal) of institutional modernization, incorporating itself into the administrative processes as a practice to satisfy expectations about the use of managerial and political powers in democratic contexts.

The second part discusses the participation-accountability nexus according to the principles of two theoretical perspectives that are currently guiding the processes of institutional reconstruction in Latin America: the *new managerialism* and *social capital*. The first emphasizes design, structure and results, while the second deals with context, process and culture. In addition, we identify some of their respective weaknesses and strengths, as navigation charts in the process of institutional reconstruction.

As a conclusion, given the need to improve government policies and build democracy, the third part identifies various aspects related to decentralized local reforms in which the diverse agents of change in Latin America require our support.

I. The Participation-Accountability Nexus in Latin America

In broad strokes, in the post-World War II period, the history of social and citizen participation in Latin America can be divided into four time periods, or “moments.” These four moments have certain historical continuity. However, throughout them, the processes and contexts of participation have substantially changed, and the nexus with the problem of accountability has been established in a slow and intermittent fashion. The first moment corresponds to the span between the mid-1950s and early 1970s. The second moment begins to emerge in the early 1970s and extends until the end of the 1980s. The third period starts at the end of the 1980s and ends in the mid-1990s. The fourth period covers the span between the mid-1990s and the present. What are the characteristics of these moments? What changes take place in the forms, contexts, and processes of participation during them? On the basis of this historic trajectory, what should be emphasized to define what participation is, and to understand how the participation-accountability nexus is established to improve governmental action?

The First Moment, Mid-1950s to Early-1970s: The State as the Organizer of Civil Society

Between the mid-1950s and the beginning of the 1970s, social and citizen participation was organized around the

Context

Accountability as a concept and process is fundamental in building good governance. However, almost 15 years after the processes of decentralization firmly began in Latin America, the idea continues to be somewhat strange to us—possibly because in our cultural milieu there is no term that conveys with relative precision accountability’s moral and practical significance in political and managerial processes. This exercise seeks to understand the participation-accountability nexus in the context of the decentralization of the state in Latin America, particularly at the local level. As input for dialogue at this Fifth Conference on Development, the exercise attempts to make a contribution regarding the origin of the nexus, its status, and the challenges we face in making it work in our contexts.

This examination would be incomplete without the participation of those who receive the mandate, through democratic processes, to orient the effectiveness of the participation-accountability nexus on a day-to-day basis, both with their successes and mistakes. Therefore, as part of our presentation, we have asked three Latin American mayors, Raul Pont from Porto Alegre, Brazil; Ronald MacLean-Abaroa, former Mayor of La Paz, Bolivia; and Ramón Fariás, Mayor of San Joaquín, Chile, to share their experiences with us. To structure this exercise, we requested them to respond to seven general questions outlined below. Finally, it would have been ideal to have other sectors of civil society and citizens participate; however, this was not possible because of time and space constraints, and remains a task for the future.

deepening of a state-centered matrix of relations that included different types of modernizing elites, an incipient middle class, dominant sectors, and popular classes (mainly urban) (Cavarozzi 1992). Participation was forged in the context of transforming the state into the articulator, guarantor, and administrator of the web of commitments and of “acquired rights” that different segments of society achieved during social modernization and import-substitution industrialization efforts. Let us recall that these are the years of inward development, of the Alliance for Progress and the “hard phase” of the Cold War. As doctrines of continental development, these guided and structured the formulation of public policies in such diverse areas as agrarian reform, education, health, and government reform.¹

In that context social participation consisted of vertical mobilization efforts (gradual or accelerated) coming from the state (and often with the collaboration of political parties and unions) that, in turn, granted to the population at large substantive political and economic rights by providing subsidized goods and services (Cavarozzi 1992). The objective of these efforts was to promote social integration, in a broad sociological sense, in rapid-growth urban and extremely poor rural areas, in order to prevent the proliferation of revolutionary ideologies, or simply to mitigate the destabilizing effects of modernization and to improve the level of welfare of the population

in conditions of underdevelopment (see Castells 1983; Germani 1967; Gilbert and Gugler 1981; Peattie and Aldrete-Haas 1981; and Portes 1976). The state, as the principal sponsor of development, tended to centralize or monopolize practically all processes and spaces for participation, even to the point of systematically suffocating or repressing independent initiatives to organize civil society (Cavarozzi 1992).

However, toward the end of the 1960s, some grassroots self-help movements in urban areas were able to set precedents of autonomy and participation (Peattie and Aldrete-Haas 1981). In the early 1970s these political movements rapidly shrunk with the ascent to power of authoritarian regimes in Brazil, Argentina, Chile, Peru, Ecuador, and Uruguay and with the wearing out of consolidated pacts of democratic alternation, as in Venezuela and Colombia. The authoritarian regimes literally flattened civil society. In Mexico, with the repressive events of Tlatelolco, the state and the dominant elite sent very clear signals to civil society that the opening of new democratic movements was not in the government’s agenda (Zermeño 1996). In other countries in the region, particularly in Central America (with the exception of Costa Rica), the state did not even serve as an organizer of participation, but rather repressed and destroyed social and political movements of different kinds.²

Seven Questions to Ponder

1. What role should central and subnational governments play in the practical definition and organization of citizen participation and accountability?
2. How independent does citizen participation need to be in order to function as an effective mechanism of checks and balances to power?
3. What risks or benefits are there in institutionalizing the participation-accountability nexus in government processes?
4. As mayors, what were the risks and benefits in opening up your government to citizen participation?
5. Are there political preconditions to implementing the participation-accountability nexus?
6. To make effective the participation-accountability nexus, is it only necessary to improve the access by citizens to reliable information via appropriate information technologies, or is something more than technological innovation required?
7. In democratic architecture, does the participation-accountability nexus serve as a complement to representative democracy, does it replace it, or does it re-orient it through, for example, new forms of association at different levels (inter-municipal, civil society, intergovernmental)?

*The Second Moment, Early 1970s to End of the 1980s:
The State in Opposition to Civil Society and the
Resistance of the Incipient Non-Governmental Sector*

Between the beginning of the 1970s and the end of the 1980s, social and citizen participation organized by the state shut down for economic and political reasons. The violent attack by authoritarian regimes against civil society's organizations and traditional bodies of representation, such as unions and political parties, disconnected civil society from the state. In countries where for diverse reasons pacts of democratic coexistence survived, a breakdown between the state and civil society also took place. The political elite began to distance itself from the grassroots base and to lose its support (Cavarozzi 1992).

But the breakdown was more than political. The shock of the oil crisis, the weaknesses of the import-substitution model, and the political closure unleashed a strong reaction against the economic practices of the developmentalist state and the ideas of inward development. The state began to retire from performing many economic activities, on some occasions rapidly and on others more slowly, in order to internationalize economies and open markets, deregulate, reduce high inflation rates, and control the fiscal deficit (Bresser Pereira 1993; Edwards 1995; Ramos 1993). In the short run, experimentation with the new policies successfully produced the expected results in macroeconomic terms, but it also contributed to the dismantling of the different networks of benefits and "acquired rights" and dramatically reduced social spending (Cavarozzi 1992; Edwards 1995).

With the debt crisis of the early '80s, the severity of adjustments increased and the retraction policies being implemented became more complex and elaborate (although not necessarily successful). They aimed to radically transform the import-substitution model and the state-centered matrix that had accompanied it for more than three decades. This situation accentuated the polarization between the state and vast segments of civil society, which demonstrated its discontent in multiple forms. During the decade there was a wave of social protest with different degrees of intensity and organization that chided the state for neglecting certain of its social welfare functions and at the same time demanded the return to democracy. In this process of resistance and reactivation of civil society, a vast array of grassroots organizations emerged and developed, which, with local and international support, were

successful in consolidating effective citizen mobilization networks. The generalized context of crisis and protest created sociopolitical reactivation that enabled the NGO sector to grow rapidly. Citizen participation was a fundamental component of this growth, although at that moment it was not geared toward government monitoring or control functions, but toward activation of the populace and democratization.³

Toward the end of the decade, the efforts of civil society and its organizations to recover and democratize the state faced the challenge of transforming their focus from problems of human rights violations and basic survival, into the development of practical tools and strategies to keep abreast with the new political and economic scenarios. The withdrawal of the state through privatization, the rationalization of its functions, and the administrative decentralization of many of its services radically changed the parameters of the relationship between the state and civil society. First, the state transferred to the market and the private sector the provision of many services. Second, the centralized state, through fiscal and political decentralization, began to hand over greater responsibilities to the sub-national levels. This new local level became fertile soil for participation. Moreover, the effectiveness and sustainability of reforms began to depend—at least in principle—on the participation of the population, given that this constituted not only an important source of legitimacy for fragile democracies, but also an important base of social capital to support in practical terms the reform efforts (Cunill 1991; Rivera, 1997).

*The Third Moment, End of the 1980s to Mid-1990s:
Dilemmas of Democratization and Growth with
Equity*

Between the end of the 1980s and the mid-1990s, diverse actors of change (public, private, non-governmental, local, and international) incorporated social and citizen participation into their formal plans and discourse for action and reform. Participation, as a widespread process began to be used as a mechanism of accountability. With the transition to democracy and the opening up of political spaces, participation proliferated from different points of civil society—points that were not necessarily under the organization or control of the state, nor exclusively for social activation purposes (Cunill 1997). Besides, if the emerging markets intended to take root in the structural matrix of

the different countries and become an important channel of expression for the citizen-consumer, forms of regulation and complementary institutions of support were required in which different types of participation were essential. In this environment, participation ceased to be a prohibited discourse and practice. To the contrary, different actors fostered the use of citizen participation within an ample spectrum of new options and opportunities, both individual and collective, that—depending on the situation—legitimized or lubricated other processes of reform and promoted a better and more transparent use of public and private resources (Cunill 1997).

This process of redefinition, expressed the search for a normative change in the restructuring of responsibilities shared by the citizen, the state, and the market in governmental administration. By contrast with the other moments, actors redefined participation not only as a process of social activation and incorporation, but also as an instrument that could be used for different purposes in order to:

1. obtain from individuals and groups who receive public or private goods or services an opinion about quality, efficiency and adequacy;
2. give individuals and groups decision-making powers regarding public administration matters;
3. create mechanisms for redress and compensation for different types of problems and abuse in markets and in public administration;
4. promote a relation of mutual responsibility—a new social contract—between the citizen and the state, which improved the equity of resource distribution and investment;
5. generate better confidence levels and rules of the game regarding the new market relations of economic exchange and resource management.

In spite of this extensive process of redefining participation—incorporating civil society and the market—the state retained a strong influence over the conditions under which participation was consolidated, and/or reoriented itself to become a tool of government administration. That

presence of the state remained in place to manage the dilemmas of simultaneous processes of reform, democratization, and economic restructuring, as well as to deactivate other vulnerabilities that threatened democratization, such as corruption in the public and private sectors, patronage, and drug trafficking, among others. In the new scenario, the dilemmas evolved in different contexts, and participation, related with accountability played a fundamental role in all of them.

THE FIRST SCOPE: GOVERNABILITY

The first scope was governability: Participation and accountability were united in an attempt to reconcile democratization and equity. After the “lost decade,” the economic situation of the population and inequality in the continent had worsened, although toward the beginning of the '90s economic growth had resumed, and various programs were implemented to reduce poverty and the deficit in services (ECLAC 1996; ECLAC 1997). The population expected timely action by the new regimes—and for the reforms to yield positive results with relative promptness. Basic reforms were needed in the areas of health, education, housing, infrastructure, and employment, but political restrictions imposed by transitions to democracy and the need to maintain the credibility of important macroeconomic and fiscal reforms placed serious constraints on spending and on participatory processes (Boeninger 1997; Borón 1998).

In this context, the state—and the new technocratic government teams—encouraged participation as a gradual opening-up process by means of limited schemes to moderate the tide of accumulated demands, while also trying to increase the capacity of the state to reach beneficiaries with its policies in a more direct, or targeted fashion. Depending on the country, these incorporation efforts achieved greater or lesser depth in terms of coverage and penetration of civil society. Some were fairly radical processes of opening up participation, as in the case of Colombia and Bolivia; others were more of a corporate nature, as in the case of Chile (Rivera 1997). With the slogan “growth with equity,” new institutional bodies were created, such as solidarity and investment funds, that outlined targeting policies which stressed and incorporated beneficiaries’ participation in the programs.

In the countries of the region, solidarity and investment funds, which initially were a temporary and partial response

to reduce the effects of structural adjustments, have evolved in a different manner. In some instances they have become mini-patronage states of social welfare, such as PRONASOL in Mexico; in others they have been transformed into ministries or have been attached as a sub-entities to a ministry, or else they have been grafted into the overall government bureaucracy. The positive evaluation of the funds, initially considered as an efficient and innovative instrument to attend the social emergency that many countries faced and to reach the most needy with greater efficiency, has been losing ground to an increasingly more critical view regarding their achievements and effects in poverty reduction, generation of socioeconomic opportunities, and community development and participation (Fox 1997; Fundación Friedrich Ebert-Fundación SERCAL 1994; Goodman et al. 1997; Parker et al. 1999; Wurgaft 1993).

Edgardo Boeninger, Minister of the General Secretary of the Presidency during the administration of Patricio Aylwin in Chile, characterized this style of administering participation with multiple strategic objectives as “sequential gradualism” (Boeninger 1997). In Central America, and to a certain extent in Colombia, unlike the Southern Cone, political pressure consisted of promoting and institutionalizing participation to achieve basic pacts of governability after years of conflict and civil war (Odoñez and Gamboa 1997; Pizarro et al. 1996). Consequently, creating conditions for participation had a more extensive scope and connotation with respect to constitutional reform, deactivation, and political incorporation of armed revolutionary movements, and agreements regarding redistribution processes.

THE SECOND SCOPE: WITHIN CIVIL SOCIETY

The second scope of redefinition opened at the heart of civil society. Different routes opened up to civil society in search of a new relationship with the state and the market.

Civil society, for example, could act as guarantor of transparency, as an agent of policy implementation, or as a set of interest and pressure groups generating checks and balances (Cunill 1997). These functions could be contradictory and demand degrees of organizational flexibility and resources that simply did not exist in civil society. Thus, we began to ask ourselves whether the state was partially responsible for indicating the path, or whether it was up to civil society to find its own route. The state, with the help of multilateral banks and other organizations such as

international NGOs, foundations, and agencies of international cooperation, promoted programs to strengthen the institutions of civil society. The ethos of many of these programs was to develop the autonomy of civil society at the local level by means of its participation in specific processes such as budget planning, leadership initiatives, diffusion of information about policy-making and development plans (Borges-Méndez 1998).

THE THIRD SCOPE: STATE MANAGEMENT

The third scope where a relationship began to be established between participation and accountability was that of government administration per se. This was where the modernization processes of the state coincided with different aspects of decentralization, which began to demand new forms of incorporating citizens and their interests:

1. Profound constitutional reforms that modified the political systems (representation), legitimized different subnational levels of government and administration, and opened new spaces for political expression, such as referendums and open *cabildos*, among others.⁴
2. Promotion of a new culture of autonomy and co-participation in the generation of priorities at the local government level.⁵
3. Redesign of multi-sectoral policies related with targeting processes and non-centralized forms of allocating and using resources (See Aghón and Edling 1997); Graham 1994; and Winkler 1994).
4. Activation of micro-forms and mechanisms for incorporating civil society (such as paving committees, intra-hospital committees, health collectives, budget planning units, citizen safety groups, environmental monitoring committees) that assumed greater responsibility, in terms of time and the contribution of their own resources, in the production of public services and in the diverse facets of public policy-making (design, implementation, evaluation) (Borges-Méndez 1998).
5. Creation of new multi-sectoral, linked public policies without the corresponding institutionality, gen-

erating jurisdictional and social conflicts (Rivera-Ottenbenger and Borges-Méndez 1998).

6. New evaluation parameters to measure the performance of new local governments and of other decentralized organizations such as school districts, educational centers, and hospitals, among others.⁶

THE FOURTH SCOPE: THE LOCAL STATE

Finally, a fourth scope of redefinition, closely related with the previous one, was specifically that of local government (and other subnational units). Toward the mid-1990s, certain problems associated with the dominant optic of fiscal decentralization became apparent, although central governments continued to increase the responsibilities and the fiscal resources that they were transferring to local governments. This optic underestimated the importance of politics because it confused it with policy.⁷ Citizen participation began to be used to try to resolve some of these problems.

1. For different reasons, reducing the size of the state proved to be a more complex process than expected.

Occasionally, adaptation and acculturation of municipal staffing to the new times implied difficult negotiations at the national level with powerful unions (whose cooperation was also necessary for the viability of reforms), central government, and legislative bodies.⁸ Moreover, political parties, for reasons of patronage, did not necessarily support the reform processes because public posts, among other things, still served as a recruiting mechanism.⁹ In fact, in certain instances, a municipal neo-patronage arose from the ashes of the old style patrimonial patronage.¹⁰ The reduction in the size of the state also led to the rise in expectations among citizens for change, which generated new demands and needs. Despite significant reforms, citizens continued to express heightened levels of dissatisfaction with government administration and felt alienated from or insecure as regards modernization processes. A recommendation was made to increase and improve conditions for participation-accountability as a means of attacking these problems (See UNDP 1998; Rivera 1997; and Rojas Ortuste and Custode 1997).

2. Decentralization programs and instruments were necessary but insufficient to induce changes in behavior at the central and local levels.

The emphasis of plans and instruments on agency and coordination problems, for example, did not replace the

problem of institutional development and maturity. Instruments and institutions are not the same thing. Instruments of decentralization, in order to be effective, must take root, and be used and accepted by the agents. Providing instruments and correct incentives does not automatically generate a new type of behavior, because the citizen and the groups of civil society still look upon these instruments as devices far removed from everyday life. Likewise, other behaviors, like dependence and patronage, do not automatically disappear with the introduction of new managerial instruments, although undoubtedly these contribute to promoting change. In a number of cities in Brazil, Mexico, Venezuela, El Salvador, and Chile, managerial initiatives were developed in different areas of public policy that were indicative of a possible acceptance of these new instruments. In Brazil, the use of participatory practices in preparing the local budget is a concrete example, as are the paving committees in Chile, whose aim was to promote coparticipation by citizens, ministries, and the municipality in building roads and streets. The efforts, sometimes related to other organizational endeavors generating positive externalities, such as the participatory paving in Chile that generated, although not always, other activities in the urban management.¹¹

3. Lack of resources, purely and simply, continued to slow down decentralization.

It was quite common to hear or read in the media local governments expressing their desire to return to the central government the rendering of certain services because they could not find the means for fostering financial participation by users, or due to a lack of support from central or regional government.

4. Leadership required to change government administration did not necessarily come from that sphere, but rather from other organizational environments, which was greeted with resistance by the prevalent culture of certain local governments.

The public sphere neither begins nor ends with the state (Cunill 1997; Rivera 1997). Different support programs for innovation in municipal activities, for example in Brazil, encountered that their capacity to bring about changes in those areas came from other organizational sectors: the private sector, religious organizations, cultural organizations, unions, and youth and sports organizations (Spink and Clemente 1997).¹²

5. What could be called the microeconomics of good citizenship—accepting responsibility and asking for accountability in exchange—blended with sociopolitical aspects of representation by gender, class, race and ethnicity.

Certain groups contributed to financing and accepted new responsibilities, but simply did not see or feel themselves to be appropriately represented. This situation has been changing slowly as a result of formal measures to guarantee the representation of women and indigenous peoples in elected and non-elected bodies. For example, since 1997, Bolivia, Brazil, Costa Rica, Ecuador, Peru, Panama, the Dominican Republic, and Venezuela have joined Argentina in approving legislation to demand that political parties reserve a percentage of the places on their lists of candidates for women. Modifications have significantly increased the proportion of women in the lower chambers and in single-chamber legislative structures, although there is still a long way to go. While in 1997 women held more than 10 percent of the seats in the chambers of deputies in the region, in 1999 that percentage increased to 15.4 percent. This surpasses the world average by two percentage points. At the municipal level, what little data are available points to an irregular panorama. In the 1992-94 period, women mayors accounted for somewhat more than 10 percent only in Bolivia, El Salvador, Honduras, and Uruguay. In Mexico, in 1995, there were 101 female mayors (4.1 percent) out of a total of 2,395 municipalities. Of these 101 women, only nine governed municipalities with more than 50,000 inhabitants, and none was in charge of a municipality with more than 100,000 inhabitants. The percentage of women in municipal councils in Latin America roughly during the same period was not very different (Constance 1998; FLACSO 1995; Htun 1998). It is essential to recognize that the social basis and leadership of many community and civil rights organizations in Latin America is in the hands of women, and that this served as a stepping stone to the development of a vast number of participatory projects at the local level with strong emphasis on accountability.¹³

Regarding the representation of the indigenous population, progress through different mechanisms in Colombia, Bolivia, and Ecuador, has been significant. In Colombia, the advances made were due to constitutional recognition of the municipal autonomy of indigenous territories, among other changes. In Bolivia, the increase in represen-

tation was due to a widespread process of incorporation under the Law of Popular Participation and the political strengthening of indigenous movements (Arango Ochoa 1994; Carrasco 1994; and Degregori 1998). In certain instances, new government organizations to be in charge of indigenous affairs were created, although with small budgets, power, and legitimacy. It is worth mentioning that the topic of the representation of indigenous peoples has gained importance in light of the publicity given to the Chiapas uprising, environmental struggles in Brazil, Ecuador, and Chile, as well as the important role played by different indigenous organizations in the events surrounding political changes in Ecuador and Guatemala during the last decade (La Tercera 1999; Nelson 1997; and Treakle 1998).

THE MESSAGE OF THE THIRD PERIOD

The message of this historical moment was that the amplitude and complexity of changes, and the rising expectations on the part of civil society for better government, began to exhaust the capacity of the participatory schemes oriented by a unique technocratic logic, or geared to primarily satisfy the microeconomic preferences of the population. The participatory schemes and how these were geared to innovate in government restructuring, required more profound learning processes that begin with the citizen and civil society. Learning needs to be endogenous, based on the very experience of society, although without a doubt, with the aid of the state at different levels and without rejecting the help of market mechanisms in adding dynamism to the process.

The Fourth Moment, Mid-1990s to the Present: New Concerns Regarding Participation and Accountability

In recent years, various environmental factors have deepened the participation-accountability nexus and assigned greater value to local experiences in institutional reconstruction at the national level. Although some of these factors do not directly touch on the local sphere, they do generate an environment that continually redefines the limits of participation and grants legitimacy to the participation-accountability nexus.

First, the visibility of accountability processes in the political arena has increased. To the cases of Dahik, Bucarán, and Alarcón in Ecuador and of Samper in Colombia have been added to the impeachment hearings of Col-

lor de Mello and Carlos Andrés Pérez, the proceedings against Alan García in the early 1990s, as well as the shady events of the Salinas administration. Other cases for influence peddling, fraud, and breaches of integrity involving the public and private sectors in Mexico, Argentina, and Chile have also contributed to strengthening the accountability environment.¹⁴

Second, the deceleration of economic growth and financial volatility have led to processes of renegotiation of fiscal pacts at the national and local level. Although central governments have tried to honor their commitments to deliver a larger proportion of fiscal funds to subnational governments, the institutional-fiscal flexibility does not appear to be sufficient to avoid political paralysis or the return of a centralist following. These oscillations in the pacts, for example, have appeared with great force in Brazil, Mexico, and Colombia. Faced with these adjustments, the subnational governments and civil society have responded with the determination to preserve their recently acquired autonomy and have suggested the need for national governments to delve more deeply into the transparency and accountability measures (Afonso 1997; Beristáin and Samaniego 1998).

Without a doubt, other political and party interests become involved and are exploited in the processes of renegotiation, which also respond to the situation that each country faces. Nonetheless, local government experience acquires an important presence in the renegotiations for control of national spaces and political pacts. In Mexico, possible presidential candidates from both the PRI as well as from the opposition (Barlett, Fox, and Cárdenas) will be displaying their records as efficient, legitimate and transparent government officials as their most important asset. The case is similar in Argentina. Three current presidents in Nicaragua, Ecuador, and Colombia will be trying to overcome the volatility situation with the experience they acquired as government officials at the subnational level. In Chile, as in the case of Venezuela (Irene Saez), a mayor is running for president. In Ecuador it has been the custom for some time for local government experience to serve as an important platform for political projection for the national level.¹⁵

Third, together with this influence of the local on the national, among municipalities (and among other subnational units) inter-municipal cooperation is expanding with the help of diverse national and international entities.

Politically, decentralization has forced subnational agents to jointly search for solutions to different types of common problems. An expression of this inter-municipal cooperation is the proliferation of municipal associations and federations in the countries of the region (Rojas 1994). These associations group municipalities at the national, at the metropolitan level, or else on the basis of other geographic-territorial characteristics (rural or coastal municipalities). A central aspect of this associative dynamics is that it frequently crosses party lines and is concentrated in the organization of activities that disseminate best government practices via leadership and strategic planning workshops, among other activities. The guiding principles for much of this pedagogical work and institutional strengthening reflect great concern for participation, transparency, and accountability. More sporadically, these associations, in the context of the reform of certain sectors such as health and education, have begun to participate directly in negotiations with national public sector unions and with the national government.

Fourth, during the 1990s, the opening up of the political systems, along with the economic easing of restrictions and decentralization, has brought to light the structural importance of the system of secondary cities in many countries, as well as the role they will play in processing the democratic juncture that the region is confronting (Dietz and Shidlo 1998). As a hypothesis, it is worthwhile to ask whether political consolidation and integration will occur with greater force in these cities, in view of the very distinct processes that are occurring here when compared with those in large cities. The idea is quite suggestive when we observe that, from the 1990s, our large cities stopped growing as a result of rural-urban migration (except for Santiago), and the flows were redirected to the secondary cities. Although urban primacy, or the dominance of the capital city, continues to be a reality, the secondary cities have become nodes of expansion and laboratories for political experimentation, even though they have fewer resources at their disposal when compared with the larger cities. This is a very different situation of sociopolitical and economic incorporation or integration from the one that imparted dynamism to the large urban political integration processes of the 1970s, which, in passing, were truncated with the arrival of authoritarian regimes. An important portion of the population that emigrated to the large cities and others who were born between the end of the

1950s and mid-'70s, did not begin to experience an actual opening up and participation until the end of the '80s, which, in certain cases, was evident earlier: at the subnational than at the national sphere.

In addition to these sociopolitical dynamics, very active local systems of production are being consolidated around these cities, with new production linkages to the national and international economy. Some examples are Tucumán, Mendoza, Rosario, and Rafaela in Argentina; Lee sociopolitical dynamics, very active local systems of production are being consolidated around these cities, with new production linkages to the national and international economy. Some examples are Tucumán, Mendoza, Rosario, and Rafaela; Rabelloti and Schmitz 1997). Two important components of development of these local systems production have been, first, the participation of local agents in associative programs, and second, the strengthening of local governments with initiatives to improve the management of local-territorial resources, through fiscal appraisal programs, the use of strategic planning, and the creation of local development units and programs to stimulate small- and medium-size companies. All these initiatives, in one way or another, use the participation-accountability nexus as part of their management.

Fifth, with the Second Generation reforms, multilateral organizations and governments have emphasized institutional development on various fronts. Increased importance is being given to restructuring the judicial branch and strengthening economic and consumer-protection monitoring agencies. In addition, the number of products dedicated to directly promoting good governance in the subnational units has increased. Finally, multilateral organizations have considerably eased the conditions for elaboration of projects in order to increase the presence and participation of civil society in the different phases of the projects. Moreover, some multilateral organizations have created permanent professional positions as liaisons between the projects, the organizations themselves, NGOs, and civil society. Participation, transparency, and accountability are all new principles that, at least in discursive terms, have become a part of the economic development lexicon (Nelson 1998).

Sixth, the participation-accountability nexus has been transformed into a specialized topic for research and action of a segment of the non-governmental community at various levels (international, national, regional) (Nel-

son 1998). Organizations such as *Transparencia Internacional* (International Transparency), among others, contribute to the systematization and diffusion of information, and the preparation of recommendations on how to attack corruption, and they keep the topic of participation on the public-policy agenda. Similarly, there is evidence of an important movement in Latin America that aims to define new structures for the association of civil society, NGOs, the private sector, and municipal government. These new modalities, principally to establish synergy in the provision of services, also influence the new ways of structuring accountability. More than the traditional government-citizen relationship, the inclusion and synergy among new actors—not only in the provision of services but also in production and final use—strengthens accountability.¹⁶ An interesting dimension of this phenomenon is the case of the colonists of the *Ciudad Satélite* in Mexico.¹⁷

Finally, in almost 15 years most countries of the region have had at least two rounds of municipal (and subnational) elections.¹⁸ These elections are beginning to demonstrate that voters are changing their political preferences based on perceptions of government efficiency and the probity of the local political class. Although the dynamics of these local urban political systems in the different countries are too heterogeneous to identify a common denominator of change, certain general trends are identifiable:¹⁹

1. **Local results are not necessarily indicative of what occurs at the national level.** There are cases of convergence and divergence between the local and the national levels, depending on how the national political forces consolidate or lose power locally. This process, in turn, appears to depend on whether local elections are concurrent with presidential, federal, or legislative elections; electoral rules on quotas and requisites for submitting candidates; ideological effectiveness of the national parties (and of an elite) in closing ranks around the selection of candidates; and the mechanism of the opening up, breakdown, or replacement processes that guide political systems, which differentiate according to whether they are anchored in hegemonic parties, bipolar pacts, or are multiparty systems. Simple correlations between the type or form

of political system (unitary vs. federal), or between district size and levels of representation, do not reveal the complexity of political dynamics that is unfolding the local level.

2. **Fluctuations (or instability) in electoral participation at the local level is a strong political trend, although not for the same reason in all areas.** Sometimes fluctuations are due to simple apathy and the dissatisfaction of the electorate with their politicians; immaturity and the fragmentation of the local arena as a sphere for political debate; parallel leaderships (positive or negative) that break or compete with the traditional political forces; and situations of overt socioeconomic inequality.
3. **Stagnation of political negotiations as a result of the electoral mathematics from the first round of elections is resolved with experience and through experimentation with specific problems of local management.** Local political agents, whether or not organized into political parties, are learning to govern the city together, with advances as well as setbacks. This learning and negotiation often leads to formal institutional modifications, but on other occasions becomes part of the new local political culture, although there may be no formal institutionalization.
4. **Political fragmentation of the local urban electoral systems is not necessarily a negative sign, nor is rotation without continuity among candidates with different political leanings or from other sectors (business, union, non-governmental).**
5. **The electoral results and political dynamics of the capital cities continue to weigh importantly on what happens in national politics, although in different ways.** More than a problem of simple proportions—concentration of electoral masses—control of the capital city may or may not affect electoral outcomes in secondary urban centers as well as in the central government. With decentralization, the influence of capital city politics on the rest of the country does not appear to be automatic, as secondary cities may pursue a more independent political identity.

THE MESSAGE OF THE FOURTH MOMENT

Seven environmental factors are inducing local changes and playing a fundamental role in redefining the participation-accountability nexus:

1. The increasing visibility and the possibility of requesting accountability from national (and local) figures.
2. The dynamics of renegotiating fiscal pacts under new macroeconomic pressures.
3. The importance of the system of secondary cities.
4. The formation of networks and inter-municipal projects of association.
5. The implementation of second-generation reforms that bring with them a reaffirmation of local autonomy via diverse channels (projects, sector policies, constitutional reforms, etc.).
6. The development and sophistication of national and international NGOs that specialize in the strengthening of the participation-accountability nexus.
7. Maturity and electoral differentiation of the local political arena.

There is a popular saying that “everything depends on the color of the glass you are looking through.” On that philosophical note, at this time, there are sufficient signs that show greater cohesion of the local sphere, whose future depends, in great measure, on how we succeed as political managers, administrators, citizens, and members of civil society in producing a paradigmatic, flexible vision regarding the role of the participation-accountability nexus in government. This sensation of cohesion, however, is also accompanied by another of vulnerability that is just below the surface, as some surveys and studies show regarding the mood of the population when it comes to the different processes of reform and modernization.²⁰ The feeling of vulnerability has perhaps intensified with the sudden and vertiginous collapse of some Asian economies. In all descriptions of the crisis, the lack of transparency, crony capitalism, corruption, absence of accountability mechanisms—in other

words, fissures in the moral order that sustains economic systems, as Max Weber and more recently Francis Fukuyama would affirm—appear as some of the causes (Fukuyama 1995). How can we synthesize experiences in order to incorporate best the participation-accountability nexus into government administration? And what would help us do so?

II. The Participation-Accountability Nexus: Toward a Synthesis

This extensive historical overview emphasized that the building of the participation-accountability nexus in Latin America has been a rough process, absorbing diverse types of social, political, economic and cultural pressures. The nexus is not the result of linear or uniform engineering, although it seems to be due to the recent emphasis on the design of normative processes that lose sight of, or simply ignore, the depth of the changes that have been taking place. Historical context and normative design have been combining as civil society and the state (and more recently the market) have become entangled in the difficult task of redefining the limits of their own responsibilities.

It is possible to argue that the participation-accountability nexus should be guided by a series of rationalist and generic schemes that apply to any context, and that these schemes, correctly applied, should lead to similar behavioral results and performance, or at least to more or less similar results. That is the premise that guides the logic of replicability behind the many institutional modernization efforts. Based on this premise, the participation-accountability nexus is practically a utopia of institutional engineering, given the history of our countries. We can distribute design handbooks from municipality to municipality, or over the Internet, but the Latin American context calls for more elaborate programs to guide the participation-accountability nexus.

In our continent, the institutionalization of new sociopolitical orders is fed by continuity and breakdown, which requires flexibility in learning. As a guiding premise, flexibility in learning does not mean that a curriculum should not exist, or that there should be no parameters to measure progress, performance, or to monitor change. What this implies is that there is a need to address the participation-accountability nexus with the vocation of an artisan and not a tinkerer. The artisan thinks, builds and sells products with a special stamp, while the other sells products of little value that are mass produced, although they may be very

useful as well. What, then, are the principles that should guide the participation-accountability nexus?

At this time, diverse agents of change are defining the nexus, incorporating principles from two theoretical perspectives: the new **managerialism** and **social capital**. The first emphasizes design, structure, and results, while the second emphasizes context, process, and culture. The points of contact between the two are being produced as each of them demonstrates its strengths and weaknesses as navigation charts of the processes of institutional reconstruction.

The New Managerialism and the Participation-Accountability Nexus: Institutionalization, Up To What Point?

In the new managerialism, the participation-accountability nexus is part of a debate regarding public administration paradigms and the optimal methods for introducing and stimulating changes in managerial behavior in the short term and at different administrative levels.²¹ In the debate, the participation-accountability nexus serves to control the efficiency and integrity of public servants who should respond to the voice, or preferences, of the voters-taxpayers or beneficiaries, and at the same time maintain a certain degree of technocratic and political independence from political cycles and organized interest groups.

In Latin America, the agents of reform, guided by these principles and equipped with certain tools adapted from the private business sector, such as strategic planning, total quality, and best practice, have sponsored diverse programs of state modernization. Almost all the countries in the region, with different degrees of depth, power, and responsibility, have created agencies, commissions and even ministerial entities in charge of designing, investigating, and measuring modernization efforts, as well as of training staff in the new practices.

In those efforts, the orientation and the use of the nexus as a tool is quite simple. Participation should be organized along clear channels of communications between the state and the citizen, in order to allow citizens to express their interests and preferences. With the correct and appropriate information (symmetry and transparency), the citizens exert pressure on politicians and civil servants. Politicians and civil servants, in turn, should respond by correcting the inefficiency at the risk of losing political backing and their jobs. This characterization, somewhat simplified for our purpose, does not account for the complexity with

which the dynamics of interaction between citizens and the state are generated in the different political systems over time, nor under conflictive circumstances, power imbalances, or the lack of resources. In the final analysis, however, what is important is that the relationship should lead to increased efficiency of government actions and generate practices of good governance.

This principle of responsibility in the context of state modernization, and of the various schemes of political and fiscal decentralization that have been deployed on the continent, has melded with diverse theoretical models of principal-agent, public choice, and transaction costs.²² Without going into detail, there have been two effects on the redefinition of the participation-accountability nexus in government administration.

First, the nexus is perceived as a mechanism for achieving a balance between the size of the government unit and democratization. An optimal balance between the size of the government unit and its democratic depth is obtained by allowing individuals to reveal their private preferences as to the use of public resources in their communities, in proportional conditions of equality. Second, the relationship between the different levels of government and the construction of public policy requires systems of incentives, penalties, and rewards that control inefficiencies, asymmetries, and other institutional flaws. The participation-accountability nexus is a crucial component of these controls.

The effectiveness of the participation-accountability nexus in government administration schemes, guided solely by that logic, has dwindled for three reasons. The three reasons are linked with what we may call the **traps of institutionalization**—that is, institutional engineering designs or situations that, in principle, aim to increase the effectiveness of the nexus and legitimize their role in government management, but in reality do the opposite. They rigidify and inadvertently micro-reproduce centralism, and underestimate the political and administrative costs of the new demands for inter-institutional and inter-sector coordination of decentralization.

1. REGULATED HORIZONTALISM

The central government (together with political parties and other organizations) used to give instructions to civil society or political organizations in a vertical fashion—that is, from the top down. Now, the central government (as well as many local and regional governments) insist on promulgating a

type of “regulated horizontalism” that generates detailed instructions for civil society from top to bottom about how to organize itself from the bottom up. This happens, for example, when it comes to stimulating opportunities for participation in which an attempt is made to regulate the life cycle of neighborhood associations, hospital committees, parents’ centers, consumer organizations—the organic composition of an infinite number of forms of organization and participation that have been designed to accompany the different types of decentralized public policies. Their full regularization and institutionalization is not the best means of exploiting their potential to strengthen government administration. In order to ensure the effectiveness of the participation-accountability nexus in local management, it must be socialized in a context of flexibility and civil autonomy, becoming part of the conventional wisdom of actors. Socialization of the nexus does not necessarily mean that it should be normalized or even institutionalized, which has the potential to become a new source of rigidity. However, it should be kept in mind that there will be circumstances in which it is necessary to have the state offer certain basic exemplars to organize the participation-accountability nexus, because of the adversity or precariousness of conditions where the nexus needs to be fostered (extreme poverty, conflict and violence, environmental degradation). To what degree must the nexus be transformed into a law and code? This dilemma has been confronted by participatory budget processes in Port Alegre and other cities in Brazil, as well as by the design of local monitoring instances within the Law of Popular Participation in Bolivia.

2. THE MICRO-REPRODUCTION OF CENTRALISM

The effectiveness of the nexus is being blocked because the presence of centralism (and other clientelist practices) in the “genetic code” of new local government institutions has been underestimated. Certain municipalities and regional governments appear to be faithful reproductions of central government (and seek to communicate via centralism with the central government). It is true that at the local level political processes are becoming more open and less directed by bureaucratic apparatuses. However, as local government consolidates, new bureaucracies become entrenched around the new demands for the internal functional specialization of municipalities. In addition, the “genes” of centralism and its rigidity are transferred to the municipal and other subnational units through the imple-

mentation demands that—in principle—accompany decentralized politics. How, then, can local institutional flexibility be preserved? The problem has arisen, for example, in providing basic social services in health and education, around which municipal bureaucracies are already forming.

3. POLITICAL AND ADMINISTRATIVE COSTS OF COORDINATION

Finally, for certain municipalities and other subnational units, the demands for inter-institutional and inter-sector coordination of the diverse decentralization designs have resulted in high administrative costs and have consumed the initial political impetus of the recently acquired autonomy. This has weakened the effectiveness of the nexus and has detracted from its legitimacy. For example, in small municipalities without material or political resources, local participation and good performance by local government are insufficient to push for local projects and initiatives that require lobbying at different levels. The problem is both of power imbalances as well as of design.

Social Capital and the Participation-Accountability Nexus: An Elusive Relationship?

At this time, a number of civil organizations and other entities are promoting a redefinition of the participation-accountability nexus as part of the formation and accumulation of social capital in civil society (Evans 1996b; Fox 1996; Putnam 1993). Social capital is the wealth of “norms of trust and reciprocity and the networks of repeated interaction that sustain them. Such norms and networks operate interpersonally and within communities and obey a logic quite different from that of ‘arms length exchange’” (Evans 1996a). Citizen participation is seen as an expression and a practice firmly rooted in the bonds of trust, cooperative behavior, and horizontal relations of association that, appropriately channeled, can strengthen government administration. Civic culture and its organizational infrastructure are catalysts and a medium for citizen expression, especially when demanding accountability from government institutions and the market.

Regarding the redefinition of the nexus, this perspective fosters taking advantage of the wide range of organizational responses by civil society that arose as a result of the political and economic debacles of the 1980s, and of the targeting initiatives of certain government agencies the

1990s. With these principles at hand, governments, foundations, agencies for international cooperation, and multilateral bodies have invested significant resources to develop the non-governmental sector, different types of alliances, and hybrid associations that do not perfectly fit into either the public or private sectors.

From the standpoint of the social-capital perspective, the redefinition of the participation-accountability nexus for improving government administration has also faced a number of obstacles. Conceptually, the problem is twofold: First, if the key to the development of social capital is the creation of a civic culture, what portion of this culture can be built and what portion is inherited? Second, assuming that it can be built, what agents are responsible for stimulating, promoting, and even “administering” it, and what organizational modalities increase participation and make it sustainable over time? In practical terms, the problems of applying a more sociocultural and less technical principle to guide the nexus have been expressed as follows:

1. AMBIGUITY (OR POLYVALENCE) OF THE PARTICIPATORY “CHEMISTRY”

It has been difficult to evaluate how it functions and what factors activate and deactivate the “chemistry” of participation, the situations in which it proliferates and those in which it does not, and what is most effective in leading the participatory process in one or another direction.²³ “Chemical ambiguity” has been perceived among the thousands of different projects that have been implemented through competitive funds organized by different government agencies and social investment funds. In situations in which there apparently is social capital—say, because of organizational density and accumulated experience—participation sometimes dies and there is no interest in using it as a managerial instrument. In other instances, the case is exactly the opposite.²⁴

2. PARTICIPATION AND ASSOCIATION: A DISCRETE FUNCTION OR AN ACCUMULATIVE PROCESS?

The second practical problem has arisen with respect to the handling or maturity of synergy, or the externalities of participation and association, in the context of government administration. Should association and collective processes be understood as a discrete and delimited function? Promoting the participation-accountability nexus generates spillover effects that are quite unpredictable and that,

depending on who applies the pressure or who benefits, can be either positive or negative. In any case, once the citizens' expectations have been unleashed, there is no precise science for determining the direction this will take. It should be stressed, however, that it is important to understand how local governments can productively interact with this reality—either as a democratic phenomenon or as the growth or “accumulation” of civic culture—without destroying it.²⁵ Such problems immediately bring us to the topic of how associative relationships mature and are cultivated, which is the basis for redefining the nexus. The networks of citizens, municipalities, and NGOs that proliferate and are consolidating throughout the continent speak of the importance of the problem (Chalmers, Martin, and Piester 1997). At this time we have few tools for understanding how this interactive density operates in promoting good management. There is evidence, nonetheless, that the influence is positive but that there exist important practical obstacles.²⁶ For example, there are still important legal impediments to inter-municipal collaboration and association that range from constitutional provisions that do not accept the legal character of these associations, to problems relating to budgeting and shared costs. In spite of this, the political potential of this connectivity is already showing in handling environmental matters, citizen safety, and territorial economic development, among other things.

3. POWER: IS IT ONLY IN UNION AND NUMBERS?

Although part of the power and autonomy of civil society resides in its numbers and associative cohesion, we have also observed that organizational density (of a community, administrative unit, or territory) is not necessarily an indicator of political force or capacity, nor does it translate into them. The problem is as simple as not assuming that because there are a thousand soccer teams in a municipality, such density translates into a mature citizenry that demands accountability from politicians and civil servants. In this regard, it has been important to classify the civic potential of different types of organizations and the role they can play in government administration (Fox 1996).

4. THEFT, MANIPULATION, AND USURPATION OF SOCIAL CAPITAL

What has been the capacity of the participation-accountability nexus in penetrating sociopolitical and cultural environments and dismantling practices that misappropriate,

manipulate, steal, or usurp social capital, in both legal and illegal contexts? Or, from another point of view, where does perverse social capital flourish, and how can the nexus revitalize or reconvert the social fabric? For better or worse, let us remember that patronage is often based on relationships of mutual benefit and trust, which often include closely knit personal and kinship relationships. In some communities, to unleash the effectiveness of the participation-accountability nexus also implies rebuilding other relationships, which is not a technical problem of management or of promoting associative practices. Achieving the effectiveness of the nexus can even be an anthropological problem.²⁷ In this vein of analysis, for example, drug trafficking and other forms of organized crime, and their organizational structures at the local-community level, constitute a type of perverse social capital that hinders democratic processes, not only through violent coercive methods, but also as a result of the organizational vacuum that it fills vis-à-vis a state with scant political legitimacy and economic presence (Leeds 1996).

III. Is a Synthesis Possible? What Do We Need to Learn, and How Do We Go about It?

The new managerialism appeals to public policy-makers and to certain elected officials because it is accompanied by a toolbox and precise programs for organizing and managing the participation-accountability nexus and even how to measure its efficiency. This is a very justified response, and, of course, there is nothing bad about it. To some extent this is what the process of promoting the nexus is all about: generating short-term visible and positive results, which is a critical topic for policy-makers, politicians, and citizens. This perspective, however, categorizes participation as a microeconomic action—as a generic expression of welfare satisfaction. And participation, from the viewpoint of the citizen, is much more than this, because it also incorporates components relating to quality of life and other ethical-moral values. In this regard, the perspective of social capital tends to be more integral, although at times it is limited in providing the tools to achieve it. The perspective of social capital is neither paralyzed nor frustrated by the slowness or uncertainty of democratic horizontalism. On the contrary, it is nurtured by this in an attempt to build democratic institutionalities—consensus, tolerance, pluralism, cooperation.

Faced with both needs—producing results and building democracy—the diverse agents of change in Latin America require the following six kinds of support:

1. Introducing the participation-accountability nexus into the heterogeneity of administrative situations.

The rugged nature and discontinuity of our realities require a flexible research and methodological approach that does not attempt to reduce all experience to replicable and transferable models. It is necessary to achieve a balance between the sociological populism of surveys that pretend to measure satisfaction as if all of us experience it in the same fashion, and the excess exploitation of successful cases, which concentrates in specific experiences. It is necessary not to run away from heterogeneity, but at the same time we should not encapsulate ourselves in the specificity of case studies. In recent years a debate has been unleashed regarding how social agents learn in different situations, which has been slowly displacing simple learning-by-repetition or demonstration with learning that is more interactive and emphasizes creation, transfer, and use of knowledge (Hollingsworth and Boyer 1997; Johnson 1992; and Sabel 1994). In that transition we have discovered that there are different ways of learning-by-doing that depend on how conditions for learning are organized and handled. This is the idea behind how "learning communities" function. How fruitful the participation-accountability nexus will be depends upon how we insert it into such a variety of learning situations.

2. Finding ways to influence the distribution curve of opportunities for participation of the population in a democratic framework.

The opportunities for participation are not uniformly distributed among the population. Moreover, it is imperative to know when to strategically scale up or scale down participation, according to specific needs or conditions. It is also necessary to find ways of handling expectations without annihilating the autonomy of civil society nor suffocating democratic processes (see Fox 1996).

3. Promoting combinations of different types of organizations that first facilitate economies of scale for participation, and that second take advantage of the positive externalities that participation (association) creates.

Given the demands of everyday life, the citizen in the participation-accountability nexus also confronts tradeoffs with respect to time and resources. Perhaps this explains the demand for micro-forms of in situ organization with rapid resolution processes and organic simplicity that can produce predictable results in relatively short periods of

time. Nonetheless, there are topics and problems of public policy that in order to be addressed and solved require greater aggregation of interests and organizational complexity. Therefore, it is also necessary to act and make the best use of the positive and negative externalities that micro-participation generates by means of interacting with other types of inter-municipal or other alliances and networks.

4. Stimulating associations in civil society and at the inter-municipal level: Can this remedy certain political flaws in decentralization—such as the absence of checks and balances among government units, society, and the state, or between the state and the market?

In Latin America, our state institutional and market environments are highly imperfect. It might even be said that these imperfections are not deformative but rather constitutive. The fiber of our states and markets has not been deforming, starting from a rational design, but it has formed through imperfections and power struggles. The result is a recurrent need to correct power imbalances. Perhaps the same is happening with decentralization: Will it be necessary to think of its development and maturation as a continuous and negotiated search for mechanisms and forms of correcting power imbalances? As the central state assigns increased fiscal and managerial responsibility to subnational governments and civil society, it will also be necessary to create mechanisms that will act to correct power imbalances. The establishment of those mechanisms, however, implies more than rationally modernizing the design of the state. Actually, there is no optimal design. In democratic political systems, these mechanisms of participation can show various forms incorporating elites, interest groups, social organizations, political parties, consumer defense organizations, etc. Outside Latin America and at other historical times, inter-municipal associative movements and various agents within civil society have played a very important role in creating mechanisms that assist political consolidation at the local or municipal sphere vis-à-vis the central government (see Katznelson 1981; Teaford 1990; and Tilly, Tilly, and Tilly 1975).

5. Developing systems of incentives and of institutional monitoring not as punitive mechanisms (without discounting their need), but as conditions for promoting learning and the acceptance of the situation of flux.

The hardening and deterioration of educational systems in different countries, as well as of the learning environ-

ment in large public and private organizations has generated a debate about what kinds of incentives and monitoring systems hinder or contribute to a better use of resources, an increase productivity, and new programs, among other things. Experimentation with new systems does not emphasize control and punishment, but rather flexibility; horizontalism and democracy; accountability; self-definition of goals; and the development of the interpretative capacities of agents as new organizational and cognitive principles (see Kochan and Osterman 1994; Kohn 1993).

6. Promoting the use of new technologies where appropriate and practical and with a critical perspective.

The development and use of new information technologies, multimedia, and telecommunications has introduced an entirely new territory into discussions of topics such as participation, transparency, and accountability in political administration. The importance of the topic can be addressed from different perspectives. In the formation of political objects or discursive coalitions it is almost impossible to ignore the role that these technologies have played in the production and diffusion of exemplary cases with respect to areas like environmental deterioration. In some of these cases civil society has combined its organizational infrastructure and natural networks with the out-reaching power and influence of these new technologies to build public pressure and stopping verticalist initiatives of states and other agents.²⁸ From another direction, simply consulting the Web sites of multilateral financing organizations such as the World Bank and the IDB gives us an idea of the importance of these technologies in managerial topics. Both banks have on-line participation manuals that are fed by information and case studies on projects, and provide formulas and methodologies for participation, that are increasingly being used for long-distance learning on topics such as public administration, institutional re-engineering, and others, oriented by new principles of participation, transparency, and accountability. Finally, the use of these technologies must be understood in the light of the privatization processes in telecommunications and the diverse modernization processes of the state that are underway throughout the continent. In simple terms new technologies contribute to the diffusion of learning and interaction models that need to be examined as to their effects on civil society, communities, groups, and territories. The new technologies can

be more than passive instruments for information dissemination. Today, the evolution and convergence of these computing and telecommunications technologies allows for better and deeper levels of interaction.

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Endnotes

1. For a review of the historical context, the formation and policies of the Alliance for Progress, see Levinson and Onís (1970), Perloff (1969), and Scheman (1988). Of the large list of publications dealing with the import substitution model, see Fishlow (1990) and Muñoz (1993).
2. Literature regarding authoritarian regimes is ample and abundant and divided by country and subregion. Among the classics that describe, explain, and debate their development are Collier (1979); O'Donnell (1973); and Schmitter, Whitehead, and O'Donnell (1986). For Central America see: Domínguez and Lindenberg (1994) and Vilas (1995).
3. For a general perspective of social movements and the general environment of conflict and protest see, among others, Escobar and Escobar (1992) and Walton (1989). Regarding the development and importance of the NGO sector see Reilly (1994).
4. For a global view of the changes see IDB (1997). For a view of different countries, subregions, and cities see, among others Campbell (1997), ILPES (1995), and Nickson (1995). Aghón and Edling (1997), compile a broad and excellent range of papers about the changes, although they are primarily related to the problem of fiscal decentralization, as well as with the successes and deficiencies of the process.
5. With emphasis on the topic of training to stimulate local autonomy and municipal development, through experiences in Ecuador, Colombia, Costa Rica, Venezuela, Perú, and Bolivia, see IULA/CELCADEL/BID (1996).
6. The problem needs to be approached from different methodological angles and with a balance between quantifiable and non-quantifiable aspects. See: Shah and Huther (1997) and Tendler (1998).
7. Curiously, in Spanish, unlike in English, there is no linguistic differentiation and sometimes not even a semantic one between *politics*, *policy*, and *polity*. In Spanish the same word, *política*, is used to denote all three ideas.
8. This is a relatively unexplored topic in academic papers that deal mainly with the restructuring of public sector policies. It has

been indirectly approached in the study of reactions by public-sector unions to privatization and structural-reform processes. See Murillo (1999). Very little is known about the types of political relationships that these unions are building with subnational units and civil society to confront the centralized state or other legislative bodies about the deficiencies and imbalances of decentralization.

9. This is a focal point of a recent collection of articles on local elections in Latin America. See Dietz and Shidlo (1998). This volume contains articles on Argentina, Bolivia, Brazil, Colombia, the Dominican Republic, El Salvador, Mexico, Peru, Uruguay, and Venezuela. The topic of political patronage in Latin America occupied an important part of academic activity of political scientists during the 1970s. After a period of abandonment the topic is returning with force in the context of how the bases for a new state-citizen relationship are being redefined. See Rivera (1997).

10. This general point is stressed in Auyero (1997). This collection contains various theoretical essays and cases from Argentina, Brazil, and Colombia. Although not exclusively on the topic of patronage, also see Dietz (1998).

11. See Bittar (1992); Campbell (1996); Carrasquero and Rojas (1996); and Fundacao Perseu Abramo (1997). Chile's experience with participatory paving was documented by the author and a group of students in the Master in Social Sciences program of the Instituto Latinoamericano de Doctrinas y Estudios Sociales (ILADES) in 1997. For this research municipal officers, councilmen, and officers from the Ministry of Housing and Urban Affairs were interviewed, and two focal groups were established with leaders from the participatory committees in the municipality of El Bosque, Santiago.

12. The point is indirectly substantiated by UNDP/IDB (1998).

13. For cases from Peru, Bolivia, Chile, Uruguay, and Argentina see Raczynski Serrano (1992).

14. Practically every country now has its own literature on the problem of corruption (distinct from patronage) in high government and private circles. This literature ranges from investigations by reporters to the most academic accounts of the problem. In Colombia, relating to the topic of decentralization, see Rojas (1996). With special allusion to Mexico, see Naciones Unidas-Programa de Gestión Urbana (PGU) (1998). For the Chilean case see Rehren (1998). With respect to the presidential impeachment cases in Brazil, Venezuela, Colombia, and Ecuador, see Pérez-Liñán (1998).

15. In Ecuador, Sixto Durán Ballén and Jamil Mahuad, and Abdalá Bucaram were mayors of Quito and Guayaquil, respectively, before becoming president. León Febres Cordero became mayor of Guayaquil after his term in office as president.

16. For more information consult Fiszbein and Lowden (1999).

17. The colonists of Ciudad Satélite was a self-governing experience of more than 10,000 suburban parcels on the outskirts of Mexico City. This experiment in community self-government, where all urban services were financed by a property tax, declined after 20 years due to internal political strife. Fortunately, the experience paved the way for a powerful civil neighborhood organization (unique in Mexico) whose main function today is to make municipal government respond to the complaints of residents and give a transparent accounting.

18. Some countries have had more than two elections. See Dietz and Shidlo (1998).

19. These points are a summary of the different papers included in Dietz and Shidlo (1998). This volume contains articles about Argentina, Bolivia, Brazil, Colombia, the Dominican Republic, El Salvador, Mexico, Peru, Uruguay, and Venezuela.

20. In Chile, UNDP (1998) has unleashed a debate about the "satisfaction gap" or the contradictions of modernization: Why is dissatisfaction and the sensation of vulnerability increasing among people whose economic condition is still good? For a reply, questioning some statements in the UNDP report, see Brunner (1998).

21. For a summary of the new managerialism see Cunill (1997) and Tandler (1997).

22. IDB (1997) adopts some of the analytical categories of these models. For a general presentation of these theoretical trends see Miller 1997. For a critical discussion of them see Udehn 1996.

23. See Fox (1996). As Fox maintains, Albert Hirschman identified this problem some time ago when he researched the cooperative-participatory efforts in a number of countries in the region. What Hirschman included in his principle of the *conservation and mutability of social energy*, the accumulated community-organizational experience, whether as result of successes or failures in performance, did not seem to necessarily determine the enterprising or organizational-participatory potential of communities. Bad experiences that should have generated participatory apathy or scant or "bad energy" were not criteria for forecasting whether or not the participation would be reborn in a new round of activation, and whether it would become transformed into new participatory processes. See Hirschman (1986).

24. See an internal report prepared by the author on the topic of participation and institutional innovation for the Ford Foundation Southern Cone and Andean Region Office. The report included Chile, Argentina, Peru, and Colombia. Comments in this paper based on the report do not reflect the position of the Foundation.

25. This was a recurring theme of discussion among the participants in IULA/CELCADEL-FUNDACOMUN-Banco Mundial (1998).

26. The experience of the "Orçamento Participativo" in Brazil is indicative of the positive influence of this organizational density. See Genro and de Souza (1997) and Pont (1998).

27. Let us recall Max Weber or Clifford Geertz, and the relationship they establish between the systems of cultural control, types of leadership, and political-administrative pattern. See Geertz (1973), and Auyero (1997), and Gunes-Ayata (1997).

28. See: Hajer (1993). The topic is indirectly addressed in Fox (1998).

Comment

R A Ú L P O N T

The Porto Alegre Experiment

Porto Alegre is the capital of the Brazilian state of Rio Grande do Sul. It has a population of 1.3 million and is the center of a metropolitan region comprising 26 municipalities and 3.5 million inhabitants. Porto Alegre was the site of the state's early industrial initiatives at the turn of the century. Today, services and trade predominate in its GDP of approximately 10 billion reais. It is a major hospital and health center and the seat of the state's largest universities and major commercial centers. In addition, it also has a strong presence in the form of civil servants employed by the federal, state, and municipal governments. The municipal budget for 1999 is 1 billion reais. A total of 830 million is earmarked for direct and indirect municipal administration, while federal transfers to the public health system managed by the municipality amount to approximately 250 million reais.

Under the Brazilian system of government, a municipality is an autonomous entity under an Organic Law, and it is entitled to derive its own revenues from taxes determined and collected within the municipality itself. In the particular case of Porto Alegre—and it should be noted that there are enormous differences in tax revenues throughout the country depending on size, population, and industrial capacity—the municipality's own revenues correspond to around 55 percent of its total resources. Receipts from the federal government represent about 5 percent, and the remaining 40 percent consists of transfers from the state.

A municipality collects taxes on urban buildings and land, real estate sales, and services of any nature; there are other levies, too, and charges for urban cleaning, water, and sewerage. The principal taxes charged by a state are the state-level VAT and inheritance and vehicle ownership taxes. The federal government collects income tax, its own federal-level VAT, taxes on imports and exports and financial operations, and social security contributions.

Popular Participation: Publicity, Decision-Making, Supervision

Porto Alegre has been governed by the Workers' Party for the past three terms. Since 1989, the government has

developed and encouraged a process of popular participation to consolidate an experiment in participatory democracy designed to stimulate regular and ongoing participation by the population and not be restricted solely to election times. The principal instruments were:

(a) **Creation of a participatory budgeting mechanism allowing for direct popular participation in the budget information and decision-making process.**

The city was divided into regions, whose number has risen over the years to the present total of 16. Five thematic plenary assemblies have been established since 1993 to deal with the major budgetary themes. Within these spaces, the population receives information, subdivides into microre-

Raúl Pont is Mayor of Porto Alegre, Brazil.

gions, and in the course of a few months builds up its claims and priorities, after which it appoints advisers to assemble and coordinate the demands that have been approved.

In addition to providing an opportunity for popular discussion, supervision, and monitoring of public resources, this experiment has proved to be a powerful tool for citizenship training and for fostering political education and a new relationship between society and state. Every citizen who participates in the meetings—and today there are thousands of them—has access to the municipality's income and expenditure data and numbers. They know where each agency or secretariat obtains its funds, how much it spends on operating and manpower costs, and the extent of its capital expenditure capacity.

This experiment, now 11 years old, involves direct participation—i.e., each citizen has a vote, and the operating criteria are decided and regulated by the participants themselves. The participatory budget is not governed by legislative act, but based on the Organic Law and the federal Constitution, both of which affirm representation and direct participation as forms of expression of popular sovereignty. The participatory budget process deliberates all new investments in works and services carried out by the public authorities. This process has led to other forms of supervision, such as that provided by service groups, works committees, and permanent regional popular councils.

(b) The Municipal Councils.

These councils are governed by the Organic Law and by state and federal legislation. They address the different sectors (health, education, children's rights, sports, etc.) and are composed (in the majority) of community delegations and (in the minority) of sectoral representatives of the municipal government. These consultative bodies formulate sectoral policies and guidelines for the executive branch, but they bring strong representative weight and pressure to bear on the government and are able to influence the debates and decisions on the participatory budget. Some of them establish policies for specific funds based on federal law (e.g., health, children's rights, etc.) and are instrumental or influential in deciding on and supervising the use of those funds.

Their ability to exert pressure varies with their degree of organization, representativeness, and influence on the government, but in the case of Porto Alegre they have become one of the pillars of the relationship between government and community. Some of them have strong roots in sector

associations (tenants' associations, day-care centers, trade unions, cultural groups, sports organizations). They exercise strong supervision over the government and possess information on the sectors that enables them to act.

(c) Publicity.

It is essential to keep the citizens informed. The tools used for this purpose are the printed word (by-laws, investment plans with total revenues and expenditures, informative bulletins, etc.), publication of meetings schedules in the daily city newspapers during periods of public assemblies, and radio and television programs promoting and encouraging participation. In the regions, cars equipped with megaphones are used to announce the time and place of a meeting and directly summon the people to attend.

Results

The pace of this participation also changes the pace and nature of the relationship between the state bureaucracy and the citizens, and their mutual influence (pressure and revenue collection on the one hand, project development and works implementation on the other) is positive and makes the state machinery even more efficient. Likewise, whenever a decision is made by the population, the demand for works and services will naturally be attuned to the needs of the most disadvantaged groups. Table 1, showing the priorities of the participatory budget over the past four years, expresses this very well:

Since this process has spanned three consecutive terms, it has made a substantial contribution to the continuity and consolidation of the experiment. Its greatest achievement consists of providing a practical means of democratizing decision-making, improving public-resource management, and introducing a new way of approaching annual and multiyear budget planning. But it is more than that: It is a powerful tool for training citizens, for sensitizing them to matters of public policy, and for breaking with traditional methods of clientelism, populism, and the corrupt use of public resources.

The improvements in living standards, the top rating given to Porto Alegre for its quality of life and for the highest HDI (UN) of all of Brazil's major cities, as well as its performance in terms of school enrollment and literacy rates, basic sanitation (water and sewerage), life expectancy, and voter participation, all well above the average for Brazil, are illustrations of the merit of the process and value of the results it has produced over the past decade.

TABLE 1

Priorities of the Participatory Budget, 1996–99

1996		1997	
1	Community road surfacing	1	Housing policy
2	Basic sanitation	2	Community road surfacing
3	Housing/land tenure regularization	3	Basic sanitation
4	Education	4	Education
5	Transportation	5	Health
1998		1999	
1	Community road surfacing	1	Basic sanitation
2	Housing policy	2	Community road surfacing
3	Basic sanitation	3	Housing policy
4	Health	4	Education
5	Education	5	Health

Making Decentralization
Compatible with
Macroeconomic Stability

Macroeconomic Management in Decentralized Democracies: The Quest for Hard Budget Constraints in Latin America

WILLIAM DILLINGER, GUILLERMO PERRY, AND
STEVEN B. WEBB

I. Introduction

Some decentralized democracies like Switzerland, Germany, and the United States are known for their macroeconomic stability, and some scholars even give federalism some of the credit for the stability (McKinnon 1997; Qian and Weingast 1997). Recent events in Brazil, however, show how decentralization can contribute to macroeconomic instability. Colombia is also a good example of how rapid decentralization can put substantial stress on macro-fiscal stability (Dillinger and Webb 1999a and 1999b). Other cases in Latin America, such as Argentina, show how decentralization can complicate achieving stability (as was the case in the 1980s) but also how it can be made compatible with stability (as has happened in the 1990s). Many other countries in the region—such as Mexico, Ecuador, Venezuela, Nicaragua, and Guatemala—have begun decentralization recently, and it is crucial that they make institutional arrangements to prevent undesirable macroeconomic consequences. This paper addresses two questions:

- *How does decentralization affect macroeconomic management and the size of the state?*
- *What institutional arrangements and policies account for the good and the bad macroeconomic effects of decentralization in LAC?*

The standard economic dimensions for evaluating public finance policy are macroeconomic stability, equity, and efficiency (Musgrave and Musgrave 1984). In analyzing macroeconomic management in decentralized democracies here, we focus mostly on the first dimension (we discuss also some broad issues of efficiency, related to the size of the public sec-

tor and the relative supply of local and national public goods), while recognizing the importance of the others.

We also recognize that the economic dimensions are not the only ones to use in judging decentralization. Indeed, the primary reasons for decentralization in Latin America and elsewhere have been political, not economic (Rojas 1998; Willis et al. 1997). Decentralization has been an integral part of programs to restore or deepen democracy in many countries. Even more, as we show below, the political dimensions of decentralized states are crucial for understanding their macroeconomic outcomes.

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On the macroeconomic dimension, as well as on the others, decentralization has raised both hopes and fears. The hopes are, first, that decentralization might improve the overall macroeconomic performance of the public sector by bringing spending decisions closer to the taxpayer. Just as people only buy what they can pay for, they might only allow their local government to spend what they are willing to pay taxes for. *This mechanism can be expected to work whenever local expenditures are mostly financed by local taxes, but not when they are mainly financed through transfers from central government.* In economic theory, only the source of revenue at the margin should matter, but in practice the most important sources on average end up with similar importance at the margin.

The second hope is that, to protect themselves, creditors might limit lending to local governments to prudent levels, as they usually do with individual households or firms. *This would happen only if creditors do not think that the central government will bail out failing local governments.*¹

These hopes for decentralization imply that central governments would be more likely than local governments to overspend and overborrow, both because the taxpayers to the national level are more remote from the beneficiaries of services, employment, and contracts, and because the banking sector is often a captive market for national debt.

The macroeconomic fears about decentralization arise precisely because the conditions emphasized above are frequently not met. First, decentralization often increases the separation between spending and tax decisions, rather than bringing them closer. This happens whenever subnational expenditures are financed mainly through transfers from the central government, as is the case in most of Latin America. Subnational governments may then overspend, expecting to get more resources from the common pool of national resources, either through additional discretionary transfers or bailouts. The fiscal decentralization process in Latin America has been politically driven, and consequently it has often been led by the transfer of resources. In other places, like some Asian countries, decentralization is part of the fiscal-adjustment strategy of the central government—pushing responsibilities downward without a fully corresponding transfer of funds or tax base. Then the quality of service might be more of a problem than macro-fiscal management.

Second, creditors usually expect central governments to bail out bankrupt subnational governments. Subnational

governments might be especially likely to run unsustainable deficits when they first acquire capacity to issue debt (due to improved tax bases, increased transfers, and more autonomy) and financiers still expect that the center will come to the rescue in case of trouble.

Bailouts of subnational governments occur not only as a consequence of excessive debt. Subnational governments may end up being insolvent due to unfunded contingent liabilities (financially unbalanced pension systems for state employees; excessive guarantees to private investors in infrastructure; losses of subnational public banks or public enterprises). Such cases are theoretically equivalent to excessive debt issuance, and are also related to “moral hazard” incentives: Subnational governments incur excessive liabilities because both they and the beneficiaries believe that the central government will come to the rescue in case of insolvency. But they may be exacerbated by the lack of disclosure, transparency, and predictability. Bailouts can also occur through discretionary transfers to finance expenditures that were supposed to be financed through automatic transfers or local taxes.

Federal systems also present the danger that states' representatives to the national government will collude to extract more resources from the common pool through legislation or negotiated agreements (Alesina and Perotti 1994; Jones, Sauguinetti, and Tommasi 1997). Such decentralized or concerted attacks on the “commons” might lead to different outcomes depending on the central government's reactions. If the central government responds by cutting its own expenditures to maintain fiscal equilibrium, the result will be an inefficient composition of public expenditures: larger than optimal spending on local public goods, lower than optimal spending on national/federal type of public goods. If the central government responds by increasing taxes so as to keep fiscal equilibrium, the result will be a bloated state: larger than optimal total public expenditures and taxes. If the central government cannot or does not do any of the above, the result will be excess fiscal deficits and macroeconomic instability.

The transition from a centralized to a decentralized system might lead to higher average deficits of the central government (or to higher taxes) because its direct spending is not reduced as it increases transfers or gives up tax bases to subnational governments. Such an outcome may develop because of a serious mismatch between allocation of

responsibilities and resources. It can also arise because the subnational governments fail to do the job with the monies transferred, leaving the center with the double cost of continued service provision plus the transfer (or forgone revenue from devolved tax base). Finally, it may happen just because the central government does not slim down even after subnational governments take over its previous tasks, as it refuses to let go the powers of patronage or is constrained by inflexible labor codes or union power.

In addition, the central government's ability to carry out stabilization policy in response to shocks may be more hampered in decentralized economies. One reason is that the central government may have to share with subnational governments the more efficient tax bases or totally relinquish them. Then, a necessary and desired fiscal contraction may not be achieved, because the central government cannot induce subnational governments to participate in the required budget cuts (Tanzi 1995; Prud'homme 1995). Alternatively, fiscal adjustment may turn out to be inefficient. Central-government expenditures might have to be cut to inconvenient levels or inefficient non-participated taxes increased beyond prudence.

Thus, together with the hopes there are legitimate concerns that decentralization will lead to excessive decentralized expenditures and thus to problems with macroeconomic management. As indicated above, compensating actions to avoid macroeconomic instability—excessive reductions in federal spending or excessive overall tax levels—can lead to efficiency and equity problems.² Decentralization can then result either in insufficient provision of federal public goods, in larger overall public expenditures and taxes, or in macroeconomic instability.

In attempting to answer the two questions presented above, this paper draws mainly on research conducted in the Office of the Chief Economist for Latin America and the Caribbean at the World Bank.³ The next section presents evidence on the effect of decentralization on public finances in a worldwide sample of countries. Section III analyzes the effects of institutions on the macroeconomic outcomes of decentralization experiences in four Latin American countries: Argentina, Brazil, Colombia, and Mexico. Section IV compares these experiences schematically to see which combinations of institutional arrangements for decentralized fiscal management suffice to avert severe macroeconomic problems, and which do not. Finally, we summarize the main conclusions from these analyses.

II. Econometric Evidence of Macroeconomic Problems

To answer the question of whether decentralization contributes, on average, to excessive public expenditures or unsustainable fiscal deficits, an econometric study analyzed the relationships between subnational and national government fiscal indicators, using data from 32 industrial and developing countries, 1980-94 (Fornasari, Webb, and Zou 1999). The dependent variables were either central-government primary spending—including transfers—or primary deficits, in order to address the question of how they were affected by subnational fiscal behavior.⁴ The main independent variables were the subnational fiscal variables—either subnational total spending and taxes, as a pair, or lagged subnational overall deficits. Some standard control variables, such as GDP growth, inflation, urbanization, central bank independence, and major political transitions, were also used.

When the data were averaged over time to make cross-section comparisons, only two coefficients on subnational fiscal variables turned out to have t-statistics indicating a significant difference from zero: In the equation with national spending on the left side, the subnational spending variable had a significantly positive coefficient and the subnational tax variable had a negative one (see Table 1). The coefficient on subnational spending was close to 1.0, which implies that central-government spending tends to grow in a one-to-one ratio with subnational spending. On the other hand, the coefficient for subnational taxes is approximately -2.0 . These results suggest that on average (1) decentralization of spending by transfers increases the size of total government, a result consistent with Ernesto Stein's (IDB 1997) all-Latin America sample; and (2) to the extent that subnational governments finance themselves with their own taxes, the public sector at the national level tends to be smaller by about as much as the subnational spending, leaving the overall size of the public sector about the same.

Figure 1 shows how the observations led to this result. The location of each observation shows the GDP share of subnational spending and taxes—the main independent variables in Column 4 of Table 1. Countries that are farther out on the x-axis have more subnational expenditures as a share of GDP. If SNGs paid for all their expenditures with their own taxes, they would be on the 1:1 line, but no country with much decentralization is close to that line.

TABLE 1

Central Government Fiscal Outcomes as a Function of Subnational Variables—Cross Section Estimates, 1980–94

(All dependent variables are net of interest payments)

DEPENDENT VARIABLE	CG DEFICIT TO GDI ¹	CG EXP. TO GDP	CG DEFICIT TO GDP	CG EXP. TO GDP
Constant	5.404 ** 2.250	0.619 0.056	5.867 ** 2.211	-5.506 -0.566
SN Total Expenditure to GDP			-0.041 -0.384	1.009 ** 2.556
SN Tax Revenue to GDP			0.033 0.180	-2.110 ** -3.132
Lag Overall SN Deficit to GDP	0.758 * 1.884	-0.199 -0.108		
Lag CPI Inflation	-0.073 ** -2.691	-0.206 -1.649	-0.068 ** -2.167	-0.122 -1.060
Percentage Urban Population	-0.029 -1.162	0.160 1.398	-0.026 -0.959	0.128 1.268
1980 GDP Per Capita in US\$	-0.272 -0.799	2.157 1.380	-0.248 -0.661	2.836 ** 2.065
Real GDP Growth	-0.539 ** -2.096	0.586 0.496	-0.570 * -2.012	0.320 0.309
Adj. R-Squared	0.25	0.36	0.13	0.52
Number of Observations	32	32	32	32

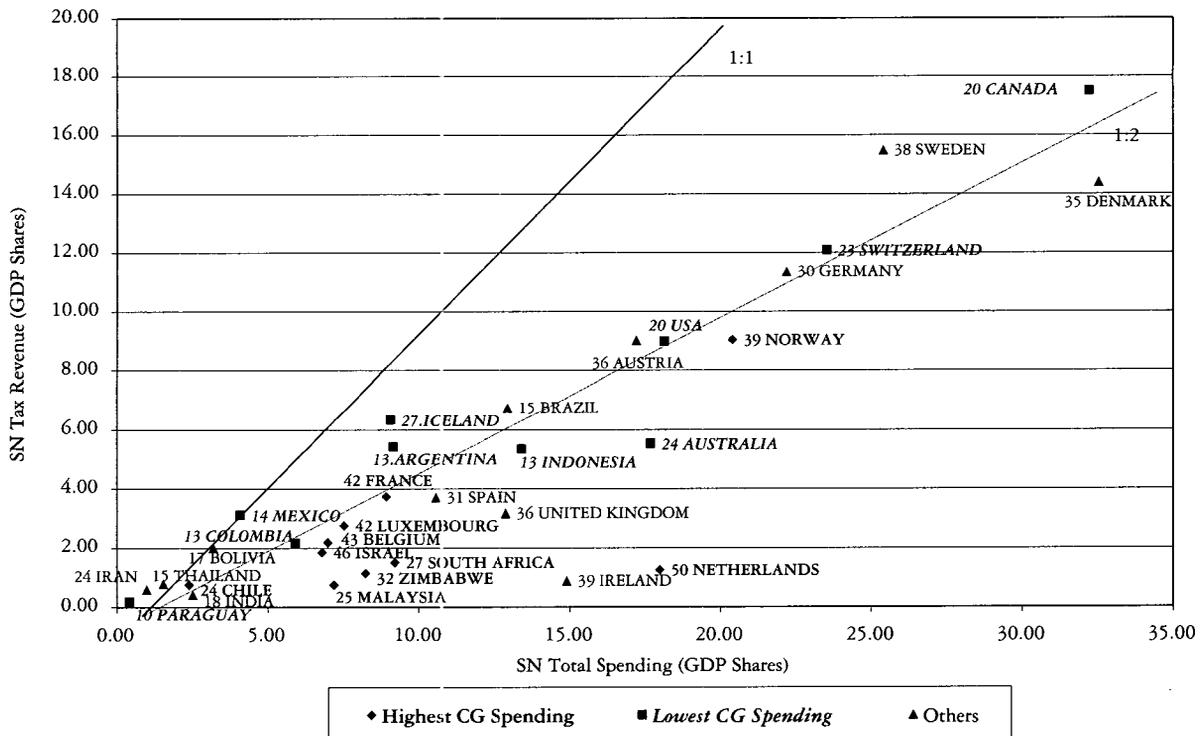
The number in italics represents the t-statistic associated with each coefficient.

* indicates a significance level of 10 percent

** indicates 5 percent significance

FIGURE 1

Central Government Spending as a Function of SN Spending and Taxes



Note: Number indicates CG Spending as GDP share.

The most self-reliant are only a little above the 1:2 line—own revenues paying for about half of subnational expenditures. The number by each observation and the font of the country name show the dependent variable—central government spending shares.

The regression result comes about because almost all of the countries that are far below the 1:2 line and close to the x-axis (heavy transfer dependency) had large public sectors (among the top third of the sample, labeled in **BOLD**).⁵ Most of those on or above the 1:2 line had small central governments (in the bottom third of the sample, **BOLD ITALICS**).

The subnational deficits did not on average affect the national spending or the national deficit in the cross-section regressions, nor did the subnational spending have a statistically significant relation with the national-government deficits. This implies that when countries are decentralized in a long-run steady state—which is the interpretation of these cross-country regressions on averages per country—they do not have higher national deficits on average than the less decentralized countries. They have presumably

developed institutions—and raised taxes—at least adequate to avert the macroeconomic fears concerning deficits.

The panel regression with changes in the national and subnational fiscal variables got very different results (see Table 2).⁶ They show that increases of subnational spending and deficits lead to higher spending and deficits at the national level. The relationships are strong economically as well as statistically significant.⁷ The results in Columns 1 and 2 have the clearest meaning—an increase in subnational deficits is associated with an economically and statistically significant increase in central-government spending and deficits in the subsequent period. This is consistent with a pattern of the central government's bailing out states and cities when they have borrowed too much.

Figures 2-A and 2-B show more of what is going on. Most of the countries in the sample were reducing their central-government deficits over the period. But the ones that had the largest average increases of subnational spending and deficits—ranked to the right in the charts—decreased their central deficits the least, or increased them on average.

TABLE 2

Central Government Fiscal Outcomes and Subnational Variables 1980–94 Panel Data, First Differences

(All dependent variables are net of interest payments)

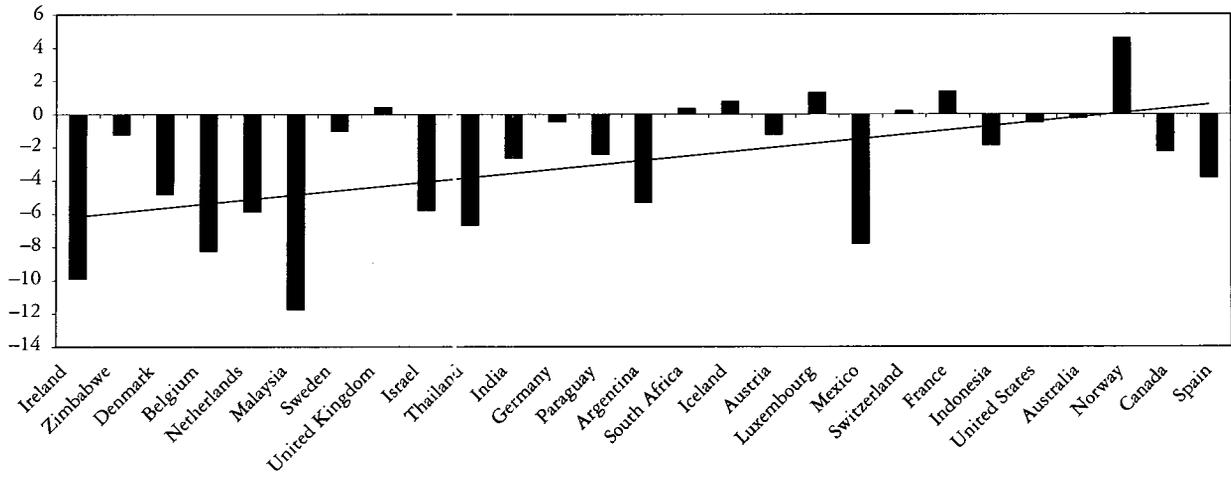
DEPENDENT VARIABLE	CG DEFICIT TO GDP	CG EXPEND. TO GDP	CG DEFICIT TO GDP	CG EXPEND. TO GDP
Constant	-0.045 -0.092	0.459 * 1.838	-0.413 -0.932	-0.069 -0.312
SN Total Expenditure to GDP			0.322 ** 4.007	0.538 ** 8.121
SN Tax Revenue to GDP			-0.176 -1.004	-0.073 -0.571
Lag Overall SN Deficit to GDP	0.234 ** 2.805	0.261 ** 7.902		
Lag CPI Inflation	-0.054 ** -2.806	-0.013 -0.592	-0.057 ** -3.368	-0.028 -1.509
Percentage Urban Population	-0.007 ** -2.019	-0.013 ** -4.657	-0.010 ** -2.693	-0.012 ** -4.959
1980 GDP Per Capita in US\$	0.070 0.985	0.089 ** 2.113	0.123 * 1.878	0.128 ** 3.393
Real GDP Growth	-0.150 ** -8.141	-0.194 ** -13.545	-0.143 ** -8.896	-0.142 ** -12.706
Adj. R-Squared	0.10	0.23	0.14	0.33
D. W. Statistic	2.12	1.77	2.13	1.82
No. Time Observations	13	13	13	13
No. Cross Section	32	32	32	32

The only variables that are in first difference are the dependent variable and the fiscal explanatory variables, i.e., total expenditure, tax revenue, and deficit. The number in italics represents the t-statistic associated with each coefficient. Furthermore, * indicates significance level of 10 percent, while ** indicates a significance level of 5 percent.

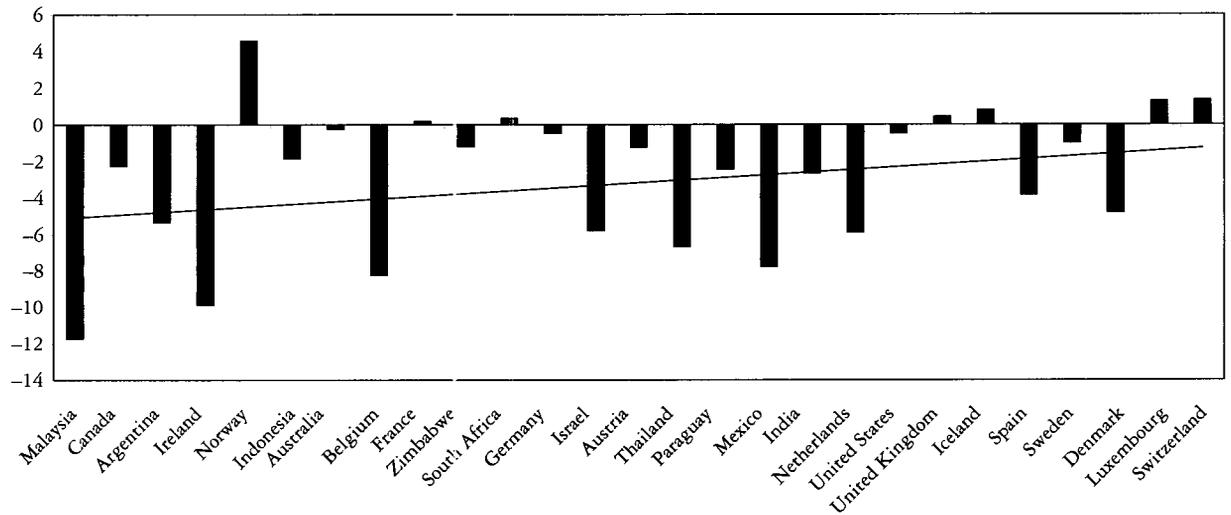
FIGURE 2

Change of Central Government Deficit 1980/84 to 1990/94, Percent of GDP

A. Ranked by Change of SN Total Spending



B. Ranked by Change of SN Primary Deficits



In interpreting these results, it is important to recognize that the use of first differences means the results are determined mainly by the countries and periods when the levels of spending and deficits at the national and subnational levels are changing rapidly—that is, by those in which increased decentralization is taking place. In these times and places, we can reject the hypothesis that the transfers between central and subnational governments are usually determined exogenously by the center. The process of fiscal decentralization tends to cause problems. These results are powerful arguments against rapid decentralization without adequate safeguards.

The results in the panel data held up even with the inclusion of political-institutional variables—major national political transitions and central bank independence—and two that pertained directly to decentralization, election of subnational officials and unitary/federal constitution. Whether or not local officials were elected had no effect on the intergovernmental fiscal relations considered here. In other words, local democracy does not seem to worsen, or improve, macroeconomic fiscal management on average. Being a unitary state (rather than a federation), on the other hand, significantly increased the extent to which national-government spending was related to subnational spending

and deficits, but this might just reflect the fact that the national spending figure includes some transfers to states, and one would expect budgeted transfers (rather than tax sharing or delegated taxes) to be more important in a unitary state. Being a unitary state does not significantly affect the transmission of subnational deficits to national deficits.

To summarize, whereas in the cross-section regression the steady state level of subnational borrowing (implicitly sustainable) is not associated with higher central-government spending and deficits, when subnational governments increase their borrowing (potentially unsustainable) the central government seems to have to spend and borrow more in the subsequent period. This implies that transitions to decentralization and fluctuations of borrowing by subnationals typically cause problems for macroeconomic management, but evidently many countries with long-standing decentralized public sectors have developed institutions to prevent these problems. Although many of these countries are outside Latin America, the experiences in the region show important positive as well as negative lessons for macroeconomic management in decentralized democracies.

The results presented thus support some of the hypotheses of hopes and fears discussed in Section I, but not others.

Fears realized:

- Decentralization based on transfers from the center, common in Latin America, tends to increase the size of the total government sector.
- Increases in subnational deficits lead to increases in national-level expenditures and deficits and to macroeconomic instability.

Fears not realized:

- Decentralization based on local taxes does not increase the size of the state in the steady state.
- Decentralization is not associated with more or less fiscal deficits in the steady state.

These findings suggest that one would expect to see more problems with macroeconomic management during and shortly after an increase of fiscal decentralization; then the problem should subside as institutions are strengthened. The case studies show how this can happen.

III. Outcomes and Institutions in Major Decentralized States of Latin America

This section analyzes the macroeconomic outcomes from decentralized fiscal management in Argentina, Brazil, Colombia and Mexico.⁸ These cases indicate which institu-

tional features of decentralized fiscal systems lead to excess deficits at national or subnational levels and which features help avert these problems. To guide the analysis we use the following framework, which summarizes the dimensions of institutional arrangements—fiscal and political—that are expected to affect the quality of fiscal management in decentralized democracies (Table 3).

Hard Budget Constraints for Subnational Governments. First and foremost, a firm allocation of expenditure responsibilities is critical for establishing a hard budget constraint for subnational governments. *If the central government can effectively delegate functions to subnational governments to go along with the delegation of revenue sources,* central spending and deficits are more likely to be contained. If this is not the case—because, for example, the constitution or the law mandates resource transfers without allocating explicitly equivalent responsibilities—the central government can find itself with a constitutional obligation and political expectation to continue providing some services, even after revenues or tax bases have been turned over to subnational governments with the understanding that they will do the task. Or it may have to resume spending on functions when subnational governments have a fiscal failure.

Basing transfers exclusively on clear rules is a second necessary ingredient for a hard budget constraint. Wherever there is recourse to significant discretionary transfers, including matching grants, subnational governments will have an

TABLE 3
Institutional Arrangements To Set and Keep Hard Budget Constraints on States

1. Hard budget constraints from the CG to SNGs	– Rule-based transfers
	– Firm allocation of spending responsibilities
2. Constraints on borrowing	– Ex ante constraints
	– Ex post consequences and resulting incentives
	– Enforcing payment by SNG
	– Enforcing losses on banks with bad loans to uncreditworthy SNGs—bank regulation
	– Central bank independence
3. Autonomy of SNG to reduce costs and raise own revenue	– Ability to control spending and costs
	– Ability to increase revenues
4. Political ability of CG to enforce HBC	– Power of the president
	– Power of the governors
	– Political party discipline
	– Electoral rules

incentive to overspend in the expectation that they can get a larger transfer.

Borrowing Constraints. Although tax and spending policies create fiscal pressures, whether they cause problems for macroeconomic management depends on whether the SNGs face hard limits on their ability to borrow or to seek other ways to increase their resources by spending more (Ter-Minassian and Craig 1997). Unsustainable deficits are less likely *if the central government effectively controls subnational borrowing ex ante*. But how to enforce this in practice is not always clear when the subnational governments have considerable political autonomy. Pseudo-strict controls could make matters worse if central-government approval creates the impression, and perhaps the self-fulfilling expectation, that the central government also has extended a guarantee. The best controls would mimic what prudent lenders would require.

To run deficits, subnational government must find a source of financing, which potentially includes contractual borrowing from private foreign or domestic banks (especially banks owned by the subnational governments), issuance of domestic or foreign bonds, and the running up of arrears to suppliers and personnel. A creditor and the subnational government would only agree to finance unsustainable deficits if both sides expect to gain, most likely through some sort of federal bailout. The bailout can take many forms, including allowing the financial system (implicitly insured by the government) to count a debt that is not being serviced as an asset. So unsustainable deficits are also less likely *if the central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debts, and if regulators force creditors to accept the losses implied by any failure to service debt by subnational governments*. It is still an open question whether ex ante regulation or ex post enforcement of debt service is more effective in preventing excessive SNG borrowing. Although conflicts are also possible, as noted above, both can work together and complement each other. Ex ante controls keep the problem from growing so big that it threatens the entire system, and ex post consequences increase the concern of individual borrowers and lenders.

Often financing from the central bank is what loosens the budget constraint for the subnational governments, either directly by discounting subnational debt or indirectly by easing the national government's budget con-

straint or allowing commercial banks to roll over bad subnational debts. Unsustainable deficits are expected to be less likely when *the central bank (and the bank supervisory agency) is more autonomous and has a strong anti-inflation mandate*.

As mentioned above, subnational governments may also accumulate excessive contingent liabilities. This situation is more likely to happen wherever subnational governments are allowed to run their own pension regimes, when they own banks and when they make concessions to the private sector without adequate regulation from above.

Autonomy of SNGs to Reduce Costs and Raise Revenue. The third group of institutions relates to subnational governments' having the capacity and autonomy to stay within the budget constraint. The first one in this category is *expenditure autonomy*. Without SNGs' autonomy over their expenditure, there is no fiscal decentralization and no macro fiscal problem likely to come of it. Giving SNGs autonomy over spending is, of course, the way in which decentralization can improve efficiency in matching the needs and desires of a diverse population. But to live within a sound budget constraint SNGs must have the authority to control their costs. Too often central governments keep for themselves decisions that critically affect the level of costs of subnational governments (such as teachers' and doctors' wages), and a liberal decision may throw them into deficits. In particular, subnational governments must have the authority to spend less—particularly to cut personnel, salaries, and pension benefits, collectively the largest single item of subnational expenditure—in order to be able to adjust to shocks or to contribute to needed fiscal retrenchment. If central rules constrain this authority, then it is more difficult to reduce deficits, and expectations of a central-government bailout are higher. Thus unsustainable deficits should be less likely *if subnational governments have authority to cut their costs*.

With fiscal decentralization, SNGs usually obtain certain tax bases, but for reasons of politics, equity, and efficiency these bases rarely cover all the expenses of SNGs, which always receive significant federal transfers. It is commonly believed that subnational governments will have smaller deficits if they rely more on their own tax bases (and have the power to change tax rates on the margin), because they have the ability to adjust to shocks by increasing revenue. Also, as discussed above, relying on one's own resources may strengthen the incentives to control spending. Thus, unsustainable overall public sector

deficits are less likely if *subnational governments raise much of their own revenue and have enough flexibility to change rates or impose new taxes.*

Political Ability to Enforce Hard Budget Constraints.

Political institutions determine the capacity of central governments to enforce hard budget constraints. The rules for intergovernmental fiscal relations and the way in which they are implemented result from the political relations between levels of government (Riker 1964; Stepan 1997; Willis et al. 1997). Why does the central government say yes or no to an SNG's request for more resources? Why do the SNGs take on additional tasks or accept reduced transfers in order to help the central government balance its budget? When the national government makes substantial transfers to politically autonomous subnational governments, its ability to take a firm stance toward subnational governments depends most on the power of the president vis-à-vis the governors and mayors themselves and their representation in congress. In classic decentralized fiscal systems, local voters are taxpayers who pay the bill and therefore exercise restraint on spending (Tiebout 1956; Weingast 1995). Systems with strong presidencies should be better able than systems with weak presidencies to fend off pressures to cover the states' deficits. The presidency is the only office with a national constituency and as such is more likely to take into account the interests of the overall economy, while the members of congress represent regional constituencies as well as their parties.

We can analyze the power relationships between the national and subnational levels in four steps, corresponding to four conditions. Unsustainable deficits arising from fiscal decentralization are less likely if *presidents are constitutionally strong at the national level, and if governors and mayors have little constitutional autonomy.* These conditions are not necessarily beneficial for all aspects of governance, and of course fiscal decentralization presumes that governors have enough political autonomy to be considered a politically separate level of government rather than just a field representative of the central government. Governors and the president indirectly contend for resources, especially via congress and the parties, whose effects on the intergovernmental balance of power we must also consider. The central government should be more able to maintain a harder budget constraint if *electoral rules orient congress toward national, not local, issues, and if party discipline is strong.* The balance between these forces depends on the interaction of the con-

stitution, electoral procedures, and party discipline. The constitution is a given at most times, as are electoral procedures. Therefore, party discipline is the dependent outcome. But constitutions and electoral procedures change with some frequency in Latin America, and they reflect the political balances and party characteristics at the time of each change.

With these conditions as framework, the next part of this section examines the outcomes and institutions in four countries.

Argentina: The Successful Institutionalization of a Hard Budget Constraint on Provinces

Fiscal deficits at the federal level were a major problem in Argentina before 1991, leading to hyperinflation, which went over 5000 percent in 1989. Provincial deficits and indirect bailouts of provincial banks, which had access to central bank credit, contributed to the financial difficulties of the period. Provinces accounted for at least half of the public sector deficits that fueled the hyperinflation. The high inflation itself disrupted and substantially devalued the national tax and transfer system in real terms, making state finances shrink in real terms and depend more on own revenues. By the end of the decade, hyperinflation had also greatly eroded the real value of domestic debt, giving governments at all levels almost a clean slate on that side, although external debts remained substantial.

Alongside major improvements at the national level—legal commitment to currency convertibility at a fixed rate with the dollar (Convertibility Law), cutting the budget deficit, and privatizing major industries—the steps to improve subnational finances in the 1990s were also important for the success of the macroeconomic stabilization (World Bank 1998). In the reconciliation of intergovernmental obligations inherited from before the stabilization, it turned out fortuitously but not accidentally that the debts between each of the states and the federal government netted out to about zero. From 1991 until 1994, the real value of revenues to subnational governments grew rapidly, both from their own taxes and even more from the growth of taxes collected by the federal government and shared with the provinces. The federal government restrained its own spending, below the growth of revenue, and negotiated a series of agreements with the provinces, getting them to accept additional responsibilities. To accomplish this politically, the government used party dis-

cipline and fiscal transfers (limited in the aggregate) to small states that had a lot of congressional votes per capita. Also, the governors understood the need for overall fiscal adjustment to sustain the economic revival and growth of their revenues, and the federal government guaranteed floors on the level of transfers.

In the early 1990s, many of the provinces borrowed heavily even though their revenues were growing strongly. Borrowing from banks, including those owned by the provinces, was the most important form of subnational indebtedness in the early 1990s. The provinces pledged their coparticipation transfers as a guarantee to private creditors. The federal government was a party to this arrangement in that Banco de la Nación would deduct the debt service from federal tax receipts and transfer only the remainder to the provinces. Aggregate provincial debt grew more slowly than GDP, however, because the most important province, Buenos Aires, and one of the next rank of large ones, Santa Fe, ran balanced budgets or only small deficits. They exercised this discipline, in step with the adjustment program at the national level, because the governors in these provinces belonged to the president's party and thus supported the overall economic program.

The economic crisis of 1994-95, ignited by the currency and debt crisis in Mexico, tested the hard budget constraint put in place by the convertibility law, the new central bank charter, and the debt-servicing arrangements. The crisis not only raised the interest costs of provincial debt but also reduced revenues from own taxes and revenue sharing. Provinces at first reacted by trying to borrow more. Non-voluntary credit from arrears to suppliers and personnel later became forced lending from them, as states paid off with bonds. These bonds could be converted to cash at a discount at provincial banks and then used to pay taxes. These two kinds of forced lending accounted for more than half of the debt incurred in 1994-95. Provinces with debt-servicing difficulties suddenly found that Banco de la Nación was withholding over half of their *coparticipaciones* to pay to creditors. Eventually they had to cut investment programs, lay off non-permanent staff, give regular staff time off without pay, and implement emergency revenue measures. In some cases the federal treasury facilitated refinancing of provincial debt, but at market rates with no bailouts. And neither the federal government nor its agencies took over any provincial debt; the law forbade it. Most of the smaller states, along with Cordoba and

the city of Buenos Aires (both run by the opposition party) had to implement strong structural adjustment and have kept their debt in check since then.

The one channel for aid to the provinces in present-value terms was the federal takeover of most of the state employee pension plans. The federal government offered in the early 1990s to take these over; most states resisted at first, for political reasons, but the economic crisis forced them to accept. This prevented future accumulation of unfunded pension liabilities by the provinces.

The strong anti-inflation commitment after 1991 and tight limits on central bank credit to the public sector in Argentina limited subnational spending and deficits in two ways. First, it allowed the federal government to reject provincial pleas for more resources after the Tequila shock, with the rationale that it could not increase transfers without endangering the stabilization gains and the survival of the Currency Board system. Second, it constrained the provinces' ability to borrow from their own banks by eliminating their access to the central bank rediscount facility and tightening bank regulation. After the 1994-95 economic shock, most provinces had to recapitalize or privatize their banks, rather than being able to borrow from them. Eighteen of the provincial banks were privatized in 1994-96, and more have gone through the process since then (World Bank 1998).

Timing—having erected these “Chinese walls” for provinces before the crisis hit them and forced their adjustment—turned out to be of critical importance for the institutionalization of the hard budget constraint in subnational finances in Argentina. By then the deficit hawks in the central government needed to have just enough political leverage to veto a change in the status quo; they did not need to impose a new one, which would have been a much harder task. Political timing also was right—getting the budgets balanced in the largest states (of the president's party) when revenues were growing. Then in the economic crisis it was politically easier for the president to enforce a hard budget constraint on the main opposition states.

Brazil: Repeated Rescheduling: No Hard Budget Constraint for the States

A state debt crisis was not the main macroeconomic problem that observers expected from decentralization in Brazil. They feared that the large increase in tax sharing mandated by the 1988 constitution would provoke federal

deficits, because the federal government would not cut its ordinary (non-transfer) expenditures or raise federal taxes by an equivalent amount. At the outset, this deficit situation seemed likely to happen, because the Congress rejected a proposal for expenditure decentralization intended to match the new division of revenues.

Nevertheless, fiscal adjustment ultimately occurred at the federal level. Part of the adjustment took place on the expenditure side in the early 1990s. Having failed to decentralize federal functions formally, the federal government succeeded in off-loading the responsibility for certain expenditures onto subnational governments on an ad hoc basis—hospitals, highways, and urban transit systems. Service from the federal level declined to the point that it sometimes became politically attractive for a municipality or state to take on the responsibility. The largest part of fiscal adjustment at the center, however, occurred through adjustments in revenue. From the late 1980s to the early 1990s, federal spending as a share of GDP declined less than 1 percent of GDP, and after that it rose again. On the revenue side, at first the federal government used the guise of economic stabilization measures to cut back some of the increase in originally mandated transfers, namely reducing by 20 percent the portion of income and industrial-product taxes subject to sharing. The federal government also increased the rates of taxes that it was not required to share with subnational governments, such as social security taxes and a new tax on checks.⁹ Consequently, the federal deficit and spending remained roughly constant as a share of GNP over this period, contrary to initial expectations, and state and local governments expanded strongly, resulting in a larger public sector overall.

The main macroeconomic problem with decentralization, however, arose from excessive state deficits and then mismanagement of the debt. In Brazil, as in Argentina, subnational deficits contributed to the fiscal problems in the high inflation periods prior to the stabilization that started in 1994. And dealing with the deficits and debt of the states has been one of the main challenges to sustaining the stabilization since then. There have been four rounds of crisis and rescheduling of state debt—in 1988, 1993, 1994–95, and 1998–99 (Dillinger 1997; Ter-Minassian 1997).

In the earlier ones, the agreements established three precedents that influenced subsequent debt agreements. First, the federal government actually put the state debt on

its books and then provided relief in the form of rescheduling, rather than forgiveness. Second, through the combination of grace periods, rescheduling, and debt-service caps, the agreements reduced the debt-service burden of sitting administrations, leaving the fiscal consequences to their successors. They reinforced the perception that the federal government was prepared to provide debt relief to any state requiring it, or requesting. Third, for heavily indebted states, especially the four largest, the limits on debt service largely eliminated the expected future cost of borrowing and interest capitalization. The repeated cycle of the federal government's refinancing state debt, coupled with caps on debt service, had the perverse incentive effects that one would expect. By the time some consensus for action had been reached, the group of bankrupt states was too big to fail, and their debt had grown too large for any solution without substantial debt relief. The lack of discipline in the political parties and the strong autonomy of the state governors, in contrast with Argentina, put the federal government in a weak position to negotiate with the states. So the terms of agreement were often generous.

Subnational debt as a share of GDP started the 1990s at a level similar to Argentina's, but it had more than doubled by 1997. Unfortunately, the Brazilian stabilization program of 1994, the most successful to date, left unchanged many rules and institutions that motivated the states to let their debt grow. Most of this debt was owed to the central government or to state banks, and up until the debt-rescheduling agreements in 1998, much of it was not being serviced by the states. Interest was being capitalized. Thus, state debt and deficits were a direct fiscal problem for the central government, as well as for the overall public sector. State debt accounted for one-third of the increase in domestic public debt from 1994 to 1997.

The situation has evolved in several ways since the mid 1990s, some of them positive. First, the Ministry of Finance and the central bank set some *ex ante* limits on state borrowing. The limits were not airtight, and they reinforced the unfortunate impression of a federal guarantee for existing state debt. Still they tended to limit state deficits to unpaid service on outstanding debt. Second, the agreements of 1998 were written in a way that allows and requires the federal government to withhold debt service from transfers, as in Argentina. Thus, even when the much-publicized refusal of Minas Gerais to pay debt service resulted in the federal government's covering the state's debt service in

order to protect the national credit rating, the state was effectively forced to pay, because the federal government deducted their payments from their transfers. (The most recent crisis in 1998-99 is not yet fully resolved.) Third, São Paulo has become one of the reform states, making it more technically feasible to impose budget constraints on the states as a group. If this strategy works, the recent crisis may end up being of the same importance for Brazil as the 1994-95 crisis was for Argentina—testing the system and setting favorable precedents.

Finally, state pensions are widely perceived as a major unfunded liability, though public accounts do not even recognize pensions as a separate line. Recent discussions between the federal government and the states have shifted from debt rescheduling to some federal support in this area. If this evolves into an agreement that would limit the future growth of such unfunded liabilities, then the present crisis will have served another positive purpose.

Colombia: Attempting to Establish Hard Budget Constraints through Ex-Ante Regulations

Unlike Argentina and Brazil, Colombia had a strong centralist tradition for a century, since the 1886 constitution. This centralism was partly a reaction to geographic fragmentation, civil war, and losses of territory in the 19th century and early 20th century. Political decentralization came recently in the form of elected mayors in 1986, then governors in 1991. In contrast to Argentina and Brazil, Colombian political decentralization was implemented without the push of a transition from military to civilian rule. It also came after spending was substantially delegated to the local levels, starting in 1968, and without the complication of fighting hyperinflation. Indeed, Colombia has enjoyed a tradition and reputation for sound macroeconomic management, which was associated in some minds with central fiscal control or the centrally controlled fiscal deconcentration in the early 1980s. In the 1990s, on the other hand, the expanding political and fiscal decentralization has coincided with expansion of fiscal deficits and a failure to share in the general increase of macroeconomic stability in most other parts of Latin America.

Total government spending grew at the same pace as GDP in the late 1980s and then grew much more rapidly during the 1990s, increasing from 11 percent of GDP in 1991 to 18 percent in 1997. Revenues, in contrast, only increased from 10 percent of GDP in 1987-90 to 13.6 per-

cent of GDP in 1997. Their increase was just partially effective as current revenues are shared up to 40 percent with subnational governments. The national government's primary spending (net of interest and of transfers to the territorial governments and entities) has roughly doubled its share of GDP since the late 1980s, from 5 to 10 percent. The national government increased its own expenditures for the military and judges (as a response to increasing violence from drug traffickers and guerrilla warfare) and social security (as a consequence of the social security reform of 1993). It did not reduce central administration outlays, however, which should have occurred with the transfer of social sector and other functions to the subnational levels. The deficit of the national government has moved in the 1990s from under 1 percent of GDP to almost 5 percent. The transfers to municipalities and to departments increased by only about 1 percentage point of GDP each, thus corresponding to only about one-third of the increase of central government expenditures (Banco Central data; Clavijo 1998).

At the subnational levels, spending and deficits of departmental governments increased only 0.1 or 0.2 percent of GDP in the 1990s, while municipal spending has gone up almost by 2.5 percent of GDP. The aggregate municipal deficit rose, however, by only 0.2 percent of GDP, as transfers from the national level and tax revenues had not also risen by about 1 percent of GDP each. Mostly the increase in transfers to departments can be attributed to the central government's objective of increasing the coverage of social services, especially basic rural health and education, and to salary increases negotiated by the central government. A special fund had to be set up to assist departments in paying the nationally negotiated salary increases. While initially small, this fund grew to about one-fourth of the total transfer to departments by 1998—a major non-formula transfer. Scheduled increases in the transfers to municipalities have increased and will continue to increase the fiscal burden on the central government. Some transfers came through matching-grant investment programs, which at least until 1997 had considerable political discretion in the allocation of projects. Up to the mid-1990s they increased in importance, reaching 40 percent of total transfers to municipalities, but since then they have declined somewhat and in 1997 were made into soft loans from the development bank *Fondeter*, with perhaps more transparency (Ahmad and Baer 1997).

Revenue sharing has complicated stabilization efforts. At present, more than 40 percent of all current revenues are automatically transferred to departments and municipalities, and the constitution has mandated that the share increase further. Unlike the other major decentralized economies of Latin America, the national government has virtually no unshared tax bases, not even inefficient ones (Perry and Rodríguez 1991). Successive tax reforms, attempting to mitigate the growth of the national deficit, have thus automatically increased subnational expenditures by roughly this proportion. The government has presented legislation to Congress to earmark part of the transfers for pension reserves, a large unfunded liability of the states, which looms large in the horizon in Colombia, as in Brazil and elsewhere.

In Colombia the controls on subnational borrowing have varied over time. In the 1980s and before, all subnational borrowing had to have approval from the Ministry of Finance, and it was an exceptional thing. This was natural, since the subnational entities were appointed representations of the central government and had no political or fiscal autonomy. The ad hoc approval process gradually allowed more freedom for domestic borrowing in the late 1980s and the 1990s, as the subnational political and fiscal autonomy increased. The total debt stock of departments and municipalities actually declined as a share of GDP from 1991 to 1998, but the debt nonetheless reached a crisis point for several entities twice during this period (in 1995 and 1998). The decrease was all due to amortization of external debt—part of which was taken over by the national government in 1992.¹⁰ Domestic debt of the subnational governments grew in the 1990s, especially to the banking sector. The latter rose from 2.6 percent of GDP in 1991 to 4.6 percent in 1997.

The departments' debt in Colombia has been problematic mainly because they have little discretion over their receipts or spending, most of which has to go for salaries. Neither the departments nor the creditors took sufficient account of this inflexibility in their ex ante evaluations of the ability to pay. In the case of municipalities, the debt crises were related to runaway expenditures financed with the pledge of increasing transfers. The predominance of private banks in lending to territorial governments, with little debt to the national government, meant that the national government was not heavily exposed to the threat of territorial default, in contrast to Brazil, and the territorial bor-

rowing has not been large enough to potentially cause a general banking crisis that would require national-government intervention. Nonetheless, subnational governments in fiscal straits have often gotten ad hoc bailouts from the center, most notably for Bogotá in 1991 and for Medellín in the late 1990s for their debt from the metro. They have also restructured their debts with private lenders several times, sometimes on terms that amounted to a bailout.

Witnessing the high rates of growth of subnational debt to domestic banks in 1993 and 1994 (more than 60 percent per annum in real terms, according to data from the Superintendency of Banks) and the debt crisis of several subnationals in 1995, the national government attempted to exert some control over it. On the supply side, the Superintendency of Banks tightened banking regulations in 1995, which slowed the growth of subnational debt in real terms for a while. A law enacted in 1996 aimed to prevent indebtedness in excess of the ability to pay, through a system of warning signals that would prompt direct control from higher levels of government.

A rating system for subnational borrowers, introduced in 1997 and scheduled for full effectiveness in 1999, was not able on its own to be a strong rein on borrowing, but has worked as a complement to bank regulation. Now banks have to provision against loans to departments and cities that do not score well enough on the rating system, which may make the banks more cautious in lending. Whether these measures will be adequate to prevent excess lending will depend on whether the national government refuses to bail out overindebted states and municipalities and their creditors in the present crisis. In 1998 the consortium of creditors to the department of Valle de Cauca (Cali) renegotiated the debt and the fiscal program, under pressure of the combination of bank regulation and the traffic-light law. If the deal with other departments make them and their creditors bear the onus and costs of fiscal adjustment and debt renegotiation, then it will improve the incentive environment for responsible borrowing decisions. As experience in the other countries shows, creditors will not lend to bad credit risks where they have no hope for a bailout from above.

Mexico: Ex-Ante Controls and Political Grip as Budget Constraints. What Will Happen in the Future?

Mexico has had a federal system on paper, and since the 1980s, considerable spending was handled by states. One

party, Partido Revolucionario Institucional (PRI), dominated governments at all levels for decades, however, so the country operated almost like a unitary state with the president and head of the PRI selecting who would run for the party and win the elections for governors and mayors of major cities. Then two important changes took place in the 1990s. First, the political system opened up, allowing other parties to compete with the PRI. They have won almost one-third of state governor seats and many municipal presidencies, and in 1997 the PRI lost its majority in the national Congress. This activated a federalism that had lain dormant in the constitution. Governorships have become important offices in the careers of politicians. Second, the transfer of resources to states and municipalities increased rapidly. This went hand in hand with reduced authority of the states to control this spending, but increased authority of municipalities.

The transfer of nominal responsibility for health and basic education to the states in the early 1990s required unification of the state and federal systems, which had previously operated in parallel. The national ministries remained in charge of establishing curriculum and standards and negotiating wages and terms of employment with the national union. This effectively eliminated some of the control that states had over their own programs. In other areas of local public services, the Congress in 1997 and 1998 voted for more decentralization transfers, but mostly to the municipalities and with reduced leeway for any control by the states over these funds, which the constitution required to pass through the books of the states. It remains to be seen whether the fiscal trend toward municipal federalism will continue, or whether it will be somehow reversed, perhaps as a result of the growing political prominence of the governors.

These developments in overall intergovernmental relations help explain what has happened with debt and fiscal management. State governments and a few municipalities have borrowed for some time from the national development banks, and recently they have been borrowing from commercial banks as well. In the aggregate the state debt levels are low—about 2 percent of GDP—although the debt has been a fiscal problem for some states. The low overall indebtedness results mainly from *ex ante* controls on borrowing. First, the constitution forbids any subnational borrowing from abroad or in foreign currency. The rule has been observed, except for one or two state bond

issues that were effectively indexed to the dollar. Second, each state congress annually sets borrowing ceilings for the state and for its municipalities. (For the Federal District, where local elections started only in the 1990s, the Federal Congress still approves the annual budget and borrowing ceilings.) Third, creditors can get and almost always want a guarantee in the form of access to federal-state transfers. This requires a review by the Ministry of Finance and registration therein. The Ministry of Finance can deny an application or request a reduced amount.¹¹ The development bank, *Banobras*, also reviews the fiscal picture of borrower states. While some say that these reviews are perfunctory, they and the borrowing restrictions seem to have prevented extremes of excess borrowing. It remains to be seen how this will work with the loosening political grip of the PRI, greater political autonomy of subnational governments, and a growing private financial sector.

Defaults on state debt have arisen in three contexts in Mexico. The largest was the economic and fiscal contraction after the economic crisis of 1994–95. Many states could not service their debt, and so all got some degree of debt relief (and bailout for creditors) from the federal government in exchange for fiscal adjustment, although the terms for individual states varied. A second context was large infrastructure projects, like metros and toll roads, that did not yield the return expected and necessary to service the bonds that financed them. Here again the federal government has provided debt bailouts along with a takeover of the infrastructure assets.

In addition to these discrete episodes, most states received every year some extraordinary transfer from the federal government; up to 1998 it was usually related to covering service on old debt or the cost of teacher salaries. The amounts varied from year to year, as well as across states, even adjusting for population. Without the extraordinary transfers, the states as a group would have been running primary deficits in 1995–97, rather than primary surpluses. These bailouts were not important on a national macroeconomic scale, but they may have created an incentive environment where creditors did not worry much about the creditworthiness of the states and the latter faced no harsh penalty for over-borrowing. The part of the budget for these extraordinary transfers was cut back in 1998 and largely eliminated in the 1999 budget.

Thus, the federal posture toward state debt has been changing rapidly in the last few years. The new system is

still taking shape and it remains to be seen how it will work in practice.

Summary of Cases. The first two cases—Argentina and Brazil—illustrate the challenges of stabilizing high inflation economies at the same time that finances are being decentralized and democracy is being restored. In Argentina, the federal executive was able to use the political dynamics of the federal system and the fear of hyperinflation (as well as the joy at its end, and the economic and fiscal rebound) to pressure the provinces to bring their fiscal policy to a stance consistent with the national stabilization program. Today the country seems to have institutions in place that impose an effective hard budget constraint on subnationals. In Brazil, the stabilization started later, and many states have not yet made the fiscal adjustment necessary to support the program. While in Argentina in the early 1990s (the first years after the stabilization) there were also many states that did not adjust their fiscal stance, the situation in Brazil seems more severe in that none of largest states adjusted early on, and the federal government continued to give bailouts—debt rescheduling—that set perverse incentives. The state-debt and exchange-rate crisis of 1998-99 could turn out to be a turning point for Brazil, similar to the Tequila shock for Argentina. That will depend on how the states and federal government react.

In the other two cases, Colombia and Mexico, the challenge has been to sustain fiscal stability and moderate inflation, at the same time that substantially more resources are being transferred to subnational governments. Although they did not have government-wide political transitions from military government to electoral democracy, as in Brazil and Argentina, they increased democracy at subnational levels and widened the range of parties that could effectively participate at the national level. Starting from strongly centrist systems, political decentralization has advanced through a combination of two processes. First, the traditional elites (in Mexico the PRI and in Colombia the two traditional parties, particularly the Liberals) sought to increase their legitimacy with those who were otherwise defecting from traditional parties, and sometimes joining insurrection movements, especially in Colombia. Decentralization was a way to appease these groups, perhaps less threatening to traditional power relations than if the concessions had all come at the national level. Second, as the non-traditional parties gained footholds in the periphery of the political system—governors,

mayors, members of congress and (in Colombia) the constitutional assembly—they voted and lobbied for decentralization of expenditure to the lower levels of government where they had a larger share of the power. In the 1980s the central governments' control procedures restrained subnational borrowing, and it regularly helped out if the debts became burdensome. The increase of political autonomy in the 1990s has made these procedures inappropriate. In the late 1990s the central governments were striving to develop new procedures and to overcome the expectations of future bailouts generated by the ones in the past.

The four cases support the hypothesis that macro-fiscal management problems increase when decentralization is increasing, but they also show that institutional reforms can help bring the problems under control. Argentina is furthest along with the process and seems to be near the end. Brazil seems to have had the worst time of it, but there are also signs that the institutional maturation has passed some critical turning points. The transition problems thus far in Colombia and Mexico have not become as severe as in the other two, although decentralization is still increasing. So it is too early to judge how well the current institutional reforms will succeed in keeping decentralized fiscal management on a sustainable path.

IV. Decentralization of Institutions and Fiscal Management

What institutional arrangements reduce the likelihood of excess debt by national or subnational governments as a result of decentralization? Table 4 summarizes the economic and political conditions that we set at the start of Section III as contributing to containing deficits in a decentralized fiscal system and rates the four countries discussed above in a comparative way.

A. Hard Budget Constraint for Transfers and Service Responsibilities

The rules and institutions for raising revenue and for spending are most directly important for determining the efficiency and equity in fiscal decisions. For overall macroeconomic management they are indirectly important, facilitating or hindering decisions and adjustments that come out of the borrowing process and the political process.

Certainly, fixing the amount of the transfers in the aggregate is important. The absence of a firm fix on the

TABLE 4

Summary of Conditions for Reduced Danger of Excess Deficits

VARIABLE	ARGENTINA, 1991-98	BRAZIL, 1994-98	COLOMBIA, 1991-98	MEXICO, 1994-98
<i>Hard Budget Constraint for Transfers and Service Responsibilities</i>				
1. Transfers are fully specified by legal formula, not ad hoc	Yes. Almost entirely set by formula and ad hoc transfers are limited in aggregate.	No. Grants from the budget and tax sharing set by formula, but large debt relief sometimes.	No. Formulas exist but with important exceptions.	No, not at the margin.
2. Central government effectively delegates functions to subnational governments to go along with the delegation of revenue sources	Yes	No.	Yes for departments. No for municipalities.	Yes for states. No for municipalities.
<i>Borrowing Constraints</i>				
3. Central government strictly controls subnational borrowing ex ante	No. Federal government has some authority but mainly requires reporting	Yes, in principle. Very sophisticated rules but also significant loopholes	Yes.	Yes.
4. Central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debt	Yes.	No. Cap on debt service allows interest capitalization.	No.	No.
5. Regulators force creditors to accept the losses implied by any failure to service debt	Yes, but rare because debt service is deducted from transfers.	No.	Yes.	No.
6. The central bank (and bank regulators) is autonomous and has a strong anti-inflation mandate	Strong autonomy and commitment to fixed exchange rate.	Limited autonomy; discretionary monetary policy.	Yes.	No.
<i>Subnational Autonomy for Fiscal Adjustment</i>				
7. Subnational governments raise much of their own revenue	No.	Yes for large states. No for small states.	No.	No.
8. Subnational governments have authority to cut their costs	Yes.	No. Legally difficult to cut labor costs.	No for departments. Yes for municipalities.	No for states. Yes for municipalities.
<i>Intergovernmental Political Relations</i>				
9. Presidents are constitutionally strong at the national level	Yes, very strong through decree powers.	Yes.	Yes.	Yes.
10. Governors have little constitutional autonomy (e.g., no re-election; central government can intervene)	Partial. Federal intervention common, at least until 1994, but re-election allowed	No. No federal intervention.	Yes.	Yes, but governors' autonomy growing.
11. Electoral rules orient congress toward national, not local, interests	Yes.	No.	No. National at-large elections for Senate may change this.	Yes.
12. Party discipline is strong	Yes. Closed lists.	No. open lists.	No.	Yes, very strong.

total was a major problem for Argentina in the 1980s and, counting the debt relief, has been a serious drawback for Brazil in the 1990s. For Colombia and Mexico, having special transfers for over-indebted SNGs that are decided on a case-by-case basis, without any hard ceiling on the overall program has been a problem, although not yet an overwhelming one, thanks to the borrowing constraints. Recent reforms to cut back such transfers will have a positive effect when they are sustained in the face of political

pressure. Having some political discretion on the distribution of special transfers within a firm overall limit, as in Argentina, does not seem to pose major difficulties. Indeed, it may be a way to allow some leeway for unavoidable patronage games while making it clear to all players that the game is zero-sum.

A clear assignment of functions between levels of government is obviously important for a rational and efficient public sector. The aspect that seems most important for

macro-fiscal management is clarifying what subnational levels will take over along with the transfers and what the national level is not expected to take over, in case of a subnational fiscal crisis. In Argentina, part of the national-level adjustment was accomplished through agreements with provinces that they would take on additional functions, since transfers were increasing during the stabilization. In Mexico, on the other hand, a significant loophole in the budget constraint of states has been the willingness of the federal government to take over failing state projects in transport and electricity. In Colombia, the lack of an explicit assignment of exclusive responsibilities to municipalities contributed to the outcome of high and rising central-government expenditures at the same time that municipal expenditures were increasing significantly.

B. Borrowing Constraints

Controlling borrowing by subnational governments has two main dimensions: their type or timing (ex ante controls or ex post incentives) and whether they act on borrowers or creditors. Together these make a matrix with four cells, as in Table 5 below.

One response to subnational borrowing problems, actual or anticipated, is to have ex ante controls or even prohibitions (Ter-Minassian and Craig 1997). If they are well implemented, they can help eliminate debt problems or make them more manageable. Sometimes the controls are self-imposed, e.g. by a state in its constitution. These are sometimes circumvented, although local voters may subsequently punish elected officials. Central controls (national control on states or state control on municipalities) are sometimes firmer, but they may be hard to enforce if there is substantial political decentralization. Also, getting adequate information is difficult; if the borrower and lender both want to make a deal, they have incentives to collude in withholding accurate information from the regulator. Most importantly, if the central approval carries, or

is believed to carry, an implicit central-government guarantee of the debt, it will increase the likelihood that the subnational government and their creditor will want to agree on a loan even if they both know it is risky. They will figure that if something goes wrong, someone else will pay—the federal taxpayer. All four countries described above provide examples of this problem, although it has been largest and most frequent in Brazil. It has the most elaborate ex ante controls, mostly put in place after the debts were already oversized, but due to lack of adequate enforcement they actually helped reinforce the moral hazard of expected federal bailouts, at least until 1998. Mexico, on the other hand, seems to have had more success with enforcement. The reasons for different outcomes with the same instrument seem to lie in differences in political institutions, discussed below.

Usually ex ante controls are imposed on the borrowers, but they might also be imposed on the creditors, as with the central bank moratorium on lending to states in Brazil or the Superintendency of Banks’ regulations in Colombia. In Mexico the constitutional provision against foreign borrowing by (and lending to) states and municipalities is an ex ante control on both sides.

The second row of Table 5 represents complementary approaches that assure that the consequences of borrowing give either the borrowers or the lenders, or both, incentives to discipline themselves. Of course, the worst incentives arise if the central government (national to states or states to municipalities) gives bailouts when subnational governments overspend and creditors finance it. Bailouts can take several forms—special transfers, takeover of costly functions, takeover of debt or contingent liabilities, or subsidized refinancing of debt. All of these reduce or eliminate the cost to the original decision-makers, allowing them to make mistakes with other people’s money. The essence of improving incentives is to assure that those who make mistakes pay a substantial share of the cost.

TABLE 5
Channels for Control of Subnational Borrowing

	FOR BORROWERS	FOR LENDERS
Ex-ante controls	- central government review of fiscal capacity to carry debt - prohibition of international borrowing	[- credit rationing to states] - prohibition of international borrowing
Incentives:		
ex post	- no bailouts - government does not hold SNG debt	- regulations require provisioning against debt from fiscally weak SNGs
consequences	- debt service withheld from transfers	- strong supervision of banks

This can put the burden on the borrower by forcing repayment, e.g. through deductions from their share of centrally collected tax revenue, as in Argentina (but without compensating special transfers as in Mexico). It can also operate by making creditors take losses for any subnational debt that is not being serviced, as in Colombia and Argentina. A combinations of controls may be best—ex ante restraints to keep individual subnational debt problems from endangering the whole financial system and ex post consequences for both borrowers and lenders to motivate them toward prudence.

C. Subnational Autonomy for Fiscal Adjustment

In contrasting the realizations of the hopes in some places and the fears in others, it seems no accident that in some decentralized countries, like Switzerland and the United States, the subnational governments (especially the cantons or states) raise most of their own resources, while in developing countries with many macroeconomic problems arising from the decentralization process, the states get much of their revenue as transfers from the center. But this oversimplifies the problem, for the relatively high share of own revenue in the largest Brazilian states did not prevent them from causing the biggest macro-

economic headaches. And some countries, like England and Germany, generally avoid negative fiscal fallout from having national transfers fund almost all local spending. Nevertheless, any government is better able to make fiscal adjustments if it has some tax power under its control and if it does not automatically have to share the extra proceeds.

For short-run adjustment to macro-fiscal necessities, the authority of subnational governments to reduce costs, especially the number and pay of employees, also seems critical. It helped in Argentina by giving provinces leeway to adjust. The lack of spending flexibility for subnational governments has been a problem in Brazil, Colombia, and Mexico. In the latter two it has led to repeated special transfers, for the terms of the transfers from the national level commit almost all resources of states (or departments) to paying salaries in education and health. Brazilian states have somewhat more discretion over spending, because the transfers are not explicitly linked to paying salaries, but until recently the constitution forbade layoffs or cuts in nominal wages and in pensions. Such provisions encumbered the adjustment of states facing debt crises and contributed to the expectation that the federal government had the responsibility to solve the problem.

Risk and Cost in the Source and Terms of Borrowing

Subnational borrowers face important tradeoffs in choosing the source and terms of their borrowing. Typically at each choice, one way has a lower risk while the other has a lower cost. Which way is preferable depends on the situation of the borrower in terms of the source of revenues and the macroeconomic context.

In choosing between domestic and foreign-currency based loans, which are typically linked to the location of the creditor, foreign-currency loans are usually cheaper, because the creditor does not bear the risk of currency devaluation. But they are only a better option for the subnational borrower if it is well-positioned to handle the risk. If it has a revenue source like tourism taxes or petroleum royalties that are linked to foreign exchange, it is a good option for the borrower. If not, it is taking a large and costly risk, which through diversification, the creditors should be able to handle more cheaply. What is more, foreign debt default may have broad externality effects, making it more likely that the central government would succumb to pressure and bail out the subnational. For these reasons, most countries place stronger ex ante controls on foreign than on domestic borrowing by subnationals.

Floating interest rates are similarly cheaper than fixed-rate loans, but carry the risk for the borrower that the rates will rise. That is a risk worth taking only for borrowers that expect rising disposable income and have a ready capacity to increase interest payments if needed. A short term to maturity for a loan also usually lowers the rate, and is a good deal for a borrower that expects to be able to pay off the principal when it comes due or that has a secure market access and expects the rate to be coming down. Otherwise it is a costly gamble. A common feature of most debt crises is that the debtor was taking increasingly short-term debt.

D. Intergovernmental Political Relations

The fiscal policy institutions, discussed above, do not stand in isolation but derive their backing and commitment in the political system, although once established in place, the institutions can set some limits to political decisions. The power of the president compared with that of governors has been important for maintaining fiscal constraints in Argentina, Mexico and Colombia, along with party discipline in Argentina and Mexico. In Brazil, meanwhile, the power of the governors, in their own state and in influencing Congress, and the lack of party discipline, all tended to make excessive state borrowing more likely.

The relation of political institutions to fiscal rules can be divided into three types. In the baseline type, the national executive (by itself or with the support of the attorney general and the courts) has enough power to enforce the spirit and letter of rules passed by the legislature, representing various subnational interests. Colombia, and Argentina and Mexico since the mid 1990s, are in this type of situation. In the second type, the national executive has power to impose fiscal discipline that goes beyond the regular laws, either through party discipline (as in Mexico traditionally and Argentina in the 1990s) or through emergency interventions (as in Argentina and Brazil during the military periods and in Colombia at times before the constitution of 1991). In the third type of situation, the states get such power, relative to the national executive, that they can block the national executive from carrying out even the rules agreed in the national legislature. Brazil has often been in this situation since the restoration of democracy.

This difference in political institutions goes a long way in explaining why on occasions the same instrument, for example, *ex ante* controls on state borrowing, worked effectively in Mexico (at least until recent times), relatively well in Colombia, and in a rather perverse way in Brazil.

V. Summary

Econometric results reported here—on a worldwide sample—suggest that fast decentralization normally leads to higher overall public expenditures and serious problems in macroeconomic management. Indeed, they show strong evidence that increases of subnational expenditures and deficits are associated with subsequent increases in national government spending and deficits.

The results also show, however, that decentralization is not associated on average and in the long term with higher

deficits—or surpluses—although it is associated with larger overall expenditures if states do not collect their own revenues. Thus, decentralized countries seem to be able to eventually develop institutions to avert the macroeconomic fears concerning deficits, though they usually end up having larger public sectors.

The four country cases examined show that it is not necessary to fulfill all of the proposed conditions for achieving an effective budget constraint on subnational governments and hence sound macroeconomic management in a decentralized context. However, they also show that if some institutional conditions are missing, the others must be stronger.

In the area of revenues, whether states raise most of their own revenue, which is true in Brazil but not the others, seems less important than whether transfers to states (including debt bailouts) are non-discretionary. Clear formulas to set the overall level of transfers in the aggregate and to each state are the first step to prudent fiscal management with decentralization. Without that, the states have little incentive to take anything else seriously.

In the area of spending, clarity in allocating spending, though important, does not seem as important as having the authority to cut or control costs (especially those related to personnel) in the areas where subnational governments do take responsibility.

In the area of borrowing controls, the name of the game is effective hard budget constraints on subnationals, and these can be achieved—and undone—in several ways. *Ex ante* restraints had favorable effects in Colombia, when they were complemented by ways to make creditors bear some of the cost if states overborrowed and otherwise to force the states to pay. In Brazil, at least prior to 1999, the *ex ante* constraints stood more in isolation and therefore may have had the perverse effect of increasing the impression that the federal government guaranteed the states' debt. Also the constraints there were tightened only after states were overwhelmed with debt. In Argentina, by contrast, the mechanisms to assure *ex post* that provinces pay their debts in full seem to have worked well in the late 1990s (after a painful test of the system in the Tequila crisis), despite the absence of strong *ex ante* borrowing controls. In Colombia and especially Argentina (after 1991), the debt constraints for states were reinforced by the autonomy of the central banks, which helped keep a relatively hard budget constraint on government at all levels.

The political factors are largely given from the point of view of the policy-maker, but they are important. When the political conditions are met strongly enough, as in Mexico and Colombia before 1990, the resulting political centralization makes the other fiscal-institutional concerns almost redundant. But as the political system delegates more true autonomy, the fiscal rules become more important in order to create the proper incentives for decentralized democratic fiscal management.

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Endnotes

1. Although we will not deal with them in this paper, there are many other hopes for decentralization on non-fiscal dimensions—for instance, that the mix of locally determined public goods might meet local needs more efficiently, and that with more popular participation public providers could be more accountable to local clientele.

2. In addition to these, there are other efficiency and equity concerns with which we do not deal here: those arising from lack of capacity at the subnational level, from eventual capture of government by local elites, from inequality of service provision because of unequal tax bases or poor allocation of transfers, etc.

3. Dillinger and Webb (1999a and 1999b) and Fornasari, Webb, and Zou (1999).

4. Primary spending is net of interest payments and budgeted transfers to subnational governments. Primary deficit is the usual definition of overall deficit minus the interest on debt. See also Treisman 1998.

5. The industrial and developing countries were divided and then each group was ranked according to the average GDP share of central government spending and divided into equal sized groups of high, medium and low CG spending. Of the 32 in the sample, the

high-CG-spending group was Netherlands, Belgium, Luxembourg, France, Norway, Israel, Zimbabwe, South Africa, Malaysia, and Chile. The low-CG-spending group was Iceland, Austria, Switzerland, United States, Canada, Mexico, Argentina, Indonesia, Colombia, and Paraguay.

6. First differences were used because the time series of values in levels were non-stationary, and the errors in the regressions were serially correlated.

7. These results show up when we look at changes between five-year periods, as well as with annual changes.

8. The Argentina and Brazil accounts draw directly on Dillinger and Webb 1999a, and the Colombia account on Dillinger and Webb 1999b.

9. Because agreements required federal and state governments to share the most efficient taxes, the agreements created a systemic incentive to increase inefficient taxes, which was also the case in Argentina in the 1980s.

10. Much of this debt was to multinationals for electrification projects in the 1980s, before the subnational governments had political or fiscal autonomy.

11. Up to 1997 the federal government essentially had an obligation to give these guarantees if the lending was within approved limits. In the 1997 the federal government tried to absolve itself of this function by making the states responsible for themselves. But the commercial banks and states pressured the federal government into an equivalent temporary arrangement where states could legally mandate this function back to the federal government.

Comment

CLAUDIO LOSER

Thank you for the opportunity to comment on this well-written and stimulating paper. The topic is certainly relevant for this region and rich with country-specific insights. The macro implications of decentralization constitute a key issue, and the paper contributes significantly to understanding it. There have been too many incidents in the recent past that would suggest the need to be ready for problems at the macro level. From a micro point of view, decentralization is crucial, but there is a need to establish mechanisms for macro adjustment when conditions so require. This requires eliminating the possibility of bailouts and having subnational governments (SNG) share in the adjustment process. For the sake of brevity, I will limit myself to four general comments.

1. Not only the forms but also the sequencing of decentralization can have important implications for macroeconomic stability. As shown in the discussion of the country cases, in Latin America the transfer of resources to SNGs, mainly because of political and institutional factors, has tended to precede the decentralization of spending responsibilities. This type of asymmetry is unlikely to promote fiscal discipline. On the contrary, it has tended to foster excessive spending by SNGs on the limited functions initially assigned to them, either through overstaffing or through generous wage increases for their

employees. Because these expenditures are rigid, it is difficult for SNGs to accommodate within their budgets the additional spending responsibilities that are subsequently transferred to them. Thus, timing in decentralization is an important policy issue. Decentralization will be more compatible with fiscal stability if there is a broad ex ante matching of revenues with spending responsibilities for each level of government.

2. Formula-based revenue-sharing arrangements, although they may be justified in terms of stability and transparency considerations, may constrain the ability of the central government to carry out macroeco-

nomical management, even when SNGs face a hard budget constraint. Let me give you two examples:

- Even when SNGs face constraints on their taxing and borrowing capacities, they can still affect overall demand and the balance of payments in ways that may conflict with national stabilization objectives through changes in the composition of their expenditure. For example, spending by SNGs may shift toward items with relatively large *multiplier effects*, such as public works or transfers to consumers with a high propensity to consume, and thus boost aggregate demand at a time when the central government

is attempting to curb it. This could be done by having a general stabilization fund applying to the central government and SNGs, and which could avoid the free-rider effect that is observed in some cases.

- On the other hand, revenue-sharing arrangements, particularly fixed revenue-sharing arrangements, can have strong *procyclical effects*. Tax revenues will rise during a boom, thus increasing the spending capacity of local governments, while declining revenue during a downturn will force them to cut back spending sharply (assuming they operate under a hard budget constraint).

Decentralization should thus be designed with a view to *maintain the central government's ability to conduct macroeconomic policies through the budget* (raising taxes or cutting spending to curb demand when needed). For example, it may be recommendable for the central government to retain responsibility for expenditures that have a particularly strong impact on demand or are sensitive to changes in the business cycle, such as unemployment benefits. On the other hand, the procyclicality of revenue-sharing arrangements could be reduced through mechanisms that relate the transfers to a moving average of central government revenues, or by requiring SNGs to build up revenue stabilization funds to even out cyclical fluctuations in transfers.

3. I would like to add a third dimension to the two-by-two matrix used in the paper to characterize borrowing constraints, with a reference to the type of economic instrument that they represent. They can go from the sole or primary reliance on market discipline, to the use of mostly administrative controls, with rule-based controls or a cooperative dialogue between central and local governments falling in-between.

On the one hand, the reliance on market discipline is appealing in principle; but to be effective in practice it requires a number of rather stringent conditions that are unlikely to be met in the short term in Latin America (they include, for instance, well regulated financial markets, the

timely availability of adequate financial information, and strong policy responsiveness to market signals).

On the other hand, the use of administrative controls by the central government does conflict with the essence of decentralization. There may be, however, a clear economic rationale for the use of some of these controls—i.e., barring all levels of governments to borrow from the central bank, and limiting foreign borrowing by local governments, not only in relation to their payment capacity, but also in relation to more general macroeconomic considerations.

The optimal approach will thus be between these two extremes, a trade-off between transparency on the one hand, and effectiveness on the other, and it will strongly depend on the specific circumstances of each country. Whenever possible, rule-based controls will be preferable to administrative controls because of their transparency and certainty. Also, the usefulness of these controls will be enhanced if they mimic market discipline (i.e., by relating the limits on SNG debt to their debt-servicing capacity) and promote greater transparency and wider dissemination of information on the finances of local governments (including through the adoption of modern, comprehensive, standardized, and transparent budgetary and accounting procedures and information systems). This will allow for a progressively higher reliance on market discipline as financial markets become more developed, information becomes more widely disseminated, and a stronger track record of fiscal and general macroeconomic responsibility is built.

4. Finally, the need to strengthen fiscal institutions for decentralization to be compatible with macroeconomic stability goes beyond intergovernmental political relations. Problems such as overstaffing, poor technical skills and training of employees, the inability to formulate and implement effective spending programs, and widespread corruption affect all types of governments worldwide, but are likely to fall more strongly on local governments, particularly in poor countries. Also, some local jurisdictions may be too small to function efficiently.

Transfers and Incentives— International Experience

Transfers and Incentives in Intergovernmental Fiscal Relations

RICHARD M. BIRD

Regardless of what revenues subnational governments can raise themselves (Bird 1999), fiscal transfers will undoubtedly continue to constitute the dominant feature of intergovernmental finance in most developing countries for years to come. The incentives such transfer systems create for both central and subnational governments will thus be critically important in determining the outcome of decentralization efforts. Before turning to some of the implications for incentives of alternative transfer designs, however, it is essential to consider briefly some aspects of the underlying context within which the transfer system must function. This is the task of the next section. Against this background, the second half of the paper considers briefly some key elements of transfer design.¹

Transfers in Context

In any country, intergovernmental fiscal transfers are part of a complex political, economic, administrative system. Their design, role, and effects can thus really only be understood in the specific institutional context in which they operate.²

Devolution or Delegation?

How one views transfers depends in part upon whether one views decentralization as a process of delegation or devolution. **Delegation** refers to a situation in which local governments act as agents for the central government, executing certain functions on its behalf. In this case, the appropriate perspective is “top-down,” that is, from the viewpoint of a central government³ whose objective in decentralizing might be to shift some of the political pressures resulting from deficits downward, or perhaps (as is

often assumed in theory if seldom very visible in practice) to achieve its allocative goals more efficiently by delegating authority to local governments. The top-down approach implies that the main criterion for evaluating fiscal decentralization should be how well it serves the presumed national policy objectives.

In contrast, **devolution** refers to a situation in which local governments not only implement policy but also have the authority to decide what is done—or, to put it another way, “local autonomy” prevails. The appropriate perspective then is “bottom-up.” Those who take this approach often stress political values such as improved governance (through increased local political participation, for example) as well as allocative efficiency (through increased responsiveness to local preferences or the increased scope for dynamic innovation that may be afforded by a variety of competing local governments). If this is the relevant perspective, the appropriate criteria in designing transfers

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may differ sharply from those under the top-down approach.

A first problem in designing transfers is thus to decide whether a “good” transfer is one that better achieves the goals of the central government (or improves national welfare as a whole, if one is an optimist), or one that frees local governments most from central dictates (or, for optimists, improves local welfare most). Decentralization may in principle have many virtues, but it is most unlikely to produce exactly the expenditure pattern the central government would choose to implement unless the goals of central and local government precisely coincide and all decision-makers face exactly the same incentives as in a centralized system. Conflicts between central and local governments as to what should be done are inevitable even if each government tries faithfully to serve the interests of its (different) constituents. The appropriate choice of perspective is thus essential in approaching issues of fiscal decentralization in any particular jurisdiction.

To put the same idea another way, how one evaluates any particular transfer design depends in part upon whether one focuses on its *intrinsic* or its *instrumental* aspects. Devolution may be considered by some to be intrinsically worthwhile. From this perspective, whatever outcomes emerge from a decentralized system of decision-making must be right. Local people may make “wrong” decisions from the perspective of the central government or of an outside observer, but if *they* make them, the decisions must, by definition, be assumed to be “right” for them. Bad results from a good process are better than good results from a bad process.

For this argument to be completely persuasive, however, several stringent conditions must be satisfied. First, the local decision-making process must be fully democratic in the sense that the costs and benefits of decisions are transparent and that everyone affected has an equal opportunity to influence the decision. Second, the costs of local decisions must be fully borne by those who make the decisions—that is, there can be no “tax exporting” and no funding at the margin from transfers from other levels of government. Third, the benefits (like the costs) of local decisions must not “spill over” jurisdictional boundaries without explicit and transparent compensation being paid. The appropriate design of transfers is thus critical even if the sole policy objective is to foster local autonomy.

Democracy is a particularly important mechanism for accountability. At the same time, accountability—in the sense of transparent decision-making—is an essential ingredient of democracy. The ultimate assurance of good local government is, on one hand, the ability of citizens to compare governments in terms of the services they provide and the tax-prices they charge and, on the other, the ability of citizens to be able to affect and alter the decisions of government (Breton 1996). Democracy without good information is not enough. Nor, of course, is information without democracy. However, even in countries without well-established democratic institutions, in which decentralization may be simply another instrument of the central government, good information is essential to ensuring enhanced service outcomes. The more that is known, and the more publicly it is known, the better the outcome of decentralization efforts is likely to be, whatever their rationale and whatever the circumstances in which they take place. The extent to which information relevant to understanding and evaluating the impacts of decentralization is available is thus critical in affecting outcomes for the better over time, almost regardless of the status of political democracy. From this perspective, it is important that transfers should be as *simple, comprehensible, and reliably predictable* as possible.

When all the conditions mentioned above are satisfied, devolution makes sense. When they are not, it may not. Even when one or more of these conditions does not hold, however, the *delegation* of implementation responsibilities to local bodies may make instrumental sense provided that the incentives facing local decision-makers are properly structured—that is, structured to produce the results desired by the central government. An important means of achieving such an outcome is, of course, by an appropriate design of intergovernmental fiscal transfers. Indeed, even if the stated objective is devolution, the central government still has its own policy objectives and should therefore consider carefully the effects of transfers on the outcomes in which it is interested. The instrumental character of transfers—their *effects* on relevant outcomes—is thus critical from any perspective.

“Models” of Local Government

Another important dimension of intergovernmental finance is the relevant “model” of local-government finance that is adopted. Two quite different models underlie (usu-

ally implicitly) much discussion of intergovernmental fiscal relations. The first model essentially views subnational government, like any other government, primarily in an ability-to-pay framework. The second model, in contrast, views subnational governments primarily as agencies providing identifiable services to identifiable local residents. This is often called the benefit model (Break 1992).

The benefit model of local finance fits best into economic analysis. In this framework, local governments are essentially viewed as equivalent to firms that provide services, for the last (marginal) units of which recipients are willing to pay a price or charge that is just equal to the benefit they receive. This approach to local finance is logically appealing (at least to economists) since the results are not only allocatively efficient but also equitable in the sense that no one pays less (or more) than he or she would be willing to pay in a free market.

There are, however, two important problems with the benefit model. First, it is difficult to implement appropriate pricing policy for local public services.⁴ Second, it is not politically appealing. These problems may be dealt with to some extent by structuring local government finances appropriately, along the following lines: Services that flow to identifiable individuals (or firms) should be priced appropriately to the extent feasible. Where such pricing is not possible, local expenditures and revenues through such devices should be linked by such means as earmarking and matching service benefit areas and the spatial dimension of the financing sources.⁵ The taxes made available to local governments to finance local services should be raised primarily from local residents. A particularly important factor is the extent to which local governments can determine tax rates. Local governments may have large revenues from what appear to be “local” taxes, but if they can neither set the tax rate nor determine the tax base, they cannot really be accountable to their constituents at the margin, as both democracy and efficiency require. Finally, when these conditions are satisfied, intergovernmental transfers should be designed to ensure that, at the margin, the costs and benefits of local fiscal decisions are borne locally, while taking adequately into account such interjurisdictional spillovers as are deemed relevant. Consistent application of these rules will impose what is called a “hard budget constraint” on local decision-makers—that is, make them fully accountable in a political and economic sense for the consequences of their decisions.

Such rules, of course, will never be politically popular, either with local decision-makers or, in most instances, with their constituents. In contrast, the political attractiveness to many of the ability model of government is clear. In developing countries, however, where most productive tax bases are invariably occupied by the central government, what the ability approach to local government usually amounts to in practice is that central transfers finance most local services—even though it is often far from clear that the local recipients of the central government’s largesse are less able to pay for what they get than those whose incomes are reduced as a result of central-government taxes. Moreover, if local governments themselves attempt to implement differentiated ability taxes (such as tax exemptions or “pro-poor” pricing policies), the result over time is likely to be an outflow of tax base and consequently a smaller package of local services than if the benefit approach were followed. Richer local governments, which can apply lower tax rates and get similar yields, are likely to attract tax base from poorer ones, thus accentuating disparities.

Pursuing active distributive policies at the local finance level thus seems generally inadvisable. The main aim of local fiscal arrangements should be to finance local services efficiently and fairly, within as simple and administratively effective a structure as possible. Similarly, since intergovernmental fiscal transfers are at best crude instruments to achieve interpersonal distributional goals, it seldom makes sense to complicate transfer designs unduly for distributive purposes.⁶ For similar reasons, it seldom makes sense to pursue regional development goals through general transfer systems rather than through specific central government policies aimed specifically at encouraging development in this or that region or in peripheral as opposed to central areas. As with interpersonal distribution, attempting to incorporate such broad developmental goals into the design of intergovernmental transfers generally results in complex and confused policies that will not only fail to achieve these objectives but also often fail to provide adequate support for the efficient and effective delivery of desired local public services.

Whatever the relevant model, the poor quality of local government administration in many developing countries is one reason many are concerned about the possible dangers of decentralization (Prud’homme 1995). While there is often good reason for such concern, to a considerable

extent countries get the local governments they want, and deserve. Subnational politicians and officials, like national government politicians and officials, respond to the incentives with which they are faced. If those incentives discourage initiative and reward inefficiency and even corruption, it is not surprising to find corrupt and inefficient local governments. The answer is obviously to alter the incentive structure to make it possible and attractive for honest, well-trained people to make a career in local government.

When increased funds that are made available for spending at the local level derive from transfers rather than their own efforts, some have seen even more reason to be concerned about local administrative and political weakness. Clearly, there is reason for concern when such transfers are totally disassociated from local fiscal effort. As discussed later, however, proper transfer design can alleviate such problems to a considerable extent—provided that local authorities are responsible for some significant “own” revenues. Indeed, provided that the financial structure is correct, experience in a number of developing countries has been moderately encouraging with respect to the ability of even poor rural local areas to carry out expanded activities competently. Given appropriate incentives—in terms of heightened expectations of improved services from their constituents and some access to resources for which they were politically responsible—even very small local governments have at times demonstrated significant improvements in administrative capacity within a relatively short time (Fiszbein 1997).

Central Government Policy

The institutional setting within which local governments in developing countries function has been characterized as falling into one of three categories: (1) the over-controlled local public sector, (2) the under-controlled local public sector, and (3) the perversely regulated local public sector.⁷ The first of these situations seems most common in developing countries. Central governments control all the details of local government—whom they hire, what they pay, where and when the buses run, etc.—and leave little or no freedom of action for local initiative. Similarly, central governments often either finance local services directly or so earmark and restrict local finance that they might as well do so. In such circumstances, local citizens look to the central government to fix potholes on their street, and they are right to do so. Moreover, just as children who are never

given responsibility seldom act like responsible adults, such “micro” control generally produces weak and incapable local governments.

While less common, the opposite ill—“under-control”—is emerging in a number of countries as a result of inappropriate decentralization strategies. For example, some transitional countries in Eastern Europe have given local governments large shares of national revenues as well as responsibility for important public-service functions, without at the same time setting up an adequate institutional structure to ensure that central funds are being properly spent in maintaining minimum standards of service in areas of overriding national concern like education or health.

Finally, all too frequently local governments receive perverse signals from central governments. In some countries, the amount of transfers received depends upon the size of the local budget deficit, an obviously perverse incentive. In others, national funding is available for infrastructure investment at no cost, but no funds are available for operation and maintenance. While common, this preference for new investment is perverse because it pays localities not to maintain existing facilities (which they would have to do out of their own funds) in order to strengthen their apparent need for new ones (which the central government will pay for).

Of course, even when the incentives facing local government are wrong-headed, local efforts and policies may sometimes make a real difference. In Brazil, for example, some cities are well-run and provide services efficiently; others, superficially similar in character and resources, are badly run and poorly equipped. In Colombia, some departments provide health services that are superior to others with similar resources. Almost everywhere, some local governments do much better than others. The reason may be simply historical circumstance: For one reason or another they started to do something well some time ago, and they continue to do so. Or it may be because of a caring and charismatic local leader or some other chance circumstance. Whatever the cause, such experiences emphasize two important points. First, even in the perverse situation in which many local governments are placed by inappropriate central policies, there is usually some scope for local initiative. Second, such local initiatives may make a real difference in the lives of local people. One important task in making decentralization effective and efficient is to make it

easier for such “good examples” to occur and to be emulated elsewhere.

In doing so, it is often important to recognize more explicitly the diversity of local governments. “Local government” is a term that covers a wide range of realities in most countries. Cities of 10 million people, villages with 200 inhabitants, densely populated rural and urban areas, sparsely populated territories—all are, as a rule, organized in one form of local government or another. Some localities are rich, some are poor. Some have strong local community spirit, some have none. Some are run by well-intentioned, well-trained people; others by incompetent and corrupt officials. Unfortunately, the diversity of local government reality is seldom matched by equal diversity in central government rules governing local governments. Even though some areas may manage to break out of the inappropriate mold into which they have been put, most will not. Successful decentralization must recognize the diversity and heterogeneity of the local government universe and allow for an equally diverse and heterogeneous set of responses to particular decentralization initiatives, including accommodating “home-brewed” solutions to particular local problems.

A useful approach to this problem in some circumstances may be through “contracts,” or the making of specific agreements with different areas in accordance with their capacities and interests. At its best, such an approach can focus pragmatically on what may work rather than on attempting to fit everyone into the same centrally determined box. It may thus be sensible for central governments to make individual contracts with particular local governments (preferably for a period of years rather than on an annual basis and preferably arrived at in an open and mutually agreed fashion). Indeed, given the diversity found within many countries and the usual political necessity to have nominally uniform laws, only something like this contract approach may be able to provide the necessarily non-uniform terms needed to secure the desired outcomes at least cost. Unfortunately, the design, and limits, of such “asymmetrical fiscal federalism” has so far received little analytical attention. The optimal design of transfers in such cases might appear on the surface to be as complex, diverse, and apparently arbitrary as the transfers that actually exist in many countries. But the complexity and diversity would almost certainly be quite different in character from that found in practice, and the system would be both more transparent and predictable.

Accountability Revisited

As emphasized earlier, if decentralization is to work, those charged with providing local infrastructure and services must be accountable both to those who pay for them and to those who benefit from them—two groups that are seldom identical. Enforcing accountability at the local level is not always easy. As noted above, it requires not only clear and correct incentives but also the provision of adequate information to local constituents, as well as the opportunity for them to exercise some real influence or control over the service delivery system. “Informal” organizations almost by definition must be structured like this or they cannot exist. But it is usually a considerable challenge in the political and social circumstances of many developing countries to introduce a similar degree of responsiveness into formal governmental organizations.

Accountability is the key to improved public-sector performance, and information is the key to accountability. The systematic collection, analysis, and reporting of information that can be used to verify compliance with goals and to assist future decisions is a critical element in any decentralization program. Such information is essential both to informed public participation through the political process and to the monitoring of local activity by central agencies responsible for supervising and (usually) partially financing such activity. Unless local “publics” are made aware of what is done, how well it is done, how much it cost, and who paid for it, no local constituency for effective government can be created. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized.

An important accompaniment of any decentralization program is thus an improvement in national evaluation capacity. Decentralization and improved central evaluation and assessment of local activities are not substitutes; they are complements. An essential element of the “hard budget constraint” system needed to induce efficient local decisions is thus adequate central enforcement capacity in the shape of credible information-gathering and evaluation. The “carrot” of central financial support of local efforts must in the end be accompanied by the “stick” of some degree of withdrawn support if performance is inadequate, which of course requires both some standard of adequacy and some way of knowing how performance measures up.

Experience around the world suggests several possible mechanisms for building such evaluative capacity into a decentralization program. One approach may be to build in “sunset” provisions into any transfer program—that is, to provide that transfers to local institutions are subject to renewal in a number of years, provided they pass some kind of independent evaluation of their performance. Another approach may be to use the likely need for some centrally supported access to capital markets for infrastructure finance not only as a screening device to reject obviously flawed projects (see below) but also an evaluation system to build up “ratings” of local capacity and effort. Yet another may simply be to assemble and publicize reliable comparative information on local-government performance. For reasons discussed below, however, it is unlikely to make sense to attempt to utilize such information directly in the distributive formula of transfers.

The Design of Transfers

As the preceding discussion suggests, no simple, uniform pattern of transfers will be suitable for all circumstances or objectives in any jurisdiction. Transfers as such are neither good nor bad: What matters are their effects on such policy outcomes as allocative efficiency, distributional equity, and macroeconomic stability. If the sole objective of fiscal decentralization is the efficient delivery of public services, then what matters is how transfers affect the effectiveness and efficiency of public-sector operations. From this perspective, what is critical about intergovernmental transfers is not who gives them, or who gets them, or even the details of program design, but solely their *effects* on policy objectives. Intergovernmental fiscal transfers are instruments of public policy, and like all policy instruments they should be evaluated in terms of their effects on relevant outcomes.

A basic principle that should guide the design of a system of intergovernmental transfers is that the purpose of transfers is not to finance particular governmental entities but rather to contribute to an effective provision of services to the population. To the extent that it has been decided, for whatever reason, that services are to be provided by local governments that do not have the fiscal capacity to finance them at adequate levels, that there are externalities beyond those received by the direct beneficiary associated with the services in question, or that interregional differences in needs are important, transfers may be needed. But

because it is important for efficiency to ensure that those responsible for the provision of any service have a clear mandate, adequate resources (including, of course, their own resources), and sufficient flexibility to make decisions—while being held accountable for results—transfers must be designed to facilitate the satisfaction of these conditions. In addition to being “incentive-compatible” in this sense, simplicity, objectivity, and transparency in transfer design are also important characteristics if the system is to work well.

The underlying task in transfer design is thus to “get the prices right” in the public sector in the sense of making local governments fully accountable to their citizens for the actions they undertake—at least at the margin of decision-making. Properly designed transfers can achieve this goal even if they finance 90 percent of local expenditures. Poorly designed transfers will not do so, even if they finance only 10 percent of expenditures.⁸

The implications of this approach for the design of transfers may be illustrated by considering briefly some of the basic tasks assigned to transfers in most fiscal systems: closing the fiscal gap, equalization, pricing externalities, and achieving political objectives.

Closing the Fiscal Gap

Transfers constitute the principal way in which countries achieve what is sometimes called “vertical fiscal balance”—ensuring that the revenues and expenditures of each level of government are approximately equal. Such “fiscal gaps” may be closed in other ways—by transferring revenue-raising power to local governments, by transferring responsibility for expenditures to the central government, or by reducing local expenditures or raising local revenues. In most countries, however, sufficient mismatch in the revenues and expenditures assigned to different levels of government remains for some balancing role to be assigned to intergovernmental fiscal transfers (Boadway and Hobson 1993).⁹

Any and all transfers from higher-level to lower-level governments will help close the fiscal gap. For many purposes, however, it is useful to think of vertical fiscal balance in an accounting sense as being achieved when expenditures and revenues (including transfers) are balanced for the *richest* local government, measured in terms of its capacity to raise resources on its own (Bird 1993). Fiscal gaps will still remain for all poorer local governments, but such

“gaps” are better considered in relation to the problem of achieving *horizontal* fiscal balance (within the local government sector).

Equalization

Horizontal fiscal balance, or equalization as it is usually called, is controversial both because different countries demonstrate very different preferences for its achievement (Bird 1986) and because it is a concept with many different interpretations. If horizontal fiscal balance is interpreted in the same “gap-filling” sense as vertical fiscal balance, sufficient transfers are needed to equalize revenues (including transfers) and the *actual* expenditures of each local government. Such “fiscal dentistry”—as Rao and Chelliah (1991) have labeled this approach—makes no sense. Equalizing the actual outlays of local governments in per capita terms (raising all to the level of the richest local government), like making up all gaps between actual outlays and actual own-source revenues for all local governments, ignores differences in local preferences. Moreover, such equalization ignores local differences in needs, in costs, and in own revenue-raising capacity. Finally, and by no means least important, equalizing actual outlays discourages both local revenue-raising effort and local expenditure restraint, since under this system those with the highest expenditures and the lowest taxes get the largest transfers.

For these reasons, in all countries with formal systems of equalization transfers, the aim is either to equalize the *capacity* of local governments to provide a certain level of public services or to equalize the actual *performance* of this level of service by local governments. The performance criterion, which adjusts the transfer received in accordance with the perceived *need* for the aided service (and which may also allow for cost differentials), is generally more attractive to central governments since the level of service funded is then determined centrally and transfers can be made conditional on the provision of that level of service. Unfortunately, unless adequate adjustment is made for differential fiscal capacity, once again that government which tries least will receive the most.

In contrast, capacity equalization aims to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a centrally predetermined level of services.¹⁰ Differentials in the cost of providing services may or may not be taken into account. Because trans-

fers in this case are based on measures of *potential* revenue-raising capacity (such as taxable assessed values) and not on actual revenues, in principle no disincentive to fiscal effort is created by such transfers. At the margin, the local government still bears full fiscal responsibility for expenditure and taxing decisions, essentially because of the “lump-sum” (inframarginal) nature of transfers. If a local government chooses not to collect all the taxes it could if it made an “average” effort to do so, the result is simply that its revenues (and expenditures) are lower. If, on the other hand, it chooses to impose higher effective rates on average than other comparable governments, it gets to keep (and spend) all the additional revenues. In effect, in terms of its expenditure level it faces an implicit tax rate of 100 percent if its taxes are less than average and 0 percent if its taxes are greater.

Of course, full equalization as defined above in the sense of closing all “gaps” will be achieved only if the standard revenue-raising capacity that the grant is intended to provide is set at the level of the richest local government. For any lower standard, such as the average revenue-raising capacity of local governments, the disabilities of below-average localities relative to those that are above average will obviously remain.¹¹

However calculated, the basic case for such an equalization transfer is twofold. First, such a transfer may be needed to enable poorer local governments to respond efficiently to transfer programs intended to generate the correct level of externalities. Such a grant will partially compensate for large differences in fiscal capacity and hence place all local governments on a more level “playing field” with respect to responding to incentive grants such as those discussed below. Second, an equalization transfer may also be needed to enable local governments to provide an adequate “minimum bundle” of public services to citizens. Transfers intended to achieve the latter purpose could in principle be conditioned on both capacity *and* performance, in the sense of actually providing the specified package of services. Equally, if a high value is placed on local decision-making autonomy, such grants could be unconditional.

A general-purpose (or equalization) grant may thus have two distinct rationales. The first, and most important from a systemic perspective, is to provide the necessary underpinning for decentralization in general (and for other transfers), by equalizing to some level the fiscal capacity of ter-

ritorial entities, thus putting all on the same footing with respect to incentives. A second rationale might be to provide sufficient resources to enable all local governments, even the smallest and poorest, to provide a basic package of local services (but probably, for reasons discussed briefly below, not the construction of infrastructure).¹²

From a purely economic point of view, the second of these objectives may appear to make little sense. In many developing countries, however, most smaller rural areas are not able to provide any significant local services solely from their own resources. This lack of local resources should not be confused with a lack of local capacity to make and implement suitable expenditure decisions, since as mentioned earlier there is strong evidence in a variety of circumstances that even some very poor areas have managed surprisingly well once they have been enabled and encouraged to do so. In any case, a critical question in transfer design is often how to provide the basic resources such municipal governments need to survive while maintaining adequate incentives for them to do what they can in terms of raising their own revenues.

Getting Intergovernmental Prices Right

The transfer rationale with the strongest basis in the economic literature is that the local activity in question may spill over to other jurisdictions. The correct way to deal with this problem is with some form of matching grant. Matching (or conditional) transfers in principle have important economic and fiscal advantages in terms of allocative efficiency (spillovers). In addition, while rendering local governments more susceptible to central influence and control, matching grants may also have the important political advantage of introducing an element of local involvement, commitment, accountability, and responsibility for the aided activities. Such grants may be particularly important with respect to capital investment projects, where they may substitute for, or supplement, subsidized loans.

The rationale for matching grants that has the strongest basis in the economic literature is that the benefits from the local activity in question may spill over to other jurisdictions—that is, provide benefits to localities other than those that decide to undertake the activity. Since such external benefits will not be taken into account by any particular local government in deciding how to spend the funds at its disposal, in general too little such externality-

intensive activity will be undertaken unless the local government receives a unit subsidy just equal to the value at the margin of the spillover benefits.

The correct matching rate (m), or the proportion of the total cost paid by the central government, should thus be set in principle by the size of the spillovers. This rate may decline as the level of expenditure rises if the externalities diminish. It may also vary across localities if there are reasons to expect greater externalities in some places than in others or if there is reason to expect a higher local price elasticity of demand for the service in question in some areas as opposed to others. Basically, however, a matching-grant program designed to encourage the optimal provision of public services would be expected to vary primarily with the nature of the activity; the matching rate should depend upon the level of associated externalities.¹³

Since no country has achieved full equalization of local fiscal capacities, however, a uniform matching level offering in effect the same “price” to different local governments would in practice discriminate against poor regions. Indeed, even if revenue bases were fully equalized, there might still be grounds in terms of need or cost differentials for including an equalization element in matching-grant formulas. For example, per capita grants for roads in sparsely populated and mountainous regions should generally be larger because the per capita cost of achieving any particular standard of road service will obviously be higher.

Matching grants may also be inversely correlated to the income level of the recipient government. The rationale underlying such transfers is to ensure that all local governments, regardless of their fiscal capacity, provide a similar level of certain specified public services to their residents. The basic idea is simply to set the price of the service $(1-m)$ to each local government in such a way as to neutralize differences in capacity by varying the matching rate (m). The higher the income elasticity of demand for the service, the higher the matching rate needed for low-income recipients (to offset the higher expenditures out of local resources on the aided service in higher-income areas), and the higher the price elasticity, the lower the matching rate needed to achieve a given level of total expenditures. In practice, there may thus be a case for varying matching rates inversely with income levels even when only the incentive effects (and not the distributional effects) of matching grants are considered (Feldstein 1975).

This approach differs from the general equalization argument discussed earlier in three ways. First, specific services are designated—perhaps because they are thought to entail spillovers, perhaps because they are considered especially meritorious. Second, the specific level of service to be provided is also established by the donor government. Third, the payment of the grant is conditioned on that level of the specified services in fact being provided.

The matching rate for each program may have two components. As noted earlier, the basic matching rate for each service reflects the degree of central government interest in the provision of that service (whether that interest is motivated by concern over spillovers, the “merit good” nature of the activity, or simply the desire to implement some plan). This basic rate may then be increased inversely to a uniformly determined measure of fiscal capacity. Capacity is preferable to macro measures of income in this context for two reasons. First, what matters is the ability of the local government to raise local revenues from local citizens, which may be only loosely related to criteria like per capita income. Second, it is important to distinguish the equalization role of intergovernmental transfers from purely distributional goals, which should presumably be focused on people, not places. The matching rate faced by any particular locality for any particular program would then be higher the greater the degree of central interest and the lower the (expected) degree of local enthusiasm (price-elasticity) and ability (income-elasticity) to support that program. The exact structure of the final formula for any service could likely be determined only after a period—perhaps a prolonged period—of trial and error, of observing the results of formulas such as those now in place and adjusting them as necessary to approximate more closely to the centrally desired outcomes.

One reason why matching grants are less commonly found than theory suggests is because, even when there are thought to be important interjurisdictional spillovers, they may largely be inframarginal, and the appropriate subsidy (matching) rate is of course that which applies at the margin. Another reason is that in practice in many countries redistributive concerns, not efficiency concerns, determine matching rates: Poor localities get more assistance because they are poor, not because, as suggested above, a higher matching rate is required to induce them to produce the socially optimal amount of the service in question. Matching grants should be used primarily for activi-

ties in which there is a clear and significant interjurisdictional externality at the marginal level of service provision. Where such externalities affect only a few localities, a more efficient approach might be direct agreements or arrangements among the affected local governments.

Perhaps the most basic problem with the matching approach, however, is that it is demanding in terms of information. Ideally, its application requires, for example, a clear specification of the level of service to be provided. In one province of Canada, for example, 29 different types and levels of primary education service are specified in the education grant. In addition, fairly accurate and up-to-date estimates of the costs of providing each level of service are needed. Moreover, as stressed earlier, local governments need to have a fair degree of tax autonomy. In addition, “standard” tax rates need to be carefully specified, estimates of local fiscal capacity must be made, and, ideally, some idea of the probable effect of income differentials on local responses to differential matching rates (the “price” of the aided service) is needed. As a rule, even the abundant information available in developed countries is insufficient to determine the precise matching rate appropriate for particular expenditure programs, let alone how those rates should be varied in accordance with the very different characteristics of different local governments.¹⁴ Nevertheless, although data limitations mean that refinements such as those discussed above are unlikely to be relevant in most developing countries for some time to come, these principles should be kept in mind in developing an intergovernmental transfer system—or, for that matter, subsidized municipal credits, where exactly the same considerations are relevant.

Achieving Political Goals

Even the purest analyst of intergovernmental fiscal relations must deal with the reality of political transfers. It may be necessary, for example, to transfer some resources to jurisdictions that do not, strictly speaking, need them, in order to make it politically feasible to transfer needed amounts to other jurisdictions. As already mentioned, it may also be essential to transfer resources simply in order to keep some economically non-viable local governments alive for political reasons—to salvage regional pride, to provide jobs for local supporters, or for some other reason. From an economic perspective, the design problem is how to minimize collateral damage in the course of achieving

the political ends of transfers. For example, transfers that simply finance local deficits or that are entirely discretionary in nature are invariably bad. Similarly, assigning the function of financing local infrastructure (new water systems, roads, schools, or hospitals) to an automatic and permanent transfer not linked to coverage needs would generate two types of problems. First, the central government would lose a potentially important tool to implement the goals of its development plan and to direct resources to those regions with the most important coverage gaps. The second problem has to do with the fact that construction of infrastructure is a discrete event. Because, as noted earlier, all too often other central government policies ensure that local governments lack the flexibility to allocate these resources to other uses, such rigidity in funding may in the end lead to even more allocative distortions.¹⁵

Key Design Options

Three aspects of intergovernmental fiscal transfers need attention in any jurisdiction: the size of the “distributable pool,” the basis for distributing transfers, and conditionality.

Determining the Distributable Pool. An important characteristic of any good system of intergovernmental grants is *stability*. Another is *flexibility*. How can both these characteristics be achieved simultaneously? Basically, there are only three ways to determine how much money to distribute through intergovernmental fiscal transfers:

1. as a fixed proportion of central government revenues;
2. on an ad hoc basis, that is, in the same way as any other budgetary expenditure; or
3. on a “formula-driven” basis, that is, as a proportion of specific local expenditures to be reimbursed by the central government or in relation to some general characteristics of the recipient jurisdictions.

Variants of all three methods are found around the world.

From the perspective of the central government, the best system would seem to be one in which the total amount to be transferred (sometimes called the “distributable pool” or the “primary distribution”) is determined annually in accordance with budgetary priorities. With

this system, however, unless the amounts received are to some extent predetermined and predictable, recipient governments will neither be able to budget properly nor will they face an appropriately “hard” budget constraint. A better way to provide both some degree of stability to local governments and some degree of flexibility to the central government is to establish a fixed percentage of all central taxes (or current revenues) to be transferred. On the whole, despite its popularity, sharing specific national taxes is less desirable than sharing all national taxes because it leads central governments over time to tend to increase more the taxes that they do not have to share.¹⁶

The Distributive Formula. Any good transfer system should distribute funds on the basis of a formula. Discretionary or negotiated transfers, such as are still common in many countries, are clearly undesirable. The essential ingredients of most formulas for general transfer programs (as opposed to “matching grants” that are specifically intended to finance narrowly defined projects and activities) are needs, capacity, and effort. Often, needs may be roughly but adequately proxied by some combination of population and the type or category of municipality. A more difficult but conceptually critical problem is usually to include some measure of the “capacity” of local governments to raise resources, given the revenue authority at their disposal. In order to remain transparent, formulas should not be too complex. As discussed further below, effort will be adequately taken into account in a formula including capacity. Any desired degree of interjurisdictional equalization can be built into such a formula.

A possible aim of a transfer system, for example, might be to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a centrally predetermined level of services. Because capacity-based transfers are in principle based on measures of *potential* revenue-raising capacity, not on actual revenues, this approach presents no disincentive to fiscal effort. Differentials in needs and in the cost of providing services—for example, in rural or less densely populated areas—may be taken into account, but caution is necessary in this respect since it is all too easy to turn a simple, transparent formula into an obscure and manipulable one by introducing too many refinements in the definition of the elements of the formula.

Conditionality. Once the total amount to be distributed has been decided, and the basic distribution formula determined, the remaining question is whether the trans-

fer should be conditioned on the provision of certain services at specified levels. Money is fungible, so even transfers based solely on need and capacity measures do nothing to ensure that the recipient governments will in fact use the funds they receive as the central government might wish—unless receipt is conditioned on performance, and compliance is monitored in some way. As a general rule, in the circumstances of most developing countries, in which the “benefit” model of local governments (see above) seems applicable, some conditionality therefore often seems desirable—particularly when important national services such as education and health are provided by local governments (Bird and Fiszbein 1998).

Fiscal Capacity and Fiscal Effort. As noted above, some measure of fiscal capacity is an essential element in the design of an intergovernmental transfer that will provide appropriate incentives to local fiscal effort and to the appropriate use and management of transfer funds by recipient governments. In the absence of such a measure, a rough approximation may perhaps be attempted by using estimates of regional GDP per capita or some other macroeconomic index. Unfortunately, experience suggests both that such an index may not be very closely correlated with any reasonable tax capacity index and that it is in any case difficult to construct such indexes (World Bank 1996a). Even if capacity could be measured in some appropriate way, many problems would remain in interpreting changes in “effort” measures in an intergovernmental context.

Despite the frequency of laments about the “fiscal laziness” of local governments and their failure to exert adequate effort at mobilizing resources, the evidence in support of this proposition is far from overwhelming (Bird and Fiszbein 1998). In any event, it is not advisable to include explicit measures of fiscal effort in such formulas, for a number of reasons. The measurement of fiscal effort is considerably more complex than usually seems to be realized. If tax bases are sensitive to tax rates, then the usual measures overestimate capacity in low tax-rate areas (and hence underestimate the effort needed to increase tax rates) because the base will decline whether the rate is increased. Conceptually, while it is not easy to define fiscal effort, it is probably most meaningfully understood as the ratio of actual taxes collected to “potential” taxes estimated on the basis of some standard measure of fiscal capacity and some standard (e.g., national average) tax rate. Even when so defined, the general absence of reliable

empirical estimates of fiscal capacity renders the concept largely non-operational.

Moreover, given the fact that most local governments in developing countries have very limited flexibility to alter their revenues through their own actions in any case, it is far from clear to what extent it is meaningful to interpret the behavior of revenues as reflecting their “effort.” In addition, placing too much weight on fiscal effort in allocating grants often unduly penalizes poorer areas, where, by definition, a given percentage increase in effort, as usually measured, is more difficult to achieve. The problem giving rise to the need for equalization in the first place is that the fiscal capacity (tax base) of poor areas is too low, not that their tax rates are too low. Imposing an additional penalty on poor localities in a transfer program that, given the shortage of resources in developing countries, will almost inevitably fall short of fully equalizing fiscal capacity seems hard to justify. On the other hand, experience in a number of countries suggests that introducing an effort correction into fiscal transfers may often give more to poorer areas—that is, increase the redistributive effect of transfers—because poorer areas, once their much smaller fiscal capacity is taken into account, often levy relatively higher taxes than their richer neighbors in any case.

In addition, including actual tax rates in the formula may undesirably open the formula to manipulation by recipient governments and introduce distortion in their allocative decisions. Such effects occur whenever actual rates enter into determining a “standard” rate, as in capacity-based grants. They will be even greater if the actual tax rate of any particular jurisdiction is a factor determining the size of the transfer it receives.

Such arguments, combined with the fact that properly designed equalization transfers in any case embody a strong implicit incentive for transfer recipients to levy taxes at least at average levels, suggest that it is neither necessary nor desirable to include explicit “effort” factors in transfer formulas—even if such factors could be calculated in some reliable way. Nonetheless, it is important to take fiscal effort into account in a more general sense in designing transfers (Wiesner 1995). The reason for concern with fiscal effort is not because of some technical worry about the substitutability of transfers for local resources. It is rather because it seems essential to require local citizens to pay in some meaningful sense for what they get, if those who make local expenditure decisions are to be held accountable

(through local political institutions) for their actions. So long as local governments are spending what they and their constituents view as “other people’s money,” they are unlikely to be under much local pressure to spend this money efficiently.

Experience everywhere suggests that people are more careful in spending money they have to earn (taxes they have to pay themselves) both because they are aware of the pain of taxation as well as the pleasure of expenditure and because they will feel more “ownership” of the activity as a result. Attention must therefore always be paid to local resource mobilization as an essential component of any successful decentralization exercise. Unless increased transfers are matched by a local contribution—however small that contribution may be in the poorest communities—the full efficiency benefits of decentralization are unlikely to be realized. People do not, it seems, take ownership of what is given to them in the same way as they do of things they have to pay for themselves, at least in part. And without local ownership, expenditure efficiency seems unlikely to be enhanced by decentralization.

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

In a decentralized system, in principle, subnational governments should identify infrastructure needs and execute projects. Financing large infrastructure projects from local resources alone may not always be possible, given the scanty current revenues of most local governments. Moreover, small localities seldom have much access to private capital markets. If they are to carry out costly public works, therefore, they must as a rule rely heavily on grants (or subsidized loans) from higher levels of government. The assistance currently provided for purposes of capital expenditure in most countries, whether through transfers or subsidized loans, could be significantly improved in a number of ways.

First, the terms and conditions of such transfers should require local governments to prepare both an adequate investment plan and an adequate maintenance plan, as well as an appropriate user-charge policy. Second, the localities that receive such transfers should be selected not by political factors but by a systematic process that pays attention both to need and capacity factors and to the economic evaluation, such as cost-benefit analysis, of the project in question. Third, adequate technical assistance should be made available to local governments (not necessarily, or indeed, not even desirably from central governments) to permit them to develop plans, arrange financing, manage construction, and operate the facility in the most efficient possible fashion. Fourth, the execution and operation of grant-aided work should be monitored and evaluated, with periodic progress reports, field inspections, and formal evaluations of outcomes. Finally, all local governments receiving such aid should be required to provide surveys of the condition of the infrastructure to which aid is to be directed in order to permit adequate assessment of future needs.

Of course, meeting such conditions may seem like a counsel of perfection in the conditions of many developing countries. Nonetheless, to the extent these conditions are not satisfied, the results of central aid to local public works projects are likely to prove as unsatisfactory as past experience with “municipal development funds” has proved in a number of countries.

As noted above, in theory a matching grant, where the central government pays part of the cost of expenditure carried out by a local government, is the best way to finance projects in which some of the benefits from the local activity in question spill over to other localities. Properly designed matching grants also have the political advantage of introducing an element of local involvement, commitment, accountability, and responsibility for the aided activities. Money alone will not do the job, however. It must be provided in the right framework, in the right amounts, and to the right recipients under the right conditions. For such a system to work, the central government must have both clear objectives and an operational system that can efficiently work with local governments interested in having access to these resources.

Guidelines for Transfer Design

Assuming that governments have decided to devolve, rather than simply delegate, some critical expenditure

functions to local governments, the principal lessons for transfer design emerging from this discussion may be summed up as follows:

First, there is a role for both general-purpose and special-purpose grants (e.g., for infrastructure).

Second, it is generally advisable, from the points of view of both the grantor and recipient governments, that the total "pool" of resources to be distributed in general-purpose transfers be set in a stable but flexible way (e.g., as a percentage of central government taxes, adjustable every few years).

Third, the general-purpose grant should take into account both need and capacity, but it should do so in as simple, reliable, and transparent a fashion as possible.

Fourth, if the general-purpose grant is properly designed, and if local governments have some discretion in tax policy, there is no need to include specific incentive features to encourage additional tax effort.¹⁷

Fifth, no conditions should be imposed (e.g., through earmarking or mandates) as to how general-purpose grants are spent.

Sixth, on the other hand, some special-purpose grants should likely have a matching component, which might vary both with the type of expenditure and the fiscal capacity of the recipient.

Seventh, to the extent such grants are intended to finance infrastructure, recipients should satisfy technical conditions sufficient to ensure that the money is spent properly.

Eighth, all local governments should be required to manage financial matters in accordance with standard procedures, to maintain adequate and current accounts, and to be audited regularly and publicly. Similarly, although central governments should not "pre-approve" or direct in detail local government budgets and activities, they should maintain up-to-date and complete information on local finances and make such information publicly available.

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Endnotes

1. Although detailed references do not seem appropriate in the context of the present paper, its contents are based largely on Bird (1993), Shah (1994), Ahmad (1996), and Ter-Minassian (1997). Perhaps unsurprisingly, it draws particularly heavily on the first item listed. I should emphasize that many of the questions discussed here are far from settled in the literature. For two recent—and very different—discussions of the role and design of transfers in developed countries, for instance, see Carlsen (1998) and Duncombe and Yinger (1998). For an example of how the general principles set out here may be applied in a particular country, see the discussion of Colombia in World Bank (1996) and Bird and Fiszbein (1998).

2. Litvack, Ahmad, and Bird (1998) emphasize the need for such a systemic, institutional perspective. For further discussion of the institutional approach, see Goodin (1996).

3. In the context of state-local finance, the state government is of course the “central” government. Incidentally, the terms “subnational” and “local” are used more or less interchangeably in the present paper. For some distinction between regional and local governments, see Bird (1999).

4. Bird (1999) and Bird and Tsiopoulos (1997) discuss this point further.

5. These aspects are considered further in Bird (1998) and Bird and Slack (1993).

6. For further discussion, see Rao and Das Gupta (1995) and Bird and Rodriguez (forthcoming).

7. See World Bank (1995). Carlsen (1998) discusses the theoretical arguments for maintaining some degree of central control and the methods of doing so. Bird and Fiszbein (1998) analyze the

importance of such controls in determining the outcomes of alternative transfer designs.

8. There is no analytical rationale for the argument sometimes made that accountability requires, say, half or more of local expenditures to be financed from local sources.

9. For a discussion of how this “gap-filling” role might be largely eliminated by better design of subnational revenue systems, see Bird (1999).

10. Note that it is important to distinguish fiscal capacity equalization (among jurisdictions) from considerations of horizontal equity (among individuals) since the two are not necessarily connected: much U.S. literature (for example, Oakland 1994) appears to blur this distinction.

11. An exception is when the positive transfers required to bring those below the average up to the average are financed by negative transfers from those above the average (as in the *finanzausgleich* of Germany and the similar system in Denmark). More generally, the effects of any grant system are obviously determined in part by how the grants are financed (Musgrave 1961), but this important question cannot be discussed further here.

12. The objective of providing similar public services regardless of location may conflict with the desirability of migration from less (privately) productive to more productive locations. Although this subject has been discussed extensively (if not very conclusively) in the literature, it is not further considered here on the assumption that in current conditions in many developing countries the relatively small differences in location-specific public service bundles (excluding education and health, which are assumed to be portable) that might result in different locations from an equalization program are unlikely to be significant factors in migration decisions.

13. A different rationale for matching grants may arise from the existence of a central government budget constraint. If the central government wishes to use its scarce budgetary resources to attain given standards of expenditure on certain services provided by local governments, it should pay only as much of the cost as is needed to induce each local government to provide that level of service. With a grant of m percent of cost, the effective price to the locality is $1-m$. To ensure maximum total expenditure (local plus central) on the service in question, given the total size of the central-government contribution, the optimal way to allocate the given total amount among localities will be to vary it inversely to the price elasticity of local demand for the service (assuming no cross-price elasticity effects).

14. For a recent example, see Duncombe and Yinger (1998).

15. An additional important political concern arises when transfers are changed. Because it is much easier to give someone more than to take away what they now have, “revenue-neutral” transfer

redesign is hard to achieve. In most instances, a substantial transitional period—with perhaps a longer transition for “losers” than for “winners”—may prove necessary, and a common result is a short-term *increase* in total transfers.

16. When national taxes are very sensitive to external shocks (such as a fall in export prices), this approach—although it may still be justified as “sharing the pain” between levels of government—may provide insufficient stability for subnational finance of such vital human

capital development services as education and health. Alternative approaches such as basing transfers on a more stable macroeconomic base like a moving average of GDP growth (as in Canada) or financing such services separately through a system of capitation grants (as proposed in World Bank 1996, for example) might be considered.

17. Unless for some reason it is desired to expand the size of the local public sector beyond the level that would be chosen by local decision-makers.

An 'Incomplete-Contracts' Approach to Intergovernmental Transfer Systems in Latin America

SEBASTIÁN M. SAIEGH AND MARIANO TOMMASI

In this paper we examine the workings of intergovernmental transfer systems in Latin America. Building on “economic” diagnoses that highlight the apparently deficient incentives in many of the federal fiscal institutions in the countries under study, the paper attempts to understand the politics behind their adoption and persistence.

Our main argument is that time-inconsistency problems, asymmetric information, and other special forms of transaction costs—plus the lack of an adequate governance structure to overcome these problems—impede Latin American political leaders from moving toward more efficient outcomes. This paper explores this issue through a comparative analysis of intergovernmental transfers in Argentina, Brazil, Colombia, and Mexico.

We use the analytical framework of Transaction-Cost Politics (one strand of the New Institutional Economics);¹ thus, the paper can also be read as a case study in that theory. We believe that the evolution of intergovernmental transfer arrangements offers a natural ground for this kind of study because fiscal issues are at the heart of the state (one of the main actors in any political-economy analysis),² and because subnational governments (SNGs) provide natural actors for a political transaction-cost analysis. Not only are some of the key actors easy to identify, but also the welfare effects of budget allocations are

easier to recognize and measure than those of, say, regulatory policy or trade policy.

The study of the Latin American cases can also be taken as a contribution to the economic theory of federalism. Some authors have recently stressed the incentive effects of decentralized authority (Weingast 1995; Montinola, Qian, and Weingast 1995; Qian and Weingast 1997). Paralleling arguments in the theory of the firm, they suggest how some features of federalism provide credible commitment to secure economic rights and enhance economic development. The argument we make here is that, despite the positive effects of federalism and decentralization of authority

pari passu, there are certain features of actual federal arrangements that can also lead to incentive problems among the different jurisdictions and negatively affect economic performance.

The paper is organized as follows. Section I offers a brief review of the recent literature on political redistributions and on intergovernmental relations from a political economy perspective. Section II summarizes the main features of the federal fiscal institutions in Argentina, Brazil, Colombia, and Mexico and their current deficiencies. Section III identifies the main reasons why the political process did not produce efficient policy selections in the

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cases under study. Section IV interprets those reasons in the language of the theory of incomplete contracts. Section V contains some preliminary suggestions for institutional reforms; given the analytical framework we use in this paper, the "policy recommendations" are at the level of politically feasible revisions of the "governance structures" that have generated those transfer systems. Conclusions follow.

I. Relation to the Literature

There is no clear consensus in the political economy literature on the ability of the political process to produce Pareto-efficient economic outcomes—that is, to allocate resources in such a way that all gains from trade are exhausted and that no one can be better off without someone else's being worse off. As Dixit (1996: 38-39) notes, that would be the case if the workings of the political process conformed to the ideal benchmark of the Coase theorem (1960), so that no exchange that can benefit some group of people without hurting others goes un consummated.

Some economists (for example, Wittman 1989 and 1995) argue that the redistributions we observe in the real world—while reflecting underlying distributions of power—are constrained Pareto-efficient. However, recent studies have made an opposing argument, claiming that the political process might fail to implement policies that could make all individuals better off, given the available instruments of redistribution. According to these authors, the reasons are associated with problems of asymmetric information (Coate and Morris 1995), time inconsistency (Dixit and Londregan 1995; Besley and Coate 1998), and other special forms of transaction costs (Dixit 1996); otherwise, again, a Coasian result should obtain.

For example, Besley and Coate (1998: 153) explain the adoption of inefficient policies (or the failure to implement Pareto-improving ones) as a result of the inability of citizens and policy-makers to reach binding agreements about future policy. According to them, making such agreements is almost utopian given the transaction costs involved.

Although this literature has been concerned mostly with the interactions between citizens and policy-makers, this approach constitutes a useful framework to understand the interactions between policy-makers of different levels of government.

In a recent contribution, Inman and Rubinfeld (1997: 49) focus on intergovernmental relations precisely from

this perspective. They claim that even agreements among few jurisdictions often fail to achieve fully efficient bargains. According to them, some of the reasons why inter-jurisdictional Coasian bargains cannot be effective are rooted in informational problems. Unless costs and benefits are common knowledge, they argue, all sides are likely to seek strategic advantage by concealing information.

To explain why beneficial intercommunity agreements might be overlooked, Inman and Rubinfeld (1997: 49) also look in the direction of time-inconsistency problems. They claim that given the fact that enforceability of intergovernmental agreements is complicated, when jurisdictions are tempted to renege, there is less incentive to reach agreements in the first place.

In the rest of this paper we describe some of the main features of the federal fiscal institutions in the referred Latin American countries, and the political dynamics behind them, and we attempt to interpret them in the framework of this recent literature.

II. Intergovernmental Transfer Systems in Latin America

A. The Cases

Argentina. Argentina has a federal structure with 23 provinces, the city of Buenos Aires, and 1,922 municipalities. Originally the constitution established that the federal government would employ tariffs on foreign trade to finance its expenditures, while provinces would finance themselves through taxes on production and the consumption of specific goods. Over time, however, for economic and political reasons the national government became the main agent responsible for the collection of most taxes, and the provinces came to rely on transfers and a federal revenue-sharing system called "*Copartición Federal de Impuestos*."³ The revenue-sharing regime was legislated and altered repeatedly according to shifting government priorities and changes of political regimes (Saiegh and Tommasi 1998, Schwartz and Liuksila 1997).

The intergovernmental transfer system presently in use dates from 1988. It is mostly based on a fixed formula (with a low level of earmarking). The federal government retains 42 percent of the shareable taxes and distributes 57 percent among the provinces; the remaining 1 percent is set aside "to finance unforeseen crises in the provinces."⁴ The law also prescribes the percentages of the secondary

distribution, and it is supplemented by several other laws regulating the distribution and destination of some specific taxes that finance a set of predetermined activities.⁵

Even though the main features of the 1988 tax-sharing scheme prevail today, there have been numerous changes and adjustments. One of the main changes was to establish “*preparticipaciones*,” that is, to redirect parts of the tax revenue originally destined to the tax-sharing scheme toward other purposes. (For instance, in 1992 and 1993 the national government was able to achieve a 15 percent reduction of the amount to be shared with the provinces, in order to finance the growing social security deficits.) Another important change was to provide some fixed-sum transfers and a minimum transfer guarantee to the provinces.

The 1994 Constitution established that a new Coparticipation Law had to be sanctioned before the end of 1996. That deadline was postponed until the end of 1998, but a new law has still not been passed.

Brazil. Brazil is a federal country with 26 states, a Federal District, and about 5,000 municipalities. Historically, intergovernmental fiscal relations have been characterized by pendulum swings between phases of decentralization and recentralization (Ter-Minassian 1997; Willis, Garman, and Haggard 1999). In the aftermath of the last military government, a new trend of decentralization began with the enactment of the Emenda Passos Porto of 1983, which increased the amount of revenue from federally collected taxes that had to be shared with the SNGs.

The redemocratization process enhanced this movement toward decentralization. In fact, the Constitution of 1988 shifted considerable political power and tax resources from the federal government to the SNGs. With regard to intergovernmental transfers, it assigned specific tax bases to each level of government and created a system of tax-sharing both among different levels of government and among the SNGs (Dillinger and Webb 1998). The main vehicles for revenue-sharing are two funds: The *Fundo de Participação dos Estados* and the *Fundo de Participação dos Municípios* (Ter-Minassian 1997).

In addition to the constitutionally mandated transfers from federally collected taxes to states or municipalities, there are also a wide variety of transfers to the SNGs in the form of block or non-matching grants, including the so-called negotiated *convênios*. The latter are negotiated on a case by case basis and not restricted by any formula or other

“objective” criteria. These transfers are usually used to finance specific projects within a state (Kraemer 1997).⁶

As part of the stabilization efforts initiated in 1993, there have been several attempts to restructure intergovernmental fiscal relations and the revenue sharing mechanisms in particular.

Colombia. Colombia is a unitary republic with 32 departments and one capital district. Even though it has a long history of political centralization, Colombia has evolved into one of the more decentralized countries in Latin America since the first decentralization reforms introduced in 1982.

More recently, the 1991 Constitution took very important steps toward political and financial decentralization of government. First and foremost, it introduced the popular election of departmental governors (Willis, Garman, and Haggard 1999).⁷

With respect to revenue-sharing, there are four mechanisms presently in use: (a) the *situación fiscal*, which provides automatic transfers to the departamentos (regional governments) earmarked for current expenditure in health and education; (b) the *participación municipal*, which earmarks transfers to the local governments for current and investment expenditure on basic services (including education, health, water and sewage, police, local public works, environmental protection, and recreation); (c) the system of cofinancing funds, which are transfers to local governments made mostly on a matching basis to finance rural development, low-income housing, municipal transport, etc.; (d) the National Royalties’ Fund, destined to distribute natural resource royalties primarily to the producing regions for purposes of investment (Ahmad and Baer 1997).

Although a system of national-government transfers to SNGs had been used since the late 1960s, the 1991 Constitution mandated important increases in favor of the lower levels of government. As required by the constitution, the share of the central government’s current revenue transferred to local governments in the form of *participación municipal* rose from approximately 12 percent in 1991 to 18 percent in 1997 and should grow to 22 percent by 2001. The size of the *situación fiscal* was set as a minimum share of the central government’s current revenues and has varied from 22.5 percent in 1993 to 24.5 percent in 1996 (Ahmad and Baer 1997).

Pursuant to the 1991 Constitution, additional legislation on transfers was enacted, most importantly Law 60 of

1993. This law defined the distribution formula for the transfers made by the *situación fiscal* and the *participación municipal*. These distributions were supposed to be revised in a new law originally scheduled to be enacted in 1997. However, until the first half of 1997 no legislative initiatives had been taken on this issue.

Mexico. Mexico has a federal structure consisting of 31 states, a Federal District, and 2,392 municipalities. However, the institutional matrix that emerged from the Mexican Revolution has been described as one that is formally based on three levels of government, but that is actually very centralized in terms of political and fiscal control (Willis, Garman, and Haggard 1999).

With regard to fiscal decentralization, the recent initiatives can be traced to an overhaul of the tax system during the 1970s: The coexistence of federal and state taxes not only favored tax cascading but also made it difficult to administer the whole system. In order to achieve tax coordination, the National System of Fiscal Coordination (NSFC) was created in 1980 (Diaz-Cayeros, Gamboa, and Hernandez 1999; Willis, Garman, and Haggard 1999). This system has regulated, since then, intergovernmental fiscal relations in Mexico.

The NSFC is essentially a revenue-sharing system, where tax collection is mainly made by the federal government and then part of it is redistributed to states and municipalities based on a formula and with no earmarking. These funds are allocated to the SNGs through three separate mechanisms: the *Fondo General de Participaciones*, the *Fondo Financiero Complementario* and the *Fondo de Fomento Municipal* (Diaz-Cayeros, Gamboa, and Hernandez 1999; Willis, Garman, and Haggard 1999).

Since the creation of the system in 1980, total revenue sharing as a proportion of GDP increased from 2.3 percent to 3.3 percent in 1994 and shared revenues increased from about 16 percent of federal government revenue to around 19 percent during the same period (Amieva-Huerta 1997).

The states receive the bulk of these revenues from the *Fondo General*, commonly known as *participaciones*, and from the *Fondo Municipal*. The transfers are based on a formula (according to population, revenue-raising effort, and equalization criteria) and they do not involve earmarking (Amieva-Huerta 1997).

Another very important source of financial flow to the regional level are the conditional federal grants to states earmarked for specific projects. These are contained within

the so-called *Inversión Pública Federal* (federal public investment), spent by the federal and local administrations (Diaz-Cayeros 1997).

As a result of 1995 crisis, the federal government was pressured to provide financial assistance to the states. This was implemented through an existing program called *Programa de Fortalecimiento Financiero de los Estados* with a cost of 7 billion pesos in 1995. This program continued until 1998, but apparently came to an end in 1999 (Diaz-Cayeros, Gamboa, and Hernandez 1999: 13).

B. Incentive Problems in Latin American Intergovernmental Transfer Systems

There is an almost absolute consensus among observers that intergovernmental transfer systems in many Latin American countries are very far from satisfying the normative properties usually enumerated in the economic literature. What follows is a brief list of some of the most relevant incentive problems:⁸

Lack of Fiscal Correspondence. In some of the countries under study, a high degree of vertical fiscal imbalance coupled with a relatively large fraction of government services provided at the subnational level, contributes to create a **common pool problem** across the SNGs. This induces SNGs to behave as if they do not face a hard budget constraint, increasing spending and reducing local tax effort.

Take, for example, Argentina. According to the Inter-American Development Bank (1997), it is the most decentralized country in Latin America in terms of public spending, with approximately 50 percent of total spending occurring at the subnational level.⁹ At the same time, Argentina has a high degree of vertical fiscal imbalance. From 1985 to 1995, an average of 65 percent of provincial expenditures were financed through transfers from a common pool of nationally collected taxes, with only 35 percent financed from the provinces' direct "own" revenues. The importance of the transfer mechanisms as determinants of provincial—and national—fiscal behavior is obvious. (It should also be mentioned that there is a high variation around this 35 percent (weighted) average.¹⁰ Ten provinces finance less than 15 percent, and 16 provinces less than 20 percent, of their spending with their own resources.)

Likewise, the Mexican federal government controls major tax sources. This leads to problems of vertical imbalances because municipal governments' own tax revenue is

only a fraction of municipal expenditures. The same problem is present at the state level (Amevia-Huerta 1997: 585). Perry and Huertas (1997) describe a similar pattern for Colombia. They argue that the decentralization process was based almost exclusively on intergovernmental transfers and not on local tax efforts. Hence, almost 95 percent of the municipalities tend to rely almost exclusively on transfers.

In contrast, in Brazil there is a relatively high degree of control over revenue sources by state and local governments. In 1995, the SNGs' own tax revenues accounted for nearly 38 percent of total tax revenues. However, tax revenues at the disposal of SNGs (including own plus shared revenues) represented nearly 50 percent of total tax revenues, whereas in the same year they accounted for about 60 percent of public consumption and for 63 percent of public investments (Ter-Minassian 1997: 438; see also Dillinger and Webb 1998).

The Bailout Problem. This dynamic version of the common-pool problem refers to the fact that higher levels of government are likely to bail out lower levels of government in financial distress. This generates a moral hazard problem that undermines the incentives of lower units to behave in fiscally responsible ways, especially with regard to the use of public debt. This is an important problem in all of the cases under study (Inter-American Development Bank 1998).

Intertemporal Fiscal Behavior. Both Keynesian and neoclassical macroeconomic models recommend counter-cyclical fiscal policy, to help to smooth out business-cycle fluctuations. Empirical studies for OECD countries have found a behavior roughly consistent with these recommendations. Most Latin American countries seem to "suffer" from procyclical fiscal policy, magnifying aggregate economic fluctuations (Gavin and Hausmann 1997, Talvi and Vegh 1997).

Some authors have argued that this is related to the behavior of multiple fiscal authorities in decentralized settings. According to Diaz, Gamboa, and Hernandez (1999) decentralized decisions by the SNGs' authorities have also amplified the pro-cyclical effect of fiscal policy in Mexico. In the case of Argentina, we have found evidence that fiscal behavior at the provincial level is highly procyclical and that this is, in part, caused by the tax-sharing system. In Saiegh and Tommasi (1998) we provide some evidence showing that the rates of growth of GDP and of aggregate

provincial spending in Argentina for the last 10 years are highly correlated, with provincial spending over-responding to the fluctuations in output. Also, the instability of coparticipation funds seems to have induced fluctuations in government consumption and a lack of predictability, which, in any sensible intertemporal model of the economy, produces welfare losses.

Difficulties for Macroeconomic Adjustment. Many authors have argued that the tax-sharing system makes fiscal adjustment much harder to attain. Recent evidence is provided by stabilization efforts during the Alfonsín administration (Aizenman 1998), and during the Convertibility Plan (Schwartz and Liuksila, 1997).

In both instances, faced with the need to correct large macroeconomic imbalances, the federal government introduced major tax, spending, and administrative reforms that succeeded in raising the ratio of taxes to GDP. Through these efforts at the federal level, provinces received an automatic revenue windfall via the various revenue-transfer mechanisms. The financial problems the provinces experienced during the 1995 recession (after the Mexican crisis) reflected difficulties in cutting back expenditures in line with reduced transfers, particularly from coparticipation.

Inefficiencies Induced in the Fiscal Mix. The fact that some taxes are shared and others are not has induced the federal government to make some inefficient decisions. As Tanzi (1996) has suggested, this leads to situations where non-shared taxes acquire greater weight in the tax system, even when they are less efficient.

In the case of Argentina, at the national level, payroll taxes are too high, especially for a country suffering very high unemployment. At the provincial level, there is an excessive reliance on the turnover tax. While the provincial turnover tax constitutes the largest source of the provinces' own tax revenue, it is a cascading tax, constitutes a drag on enterprise costs, benefits imports over domestic products and increases the cost of exports, has a tax base that overlaps with the federal VAT, and makes it difficult to audit interprovincial transactions.

Also, when fiscal adjustment is necessary, the "optimal response" tends to include a mix of increased taxation and spending cuts. Given that the increase in taxes is partially dampened by transferring 50 percent of them to the provinces, this biases the federal government toward "excessive spending cuts." Similarly, at times this has

prompted the federal government to raise import-related revenues.

Poor Tax Compliance. There are problems of tax compliance with respect to both national and local taxes. In the case of Argentina, compliance with the nationally collected VAT was estimated to be 34 percent in 1989 and 55 percent in 1994, while neighboring countries like Chile (80 percent) and Uruguay (70 percent) have much better compliance rates (Crotty and dos Santos 1996).

This is not strictly a consequence of the tax-sharing system, but there are reasons to believe that the current regime provides no incentive for provincial authorities to collaborate in the enforcement of the collection of the most important shared national taxes. This is the common-pool problem again: Why pay the political cost of using local police to close down businesses that fail to pay taxes if there is no connection whatsoever between how much is collected and how much is received by each province out of national taxes?

There are also problems associated with the tax efforts at the local level. In the case of Brazil it is interesting to see what happens at the municipal level. Given the transfers received through the *Fundo de Participação dos Municípios*, many municipalities that have a tax base do not even bother to utilize it fully, preferring to depend more heavily on federal and states transfers. According to Selcher (1998), as of 1995, 54 percent of municipalities in Brazil did not raise enough revenue within their own borders to "cover even the administrative expenses of the mayor's office and the municipal council," whereas in 1,965 of the poorest municipalities no federal taxes were collected at all.

Irregular Provision of Public Goods. Part of the proceeds of several specific taxes are earmarked to finance several specific services. In practice, the provision of those services fluctuates along with those taxes, instead of following actual demand.

Lack of Achievement of Fairness of Redistributive Outcomes. In all these countries, the development of revenue-sharing mechanisms and intergovernmental transfers has been intimately related to redistributive efforts. However, many analysts argue that "genuine" redistribution toward the poorer regions has been mixed with other redistributive ventures, favoring politically powerful actors, whether they are needy or not.

For instance, Porto and Sanguinetti (1996) show that in Argentina, even though on average redistribution has

avored poorer regions, some richer provinces have benefited more than some poorer ones, and even among poor provinces, the redistributions do not follow any reasonable indicator of fiscal need. There is also the suspicion among observers and political actors that the true impact on the personal distribution of income does not follow the regional distributive pattern—that redistribution favors the richer citizens of the poorer provinces (FIEL 1993). One example of that is Argentina's "industrial promotion" (i.e., tax breaks for businesses in poor provinces). Another suspect is the "national housing fund" (FONAVI), which does not reach the very poor and has evolved into a mechanism for subsidizing middle-class housing (Schwartz and Liuksila 1997).

With respect to Brazil, according to Ter-Minassian (1997: 450), a quantitative assessment of the redistributive impact of block and special grants across and within states is extremely complex. However, as she points out, available studies suggest that such programs have been sporadic over time and not clearly related to the level of development of the states.

Lack of Achievement of Interjurisdictional Risk-Sharing. Other than redistributing resources in an ex ante sense as emphasized in the point above, one might expect an intergovernmental transfer system to provide cross-sectional insurance against shocks to local tax bases.

In Nicolini, Sanguinetti, and Tommasi (1999) we compute the optimal risk-sharing level of transfers for Argentina from 1985 to 1997, and we measure the deviation of actual transfers from that norm. The implementation of an optimal risk-sharing scheme in Argentina would have been equivalent, in welfare terms, to a permanent increase of 3 percent in the public spending of all jurisdictions.

Lack of Incentives to Produce Information. This refers to the existence of very weak or even perverse incentives to produce information. In Argentina, for example, there is a clear sense among political leaders that the existing coparticipation regime rewards inefficiency through some sort of "ratchet effect," by which provinces that behave with austerly today are penalized with reduced funds next round (Palanza and Sin-Silva, 1998). Hence, there is little incentive, at the level of one individual provincial government to spend the effort and the resources necessary to provide better information about the costs and technologies for satisfying the different public needs in that province.

In the case of Colombia, there are also informational problems related to the data that is used to determine the amount of territorial transfers. In the case of population data, the lack of up-to-date information and the use of old censuses to estimate the transfer level has favored static areas or areas with a declining population and penalized those areas—including the big cities—experiencing massive inflows of new migrants (Ahmad and Baer 1997).

Misallocation of Time and Managerial Effort. In many cases the dynamics of the “intergovernmental fiscal game” provides incentives to political participants to spend most of their effort and ingenuity trying to alter the redistributive mechanism in their favor. As Diaz, Gamboa, and Hernandez (1999: 4) point out, in Mexico state governors and finance ministers have traditionally spent an important part of their time lobbying in the center in order to obtain resources, via federal public investment or via extraordinary transfers. Similarly, it is commonplace in Argentina for governors and other local officials to spend more time in Buenos Aires lobbying for redistribution than in their own provinces generating, implementing, and monitoring adequate public policies (this is related to the poor information incentives described above).

Complexity. Another problem with intergovernmental transfer systems is that they become more complex. They develop interdependent networks of different shared taxes and of expenditure functions and decision-making bodies, and it is impossible for voters and taxpayers to identify which government spends or taxes and for what purposes. This breaks the benefit-tax link that is essential for enhancing efficiency in the provision of public goods, at the same time that magnifies the problem of exploitation of the common pool.

III. Transaction Costs and Policy-Making

Revenue-sharing mechanisms and intergovernmental transfer systems are the result of bargaining processes in which numerous political actors with different interests are involved—presidents, legislators, subnational politicians. In addition, the “day-to-day” management of policy involves ongoing negotiations. This might give some actors the opportunity to, at least partially, modify the decisions that were made in the original bargain.

Decisions have to be made almost continuously, due to changes

1. In the stochastic environment (say, economic shocks), or
2. In public policies chosen due to changes in underlying “preferences,” or even
3. In the balance of power across political actors.

Examples of (1) would be an international economic shock, which substantially reduces economic activity, and hence tax bases, or the elimination of an external threat, which was the reason for a high demand for nationally provided military spending.¹¹ Examples of (2) would be an increase in the demand for mostly provincially provided police protection, or a decision to increase the minimal levels of provincially provided schooling. Finally, an example of (3) would be a mid-term congressional election, simultaneous with gubernatorial elections. This may produce an important change in the balance of power, increasing the congressional representation and the number of provinces under the control of the opposition party—hence increasing the relative bargaining power of some provincial actors.

Each of these “decision moments” can be analyzed as a transaction among political actors that is going to affect the welfare of economic actors in the different jurisdictions and the “political welfare” of the transactors.

In Part A of this section we provide some examples of the actual political negotiations involved around some of those decision points—whether or not they resulted in a policy (or rule) change. In Part B we attempt to characterize the general nature of the transactions involved.¹²

A. Some Examples

1. Tax Assignment and Tax Mix

The most salient characteristic—and defect—of the Argentine federal fiscal system is the lack of fiscal correspondence faced by all provincial jurisdictions. Scholars and policy-makers agree on the need to “decentralize taxes,” while eliminating several distorting provincial taxes and replacing them with the tax bases decentralized from national control.¹³

The timid attempts at implementing such decentralization face fierce opposition from most provincial governments—the opposite from what one would expect, and from what happens in other countries (see Painter 1998 for the Australian case). This attitude, which is perfectly understandable in light of prior experiences, reflects the nonexistence of adequate mechanisms to calculate compen-

sations and enforce the deals necessary to instrument such a reform. Every actor fears losing what it now has; the new system has only uncertain payoffs. (There is also an element of "hold-up" as provinces refuse to approve a beneficial social change in the hope of receiving an extra payment for their vote.)

The "Fiscal Pacts" of 1992 and 1993 constructed a schedule for the gradual elimination and replacement of the inefficient turnover tax, but it has not been implemented due to uneven compliance across provinces and some unfulfilled promises by the federal government. The following description of the second Fiscal Pact by Schwartz and Liuksila (1997: 408-412) is particularly telling:¹⁴

Tax reform was clearly the centerpiece of the second fiscal pact. Provinces adhering to the pact committed themselves to eliminating stamp taxes on checking accounts, taxes on the transfer of fuel, gas and electricity and, most important, phasing out the provincial turnover tax. ...

Initially, the provinces were slow to join this second pact, largely because of the revenue implications of the tax reforms, particularly the initial stipulation to abolish the provincial turnover tax before June 1995. While the provinces were free to replace the turnover tax with other taxes, many have not yet done so. ...

Overall, there is no easy short-term alternative for replacing the provincial turnover tax. ...

Other alternatives for improving provincial revenue would be beneficial in the long run, but would not yield short-term results. ... Similarly, improving real state taxation would require substantial initial efforts, including, for example, improving property mapping and property registries; providing better and more consistent application of valuation techniques; improving the exchange of information between local tax offices, property registries. ...

The announcement in December 1993 that federal payroll taxes levied on employers would be reduced, depending on region and sector, in those provinces participating in the second pact increased pressure on provincial governments to join. By May 1994, all but one provincial legislature had ratified the second fiscal pact, and most had taken at least some initial

steps toward implementation. Also the provinces were given a minimum revenue guarantee and some other guaranteed fixed payments that provided a floor of federal transfers equivalent to about 4.5 percent of GDP annually.

The second fiscal pact clearly shows the "horse-trading" that is involved in implementing structural reforms of the system of fiscal federalism, ... but came at the expense of making payroll taxes an explicit instrument of regional and sectoral policies, and contributed to the growing social security deficit.

2. *Tax-Sharing Related Obstacles for Economic Policy*

In 1998 the National Executive in Argentina attempted to introduce a tax reform to lower the non-shared inefficient labor taxes at a time of high unemployment, and to raise shared taxes.¹⁵

To compensate, it requested some amount to be pre-participated to the national government. The provinces resisted this complementary clause (in part because of disagreements about the estimates of the revenue potential of the increase in the rates of shared taxes that it would produce). This reflects the incapacity to come up with more complete contracts, contingent on the actual produce of the tax changes, at the same time that it highlights some rigidities we want to emphasize.¹⁶

A similar dynamic can be found in Brazil. Consider the episode around the Kandir Law described by Selcher (1998: 14):

In September 1996, the federal government considerably reduced states' revenues (and the funds they transferred to the local level) when it exempted from payment of the ICMS [the tax on circulation of merchandise and services] all primary and semimanufactured products headed for export, as well as capital goods that companies used to upgrade their operations. The purpose was to promote exports and increase national competitiveness, so Brasilia promised payment of a partial compensation to states and municipalities for the losses suffered from this so-called Kandir Law. Delay in reimbursement, however, added one more dimension to the struggles in the federal system.

3. *Bailouts*

As Dillinger and Webb (1998) point out, state deficits in Brazil were often out of control in the 1980s, contribut-

ing to the country's overall macroeconomic problems. Hence, as part of the stabilization efforts, the federal government in Brazil has sought to bring subnational spending and borrowing under control throughout the 1990s.

In particular, the Cardoso administration wanted to find a solution to the growing stock of state debt after the success of the Plano Real stabilization plan. However, even though a lot of political will was devoted to this endeavor, the results were quite disappointing.

Dillinger and Webb (1998: 25-26) provide a very good description of the problems faced by the Brazilian political actors around this issue:

Negotiations with individual states began in mid-1995. There were three parties to the negotiations. The first was the federal government, because any debt refinancing required an act of legislation. Although the large debtor states accounted for nearly half of the population of Brazil (47 percent), their representation in congress was much less. With three senators per state, the big debtor states held only 15 percent of seats in the Senate. In the Chamber of Deputies, due to constitutional minimum and maximum of seats per state, the debtor states held only 39 percent of seats. ...

The second party to the negotiations was the president and his economic team. In principle they were the one constituency with a clear interest in bringing state debt under control. ... But the president himself was constrained. He was constrained, first, by the weakness of party discipline in Brazil, which meant that he could not compel support from his coalition partners in congress. He was constrained further by the number of competing items on the legislative agenda. In addition to debt workouts, President Cardoso sought constitutional reforms that were critical to sustaining his victory over inflation. ...

The third party consisted of the individual states themselves, as represented by their governors. The debtor states were comfortable with the status quo and resolutely opposed to any agreement that would require them to resume servicing their debt, at least during the current administration. ...

At the outset there was some expectation (particularly at the World Bank) that a Brady-style agree-

ment might be reached. Under such an approach, each state would commit itself to internal fiscal reforms. ... [However,] the debtor states ... were disinclined to undertake any internal fiscal adjustment and saw no reason to raise taxes or cut expenditures simply to begin servicing debt on which they were currently paying nothing. Not surprisingly, negotiations proceeded intermittently, and the stock of debt continued to grow. A set of agreements-in-principle signed between September 1996 and January 1997 did not yield binding contracts.

4. *The Decentralization of Health and Education*

The policy of devolving spending from federal to subnational levels of government is a good example of a coordinated effort between the different levels of government that can improve public-sector efficiency. In theory, the devolution of expenditure responsibilities to the SNGs in areas such as health and education need not affect their financing: The federal level could continue to provide financing via transfers. However, this is not what has happened in practice with decentralization processes in Argentina and Brazil.

In the case of Brazil, decentralization enhanced the SNGs' revenues, whereas in Argentina the devolution of responsibilities to the SNGs was not accompanied by sufficient additional resources to undertake the new responsibilities. This was the result of the way in which the decentralization took place. For example, in Brazil fiscal decentralization mandated by the 1988 Constitution proceeded apace, shifting tax bases, revenues and block transfers to SNGs. However, as Selcher notes, the constitution assigned relatively few functions exclusively to each level of government, and overlapping, concurrent, or exclusive competencies were not subsequently defined in law or ironed out through intergovernmental consultations or planning. Thus, Brasilia politicians believe that this lack of clarity in the assignment of spending responsibilities has given the states and municipalities more funds than tasks, while the federal government suffered the reverse (Selcher 1998; Ter-Minassian 1997).

Conversely, the decentralization of some health and education services in Argentina in the 1990s can be interpreted as the opposite phenomenon: The expenditure responsibilities were devolved to the SNGs without providing full financing for the transfer of responsibilities (Schwartz and Liuksila 1997: 396). In this case, the reason

was that the national government, instead of pursuing a more rational reformulation of the tax-sharing regime, saw decentralization as a way of transferring spending responsibilities, without an equivalent tax compensation, to the provinces at a point when it had the political maneuvering room for that change.

As a result, instead of being an efficiency-enhancing change, decentralization produced a series of undesirable outcomes. First, as Schwartz and Liuksila point out:

To face the increased expenditure responsibilities, subnational governments resorted, among other things, to financing from provincial banks or commercial banks (often collateralized by future receipts from revenue-sharing agreements), or issued IOUs in lieu of paying wages; provinces also received discretionary aid from the central government in the form of loans and grants.

More recently, the effects of decentralization have also negatively affected the national government's behavior. Since teachers' unions continued to act nationally, the national government was forced to establish an inefficient national tax to finance an increase in teachers' salaries—which, is of course, totally unrelated to teacher performance, is uniform across provinces, etc.

5. *The Negotiation of a Tax-Sharing Law (Argentina, Law 23.548, 1988: The Extant Regime)*

In Argentina, the distribution of shared revenues between the federal and subnational governments and among the SNGs is mandated by Law 23.548. Although the law was passed in 1988, it was the result of a negotiation process that started four years before, when the previous regime, dating from 1973, was going to expire.

Although studies and negotiations began in 1984, a new accord could not be reached, which led to the definitive expiration of the 1973 regime. Therefore, 1985 was characterized by the absence of a legal regime for "coparticipating" tax revenue between the federal and provincial levels, and all transfers to the provinces were channeled under the form of discretionary funds called National Treasury Contributions (ATNs). In practice, as Schwartz and Liuksila note, each province "negotiated *bilateral* agreements with the federal government" (1997: 401, emphasis added).¹⁷ Nonetheless, the provinces and the federal government sought the enactment of a definitive norm, and

during that year began a series of negotiations that led to a transitory financial agreement for 1986. This agreement was signed on March 13, 1986, and established the coparticipation shares for that year on the basis of the 1985 period, altering the allocation criteria of the 1973 Law and benefiting the poorer provinces.

At the same time, the macroeconomy was in a critical state. This had two direct consequences: On the one hand, the president's party, the UCR, suffered an important defeat to the Peronists in congressional and gubernatorial elections. The Peronist Party staged an impressive political comeback in Congress and took control of 17 of 22 provincial governorships, including Buenos Aires. On the other hand, the national government's need to implement economic adjustments was compelling, which forced it to enter into negotiations for the approval of a tax-reform bill. But as we argued before, the new composition of Congress made the prospects for approval of the tax-reform bill not good. So in order to get it, the UCR had to negotiate with other forces, specifically the Peronists. It was in this context that the negotiations for the new coparticipation law came up.

The Peronist governors, as a block, tried to obtain the most they could in exchange for their necessary support. On the one hand, each one tried to obtain relative improvements for his or her own province. On the other hand, they wanted to get enough funds to meet financial difficulties until the new taxes started to be collected. In the last stage of negotiation of the law, even the unions got into the debate. Given their political representation in Congress within the Peronist Party, union leaders conditioned their support for the tax reform on the passage of a series of laws related to labor.¹⁸ Finally, both tax-reform and coparticipation bills were approved.

The coparticipation law, N° 23.548 was passed on January 7, 1988. It stipulated that 56.66 percent of coparticipated revenue accrue directly to the provinces, with an additional 1 percent allocated for distribution to them in the form of ATNs, while the remaining 42.34 percent was retained by the central government. With respect to the secondary distribution, instead of adopting any kind of objective criteria to calculate each province's share of the coparticipated funds, the law tended to validate the share that each province had obtained in the 1985-1987 period through a quantitative coefficient that constituted a sort of "magic number." As Porto (1990) notes, the adoption of

such “numbers” has no explanation whatsoever in the law or in the parliamentary debate.

B. Transactional Problems Associated with Intergovernmental Bargaining

What these examples are trying to illustrate is how some structural characteristics of the decision-making processes affect the way in which transactions among the different political actors are conducted. It seems that the relevant political actors (1) may overlook economically efficient policies; (2) may not be able to block the adoption of inefficient policies; (3) may alter resource allocations in the long run in exchange for short-run gains.

In order to understand why some transactions are made while some others are not, we need to study the potential transacting problems faced by policy-makers, given the types of trades they seek to make. Although we will refer to them separately it should be noted that in reality these problems often interact with each other.

Efficiency Gains. It seems that given the bargaining costs, in terms of the opportunity cost of bargainers’ time and the costs of monitoring and enforcing intergovernmental fiscal agreements, the absolute size of the efficiency gains should be considerably large for a good trade to happen. This means that sometimes, even if there are positive gains from exchange, if these are relatively small, some trades might go un consummated. The case of the decentralization of taxes in Argentina shows clearly that even though there were efficiency gains to be achieved, because of the transaction costs, some reforms were not implemented and some others were even reversed.

Compensation. It is commonly argued that efficiency-enhancing changes can be enacted not only if they maximize the aggregate welfare of all the affected parties, but also if there is proper compensation for those adversely affected by them. However, making those compensations is not an easy task. The 1998 tax reform in Argentina and the Kandir Law episode in Brazil presented above constitute very good illustrations. Given a collectively decided policy, the more heterogeneous the differential payoffs for each individual relevant political actor, the more difficult it will be to make such compensations.

Noncontemporaneous Benefit Flows. As Weingast and Marshall (1988) point out, differential patterns of benefit flows potentially inhibit political trades. Political actors usually discount the potential gains from a proposed trade

by the probability that the benefit flows will be curtailed because of renegeing on the part of the other party. Hence, if there are no commitment mechanisms against renegeing on the agreements, some transactions will not take place. As it was shown above, the difficulties associated with decentralizing taxes and expenditure responsibilities have this structure: Many times the SNGs fear that once an agreement is reached, the federal government will not stick to the deal in the future by retaining some of the revenue that was bargained over; or that other SNGs will not undertake adequate reform efforts and will end up being “bailed out” in a perverse Ratchet effect.

Uncertainty and Risk. In addition to the previous problem, the more uncertain the pattern of benefit (or costs) flows, the more certain the compensation that is going to be demanded by the contracting parties to assume its associated risks. This also makes agreements more difficult or too costly to achieve. The risk is not only due to the realization of unpredictable economic outcomes, but also to the political risk of future appropriations.

A good illustration of those problem is the adoption of very deficient commitment devices, like the aforementioned “coparticipation floors” established by the Argentine fiscal pacts or the “magic coefficients” of the 1988 coparticipation regime. Similarly, the fact that some specific expenditures are tied to economically unrelated specific taxes, reflects the political preference for insuring some sources of funding away from the “standard” appropriation process.

Complexity and Information. On top of the problems associated with the time dimension of political transactions emphasized above, we also want to stress here the cognitive difficulties involved in the policy-making process. In order to achieve “Coasian” bargains, policy-makers must know the connection between the policies they adopt and the effects they desire. Still, political actors do not choose policy outcomes, but rather policies whose effects are, usually, uncertain and realized over time (Cukierman and Tommasi 1998). As North (1990b: 356) suggests, those who participate in politics frequently use erroneous models of the world to guide their actions, and the information feedback they receive is usually not sufficient to cause them to revise their initially incorrect theories. Moreover, ideologies underlie the subjective models these actors have to explain the world around them. Some of the features included in the Argentine coparticipation

history, like the goal of developing under-populated areas or the industrial promotion schemes, can be interpreted along these lines.

Agency Problems. Although throughout this paper we have treated the different political jurisdictions as if they were unified political actors, this is certainly not the case. Agency problems are pervasive in this type of settings. Specifically, one of the reasons why potentially beneficial transactions might not be undertaken is related to the distribution of benefits and costs associated with them. In many cases what constitute a benefit (or cost) for the citizens of the different jurisdiction does not necessarily match with those of their rulers. Hence, agency problems and imperfect voter information are at the crux of the transaction costs that we emphasize.

IV. An "Incomplete-Contracts" Approach to Intergovernmental Fiscal Relations

The questions to be addressed, thus, is: Why are intergovernmental fiscal relations plagued by the problems summarized above? In this section we intend to provide an answer following what Qian and Weingast (1997: 84) have dubbed "the second generation economic theory of federalism," an approach that is very much influenced by advances in the new theory of the firm. In particular, we analyze intergovernmental fiscal relations using the analogy of incomplete contracts.¹⁹

Contracts are complete when every provision that is or *will* be relevant to a transaction can be written down and bargained over by contracting parties. Hence, once the contract is signed, all that remains is a mechanical unfolding of its provisions over time. This means that every possible eventuality is knowable, and so contractual obligations can be made contingent on future events. In reality it is usually very difficult to frame intergovernmental fiscal agreements in such a way. Mainly, because future contingencies cannot be described contractually today, so that changes in the economy or the polity may make current long-term contracts meaningless.

Therefore, in framing agreements that call for the future collection/transfer of fiscal revenues, both the central and subnational governments will have incentives to try to keep a free hand rather than abide by a rule that sometime in the future might be inappropriate. As a result of this incompleteness, intergovernmental fiscal relations will always be under negotiation, as parties to the original

agreement will be continuously adjusting their actions in response to changing circumstances. The problem with this continuous bargaining process resides in the transaction costs associated with it.

We have already mentioned that transactions among politicians at different levels of government are particularly costly because of time-consistency problems, incomplete and asymmetric information, and enforcement issues. Moreover, as the examples presented above show, sometimes those costs are so high as to prevent Pareto-improving bargains to take place.

Unfortunately, there is no easy way to solve these problems. However, the referred literature on the theory of the firm might be helpful in giving us some useful insights. This literature posits that the key to reduce some of these transaction costs lie primarily in the **governance structure** that frames the relationship when circumstances not foreseen in the contract arise. This governance structure should be one that fixes general performance expectations, provides procedures to govern decision-making in situations where the contract is not explicit, and outlines how to adjudicate disputes when they arise (Milgrom and Roberts 1990: 62). That is, it should be an "institution" whose role is to ensure that the instructions that have been included in the intergovernmental transfer scheme are fulfilled and with the authority to fill in the details when unforeseen contingencies occur is needed. In the case of the theory of the firm, the party that has the right to determine how assets will be used when a gap in the contract is reached is precisely the firm (Kreps 1992). However, in the case of intergovernmental fiscal relations, especially in federal countries, it is not very clear who will play such role.

In the case of Argentina, in practice, the federal government, often in alliance with one or several provincial governments, tends to be the governance structure used to adjust the contract to economic and political changes—even though it is not constitutionally endowed with such authority.²⁰

From a theoretical point of view, several authors have argued that in the "game" across provinces, the national government is a potentially efficient institution onto which they can delegate powers as a way of solving some of their collective-action problems. For example, Sanguinetti (1994) presents a model motivated by the Argentine experience, in which there are a number of local governments

and a central government engaged in deciding their respective spending levels, to be financed out of national taxation. He analyzes three regimes: cooperative, non-cooperative, and “commitment.” In the “commitment” regime, the national government is a Stackelberg leader who sets the tax rate before the simultaneous spending choices of all players. This regime leads to welfare outcomes superior to the non-cooperative case, although inferior to the cooperative one.

However, in reality, the intergovernmental transfers “game” is far more complicated, because the player “central government” is not just a “benevolent central planner” but also a self-interested opportunistic actor. The following dilemma, thus, arises: A federal government with sufficient power to enforce and complete the contract also has the power to alter it in its favor. Hence, for the SNGs to grant the central government the authority to complete the contracts, they must believe that it will be used fairly. Note that the source of this faith will be the incentives that the federal government possesses. Nonetheless, being an actor with its own interests, the federal government faces serious credibility problems.

The potential federal abuse of discretionary authority is a political equivalent of, again, a problem identified in the transaction-cost economics literature: the hold-up problem. Given the federal government agencies’ inability to commit to a future course of action, potentially valuable transactions between provincial and national leaders may never take place. This is magnified by the fact that oftentimes, the federal government can “move” faster than the provinces due to their collective action problems.

These problems also showed up during the recent economic adjustment efforts in Brazil. In order to achieve macroeconomic stabilization, Congress established in February 1994 the Fiscal Stabilization Fund (which eventually became the Social Emergency Fund). This Fund was used by the Cardoso government to impound or divert funds destined for the states and municipalities—even constitutionally mandated transfers—for the sake of “emergency” fiscal stabilization. As Selcher (1998: 13) points out, this measure made SNGs leery of any federal scheme that allows Brasilia discretion over when and how to release money due them. Hence, as it will be argued in the following section, a governance structure different from the federal government is needed.

V. Some Preliminary Ideas on Institutional Engineering

There is almost absolute consensus among observers that the countries studied in this paper should undertake various reforms to their intergovernmental fiscal relations. In fact, major lending organizations and other specialists have produced many reform proposals seeking to improve government efficiency, to redefine the role of the lower levels of government, and to improve intergovernmental transfer systems. However, these “recipes for change,” even though they might entail important benefits, are seldom followed. As we argued throughout this paper, even if there are efficiency gains, problems of asymmetric information and of intertemporal enforcement make the reforms difficult to enact. We believe, therefore, that the reform strategy should focus at a higher level of institutional design, exploring the possibility of establishing governance structures capable of minimizing the transaction costs involved in intergovernmental negotiations.

Among other things, this would involve a trade-off between **rules** and **flexibility**. That is, the reform should create a stable framework that will make it possible to avoid costly ruptures and discontinuities. This should forestall the creation of a propitious atmosphere so that the involved actors can make decisions in a foreseeable setting, and concentrate on managerial efforts instead of absorbing themselves in the process of continuously bidding for resources. On the other hand, it would also be commendable to provide an institutional arrangement that will allow for the introduction of improvements and have the capacity to adjust to changing circumstances. In sum, the reform should focus on the creation of an enduring legal framework with the necessary flexibility to adapt itself to:

1. Changes in the economic and social structure of a country, and also in the public policies chosen by the elected politicians.
2. Scientific, technical and informational advances that would allow an improvement in the provision of the public services.

A “governance structure” of this sort, at the same time will allow politicians at different levels of government to deal with ongoing problems as they arise and yet provide a

degree of durability to the whole intergovernmental transfer system.

Nonetheless, it is worth reflecting on the convenience of introducing flexibility in this way or in another form, such as with a legal framework with a predetermined duration that should be replaced in turn by another institutional arrangement. The Argentine historical experience indicates that the latter could lead to a series of partial solutions (often inconsistent with each other) and incessant conflicts—and actually to the very same problems we are trying to leave behind. From a social choice perspective, such institutional “flexibility” can lead to very volatile outcomes, because the size of the set of points that can defeat the status quo is usually quite large.

Some work in progress with respect to the Argentine case is summarized in Iaryczower, Saiegh, and Tommasi (1998). In this section we present a brief sketch of some of the suggestions included there. Even though this refers exclusively to the Argentine case, we believe that some of the principles might be generalized into a more comprehensive proposal. Of course, the details on how to improve governance structures will vary from country to country—and so would the likelihood of implementing such changes.

The Argentine Constitution of 1994 calls for a new tax-sharing regime. It requires that it be approved as a “Ley Convenio,” a mechanism that, in practice, approximates the need for a unanimous consent by all the provinces; it stipulates some guiding principles that the regime should follow; and it mandates the creation of a “Federal Fiscal Institution” to be in charge of controlling the regime.²¹

The positions of most economists with respect to this new regime tend to lean on what we might call a “rules” approach, drawing from the well-known discussion on “rules versus discretion.” They call for a new law that would stipulate a series of “rules,” such as increasing fiscal correspondence and tax compliance by decentralizing several taxes and imposing credit ceilings on the indebtedness of provincial governments and, in some versions, also of the federal government.

As is well-known, adequate rules have the advantage of correcting underlying biases—in the paradigmatic application, time-inconsistency biases, but in this case an interaction of time-inconsistency with other collective-choice problems. The problem, of course, is their rigidity and subsequent failure to accommodate a reality, which is in a

continuous state of flux (as reflected in the Argentine case by the numerous modifications, many of them by “outside channels” to the extant 1988 law).

Our own proposal, taking advantage of the window of opportunity provided by the constitutional mandate, is to reform the structure and process of intergovernmental decision-making on fiscal matters. The reason is that, as the problems identified in Section II.B. suggest, an appropriate reform should also address the dynamic dimension of the politico-institutional game around these issues. Hence, any feasible and sustainable improvement requires the establishment of a procedure to cope with unforeseen contingencies; otherwise, the “monsters lurking behind” will keep reappearing.

In the specific case of Argentina, we think that the new “design” has to:

- Strengthen federalism by bringing many decisions that today are at the discretion of the national government, into an explicitly intergovernmental decision mechanism.²²
- Bring inside the collective decision process a number of choices that in the past have been dealt with through “lateral” channels.²³
- Attempt to solve some of the collective action problems by *delegation* in the spirit of the delegation of monetary authority to the Central Bank and of regulatory authority to independent regulatory agencies.
- Reduce the chance that viable policies are overlooked, either because they are not considered or because information on their viability is misleading.
- Ensure the enforcement of political agreements.

More specifically (and hence more preliminarily):

- We suggest a “Federal Fiscal Institution” organized in a manner somewhat similar to the Australian Commonwealth Grants Commission. It will be composed of a highly qualified and well-equipped Technical Commission with technical capabilities comparable to those of the Central Bank and of the Ministry of Finance; and a Council of Ministers (Federal Fiscal Assembly—FFA) with political representation from the national government and each of the provincial governments.²⁴
- The Technical Commission will be in charge of generating the studies and information, on the basis of which decisions will be made by the FFA. These studies may include the data necessary to adjust the

distribution of revenue as a function of sharing-formulas previously decided (if indeed, formulas are used), as well as suggestions for changing those formulas in light of changes in other parts of the system (say a new Tax Law by Congress), in order to maintain the spirit of the original agreement

- The *political property rights* of the different jurisdictions will be respected by appropriate voting mechanisms in the FFA. In an extreme pessimistic scenario one can imagine a unanimity rule for every single issue. In that case most proposals will be defeated (what is equivalent to the “rules forever” solution) and a few Pareto-improving ones will be approved. Hopefully the Technical Commission would be able to present bundles of proposed reforms that might generate Pareto improvements. Less pessimistically, one can imagine softer majority requirements so that each jurisdiction, even though it may lose from a decision at some particular point, expects to gain from the mechanism on average.

Our research is still preliminary. Further work is needed in order to establish who should be the “first mover” in each one of the types of situations that might arise, and to study in more depth the “game” that would unfold after the players make their respective proposals. Ideally, and after conducting an in-depth analysis, we would like to provide some recommendations with respect to voting rules and procedures in the FFA, the most desirable sequence of moves, etc.

In any case, the main idea that is guiding these preliminary thoughts on institutional engineering is that under a federal fiscal institution with these characteristics, political actors will delegate the technical aspects to a technical committee—taking advantage of its expertise and conserving on scarce resources of time, staff, and energy—and at the same time there will be an institutionalized context for political bargaining over fiscal matters.

VI. Conclusions

The aim of this paper was to analyze the main factors behind some of the deficiencies present in the intergovernmental transfer systems of Argentina, Brazil, Colombia, and Mexico.

We have argued that the reason these country’s political leaders do not move toward more efficient outcomes is mainly the absence of an adequate governance structure to

overcome problems of time-inconsistency, asymmetric information, and other special forms of transaction costs.

Using the analogy of incomplete contracts, first we summarized the consequences of this incompleteness for intergovernmental fiscal relations. As part of this analysis we suggested why the federal government does not constitute the most appropriate governance structure to solve some of the problems associated with such incompleteness. Second, we explored which governance structure would be the most adequate one.

We claimed that a proper reform strategy of intergovernmental transfers systems in these countries should focus at the level of institutional design. More specifically, we explored the possibility of establishing governance structures capable of minimizing the transaction costs involved in intergovernmental negotiations.

Having said this, a caveat and a call for further research should be made. The approach used in this paper emphasizes the study of the historical evolution of the institutional structures that affect fiscal outcomes. In writing this paper, we relied heavily on our knowledge of the historical process for the Argentine case. We believe that a detailed study of each country’s fiscal institutions—identifying not only its current structure but also the underlying process of institution-building that historically took place—will help to improve our understanding of the dynamics of intergovernmental fiscal relations and will enable us to generate more sound recommendations for possible reforms.

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Endnotes

1. The pioneer application of the "transaction-cost" logic to study the policy-making process is North (1990b). It is worth noting, though, that "transaction costs" do not provide a single analytical framework, but only a loose conceptual background for organizing many analytical models (see also Dixit 1996 and Epstein and O'Halloran 1997).
2. Some of the most important work in modern political economy has tended to move swiftly from general theoretical discussion to fiscal applications. Inman (1987) provides an excellent survey and overview of this "general-fiscal" political economy literature.
3. This regime defines the share of specified taxes to be transferred from the central government to the provinces ("primary distribution") and the way in which these funds are to be allocated among the provinces ("secondary distribution").
4. In practice, the remaining 1 percent, called National Treasury Contributions (ATNs) are distributed in a discretionary way by the National Executive, through the Ministry of the Interior (the "political" ministry *par excellence*).
5. It is worth mentioning that the secondary distribution among the provinces established in the 1988 regime fixed by law the outcome of the bargaining process between the provinces and the federal government in the 1985–1988 period.
6. According to Kraemer, more than 3,000 of these convenios existed in 1988 alone, accounting for almost half of the transfers not

mandated by constitutional tax sharing imperatives; whereas in the 1990s, they represented about a fifth of total transfers (1997: 38).

7. The president could still suspend or remove elected governors for reasons specified by law (Willis, Garman, and Haggard 1999: 34).

8. This "laundry list" is an idiosyncratic summary of a large literature on the Argentine case. Yet many of the items in the list seem to be present in other cases, too; see, for instance, Inter-American Development Bank (1997).

9. Excluding the pension system, provincial plus municipal spending in 1997 was twice as large as spending by the federal government (Piffano 1998).

10. The simple average is just 23 percent, the difference being explained by the fact that the larger provinces (like Buenos Aires) tend to have smaller imbalances.

11. An extreme example of the opposite sign would be a nationally conducted war.

12. Most of the examples, as well as the rest of the paper, focus on Argentina.

13. There is more disagreement about the details of such decentralization.

14. One of the centerpieces of the first Fiscal Pact was the agreement that 15 percent of all coparticipated tax revenue would be transferred to the social security system in a pre-coparticipation arrangement, implying a "gain" for the national government because social security is part of the national public sector.

15. After substantial negotiations and modifications the law has been passed, although there are still several attempts at changing and partially reversing it.

16. It also seems that tax-sharing schemes might induce the federal government to make some inefficient decisions in the choice of taxes (Tanzi 1996). In the case of Brazil, "some federal sources of revenue are subject to sharing with subnational governments, while others are not. This has led to undue reliance of the federal government on these latter sources, which tend to have substantial efficiency costs (for example, contributions on salaries or on enterprise turnover, or taxes on financial transactions)..." (Ter-Minassian 1997: 450).

17. According to Sanguinetti (1993), during this period political factors played a dominant role in allocating transfers across provinces. Cf. Schwartz and Liuksila (1997).

18. In fact, three of these laws were approved, at a cost eventually too high for the government. The one governing collective bar-

gaining especially had an impact on the escalating inflationary process. It is worth mentioning that the Radical government lacked credibility in the eyes of the Unions, unlike its successor. (See Cukierman and Tommasi 1998 for insights on the "Nixon goes to China" strategy of Menem vis-à-vis the Peronist unions.) Interestingly, in 1998, the now-Peronist government tried to modify some of those labor laws, while trying to pass a tax reform, whereas the new constitution mandates a new coparticipation law.

19. We refer here to such literature as Grossman and Hart (1986), Holmstrom and Tirole (1989), Milgrom and Roberts (1990), and Williamson (1975). See also Epstein and O'Halloran (1997) for an explicitly political application of incomplete contracting.

20. More generally, the ex post governance structure is a function of formal and informal political institutions of each country, such as the role and composition of Congress, the relationship between national-level and local-level party politics, etc.

21. Note that the constitutional mandate of promulgating a new regime was not fulfilled in time. This shows the difficulties of reaching an agreement on this matter.

22. One example of that would be the "federalization" of the mechanisms for controlling the indebtedness of subnational governments. (For the details, see Iaryczower, Saiegh, and Tommasi 1998.) It is worth noting that this "collective" but explicit governance structure stands as an alternative to the listing provided by Ter-Minassian and Craig (1997): market discipline, "cooperation," rules, and administrative controls.

23. (1) We suggest a more encompassing political decision mechanism, formalizing the arena of federal fiscal choices, regulating procedures, and making them more transparent, in order to move to a set-up closer to the "world" of Weingast and Marshall (1988)—which, for reasons about which we speculate in Spiller et al. (1999), has not evolved in Argentina. (2) In describing the political uncertainties reflected in the history of federal fiscal arrangements in Argentina, we pictured the actors asking themselves (regarding the federal fiscal negotiations): "When will be the next meeting? Where will it take place? Will I be invited?" (Saiegh and Tommasi 1998).

24. This springs out of the window of opportunity provided by the constitutional mandate. The hope is that this "institutional engineering" in this open margin will have virtuous implications on the whole "institutional general equilibrium."

Governance and Incentives in the Public Hospital Sector

FLORENCE EID AND PERE IBERN

I. Introduction

Corporatization is a hybrid organizational form between government ownership and privatization that seeks to improve efficiency and reduce transfers (and costs) in a publicly owned public sector. Corporatization is also a type of decentralization, in that it reallocates decision-making authority from the central administration to lower levels of the public sector.

After a brief overview of decentralization and corporatization in public health, this paper analyzes the role of governance and incentives in corporatized hospitals. The analysis focuses on the design of public hospital corporate boards, the institutional linchpin of such systems. Drawing on Dixit's (1996) multitasking common-agency model as a conceptual lens, we propose a manner of assessing the institutional design of corporatized hospital boards. We analyze the extent to which the Dixit model explains factors salient to such boards, and we point to other factors that come into play. We conclude with some policy implications for the systems in Lebanon and Catalonia.

In the next part, we discuss the role of decentralization and corporatization in public health reform to indicate the institutional structure that has recently been promoted in a number of countries. In Section III we introduce the multitasking common agency model and map it onto the problem of hospital board design. We introduce the case of Lebanon in Section IV and discuss the objectives of the reform as well as

the principal features of the institutional structure governing corporatized hospitals. In Section V we discuss the coordination and agency problems emanating from the design of corporatized hospitals in Lebanon and offer some ideas for the reform of the system. We do the same in Sections VI and VII for the case of Catalonia, then conclude in Section VIII.

II. Decentralization in Public Health-Care Provision

There are three possible types of government involvement in health: regulation, finance, and service provision. Regu-

latory functions include decisions on the rules of system configuration and the definition of respective roles for the public and private sector. Finance functions determine the extent of universal health coverage using public funds. The government may also be involved in direct provision of services, as the owner and manager of hospitals and primary care services. The limits of private initiative in the delivery of public goods and political constraints on privatization are the two main factors behind public health provision.

Two principal schools of thought have developed in answer to the question of how to increase efficiency in public service provision, health included. Some argue that effi-

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ciency and performance are more important than ownership, and that good management is key (e.g., Moore 1996; Barzelay 1992). As such, hiring innovative managers with the right technical and leadership skills and introducing the appropriate (“private sector-like”) management systems improve efficiency. But others argue that the public sector has inherent inefficiencies due to the nature of the goods it provides and to the limited power of incentives it can offer, and that the size of the public sector is better reduced to a minimum through the transfer of responsibilities to the private sector where possible (Wilson 1989; Kikeri, Nellis, and Shirley 1992; Schleifer 1998). From this perspective, privatization is the preferred option for better service delivery. Advocates of corporatization take a middle ground—namely, that both the public sector and the market are capable of failure, necessitating the search for organizational forms that reduce inefficiencies on both sides. In designing such organizational forms, incentives and coordination are key levers.

Public ownership implies, in practice, various constraints on the management of facilities. Personnel are usually civil servants, and procurement procedures are subject to system-wide rigid rules. Therefore, an inevitable effect of public ownership is less flexibility in adapting to local conditions, and “low-powered” incentives. Tirole (1994) considers four reasons why the “power” of incentive schemes tends to be “low” in public sector agencies: a) the multiplicity of goals and the difficulty of their measurement; b) the unavailability of benchmarks for comparisons; c) the heterogeneity of owners; and d) property dispersion. Holmström (1989) arrives at similar results with respect to large organizations: In developing systems to manage diverse sets of activities, they tend to dampen incentives and quell innovation.

Coordination issues are also extremely important when agents have low-powered incentives, because discretion and autonomy can lead to poor performance, such as shirking. Resolving coordination issues relates to institutional design.¹ A central element of design is the allocation of residual control rights (or decision rights), between centralization and decentralization.² An inevitable tradeoff exists between centralization and lack of efficiency, and decentralization and lack of monitoring. Coordination seeks to minimize this tradeoff.

Studies of organizational boundaries consider two elements in the decentralization of decision rights (Holm-

ström 1996; Hart 1995; Milgrom and Roberts 1992; and Kreps 1992). First, those with authority must also bear the responsibility for their decisions because the alignment of authority and responsibility creates incentives for optimal decision-making. Second, coordination is important in ensuring that organizations allocate the authority to make decisions to the agents best informed to make them. The benefits and costs of decentralization have been well studied.

In health service delivery, organizational boundaries are in flux throughout the world, because of changes in medical technology, know-how, and costs, resulting in differential changes in transaction costs (Robinson 1996). Organizational boundaries have also been in flux because policy-makers have deliberately experimented with new organizational forms to solve the agency and coordination problems outlined above. In the U.S. private health sector, for instance, vertical disintegration and horizontal integration have been the two prominent trends in managed care (Robinson 1996). Numerous industrialized and developing countries are experimenting with the separation of funding from provision functions, with the aim of improving efficiency (Govindaraj and Chawla 1996). One of the main institutional responses to this effort has been the corporatization of public hospitals.

Corporatization and Its Implications in Public Hospital Reform

Corporatization seeks to retain public sector ownership of hospitals, but to reduce their cost by (a) granting them revenue-raising capacity and (b) changing the incentive structure at the local level, including the level of risk incurred by hospitals. By transferring decision rights over finance and management to the level of hospital managers, corporatization also seeks to improve the quality of public health provision. However, unlike what happens in private health

TABLE 1
Benefits and Costs of Decentralization

BENEFITS	COSTS
Better use of information at the local level	Agency costs
Lower response time in adapting local conditions	Coordination costs
Increased motivation of managers	Costs of communication between central and local units

Source: Brickley, et al. (1997).

provision, corporatization cannot achieve a complete transfer of risk to the provider (hospital). Because financial risk continues to be consolidated at the level of the national public sector, among the difficult issues in the design of corporatization is the decentralization of decisions in a way that transfers a sufficient degree of financial risk to the corporatized entity to improve performance.

Under corporatization, public hospitals are generally required to develop a revenue-raising capacity through user fees. However, the incentive to raise funds depends on the role and structure of health insurance coverage. Under universal coverage, hospitals receive a transfer from the public budget. The design of hospital finance options ranges from (a) an allocation based on transfers made in previous years to (b) a performance contract. In the former case, the hospital is designed as an administrative unit similar to any arm of the central administration. In the second case, when establishing a performance contract, the central administration or sector aims at setting the goals and expected budget and empowers decisions and responsibility at the level of the hospital (Harding and Preker 1999).

The impact of performance contracts has been mixed (World Bank 1995). Since there is no significant transfer of risk, the real effect on incentives depends on multiple factors that go beyond the definition of the contract. As an example of the range of options under this arrangement, the hospital manager reports to the Minister of Health in some cases, while the manager reports to a board of directors in other cases. Further complicating this sort of arrangement is the difficulty of monitoring hospital directors and board members in the presence of political intervention. As a result, especially when performance contracts are present, the design and effectiveness of hospital governance institutions are key, and they depend on the following types of factors, currently being grappled with:³

- Consistency between the proclaimed objectives of corporatization and organizational design—i.e., where on the gamut between administrative units and performance contracts the system lies.
- Whether key stakeholders/principals are represented on hospital governing boards and how much influence they wield.
- Requisite alignment of the incentives of the agent, or hospital manager, with those of the principals, and, by extension, alignment of the objective function of the hospital with that of the sector—a coordination

problem that affects both the quality and cost of service provision.

- Adequacy of the power of incentives given intended outcomes.

In what follows, we discuss the relevance of some agency models to understanding incentives and coordination in the institutional design of corporatized public hospitals.⁴ We then evaluate the incentives that the system in Lebanon has provided for hospital boards of directors to be responsive to the objectives of their stakeholders, of which there are at least two sets—the health sector’s regulators of public hospitals and community members/hospital users in their areas.

III. Conceptualizing the Corporate Governance of Public Hospitals

Dixit’s (1996) formulation of the problem of governance in the public sector builds on two seminal models in the field of organization economics. The first is the multitasking model, developed by Holmström and Milgrom (1991). In this model, an agent has several tasks that compete, at least partly, for the agent’s attention and effort. Because the agent’s priorities over tasks are not certain to correspond with the principal’s, the latter devises an incentive scheme to influence the agent’s allocation of effort. The choice of incentive scheme depends on the degree of observability of inputs and outputs, and on the differences in values between the agent and the principal. Two important results derive from the Holmström-Milgrom model: (1) If the output from one task is poorly observable, compared with output from a competing task, then the incentive scheme for the competing task must have lower power (i.e., the reward must be less) to avoid excessive diversion of effort from this task to the more observable one(s). (2) If some tasks are primarily of value to the agent (as compared with the principal), and can be controlled by being prohibited altogether, then it may be preferable for the principal to prohibit them rather than to attempt to provide stronger incentive schemes for the performance of other tasks.

Bernheim and Whinston (1986) consider the problem of one agent with more than one principal. The agent may work on the basis of explicit delegation by principals or by intrinsic assignment (when the agent takes decisions that affect several principals). If principals cooperate or agree on goals and coordinating incentives, the result is similar to having a single principal. If principals do not agree on

goals, then actions by the agent may be biased to those principals providing greater incentives; otherwise, the mean behavior by the agent would be to satisfy all principals at the same level.

Dixit combines the two models to show that the combination of multiple principals and multiple tasks results, perforce, in low-powered incentive schemes. His model is based on the intuition that in such situations each principal will try to free ride on the incentives provided by the other(s). The multitasking common agency model predicts that given unobservable effort, an agent will exert second-best effort if the principals are united and third-best effort if the principals do not act cooperatively. Under non-cooperative arrangements, even though a given Principal J may not be concerned with any other components of the agent's output but those of interest to J, Principal J would prefer that the agent exert less effort in other dimensions because that would induce the agent to make more effort in the dimension that benefits J. In equilibrium, a situation with multiple principals and multiple tasks yields low-powered incentive schemes because some of the incentive provided by Principal J to the agent results in benefits to other principals as well. This "leakage" makes it much less desirable for Principal J to offer a powerful incentive scheme. Given unobservable effort, improving on this outcome involves better coordination of principals—an important potential lever in the design of public sector organizations, especially given the difficulty of providing high-powered incentives.

Mapping the Model onto the Problem of Hospital Board Design

In applying the multitasking common agency model, we consider the hospital manager or CEO as the agent. This agent has several principals (stakeholders) such as the Ministry of Health (MOH) (tutelage sector) on one end and the community on the other, as well as doctors, licensed employees, unions, etc.—some or all of whom can be represented on the hospital board. To simplify, we take a case where the manager has two principals, and assume they are the MOH and the community. The MOH's primary objective is to reduce the costs of the sector given minimum standards of quality—a goal partly achieved through reductions in transfers for public health provision. The more a hospital gets its financial house in order, through cost-recovery and cost-effective service provision, the closer the MOH gets to fulfilling this objective. The communi-

ties dependent on public hospitals have different and potentially conflicting objectives. Public hospital users, or "stakeholders" (Savage et al. 1997), want the best possible care at the lowest possible price, especially since the previous system provided the possibility of universal coverage.⁵ Prima facie, the objectives of these two principals are in conflict under the new law in Lebanon.

A further dimension is the agent's tasks. To simplify, we assume that the hospital manager under the new law has two main tasks: to control costs and to improve the quality of health-care provision. The former task is easily measurable while the latter is not, but it has important equity implications. A similar question about the incentive trade-offs between prospective payment and cost reimbursement systems in the United States has been analyzed by Ma (1994) using the multitask agency approach (Holmström and Milgrom 1991). In this model, the hospital allocates its efforts between cost reduction and quality enhancement. Along similar lines, this approach allows for an analysis of the extent to which hospitals in Lebanon and Catalonia, in having to internalize their production costs once corporatized, risk resorting to excessive cost reduction, and compromising quality. A desirable objective of design would be for corporatized hospitals to internalize the benefit of quality as well.

For any given public hospital, it is clear that controlling costs will be a more measurable task than the improvement of the quality of health-care provision. It remains to be established whether principals are united in their demands on the agent or not. In a micro-organizational setting such as a public hospital, this task is more difficult than for the macro-policy-making example of GATT, illustrated by Dixit (1996). Determining the degree of principal coordination can be done by looking at the principals' channels of influence, in terms of (1) appointment rights (i.e., rights that principals possess because of the manner in which they came to occupy their positions), and (2) decision rights (the formal and informal prerogatives of principals once they are appointed to a board, defined by law and convention). To simplify, the main difference between rights (1) and (2) is that the former yield power that emanates from the person, while the latter yield power connected with the position. Empirically, this difference is important, as we will illustrate.

Take the example of appointment rights. There are cases where there are differences in the strength of appointment

rights granted. For instance, a local political appointment to a hospital board will enjoy a more powerful appointment right than a politically unconnected community member. A political nominee to the board would also enjoy a more powerful appointment right than a physician who sits on the board representing medical staff in the hospital, but who is not affiliated with the local political leadership in the area.

There are other cases where a principal is not granted a decision right all together, as the following example illustrates: By definition, any public agency has at least two sets of principals, the governmental body (or sectoral tutelage) in charge of it, and its taxpaying beneficiaries (or community). If both principals are present on the board, they may or may not be coordinated. When a public hospital board does not contain a member of the community, it cannot be representative of it. Therefore, by virtue of the fact that an important principal (in this case a community representative) does not sit on the board, the board would not embody the interests of both principals. In such a case, principals can be considered to be uncoordinated because an important principal does not enjoy an appointment right at all.

Such cases from Lebanon shed interesting light on how the manner in which stakeholder representatives come to sit on a board influences the decisions they are able to make. This case also offers an opportunity to analyze the *currency of influence* behind the differential capacity of principals to provide incentives to the agent, and the circumstances under which a given principal may choose to exert influence.⁶ We analyze the institutional design implications of the Lebanese and Catalonian systems in the sections that follow.

By analyzing the problem of public hospital board formation in Lebanon using this approach, we try to answer the following questions:

- If the key principals of public hospitals can be considered to be “uncoordinated,” what sorts of outcomes can be expected, and how well does the empirical evidence to date corroborate predicted outcomes?
 - What can be done about the structure, prerogatives, and manner of appointment of a board to increase coordination among principals?
 - To what extent is better coordination of principals likely to improve the system?
- Dixit’s model assumes equal power on the part of the principals to influence the agent. Empirically, we observe significantly different levels of power to influence the agent, both through appointment rights and (post-appointment) decision rights allocations. Can the design of governance institutions (boards) account and correct for skewed distributions of power?

The conclusions of this paper are based on open-ended and structured interviews, analysis of documents, and draft and published legislation. Hospital budgets, accounts, and strategic plans (where available) were also drawn on in the analysis.

IV. The Case of Lebanon: Background and Policy Reform

The Lebanese public hospital sector experienced a deterioration in coverage, quality of service, and financial management during the country’s civil war from 1974-1990. By 1990 the sector was providing a set of perverse incentives. For instance:

- *Incentives for uninsured patients to seek expensive private care because the quality of care at public hospitals was low and provision was erratic.* The Ministry of Health had begun to reimburse uninsured patients who sought private care during the war in order to ensure that all those in need of health care were able to get it without having to travel during battles. Given that the uninsured constitute 44 percent of the population, this policy resulted in a rapid escalation of public health expenditures, 77 percent of which went toward the purchase of medical services from the private sector in 1994, when the reform was launched (MOH reports and data).
- *Incentives, created by the cost reimbursement system, for physicians to choose to hospitalize patients for interventions that could be provided on an outpatient basis, and for hospitals to use high-cost interventions when lower-cost treatments would be sufficient.* Not surprisingly, cost reimbursement also created incentives for over-billing, especially given expected and actual arrears on the part of the MOH.
- *In the public hospitals, eroded public-sector wages and compressed pay scales.* These created incentives for public hospital staff to absent themselves from their positions and seek employment in the private sector in order to supplement their income.

- *Weak incentives and meager means for hospitals to gather and use information that would improve their performance, and an even weaker regulatory capacity at the level of the Ministry of Health to oversee the operation of public hospitals.*
- *No consumer-protection policies, and therefore weak incentives on the part of hospitals to ensure that they were satisfying community needs and equity considerations.* Despite the possibility of government reimbursement, poor patients have difficulty accessing private hospital services, and when they do receive care, they are often asked for significant copayments. Those who were most politically connected benefited most from the cost reimbursement system.

The Declared Objectives of the Reform

As part of the effort to restructure the public health sector, a law was drafted to corporatize public hospitals by granting them a degree of fiscal and managerial autonomy. Corporatization grants public hospitals their own governing board, thereby delegating some of the regulatory authority of the MOH, but retains the MOH as residual claimant on the hospitals. As part of their autonomous status, hospitals have the right to charge patients for their services to develop a revenue base that would gradually replace transfers received from the MOH. The objective of the law on public hospital autonomy is to provide

- incentives for hospitals to improve the quality of care they offer while keeping costs under control, thereby satisfying the health sector's equity objective of providing good-quality affordable health care for low-income and uninsured patients;
- incentives for hospital management to be responsive to the sector's cost reduction priorities; making hospitals financially autonomous reduces (and eventually stops) the need for transfers;
- incentives for hospitals to be more attuned and responsive to specific local needs, especially in preventive and basic health care.

Central to how well hospitals achieve these objectives is hospital board effectiveness in regulating the activities of their hospitals. The design and prerogatives of hospital boards, discussed later, are therefore key.

Under the new, corporatized system, hospitals sign a service contract with the MOH, civil service bureaus (e.g., the army and internal security administrations), and insurance

companies and other private purchasers. Hospital own-source revenue is raised through private sector purchases and through patient contributions to the price of treatment partly covered by the MOH. Under the new cost-sharing rules, uninsured (MOH) patients are required to pay 5 percent of the price of treatment at public hospitals, while the MOH contributes the remaining 85 percent—effectively “purchasing” services from its own hospitals. (The remaining 10 percent comes from the hospitals' profit margins.) The new system continues to provide universal insurance for the time being. Eventually, benefits (or MOH contract privileges) will become means-tested in the sense that public hospitals that do not break-even will cease to operate.⁷

Hospitals are to prepare and agree upon an annual Strategic Plan with the MOH, which constitutes a basis for the MOH's continued purchasing of services from the hospital. To encourage use of public hospitals, the MOH insurance scheme is available to only 15 percent of private hospital bed capacity, while it covers 75 percent of public hospital bed capacity. Today, hospitals are receiving a one-time transfer ranging from 300 million to 3 billion Lebanese pounds (US\$199,000 to US\$1,989,000), depending on their size, to help jump-start their autonomous operations. The years 1999 and 2000 are being considered by the MOH as trial periods for the reform, with the objective of reaping lessons of experience and improving the system. (Interview with Roger Sfeir, Advisor to the Minister of Health, Lebanon).

Implementation of Law No. 544 began in 1998, once the decrees were drafted. To date, only four out of 17 public hospitals in Lebanon have begun to function under the new regime. These cases form the empirical evidence this paper is based on. Because of the dire need for public health provision in Lebanon, the nomination of further boards of directors for public hospitals is under way, and more hospitals are expected to adopt the system in the next year. However, the intention of the MOH is to amend the hospital corporatization decrees. The hospitals corporatized to date are Nabatiyye, Qartaba, Dahr el-Bachek, and Tannourine. The 11 board members and directors interviewed are from these hospitals, but their names are referenced in this paper as numbers (1-11), and their affiliations are omitted.⁸

The objective of this paper is not to arrive at incontrovertible conclusions about the system in Lebanon, nor are such conclusions possible given the limited sample of hospitals corporatized to date. Instead, this paper seeks to

explore ways of understanding the problem of board design, in anticipation of a time, in the near future, when the empirical evidence from Lebanon and elsewhere will be richer and both the application of models and the conclusions can be more definitive.

Describing the Institutional Design:

Principal Features of the Legal Structure

Governing Corporatized Hospitals

Law No. 544 mandating the “Establishment of Public Enterprises for the Management of Ministry of Public Health Hospitals” was promulgated in 1996. The simple three-page document outlining this law is followed by five Implementation Decrees that lay out the technical details and instructions for applying the law. Laws are voted on in Parliament. Implementation Decrees are drafted by the ministry concerned, in consultation with legal, administrative, and financial experts in the various sectors, including the Ministry of Finance, and then submitted for ratification by the Council of Ministers.

Law No. 544 mandates the following:⁹

1. A public enterprise (also “public health enterprise” or “public hospital board” in this paper) is to be founded to manage each public hospital in the country. Public health enterprises are to enjoy financial and managerial autonomy, subject to the supervision of the Ministry of Health. Such enterprises are subject to regulation by the Ministry of Finance, the General Accounting Office, and the Central Inspection Office.
2. The revenues of such public enterprises consist of (a) central government transfers, (b) fees for services, and (c) other sources.
3. The Ministry of Health’s responsibilities include the definition of sectoral strategy, the coordination of health provision at the national level and the rationalization of the sector.
4. The drafting of five Implementation Decrees defining (a) the appointment of boards of directors and ministry representatives; (b) financial regimes for public hospital enterprises; (c) personnel matters; (d) compensation; and (e) internal administration of public hospital enterprises.
5. The determination of fees for services, patient contributions to fees and budgetary matters, including MOH transfers to public hospitals.
6. The Minister of Health’s responsibilities and prerogatives in establishing collaborative agreements among public health enterprises, and between public health enterprises and medical schools domestically and internationally.
7. The determination of the size of boards of directors for public enterprises.
8. The establishment of a consultative committee to study the impact and implementation of public hospital autonomy.

The law contains two additional items mandating the drafting of the five Implementation Decrees defined in Item 4 above, and activating Law No. 544 upon its publication in the Official Journal, respectively.

The Linchpin of the System: The Governance Decree and its Implications

The decree outlining conditions for the appointment of boards of directors and ministry representatives (henceforth, the “Governance Decree”) determines the size, composition, prerogatives, and MOH representation on oversight of public health boards. The detailed content of the decree underscores the centrality of the board to the operation of corporatized hospitals and the importance of its governing mechanisms in advancing or retarding the goals of efficiency and coordination. Some elements of the Governance Decree are important to examine in light of Decree No. 4517 (1972)—the legal underpinning which defines the establishment and operations of all public enterprises and autonomous agencies. The following discussion draws on both decrees to analyze salient aspects of the institutional design of public hospital governance. The particular elements that are important in this context include:

- *Stakeholder (Principal) Mix*

The decree stipulates that board members should have a background in medicine, business administration, finance, law, or public health. However, apart from listing a restricted set of possible specializations, the decree does not ensure that

board members have the required skills to represent at least the most important and most obvious stakeholders, such as the user community, medical staff in the hospital, the MOH, etc. Hence, the focus is more on defining eligibility to the board than on ensuring representativeness on the board.

- *Manner of Appointment of Board Members (Principals)*

The process of selecting board members is highly ambiguous. Provision No. 2 stipulates that the board is appointed upon the recommendation of the MOH through a decree to be ratified by the Council of Ministers. Among the important issues to clarify are how the MOH forms the list to be submitted for ratification, what criteria are used, and how immune from adverse political influence the system is, keeping in mind that responsiveness and accountability to political demands are desirable features. Empirical and implementation evidence to date point to unclear or inadequate criteria in the selection process, as well as politicization in the choice of candidates, which have led to the administrative paralysis of some newly inaugurated and much needed hospitals. One important reason for this paralysis has been the lack of coordination between board members. The system places a large onus on the Minister of Health to select the right people and negotiate their appointment.

- *The Hospital Manager (Agent)*

The manner of appointing hospital managers is unclear. Although the decree does state that the hospital manager is to be appointed by the hospital board, it contains no further detail on the selection and appointment process.¹⁰ Furthermore, the practice has ranged from the board's making recommendations that the MOH may or may not accept, to a local political leader's submitting one name to the Minister of Health, who then recommends the appointment without consulting with ministry officials, the hospital board, or the MOH division in charge of public hospitals. The hospital manager sits on the board of directors *ex officio* and is responsible for the day-to-day running of the hospital. Because of an informational advantage, the manager has the potential of wielding important influence on the board, despite her non-voting position.

- *The Extent of MOH Regulatory Responsibility Decentralized to the Board*

In sharp contrast to the weak structure described above, the responsibilities of the board are fairly significant. The

board and hospital manager are responsible for setting the policy and administrative direction of the hospital; overseeing inpatient and outpatient service provision, quality control, and cooperation and collaboration with educational organizations; setting policy and strategy for various departments within the hospital; setting the annual strategic plan and budget for the hospital; and overseeing contracts and collaboration with the private sector (translated from the Governance Decree).

Although, as this list shows, the board has extensive responsibilities, there are few areas in which the board and management can make decisions without clearance from higher level authorities. In only four out of 20 decision rights or areas of responsibility devolved to the board by the Finance Decree can the board actually make decisions without clearance from either the MOH or the Ministry of Finance, or both (Mubarak 1999). These are instances of transfer of responsibility without the transfer of full authority, and they weaken incentives for optimal decision-making.

- *Sectoral Oversight, or Accountability between MOH and Hospital*

The MOH oversees the day-to-day operation of the hospital through its principal and voting member of the board—the ministry delegate (or representative). This principal's objective is to influence the operation of the board by aligning the hospital manager's incentives with those of the MOH, thereby ensuring that sectoral standards and priorities are satisfied at the hospital level. The MOH's oversight and regulatory functions, carried out partly through the MOH delegate, are well laid out in Decree No. 4517.

- *Appointment of the MOH Delegate*

Similar to the ambiguity surrounding the appointment of the hospital director, it is not clear how the MOH delegate is appointed. Provision No. 10 in the decree only defines two aspects of this appointment: the five-year term and the requirement that the delegate be an MOH civil servant of a certain grade or above. Crucial issues receive no mention—such as how this person is selected, how close to some key functions of the administration such as finance and procurement the delegate can be, what the delegate's relationship to the local or political community should or should not be, and what the delegate's area of specialization

should be. As a result, despite the fact that all MOH delegates to hospital boards enjoy the same set of decision rights and one vote on the board, some of them can exert an excessive degree of influence on the hospital, and others not enough.

- *Risk Transfer*

Similar to the ambiguity surrounding the appointment of board members, a degree of ambiguity surrounds the degree of risk borne by board members, the hospital director and the MOH delegate for the performance of the hospital. Apart from defining board member remuneration per meeting, the decree makes no mention of the consequences of bad performance. As a result, both in regards to term renewal and in regards to compensation, the financial risk of hospital insolvency on the hospital board appears to be zero. Given local conditions and the unfavorable reputation of the public sector in Lebanon today, the reputational consequences that hospital managers and board members bear can also be relatively minor.

In summary, the institutional structure of corporatization in Lebanon is strong in some areas and weak in others. It is strong (and ambitious) in that it seeks to deconcentrate a significant degree of administrative, fiscal, and regulatory responsibility from the central administration of the MOH down to the hospital level. Reallocating decision rights down to the level of agents with the information needed to make decisions is a way of improving organizational output. On the other hand, the design of the Lebanese system is weak because it is replete with ambiguities that allow for much variance in outcomes depending on the personalities in place. This is particularly apparent in the choice of principals, the choice of the agent, and the definition of their decision rights.

Examining Partial Empirical Evidence

The following discussions are based on two illustrative provisions from two decrees: the Decree on Finance and the Decree on Personnel. We analyze the provisions to understand whether the extent to which the system in Lebanon can generate Dixit's third best, how much of this is due to lack of principal coordination, and to point to other factors that might be at play.¹¹ For the purposes of this analysis, we take Dixit's conclusions on the making of economic policy as a point of departure: The difficulty of achieving good performance in government is due to the fact that principals

tend to be uncoordinated, incentives weak, and outcomes third best. The question then becomes how uncoordinated principals on Lebanese hospital boards are in practice, and what can be done to improve the equilibrium.

In Table 2 below, the "expected outcome" listed in the second column corresponds to the "policy action" in the same row, mandated by the decree. We treat the expected outcomes as hypotheses for how the system can be expected to behave, and provide, following the table, a discussion of the degree to which the empirical evidence to date supports the hypotheses. The Policy Options presented in the first column of Table 2 are taken from Provision No. 14 in the Decree on Finance, which mandates the possible actions a manager can take in case of hospital budget deficit. The Policy Options (1-5) constitute recommendations that the hospital manager can make to the board, to cut or control costs (translation from the Decree on Finance, Provision No. 14). Provision No. 14 was selected for this analysis because it touches upon a broad range of management and finance decisions, and because the policy options it offers are amenable to analysis as hypotheses about the behavior of the system.

It is interesting to note that Policy Options 1 and 2 did not result in the expected outcomes in hospitals where board members are also members of the community served by the hospital. Social sanction, reputation, and a degree of altruism have prevented board members from raising fees (interviews with Board Members 1-7). In the case where the hospital director and board members are not from the community, complaints have been filed by patients that hospital fees are too high. These results shed interesting insights on the way we might think of principals and principal coordination. The Lebanese hospital boards do not include a community representative, while in other countries, such as Colombia and France, the boards include an elected or appointed community representative (Discussions with health policy experts from New Zealand and France, 1997/1998). However, as the case of Lebanon illustrates, the physical presence of a community representative is not necessary if community "interests" are represented. This is an especially interesting proposition if the objective is to keep boards small, for reasons we will discuss below.¹²

Policy Option 3 presents an example where the presence of a principal is not necessary if the coordination problem is resolved at a higher level in the administration. Hence, although insurance companies are important stakeholders

TABLE 2

Identifying Outcomes Based on the Decree on Finance

POLICY OPTIONS FOR HOSPITAL BOARDS	EXPECTED OUTCOME AND BRIEF REASONING	EMPIRICAL FINDINGS
1. Increasing fees	Expected: Excessive fee increases. Reason: No community representative on the board.	Outcomes 1 and 2 have occurred in some hospitals, but not in others. They have not occurred where board members are also members of the community, originating <i>and</i> residing in the community. On the other hand, these policy options have been a problem where none of the board members is selected from the community, especially not the hospital director.
2. Increasing patients' contributions to fees	Expected: Patient contributions could be set too high. Reason: No community representative on the board.	
3. Increasing fees charged to insurance agencies	This coordination problem is resolved at the level of the central administration of the MOH, which sets rates to be charged to insurance companies by all public hospitals. In practice, because Policy Option 3 is difficult (and impracticable) to implement at the level of a hospital board, it is a very weak (or "hollow") decision right. The author of Policy Option 3 assumed an imperfection in the insurance market that is resolvable through regulation at the level of the public hospital board. The MOH's retention of a central decision right over such an issue, if a market imperfection indeed exists, is a good idea for a small country like Lebanon where regional idiosyncrasies and the need to adapt to differential market conditions are relatively minor.	
4. Increasing first-class hospital fees	Expected: Frequent implementation of this option. Reason: Lack of community representation on the board.	Decision right not implemented in any of the hospitals to date. Reasons are fear of social sanction and the reticence to develop a reputation of being expensive, while the goal is to encourage use of public hospitals..
5. Recommending to MOH and MOF that the deficit be covered through reserve funds	Expected: Strong influence of MOH delegate on the board could rule this out every time, even when necessary. Weak influence of the MOH on the board could ratify such recommendations, when they are not necessary. Reason: Possible randomness with which MOH delegate is selected.	Although none of the corporatized hospitals has resorted to this policy option to date, interviewees have mentioned and expressed concern for influence in both directions, depending on the MOH delegate appointed.

in a hospital system (Savage et al. 1997), the case of Lebanon provides an example of their interests being represented through means other than a principal, further reducing the need for principal coordination on a board.

Policy Option 4 presents a decision right that has not been exercised to date, and is unlikely to be exercised because public hospital users are by definition those who seek to pay the lowest possible prices for health care, even if they can afford to pay higher rates (interviews with Board Members 1-6 and 8). On the rare occasions when first-class service has been requested, the MOH recommendation for first-class fees has been applied because the community members of the hospital board have not wanted to be seen as trying to exploit patients who could otherwise afford to seek private sector care. They have also done this in order to encourage people to use public hospi-

tals. Again, social sanction and reputation have played an important role to date, and good business skills have certainly contributed. The reticence to exploit this provision is an indication that in some instances the manner in which principals are appointed has contributed to controlling the price of care charged to patients.¹³ Policy Outcome 4 raises questions similar to those discussed above, with respect to how one might define who the principals are and how important it is for all of them to influence the agent directly.

For Policy Option 5, the closer the MOH delegate is to the treasury and finance functions of the MOH, the more influence the delegate can wield in this very important area (interviews with Board Members 1-11). The amount of finance a hospital has partly determines the degree to which the hospital can pursue aggressive development and

capital investment strategies. Access to finance and a tight reign over use of finance are necessary for survival in the face of stiff private sector competition. A similar predicted result also applies to two other decision rights not listed in the table: the right to request a treasury loan (Option 6) and the right to request a private sector loan (Option 7). None of the hospitals corporatized to date has attempted to exercise these rights; however, interviewees expected the same type of influence to result from the mix of principals present on the hospital board.¹⁴

Placing the Evidence in Perspective

More than a decade ago, as the health-care market became more competitive and accelerated the drive toward organizational forms that split purchaser from provider functions, the literature on hospital board effectiveness in U.S. markets listed a number of challenges (Shortell 1989). As hospitals moved from relatively benign to competitive environments, they needed smaller, more nimble and risk-taking boards, composed of members who focused on strategy, specific expertise, evaluation, and accountability. These boards are closer to the boards of competitive firms than to the benevolent, community notable-type boards of hospitals in previous, less-demanding market environments (Shortell 1989; Kovner 1985; Delbecq and Gill 1988; Weiner and Alexander 1993). Since the late 1980s, nonprofit boards across sectors have moved in the direction outlined then, and the focus continues to be on smaller-sized boards with fewer insiders, and responsibilities related more to the ratification and monitoring of policy, than to direct involvement in specific operations (Taylor, Chait, and Holland 1996). Hospitals in Lebanon are facing a similar set of challenges, among them:

- managing diverse groups of stakeholders (principals);
- involving physicians in the management and governance process;
- responding to the needs of hospital restructuring;
- meeting the challenges of diversification;
- understanding and carrying out strategy formulation;
- balancing equity and efficiency considerations.

The design of Lebanon's public hospital boards is similar to the "new" hospital board in some ways, and different in other, important ways. It is closer in its small size, focus on strategy, and representation of stakeholders. It is further away in its capacity to assume risk and carry out evaluation and in its accountability. The examples discussed in Table

2 bring the capacities of the Lebanese boards to bear in ways that we expand upon below.

For example, despite the fact that public hospital boards in Lebanon do not include a member who is officially appointed as "community representative," community representation is not compromised because some board members fulfill a dual function of, for example, "doctor" and "community representative." This manner of selecting board members resolves part of the principal coordination problem while helping keep the board size to a minimum. In moving toward more technocratic boards, it is important to ensure that the community continue to be represented on the board in some manner, without expanding the size of the board significantly. In a similar manner, Policy Option 3 illustrates that keeping some decision rights at the level of the central ministry serves to unify policy and reduce costs of principal coordination, contributing to the nimbleness of the system.

On the other hand, the randomness in outcomes based on important Policy Options 5, 6 and 7 indicates that the system is weaker on the financial management side, perhaps including the financial accountability side, although more evidence will be required to establish this. What is certain is that the politicization of boards has resulted in some loss of transparency and some non-technocratic decision-making and strategy formulation. This suggests that public hospitals in Lebanon today may not be in the best position to respond to the needs of restructuring and adaptation to a competitive market.

Further Evidence from the Decree on Personnel

A reading of an example from the Decree on Personnel serves to illustrate the importance of issues other than principal coordination in the design of hospital governance institutions. These include simple agency and information problems that could result in collusion, political pressure and graft.

In Provisions 9-11 the decree states that applicants for hospital vacancies must be ranked based on performance on an exam. The hospital board holds the decision right to arrange to carry out the exam. By virtue of his ex officio position on the board, the hospital manager is a co-holder of the decision right. Given that the decree does not specify any details with respect to the manner in which the exam or examiner is to be selected, the ambiguity has resulted in less than the best solutions. A first-best out-

come could be characterized as one where the hospital board, taking into consideration recommendations from manager(s), short-lists a set of possible examiners, and in consultation with experts in the field, selects the best possible one, ensuring proper screening in its recruitment process. Agency and information problems (but not coordination problems) likely to prevent this first-best outcome from occurring include collusion between some board members and the manager at the expense of other board members. This could influence the choice of examiner, in the absence of criteria for this choice. The influence could include political pressure through one of the principals on the hospital board to favor applicants from specific political or religious backgrounds.

Under this scenario, outcomes inferior to first-best include instances where the decision is made to grant the contract to an examiner with a lower benchmark for “successful” performance. In this case, an exam would have been carried out, but the pool of applicants from which the final choice of employee will be made is of lower average quality, and criteria other than performance on the exam will carry larger real weight. Another outcome inferior to first-best could be one where both the choice of examiner and the choice of exam are determined in ways that maximize chances of success for less competitive applicant profiles. In this case, the use of an exam as a screening device would have failed.

Empirically, there have been three different applications of these decision rights to date. In one case, the hospital manager and some board members agreed to disregard the examination requirement and established their own point system for the ranking of applicants for positions. This system has not served the hospital well and has resulted in a number of physicians it wishes to dismiss because of malpractice, and one lawsuit as a result of a dismissal. Also, there is evidence that the powerful political appointees to the board had an overwhelming degree of influence on the final choice of candidates who were hired (interviews with Board Members 2-5).

In another hospital, the director of the board is wondering how many competitors he is likely to have for the positions the distant rural hospital is looking to fill. When asked about whether and how his board will comply with the requirement to carry out an exam, he said that they would probably put together a pro forma writing and interview exam for those who do apply, to be evaluated by

the board (interviews with Board Members 6-7). A third hospital has selected an outside screening committee that is likely to achieve an outcome closest to first-best. At the time of this writing, the hiring process was just beginning and no further information was available.

Mechanisms that would improve this outcome include amending the Decree on Corporate Boards to minimize the chance of collusion between board members and the hospital manager(s), and to minimize pressure for political appointments. This would affect appointment rights as well as decision rights. However, given the inevitable presence of some political interference in multi-confessional countries like Lebanon, and differential powers on the part of principals to influence the agent, minimal criteria for the selection of the examiner and exam would move the outcome closer to first-best. But if a net improvement in the allocation of decision rights is not feasible at this level, a possible solution would be to reallocate the decision right over exams to a regional or central level, where transparent and technocratic selection of examiners can be carried out. Principals represented on the board would then retain decision rights over other aspects of screening that are related to local specificities and needs, even political preferences within technocratically circumscribed limits. The local choice of candidates would be made from a short list compiled at the national level. The short listing of candidates would effectively provide two levels of screening and scrutiny that, combined with visibility and transparency, would prevent egregious errors from occurring. Countries such as New Zealand and the United Kingdom have resorted to similar solutions for the appointment of staff to corporatized entities.¹⁵

Problems Emanating from the System's Institutional Design

In this section, we synthesize the evidence to date in answer to questions the theory can help inform. We underscore the importance of Dixit's model to some areas, and show how simple agency, influence and information costs are inherent to institutional design in other areas. We also offer some preliminary answers to the questions raised in Section II about the design of corporatization.

- *Representation of Key Principals/Stakeholders*

On the one hand, there is some evidence that the main principals, are fairly well represented on Lebanese public

hospital boards de facto, even if they are not represented de jure. The size and composition of the board parallels fairly well what is suggested in the empirical literature on new, strategy-oriented boards in hospitals. There arguably is some room for enlarging the Lebanese boards slightly, from an average of four members to six, which is closer to the average in nonprofit hospital boards internationally. Enlarging the size of boards would allow for a stronger presence for some principals and broader representation of principals.

On the other hand, the lack of strict criteria in the selection of principals and differences in appointment rights and power can affect outcomes in a significant way, and are problems of design beyond the principal coordination problem. The result is that even when the important principals are represented de jure, the coordination problem is still not necessarily resolved because of the differential capacity of principals to exert influence over the agent.

- *The Currency of Influence*

In the case of Lebanon, three currencies of influence appear to determine the power of principals over the agent, although this appears to be changing today as the new presidential administration accelerates the push for public sector reform and accountability. The order in which we discuss the currencies reflects their relative importance. The first is *political*. Appointees of political leaders have tended to wield the most significant influence by any measure. The second is *informational*, a result found by Aghion and Tirole (1997) in private organizations. The third is *technocratic*, granting those with skills and experience some leverage over the direction of policy on the board.¹⁶

Two aspects of the manner in which currencies of influence work in hospital boards in Lebanon are important. First, combinations of two types of currencies are what tend to empower principals most. As such, political and informational currencies combined have wielded virtually uncontested influence over the agent. Combinations of political and technocratic currencies have also been fairly powerful. The informational and technocratic currencies on their own have yielded fairly low-powered incentive schemes. The relative importance of these two has been a function of the personalities in place. The political currency on its own has been an important source of influence, but this may be changing today. The relative importance of currencies of influence is a good proxy for the relative influ-

ence of appointment rights that principals have when they act on the board.

- *Decision Rights*

Some decision rights are expansive, while others are fairly circumscribed. For example, by virtue of the fact that they are minimally defined, decision rights over hiring transfer all authority over hiring to the hospital board, thereby devolving a significant degree of power to the board. On the other hand, while the responsibility over procurement is devolved to the board, the authority devolved to board members is circumscribed by virtue of the fact that decision rights are co-held with the MOH and Ministry of Finance, through a series of controls, mostly ex ante. Such “weak” devolution of decision rights might have been intended as a mechanism for controlling agency problems when board members do not bear the risk of procurement decisions, but it is not clear that this indirect mechanism will achieve its objectives without compromising others, such as agility and adaptability to demand. Instead, some level of direct financial risk (and benefit) might be transferred to the level of the hospital manager and board, further strengthening the power of the MOH to influence the hospital on the cost-control side.

- *Improving the Coordination of Principals*

The types of policy measures that can improve the coordination of principals, and consequently the outcomes, have to do both with appointment rights and decision rights. More homogeneous appointment rights can decrease the variability of the power of incentive schemes that principals can exert over the agent. Such measures can range from a more transparent, technocratic, and systematic screening and selection of board members, to the development of a public sector corporate culture combining the Weberian and Krepsonian notions. While it is important not to overestimate the degree to which the “personality effect” can be controlled, some reduction in arbitrariness is clearly possible in the case of Lebanon. This could be achieved either through benevolent and enlightened top-down selection of candidates for positions (as the government is attempting to do today) or through the establishment of institutions that guarantee a minimum degree of continuity across political regimes.

In the area of decision rights allocations, withdrawing some decision rights altogether from the level of the hos-

pital board, and reallocating them to the level of the central administration or some other third body can serve to decrease the need for coordination among principals. For example, in instances where unanimity (or at least a supermajority decision) is desirable but cannot be guaranteed by the board, decisions are perhaps best taken outside the board.

- *The Proclaimed Objectives of Corporatization*

From the case of Lebanon, there is evidence that the cost-quality coordination problem is difficult to resolve. In cases where the cost of care has been kept low, there have been complaints about quality. In cases where quality has been improving over time, evidenced by demand for the hospital's services, there have been complaints that costs are too high. This may well be a perennial problem for hospital management worldwide. The data collected for this paper do not allow for stronger conclusions about the situation in Lebanon.

What is certain is that the difficulty of achieving this balance in Lebanon is partly due to the lack of transfer of financial risk from corporatization. Although the law does specify that hospitals are to be financially solvent (after an initial transitional period), it does not indicate what the consequences of violating budget constraints are for board members and the MOH delegate on the board. By default, the risk of financial default is assumed by the MOH, the recurrence of which would presumably cause the hospital to be shut down. There are no explicit financial incentives relating, for example, salary bonuses to cost containment that could improve the expected outcome. This is one of many design deficiencies outside the scope of the principal coordination problem, which will need to be handled through the amendment of the Implementation Decrees.

- *The Power of Incentives*

The power of incentives is high in terms of the agent's response to some principals in some cases. For example, hospitals whose board members are chosen from the community tend to have boards that are sensitive to social sanction. This is not the case in hospitals whose boards are selected from outside the community, where increases in fees have been easy to implement and have resulted in complaints from the community. In terms of the financial solvency of the hospital, incentives tend to

be relatively low powered across the board for reasons discussed above. This outcome corroborates the low risk, low power of incentives conclusion from the moral hazard model.

V. The Case of Catalonia: Background and Policy Initiatives

The Spanish National Health System has been set up as a universal coverage system financed by taxes. It is a highly decentralized system for seven of the 17 autonomous communities that make up the Spanish state. These seven communities represent about 62 percent of the population. The remaining 10 communities, which account for the other 38 percent of the population, still have health-care systems under the direct control of the central government.

The principles of the National Health System as defined by the General Health Act of 1986 are

- a. universal coverage with free access to health care for all citizens,
- b. public financing through general taxation,
- c. integration of different health service networks under the National Health System structure,
- d. political devolution to the autonomous communities, and
- e. development of a new model of primary care, emphasizing promotion and prevention activities.

Diversity in organization and management characterizes the Spanish health system. Each autonomous community with devolved responsibilities has set up its own policy; there is some limited coordination at a national level by the Interterritorial Council, which comprises the councilor for health in each of autonomous communities and equal members from the central government.

The Declared Objectives of the Reform

In Catalonia, where the *Servei Català de la Salut* (Catalan Health Service) is the governmental agency responsible for public health care, hospitals have been an area where clear efforts have been made since the initial devolution. The Public Utilization Hospital Network is made up of 68 hospitals with differing ownership (public, nonprofit, and for profit). Currently 57 percent of the hospitals are under private ownership. The remaining ones are controlled by *Institut Català de la Salut*, public firms, or consortiums.

*Describing the Institutional Design:
Principal Features of the Legal Structure
Governing Corporatized Hospitals*

This section focuses on public firms and consortiums created by the Catalan Health Service (Tables 3 and 4). There is no specific regulation about the creation of public firms in health care. The process has been initiated as a response to specific demands resulting from the devolution process and according to existing general regulation.

While there are some clear trends, there is no unique solution to the problem of decentralizing decisions. In general, the arrangements are related to concrete conditions and outputs that define their existence. There are two main types of public hospitals—public firms of the Catalan government and consortiums of different public administrations. The former represent a spinning off from the previous public health-care sector (new public firms), while the latter represent a joint effort between the Catalan government and local governments.

Besides these firms, there are two additional public firms that are not related to health delivery: technology assessment and energy efficiency. Each firm has a manager who is proposed by the Board of Trustees and appointed by the director of the Catalan Health Service. Although the average number of trustees on each board is eight, the size of the boards range from six to 12. Different government departments usually participate.

The Catalan government has also promoted the creation of consortiums for delivering health services. After building a new hospital, the government creates a new independent organization with the involvement of local administration and civil society. In these cases, the Catalan Health Service has a voting majority on the board (60 percent), and the remaining seats are covered by councilors or citizens belonging to nonprofit foundations or other well-

known individuals. Boards range in size from five to 12 members, averaging about 10.

These hospital management consortiums have developed a new personnel arrangement under labor law. Their employees are not civil servants, allowing them greater flexibility and autonomy. Each hospital contracts with the Catalan Health Service every year. These contracts are “at risk” in the sense that they are not consolidated in the same budget as the Catalan Health Service’s. The board and the manager adopt strategies to fulfill the goals in the contract. The big difference between public firms and consortiums is the contracting and risk issue. While in the former there are performance contracts, in the latter all contracts are at risk. Although 95 percent of revenue of consortiums come from public funds, they have to make decisions properly in order to fulfill their goals and budget.

The Linchpin of the System: The Design and Role of Boards and Their Implications

Each firm’s bylaws define board composition. The most relevant issue is the representation of the Catalan government in 60 percent of all consortium hospital boards. This promotes easier cooperation between members of the board (one of the concerns raised previously). In the public firms, 100 percent of board members are from the Catalan government.

The relationship between governing board composition and performance has not been explored. There is no specific study that addresses it, though it seems important in any nonprofit organization (Molinari et al. 1993).

Stakeholder (Principal) Mix

The boards of public firms comprise Catalan government officials from several departments, though 61 out of 72 members are from the Department of Health. In the

TABLE 3
Public Health-Care Management Firms

FIRM	GOAL	DATE OF CREATION
Institut de Diagnòstic per la Imatge	Management of three imaging centers (MRI, CAT)	1990
Gestió de Serveis Sanitaris	Management of hospital care, primary care in Lleida area	1997
Gestió i prestació de Serveis de Salut	Management of hospital care and primary care in Tarragona area	1992
Institut d'Assistència Sanitària	Management of hospital care and primary care in Girona area	1992
Sistema d'emergències mèdiques	Management of emergency transport in Catalonia	1992
Serveis Sanitaris de referència	Management of blood bank and tissues	1995
Institut Català d'Oncologia	Management of cancer care	1995

Source: Servei Català de la Salut. Memòria d'activitat 1997. Barcelona, 1998.

TABLE 4

Health-Care Management Consortiums

CONSORTIUMS	GOAL
Hospitalari de Vic	Hospital management
Parc Taulí de Sabadell	Hospital management
Sanitari de Terrassa	Hospital management
Sanitari de Barcelona	Hospital management
Corporació Sanitària de Barcelona	Hospital management
UDIAT	Imaging services
Creu Roja l'Hospitalet	Hospital management
Laboratori de l'Anoia	Clinical laboratory services
Sanitari de la Selva	Clinical laboratory services
Sanitari de l'Alt Penedès	Clinical laboratory services
Sanitari del Maresme	Clinical laboratory services
Institut de Salut Pública	Public health teaching and research

Source: Servei Català de la Salut. Memòria d'activitat 1997. Barcelona, 1998.

case of consortiums, 64 representatives out of 112 are from the Department of Health, 23 from local governments, and 25 from different organizations (nonprofit foundations, associations, etc.).

Manner of Appointment of Board Members (Principals)

As in Lebanon, the selection of members is an ambiguous process. Appointments are made by political negotiation. Currently there is an increasing effort to introduce some criteria on this matter (interview with Joan Sintes, Servei Català de la Salut).

The Hospital Manager (Agent)

Political criteria weigh heavily in the appointment of hospital managers. The executives market is practically nonexistent, and past performance is not necessarily a good predictor of a better appointment.

The Extent of MOH Regulatory Responsibility Decentralized to the Board

Oriol (1998) states that the role of the board is to guarantee the firm's mission, approve and review strategies, monitor management, select executives, mediate conflict, guarantee responsibilities (financial, legal, ethical), and secure a relationship with the community. In essence, the roles of the board are related to *ratification* and *monitoring*, while the executives *initiate* and *execute*. These four types of decisions are widely recognized as the crucial ones.

The problem that arises is when ratification and monitoring have to be undertaken without proper information. There are multiple examples of asymmetric information between executives and boards. In nonprofit

boards this potential conflict also appears as the most likely one.

Besides selection and composition of the board, there is also the need to create teamwork. In order to be effective, the size, duration, work methodology, responsibilities, community communication, and evaluation are some elements to take into account in setting the board's rules. These topics are under debate at this moment. Adaptation from reports and recommendations on this issue coming from the private sector are not easy. Last year the Spanish government released a report on governance of for-profit firms, but nonprofit and for-profit firms have wide differences that are reflected in board composition and firm goals. It is not easy to compare one to the other.

Principal Coordination/Agency Problems Emanating from the System's Institutional Design

There are several issues that are especially difficult to solve regarding governing boards of hospitals in Catalonia. Incentives and information are the two critical issues. Their assessment will require future study.

On the incentives side, board members are not paid, so many individuals refuse these positions unless they have community commitments or are currently in a political position that obliges them. After being selected, incentives for effort in monitoring and close supervision of management are not clear. Some individuals may have a strong commitment, but it is difficult to predict a general pattern.

On the information side, managers select the information available and its use depends on the capabilities and knowledge of board members. Therefore, the current sys-

tem doesn't guarantee the best information and incentives for these organizations that have low exposure to market.

VI. Practical Insights from Catalonia

During the 1980s in Catalonia, professional managers were introduced in public hospitals. This meant a new administrative perspective toward management, but currently there is no study available on the impact of hospital boards in public firms.

Public policy has emphasized the importance of separating the role of funding from the role of providing. However, since representatives of the Department of Health make up the majority on many boards, concerns have arisen about the integration of financing and providing functions in a subtle way. Public firms belong to the government, and therefore it must be represented on the board. On the other hand, representatives of the Department of Health have the opportunity to get information on health costs and quality that it is useful in their regulatory and financing functions with the private sector. In practice, it is understandable that policy debates are adapted to real conditions.

The analysis of key issues such as board composition and selection has not been undertaken. Team-building and access to information by board members is currently regarded as a need, and a unit within the Catalan Health Service is collecting and delivering information for board members.

Considerations about typical features of nonprofit boards made by Oster (1995) are replicated in the case of the boards of Catalonia public firms: "They are larger, with fewer insiders, more conflicted and more involved in operations than for-profit boards." Oster has suggested that in order to improve performance, nonprofit boards should be staffed with people having short tenure; this would reduce the probability of the executive director's taking control of the board. This potential danger needs to be addressed. Increasingly, governance boards will focus on ratification and monitoring tasks, rather than direct involvement in specific operations. But information flows may be inadequate to undertake these tasks. Therefore, the usual private-sector concerns are equivalent to those in public firms in this respect.

VII. Concluding Comments

There is an increasing attention to the role and performance of the board in corporatized hospitals. However,

designing hospital boards in nonprofit firms raises additional concerns compared with for-profit ones. The performance of the board is related to board composition, selection, and the degree of cooperation between selected members. These issues are highly variable in practice because nominations are often politically determined in corporatized hospitals.

Since many features of private sector governance are not present in the public sector (such as alienability of shares, product and market competition, market for corporate control, a managerial labor market, and corporation law), the performance of the board of directors in a public organization is crucial. Given that decentralized systems tend to increase the need for transactions, and therefore transaction costs, board performance is one key determinant of these costs.

One of the key roles of governance in public health firms consists of the ratification and monitoring of executive activities. The likelihood of optimal performance is maximized if appropriate incentives for board members are implemented. Autonomy and accountability in taking decisions on technocratic rather than political bases improve the reputation and increase the independence of the board. Otherwise, boards remain extensions of central authorities, and lack the capability of implementing decisions based on local needs.

The two case studies analyzed in this paper highlight slightly different approaches to decentralization of public firms in the health sector. The goals of corporatization (revenue-generating capacity and new incentives for efficiency) have different effects in each case. In Lebanon, revenue-generating capacity is seen as a key issue; in Catalonia it has a limited impact on the decision to corporatize. In the latter case, the decision to create a public firm has been mostly related to the opportunities to introduce new management styles in hospitals built recently. Stakeholder/principal representation on hospital governing boards is regulated by law in the case of Lebanon, while in Catalonia each case applies the same rule of participation of regional government.

Finally, incentive alignment is a key issue that requires further analysis. The level of cooperation between board members determines the extent of clear incentives for the manager. This paper has sought to suggest a conceptual lens for assessing the level of cooperation, adequacy of incentives, and performance in corporatized hospitals—a research agenda that calls for further empirical work.

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Endnotes

1. Throughout this paper we use North's (1990) distinction between "institutions" and "organizations." Institutions are the formal and informal rules that shape interaction. They range from constitutions, to laws, to common practice, to corporate culture (Kreps 1993). Organizations are groups of individuals bound by some common purpose to achieve a given set of objectives. They include political, economic, social and educational bodies. In this proposal, a hospital is an organization. The law and decrees governing the operation of the hospital are a set of institutions.

2. Hart (1995) defines "residual control rights" over an asset as "the right to decide all usages of the asset in any way not inconsistent with a prior contract, custom, or law. ... [P]ossession of residual control rights is taken virtually to be the definition of ownership

... in contrast to the more standard definition of ownership, whereby an owner possesses the residual income from an asset rather than its residual control rights" (p.30). Holmström (1996), Roberts (1992), and Kreps (1992) also refer to residual control rights as "decision rights." In this paper, we use the latter, shorter term more frequently.

3. These questions are of special interest, given the international trend toward decentralization and corporatization of the public sector, and given the apparent difficulty of designing effective public hospital boards in both industrialized and developing countries (Govindaraj and Chawla 1996; Barnum and Kutzin 1993; Shonick and Roemer 1983; Savage et. al. 1997; Schleifer and Vishny 1997; Gertner and Kaplan 1996). It is curious that despite the wide interest in this topic, there is little theory that informs it.

4. We use the terms institutions, institutional structure, institutional design, laws and their decrees of application interchangeably in this paper. A comprehensive treatment of institutions would normally cover problems of implementation, enforcement, and monitoring in addition to issues of design (structure) (Polenske 1999). For the sake of narrowing and deepening the scope of this research, we focus on issues of design, which are most amenable to the analysis of decrees—an important component of our data and policy problem. We will bring in issues of implementation, enforcement, and monitoring insofar as they enlighten the problem of design, but they will not be the focus of the discussion.

5. The idea of considering hospital users or the "community" in general as "stakeholders" or principals is prevalent in the health-care literature. Among the possible hospital stakeholders (see, for example, those enumerated by Savage et al. 1997) are patients and local communities, state and local governments, health plans, professional/trade associations, physicians, and employers.

6. Aghion and Tirole's (1997) work on the difference between formal and real authority in organizations describes similar empirical outcomes.

7. Given the geopolitical nature of public hospital care provision in Lebanon, however, the closing down of unprofitable hospitals would be rationally desirable, but politically difficult.

8. Some of the information we have obtained on the weaknesses of the system and used as empirical evidence in this paper constitutes criticism of sectoral structures and policies by people employed in the sector, and can compromise the professional positions of its sources. As a result, the names of both individuals and their affiliations are kept confidential in this version of the paper, as the reform proceeds.

9. The following items are translated from the Arabic text of Law No. 544.

10. Decree No. 4517 states that the director is to be appointed by the Council of Ministers upon the recommendation of the relevant sectoral ministry, in this case the MOH. This decree also stipulates that the Council of Ministers sets the salary of the director.

11. Using the Decree on Boards of Directors as a baseline, a similar analysis can be carried out on the remaining decrees.

12. Furthermore, if we are exclusively concerned with coordination, it appears preferable to exclude the community from the board, so that the agent (hospital director) is certain to respond to the MOH's incentive to reduce cost. The agent's problem then becomes one of fulfilling the right social welfare function (because the director is not alerted to community needs), but the board would be more coordinated.

13. The reticence to charge high fees may also have a positive impact on equity considerations, although this work cannot substantiate it.

14. The analysis carried out based on Table 2 can be extended to other areas of hospital board decisions using the remainder of the Finance Decree in addition to the Internal Administration, Personnel, and Compensation Decrees, to a larger and more detailed survey

design, from which we expect broadly similar findings. Extensions of this work would be helpful in substantiating testable hypotheses, and in developing a method for analyzing the institutional design of hospital boards.

15. Yet another solution could be to do away with the examination requirement altogether, as is done in the private sector, and replace it with screening instruments set by each hospital individually. The experience with the point system in one public hospital, however, indicates that the easy politicization of what are still considered "public sector jobs" may preclude the proper operation of market-like hiring practices in a country where the religio-political map is still expected to be reflected in the distribution of public sector jobs.

16. The analysis of power wielded through property rights (decision rights) is not a new subject. See Polenske (1999) for an insightful discussion of the relationship between different types of power, property rights, and development strategies. Contributors to this topic, discussed by Polenske, range from Marx (1967 [1888]) to Parsons (1963) to Poulantzas (1973) to Weber (1978), and Bowles and Gintis (1986).

Comment

A L B E R T O D I A Z C A Y E R O S

The papers that have been presented in this panel are all insightful studies of the issues raised by the design of transfers and governance structures in decentralized countries and the incentive problems faced in such design. The paper by Bird is, I believe, a call for a systematic rethinking of the guidelines for transfer design, informed by theoretical debates and the wealth of experiences found around the world. In the case of Saiegh and Tommasi, this rethinking goes even further, in their call for a political economy approach as the way to understand the mismatch between normative benchmarks and actual practices. Their discussion makes use of the “transaction cost politics” approach (Dixit) and a theoretical literature that understands representatives in legislatures and financial resource allocation as games of distributive politics. The paper by Eid and Ibern provides a rich contrast of two cases of corporatization in health provision, although the implications of their work go much further in understanding the incentives created by institutional design and governance structures in contexts of public-private, national-subnational cooperation. Rather than commenting on each paper individually, I want to draw some common themes and propose certain topics that merit further research, particularly in the political economy of transfers. I will make six assertions about this political economy; exemplify them drawing from the papers and the Mexican experience of transfer design, which

is the one I know best; and I will finish by pointing out some specific issues that I believe deserve greater attention in the individual papers.

1. **Transfers are political.** Transfer design is not just a matter of “depoliticizing” the process through which they are determined. The real issue is to understand what needs to be done in order to make transfers (or public entity governance structures) closer to an economic and policy ideal (revenue adequacy, not to encourage fiscal deficits, promote equity, transparency, and instability, in Shah’s terms quoted by Saiegh and Tommasi; or in Bird’s terms, to be stable and flexible, simple, reliable, and transparent; or, in

the case of public hospitals, improving the nomination procedures to their boards). I believe this question is not one of finding ways to prevent politicians from playing a role in transfer or governance design—which is a self-defeating strategy—but rather to understand the political incentives present in the system, and whether politicians can be enticed to produce better designs through specific benefits either “buying them off” in other budgetary areas that will not become permanent features of the institutional landscape; or providing them longer time horizons in such a way that the system will evolve favorably in the future. One remarkable example of how politicians can be

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brought to accept better transfer designs is the transformation of Mexican Item 26 funds for regional development from the highly discretionary and allegedly politically manipulated Solidaridad program to the Fondo de Infraestructura Social (FIS) within Item 33 to finance local public works, which follows poverty criteria and public service needs. This was made possible, I believe, through the creation of a new fund for municipalities, allocated on an equal per-capita basis, which came to favor urban municipalities, and skillful bipartisan negotiations that involved both the ruling party, the PRI, and the opposition PAN, which has traditionally advanced an agenda for greater decentralization and municipal autonomy.

2. Politicians are more concerned about distribution than efficiency, because “fairness” (or the perception of transfers being “just”) is central both to their world-view and their political incentives. Such “fairness” does not mean that politicians are more concerned for the poor or that they seek a progressive redistribution of financial resources; the opposite is often the case. Rather, political players are more willing to trade off efficiency for other goals. The promises they must deliver to their constituencies constrain politicians to find a better deal than the neighboring governor or deputy. In this sense, the Coasian framework to understand the allocation of property rights and the role of transaction costs, although useful, is inappropriate, because it centers its concern on efficiency, not on distributive consequences. In particular, Coase does not help us understand the trade-offs that are often made between distribution and efficiency, which is at the heart of transfer and institutional design. A very clear example is the notion in Eid and Ibern’s paper that residual claims (and hence property rights) lie in the Ministry of Health in Lebanon, which should presumably lead to greater efficiency, but boards seem to be designed instead to bring about some distributive goals. The same appears to be true of the common presence noted by Bird of transfer designs that provide equal funds per region, which is obviously highly unequal in per capita terms, but must surely play a perceived distributive goal which, at least in politician’s views, makes the outcome “fair” (i.e., one senator/deputy/mayor, one state/department/province/city, one “equal” transfer). In Mexico this is the case in the FIS, which notwithstanding the advances in formulas, still provides an “equity” criterion of distributing 0.5 percent of the funds to each state regardless of size—the opposite of what a “fair” poverty fund should do.

3. Politicians want transfers to be understood as zero-sum games, rather than as a common-pool resource problem. A zero-sum view of distributive politics is the most extreme form of political conflict: What I win is someone else’s loss. In game theory this is an extreme case, which finds at the other extreme cooperative theory and bargaining games (which can be constructed also in a non-cooperative but positive sum fashion). It seems to me that although there do exist prisoner-dilemma type issues in transfer design, fiscal federalism is never a zero-sum game. Cooperative game theory provides for Pareto improvements if cooperation succeeds. The threat of negotiations breaking down—falling into a disagreement outcome (or reversion point) where everyone loses and failing to reap the benefits of cooperation—is what brings parties to cooperate. Because politicians are not as concerned about economic efficiency as economists are, they are more willing to forgo opportunities for cooperation if it provides them with some immediate benefit. In the short run, local politicians prefer to enter into a vicious cycle of greater spending, less local tax effort, increases in federal/national transfers (or discretionary funds), which lead into even greater spending and less effort, guaranteed by an ill-designed transfer system. The rhetoric of zero-sum is an extremely useful device to keep this vicious cycle in place—and to hide the real issues of efforts and incentives, enabling local politicians to always blame other levels of government and competing local governments for their lack of resources.

4. Politicians have few incentives to increase the supply of information of transfers or public service performance to the extent that this increases their risk and exposure. If accountability is also weak, as is common in most of Latin America, citizen demands for information will also be limited. Moreover, if there is little clarity due to the transfer system of who is responsible for the scarcity of financial resources or the deficiencies in public good- and service-provision, local politicians will not seek to make information widely available. To this one must add that fiscal federalism is often couched in arcane terms and complex technical formulas, which most observers and players will be unable to apply or reproduce. Politicians can have incentives to change this and provide more information, but it depends on their available future career paths, local party competition, and legislative-executive relations. At the extreme, the Mexican incentives from the past, with no

re-election, hegemonic party rule, and unified government are conducive to the least information. Not surprisingly, as party competition became vigorous and the national government was divided, the flow of information increased exponentially.

5. National politicians and agencies that make up the federal/central government are not “benevolent central planners.” Tempting as it is to believe that the central/federal government has better incentives than local governments to provide for efficient policy, the central/federal government is not a unitary actor, but a complex set of “multiple principals,” as Eid and Ibern note in their paper, with complex coordination problems and real self-interested, often opportunistic political goals. Moreover, central/federal governments are often more constrained by veto players and other institutional devices that narrow the space for policy change, so that their room for maneuver to improve institutional design is probably even more limited than the one found at the local level. This suggests that although we have witnessed a remarkable trend toward decentralization in Latin America, changing the deficient transfer designs that now exist will be increasingly more difficult. In Mexico, the contrast between the relatively technical decentralization of resources in health and the highly politicized process in education bears witness to the difficulty faced by a national government committed to decentralization that was unable to create a reasonably equitable per-capita transfer of education funds. Education funds constitute the largest component of Item 33 due to the strength of the national teachers union, its links to the PRI, and the “colonization” of this union over the Ministry of Education, the Secretaría de Educación Pública.

6. Politically connected citizens can disproportionately benefit from the conditionality of transfer design. This insight comes from the Eid and Ibern paper in the hospital context in Lebanon. It is one of the most important design issues if we believe transfers are meant to increase a social welfare function, as the Bird piece notes. If transfers will tend to have an urban bias due to their earmarking for public works, or the provision of public goods is biased toward the politically relevant groups, while the

poor are de facto disenfranchised, a direct central/federal intervention in the poorest regions targeted toward women and children might be a preferable policy strategy. In Mexico this issue is clearly reflected in the slim chances for a strategy like PROGRESA, a well-designed federal targeted program for poverty alleviation, to survive in the future; both the left and the right attack it, either because of its “neo-liberal” outlook or its “centralist” connotations in bypassing local governments. In the end, both the right and the left would rather have programs that are relevant to their political constituencies, and PROGRESA does not seem to cater to either of them.

Specific comments

Bird. I am not sure that the conclusion that it is not so important to have transfers linked to incentives really follows. It seems to me that it depends on the nature of transfers. If we are discussing unconditional revenue sharing, something akin to a derivation principle should prevail, so that transfers are consonant with what would prevail if states and municipalities relied more on own taxation (even if inefficient).

Eid and Ibern. I missed finding a theoretical argument for why one would expect different governance structures in the boards of profit as compared to nonprofit institutions. In particular, Yoram Barzel would argue that the difference would depend not on residual claimants, but on the fact that whoever has the greatest capacity to affect the flow of resources will in fact capture property rights, and that governance structures should be designed to prevent such captures.

Saiegh and Tommasi. I would have wanted to see a better notion of how fiscal federalism is indeed an incomplete contract in the countries studied. Who has authority to appropriate the residual? To whom is delegation of decisions for unforeseen contingencies provided? Mexico, for instance, includes contingency reserve, administrative collaboration, and exit provisions, which seems to me to be a rather comprehensive contract between states and the federal government (or at least as close as one could get to a complete one).

Equity and Decentralization

Equity and the Decentralization of Social Services

EMMANUEL JIMENEZ

I. Introduction

Many developing countries are decentralizing social services like education, health, and welfare. In Latin America, the movement started in the 1970s and early 1980s, but the efforts accelerated in the 1990s (di Gropello and Cominetti 1998; Winkler 1999; Griffin 1999.). In Eastern Europe and Central Asia, the move away from formerly heavily centralized systems started with the transition to market economies (Wetzel and Dunn 1999). These developments, particularly those reforms that involve decentralization to the lowest levels, are supported strongly by multilateral institutions:

By increasing involvement of parents and local communities, addressing constraints in personnel management, improving financing allocation mechanisms, and expanding the delegation of functions, countries in the region can accelerate educational progress and create conditions for substantially reducing income inequality in the future (IDB 1998-99, p. 131).

While much of the impetus for decentralization may be political, the main economic justification has been to improve efficiency. And the most important aspect of efficiency in decentralization is information—lower tiers have better information about what kinds of services they want and are willing to pay for. Decentralization makes local units accountable to the direct beneficiaries, who may also have to bear

more directly the financial consequences of their choices. Other efficiency reasons include lessening administrative burdens for large bureaucracies and the more active participation of beneficiaries in ensuring the sustainable use of services.¹

There is a lively debate about these efficiency effects. Detractors claim that the information advantage at the local level is overestimated; the administrative capacity at local levels is too limited to enable them to take on much responsibility; there could be scale-diseconomies; and there could be principal-agent problems if local authorities have distinctly different preferences that could lead to ineffi-

cient social (or national) outcomes and strategic behavior results from information asymmetries.

There has been less of a debate on the equity effects of the decentralization of social services. This should be of some concern because spending on social services may well be government's main instrument to redistribute income in society, as explained in Section II. However, Section III shows that decentralization is not necessarily equitable. First, the effects depend on differences in preferences, capacity, and the distribution of the population. Second, there are many different types of decentralization—equity effects depend on what function is decentralized and to

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whom. It is not possible to generalize from the present experiences because they are so varied. So, it is largely an empirical issue. Unfortunately, as discussed in Section IV, the empirical evidence is weak. Despite its current popularity, decentralization is a fairly recent phenomenon, and results have not been reviewed thoroughly. While rigorous statistical analysis is thus difficult, it is instructive to review some case studies of the experiences of specific countries and programs, which is done in Section IV. Section V summarizes the paper.

II. The Center and Equity

The equity objective is multi-dimensional. Most societies place a premium on ensuring that all of their members have the capacity to enjoy a certain minimum standard of living (usually measured in terms of income or consumption, often referred to as "money-metric" measures of welfare) or to have access to certain basic services, such as education or health services, that will provide them with the wherewithal to meet that standard. Many societies also value some kind of equality in standards of living.

Strong Conceptual Arguments

There are strong arguments to support a central-government role in meeting a society's equity objective, whether expressed in terms of poverty reduction or welfare equalization. Central governments can compensate for differences in preferences for inequality, the distribution of income, and the capacity to tax and spend (Oates 1993; Musgrave and Musgrave 1980).

First, if people in different regions have different preferences for equity, then the central government would have a strong role to play. Horizontal equity² requires that persons ought to be treated the same regardless of where they live. This has been a strong justification for the centralized provision of health and education in the past, because these are valued not only instrumentally, as a means of improving incomes, but are also valuable ends in themselves.

Second, even if preferences for equity are uniform, if household income is distributed unevenly, then the central government would have a strong role to play to ensure equity. Relying on subnational units to meet a nation's equity objective would be difficult for some regions if the disparity in average incomes is too wide. The problem becomes worse if there is migration. If one jurisdiction redistributes more income than another, then the poor

could simply move to the community with a more progressive policy. By adding to that jurisdiction's costs, it diminishes the incentive to redistribute. This is why many transfer programs are federally mandated even in countries with relatively powerful subnational governments, such as Canada (Boadway 1992).

Moreover, Tiebout (1956) hypothesized that if jurisdictions formed to provide local public goods and they competed with one another, individuals would reveal their preferences for those goods by where they lived. If true, welfare is likely to be substantially homogeneous within those jurisdictions, thus reducing the scope for subnational redistribution.

Third, the capacity of subnational governments both to raise revenue and to spend effectively may be less than that of the center. As discussed earlier, subnational governments have a more limited set of revenue-raising tools at their disposal because they cannot print money and they have limited borrowing authority in countries concerned with controlling macroeconomic imbalances. Moreover, where there is limited administrative capacity, the central government often attracts the more able administrators. Finally, some are concerned that corruption would be uncontrolled and almost unseen at lower levels.

Weak Empirical Evidence

These are compelling arguments why there needs to be a strong central-government role to ensure equity. Yet the little empirical evidence that exists indicates that the source of spending—whether it be the central government or elsewhere—has very little to do with either equity of access or equity of outcomes.

Table 1 shows the degree of financing decentralization of basic (primary and secondary) education in a few Latin American countries. In Argentina, for example, 8 percent of financing comes from the central government directly, while the other 92 percent is routed through general transfers and local taxes (the source unfortunately does not give the breakdown for own sources versus transfers). Intermediate levels of government refer to states, provinces, or departments, while the local level refers to municipalities. Argentina and Chile have similar outcomes in terms of equity of access to basic education subsidies—the bottom 20 percent receives about 5 times more of basic education subsidies relative to that received by the top 20 percent—but have very different mechanisms of decentralized

TABLE 1

Decentralization of Basic Education and Equity

	SOURCE OF FINANCING BASIC EDUCATION				
	(1)	(2)	(3)	(4)	(5)
	CENTRAL	INTERMD	LOCAL	PERCENT OF PRIMARY ED SUBSIDIES RECEIVED BY BOTTOM QUINTILE RELATIVE TO TOP QUINTILE	PROP COMPLETED PRIMARY—BOTTOM 40 PERCENT RELATIVE TO TOP 20 PERCENT
Argentina	8	92		4.80	
Bolivia	10	90			.337
Brazil	26	44	30	1.43	.260
Chile	50		50	5.00	
Colombia	10	50	40	8.00	.668

Note: Decentralized financing includes both transfers from the central government and local contributions through taxes.

Sources: Columns 1–3, diGropello and Cominetti (1998), Cuadro 17; Column 4, IDB 1998–99, Figure 8.24; Column 5, Filmer and Pritchett 1998, Table A-1.

financing (Argentina relies more heavily on departments and Chile more on local municipalities). Brazil, Chile, and Colombia, in fact, all rely heavily on local municipalities but with vastly different outcomes in terms of equity of access to basic education. In Brazil, the top 20 percent receives almost as much as the bottom 20 percent of primary education subsidies.

These findings are also reflected in equity of outcomes, as measured by the proportion of those in the bottom 40 percent who have completed primary education relative to those in the top 20 percent. The closer this number is to 1, the more even it is. Both Bolivia and Brazil are as heavily decentralized as Colombia and yet have worse equity outcomes—in Brazil, the bottom 40 percent completes primary school at a rate that is only one-quarter that of the top 20 percent.

Similar results hold for health (Table 2). First, the inequality in health access is more pronounced than in pri-

mary education, as might be expected. Health services are regressively distributed in Brazil and Nicaragua (as they are for all education). Second, while these countries are both more centralized than Argentina and Colombia, they are no more centralized than Chile, where health subsidies are progressive.

In terms of outcomes, disparities are less in the case of decentralized systems like Colombia and Bolivia. Brazil, where financing is more centralized, has more inequitable outcomes (Column 5 of Table 2). There, the bottom 20 percent has an under-5 mortality rate that is four times that of the top 20 percent.

Because of the small number of observations, these trends (or lack of them) are merely indicative rather than conclusive. There is clearly a need for more research to compare different decentralization experiences broadly across countries and across types. Nevertheless, there are at least two important reasons why we find no strong system-

TABLE 2

Decentralizing Health and Equity Effects

	SOURCE OF FINANCING HEALTH				
	(1)	(2)	(3)	(4)	(5)
	CENTRAL	INTERMD	LOCAL	PERCENT OF HEALTH SUBSIDIES RECEIVED BY BOTTOM QUINTILE RELATIVE TO TOP QUINTILE	UNDER 5 MORTALITY— BOTTOM 40 PERCENT RELATIVE TO TOP 20 PERCENT
Argentina	15	76	9	5.50	
Bolivia	12	62	26		2.5
Brazil	52	33	15	0.40	4.0
Chile	90		10	2.00	
Colombia	17	69	14	2.08	1.9
Nicaragua	81	19		0.21	

Note: Decentralized financing includes both transfers from the central government and local contributions through taxes.

Sources: Calculated from Columns (1)–(3), diGropello and Cominetti (1998), Cuadro 31; Column (4), Filmer et al. 1998, Table C-2; Column (5), Hammer (1999).

atic evidence that centralized systems are better at meeting equity objectives: First, systems that are heavily decentralized in terms of provision but centralized in terms of finance can still meet equity objectives. Second, when spending is decentralized, there is growing evidence that local communities are better at meeting equity objectives because of their information advantage. We turn to these points in the next two sections.

III. Balancing Financing and Spending Responsibilities

Most of the arguments for a strong central-government role have to do with the central government's role in financing social services. But the majority of decentralization episodes have to do with decentralizing spending.

What Function Is Decentralized?

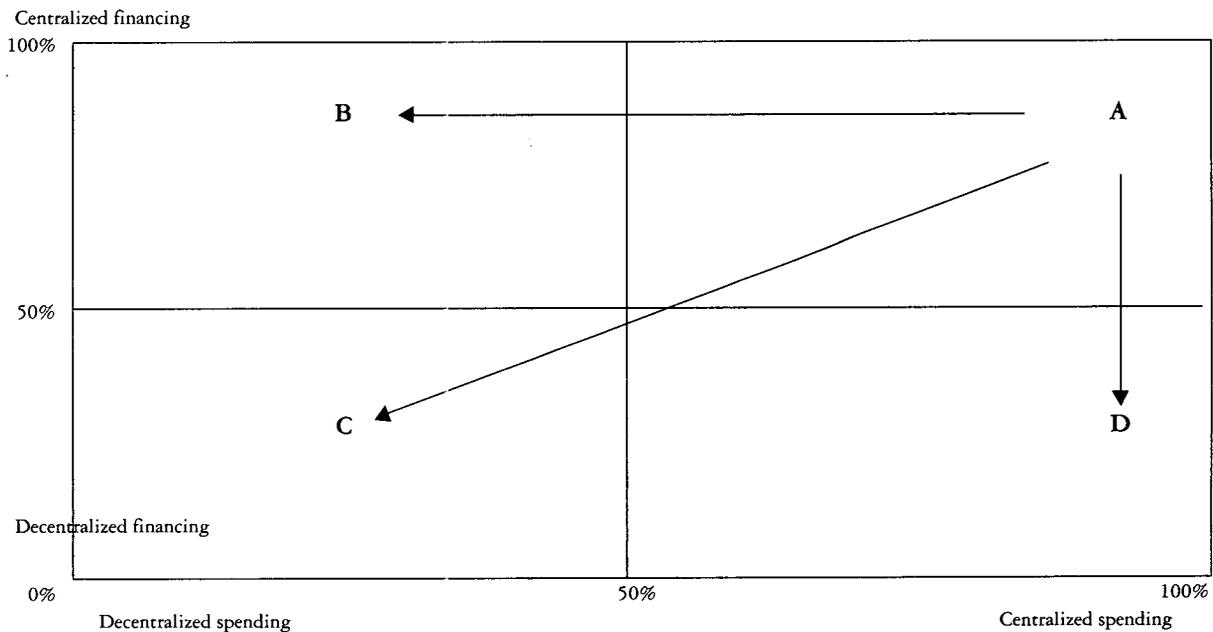
Transferring authority from the center downward will have different equity effects depending upon which functions are most affected. For example, decentralizing spending authority, either to provide social services directly or to subsidize someone else to do it, will have very different effects if financing responsibility is also decentralized than if it is not. (The effects also would depend on whether the activities of that entity were heavily regulated.)

These categories make for a potentially complex menu. To simplify matters, let us assume that for any one function we can rank the degree of "centralization." For the finance function, resources can all be raised through national taxes and that function would be 100 percent centralized. Alternatively, there could be no national taxes at all and only subnational ones; then the index would be zero. Similarly, for the spending function the decision to spend could be vested completely in the central authority (100 percent) or subnational levels. These are the axes of Figure 1. (For the moment, to stay within the two-dimensional space, the further complication of the regulatory task of government is not shown.)

In Figure 1, a completely centralized system would be in the northeast quadrant, say Point A. Decentralization toward B will mean that spending is decentralized, but financing is not. This might mean relying more on transfers to subnational authorities, who might then be given the authority to spend. This is perhaps the most common form of decentralization.

But this is just the beginning of the story. Decentralization from A to C would mean that both financing and spending authorities were transferred. And, as one moves further clockwise, to the A-D reform, the financing function is more decentralized.

FIGURE 1
Decentralizing Functions



As the financing authority for spending on social services is devolved from the center, equity could be adversely affected depending on the initial distribution of income, the capacity of different jurisdictions to collect revenues, and the preferences of various jurisdictions for equity. If income is distributed more unevenly across jurisdictions than within jurisdictions, if all else is constant, decentralizing financing will tend to be regressive. Thus, in Figure 1 as one moves counter-clockwise from the A-C type of decentralization, decentralization tends to be more regressive. But if income is distributed more unevenly within jurisdictions than across them, then decentralization could be equalizing if local authorities have the capacity to transfer incomes (they could even have an informational advantage in distinguishing rich from poor) and share the equity objectives of the center.

The equity effect of transferring the authority and responsibility to raise resources from the center downward also depends on the relative incidence of the different instruments used by various authorities. As noted in the annex, this is often difficult to assess. Legal tax rates are a poor guide to incidence because the capacity and willingness to collect may vary. Moreover, the burden of the tax can be easily passed on.

Property taxes are an important source of local finance and are often associated with educational expenditures. In the United States, these can be viewed as a "benefit tax" that is borne by those who enjoy the public goods they consume. Bahl and Linn (1992) conclude:

In sum, of nineteen studies of the incidence of the property tax in developing countries or cities, only two found clear evidence of regressivity. ... In both cases, rather extreme assumptions were made regarding the full shifting of the tax burden to consumers and occupants, and general expenditure patterns were found to be unusually income-inelastic. For the remainder of the studies, incidence varied from neutral to very progressive depending on the precise assumptions made. ... [T]hese empirical studies lead to the conclusion that a proportional property tax in developing countries is likely to be very progressive in the short run and at least neutral, if not slightly progressive, in the long run (p. 143).

User charges are a small but increasingly important source of financing social services (Jimenez 1987). Increas-

ing prices for services that had been free would normally be regressive. However, even here the situation can be complicated. Free provision of a service does not necessarily mean that the poor get access if the service is rationed. If services are expanded with the revenue from increased prices, equity could actually be improved.

One should then combine the incidence of taxation and spending to obtain the net effect of government in centralized and decentralized settings. In the United States a review of incidence papers indicates that taxes are mildly progressive at the federal level, proportional at the state level, and somewhat regressive at the local level (Rubinfeld 1987, p. 629). At the same time, spending is essentially progressive at the federal level and somewhat pro-rich at the state and local levels. This is not surprising given the Tiebout hypothesis. I was unable to find a similar review for developing countries.

What Do Countries Do?

One of the main reasons that decentralization in developing countries is not associated with a drastic worsening of equity is that most of what has taken place has not involved a decentralization of financing. It has only involved decentralization of spending (which is discussed more fully in the next section).

In education "...countries have given school councils and schools significant autonomy in managing (but rarely financing) education" (Winkler 1999, p. 9). In fact, of the seven decentralization case studies mentioned in Winkler's study, only two actually had, as part of the reform, a program whereby schools would even be allowed to raise their own revenues significantly. Still, these country cases are considered successful decentralization experiments because they devolved many other responsibilities.

In health a similar situation holds. "While the central governments [in Latin America] tend to retain responsibility for policy-making, overall financing, and operation of highly specialized medical care centers, states or provinces have often been given responsibility for provision of secondary and tertiary hospital care, and municipalities that for primary health care" (Griffin 1999, p. 9). States and municipalities are often pressed to contribute more of their own resources, but they "have few resources of their own as they lack fiscal powers" (Griffin, 1999, p. 11). State and municipal contributions for health care are less than 20 percent of total health expenditures in most countries.

In the framework of Figure 1, most decentralization has thus been more of the form of movements of A to B (or at least north of the A-to-C line). The equity effects thus hinge on what happens as a result of decentralizing responsibilities to spend.

IV. Equity and Spending

Governments spend by either transferring funds to others or by in-kind transfers (such as staff, supplies). Both activities can be decentralized, possibly with different effects. Transferring funds to lower levels of authority can give the latter more freedom to change the mix of spending categories. For example, a subnational authority with full control of funds might decide that it would require fewer personnel in schools and hospitals relative to non-salary inputs. Since many poorer communities often suffer from lack of supplies, this could affect effectiveness at that level. At the same time, even if a transfer to a jurisdiction were severely restricted so that it was transferred in-kind (such as an allocation of centrally hired staff to districts), the subnational level could simply cut its own local hires to preserve staff numbers. Thus, one must analyze, not only these first-round effects (that is, without any reaction by the receiving jurisdiction), but also second-round effects that take behavioral responses into account.

There are at least two important arguments why spending may improve equity outcomes. First, even if they were, people in one area may not necessarily value redistribution as much as people in another area. Indeed, some (Pauly 1973) would go so far as to say that, because redistribution is largely due to altruism, and altruism applies more to one's own community rather than society at large, there may be more scope for redistribution at subnational levels.

Second, the capacity to redistribute does indeed vary across communities. While the standard story is that lower levels of authority are less able to tax and spend effectively, this can be partly due to administrative capacity—central authorities often have access to a better pool of human resources than subnational governments. But it may not always hold. For example, the previous section discussed how many central governments in developing countries are incapable of collecting revenues effectively. If the budget is truly constrained, second-best considerations could apply even if it might be optimal as a first-best solution for the central government to deliver services.³ In education, for example, the central government often allocates up to 15

percent of the budget for non-salary expenditures to fund school materials. But this allocation rarely makes it down to the schools, which must generate these funds from local sources. While this may be inequitable if localities are vastly different from each other, it may still help the poor if the alternative is to have no materials at all. Since health and education outcomes depend not only on services delivered, but on complementary inputs from home, such involvement may also provide a mechanism for community and household ownership of the service.

The capacity to deliver public services also hinges on the relative ability of different tiers of government to match quantity and quality of services delivered with a community's needs and wants. This requires information. Lower tiers of government have better information about local conditions. Even poor communities could provide service delivery better than centralized systems.

There are few rigorous evaluations of the equity impacts at the household or individual level of decentralizing social services. However, the case studies that have been done for anti-poverty and education programs point to the following conclusions:

- Intra-regional differences in the capacity and willingness to target subsidies to the needy are more important than inter-regional differences in determining overall equity impacts.
- Within jurisdictions, there is a greater likelihood of benign or even positive equity impacts if decentralization results in efficiency gains.
- There is evidence that these efficiency (and thus equity) gains are more likely to be realized at local (neighborhood, district) levels rather than intermediate (provincial, district, even municipal) levels, as the former have more of an advantage in terms of the availability of information.

In the rest of this section, we review the evidence for anti-poverty programs and community schools.

Anti-Poverty Programs

Many anti-poverty programs are already or are in the process of being decentralized. In federal countries like Argentina they are decentralized down to the provinces; in India states are responsible for some of the largest public works programs (Datt and Ravallion 1993); even in the formerly heavily centralized countries of Eastern Europe and Central Asia, a significant portion of social security

and welfare spending (20-60 percent in Albania, the Czech Republic, Kazakhstan, and Ukraine) is done by subnational units (Wetzel and Dunn 1998)

What would the effect of decentralization be on these programs? On the one hand, when these are decentralized solely in order to shift the financing burden from the central to the subnational authorities, the equity effects are often regressive. This might be done if preferences for equity change in a society. One way to do this is to reassign financing without making requisite transfers to account for inter-jurisdictional transfers.

But, on the other hand, if there are gains to better targeting as a result, then equity could improve. As argued earlier, the scope for poverty reduction as a result of decentralization of transfer programs depends on the distribution of the population as well as that of the preferences for poverty reduction among different jurisdictions and of capacity to implement the programs. When budgets are constrained, it is crucial for governments to be able to direct spending toward those who are most needy.

Unfortunately, this is easier said than done. There is often no easy way to distinguish rich from poor. Recipients may, for example, dissemble in order to obtain benefits. The administrative costs are substantial, and when they are combined with incentive costs, they can be substantial.⁴ Many governments find this to be an enormous challenge.⁵ However, some analysts argue persuasively that (a) it is possible to use inter-regional differences in income or some other welfare measure as a way to target; (b) local authorities may have more information regarding who is rich and who is poor; and (c) as Pauly (1973) argued, people may be more altruistic toward their immediate neighbor rather than the nation as a whole. If so, then, decentralization can be progressive.

One blunt measure of the scope in using inter-regional disparities as a targeting device is to ask what percent of a nation's aggregate poverty rate can be attributed purely to differences in mean income (or consumption) across jurisdictions versus differences in welfare within those jurisdictions. More formally, the national poverty level can be shown to depend on three components: the national mean income (or welfare measure), regional disparities in average income, and intra-regional inequalities. One measure of the contribution of regional disparities alone can be estimated by measuring the poverty level that would obtain if regional mean incomes were equalized, holding constant

for the other two components (Datt and Ravallion 1993). The conclusion seems to be that this contribution is generally limited. In India, for example, removing regional disparities would reduce the headcount of poverty percent (32.7 percent in 1983) by only 5.3 percent.⁶ In evaluating Argentina's Trabajar program,⁷ Ravallion (1998) found that only 17 percent of the original program's targeting performance was due to allocation between provinces; the rest was due to targeting within provinces.

This implies that it is critical to rely on improved targeting within provinces (rather than just across them) if there is to be an equity gain to decentralization. In evaluating the difference in performance between two phases of the Trabajar program, Ravallion (1998) concluded that:

two-thirds of the gain in the program's overall performance was from better targeting *within* provinces. The provinces differed greatly in their success at reaching poor areas (p. 17).

Alderman (1998b) also finds this for Albania, where the allocation of social assistance among households by local authorities is much better targeted than the allocation of social assistance among local authorities by the central government. This is consistent with Pauly's (1973) hypothesis that local altruism may be a powerful force in determining outcomes. But it can also be explained by the fact that localities may have more information than would be available nationally. Alderman (1998a), in evaluating the economic support program in Albania,⁸ found that local officials were indeed using information that analysts cannot ordinarily observe in targeting.⁹

One interesting question is what explains the difference in targeting performance between jurisdictions. In particular, do poor areas do a poorer job at targeting than rich areas? This would not be surprising on the basis of preferences or of capacity. The answer seems to be that it depends on the level of decentralization. In Argentina, "poorer provinces tend to be less effective in discriminating in favor of poor areas *within* the province" (Ravallion 1998, p. 23). This may have an effect on how one targets provinces when trying to reduce the national poverty rate with a given budget—one may wish to give more to richer provinces if they are more effective at it.

In contrast, in Albania poorer jurisdictions are more likely than richer communities to target poorer households (Alderman 1998a). This may not be inconsistent with

Ravallion's results for Argentina, because the jurisdictions that Alderman is considering are much smaller communes. These communes may indeed be more altruistic within the localities as well as having more information about who the poor really are.

Community Schools

Another example of an informational advantage is in decentralized education. Central governments in developing countries usually play a major role allocating educational resources. Even when authority is delegated to sub-national levels such as provinces or municipalities, individual school administrators and parents play only a limited role. Such a centralized structure might make it easier to regulate and administer large systems uniformly; but it may also lead to ineffectiveness and high cost when school needs differ widely across communities and when there are diseconomies of scale. Moreover, it can stifle initiative among those who are most critical in affecting school outcomes—teachers, principals, and parents. These schools can improve equity in terms of access if their localized nature encourages parents to send more children to school.¹⁰

The community schools that have arisen from the war-torn societies in Nicaragua and El Salvador are good examples. In the latter case, the schools in the Salvadorean *Educación con Participación de la Comunidad* (EDUCO) program

were originally spontaneous efforts by isolated localities that could not get access to traditional educational forms during the respective civil wars. They were then formalized by the government as a way to deliver educational services quickly to remote rural areas during post-war reconstruction. Although there have been no comprehensive evaluations to see whether this has occurred when compared with what would have happened to access to these rural areas without the program, there is evidence that the program is well-targeted. Those participating in EDUCO programs tended to be from more disadvantaged programs than those in traditional programs in rural areas (Jimenez and Sawada 1999).

These programs have been evaluated on the basis of their effect on schooling outcomes of children. Table 3 summarizes the main components of the decentralization reform. However, there is considerable diversity across schools in terms of how decentralized they are. In Nicaragua some functions are as decentralized in the autonomous schools as they are in the traditional schools (see Table 4). This affects how one might interpret the results of the decentralization.

The results from El Salvador indicate that, despite being targeted at the poorest areas in the country, the children in the EDUCO programs have not suffered as a result of the decentralization. Children in the program do not achieve less in terms of mathematics achievement and they

TABLE 3
Two Cases of Education Decentralization

EL SALVADOR	NICARAGUA
<ul style="list-style-type: none"> • School governance to community associations: hire/fire teachers, administer government funds • Members elected from community • Legally responsible for operations 	<ul style="list-style-type: none"> • School governance to school council • Members include director, teachers, parents • Additional resources retained at schools

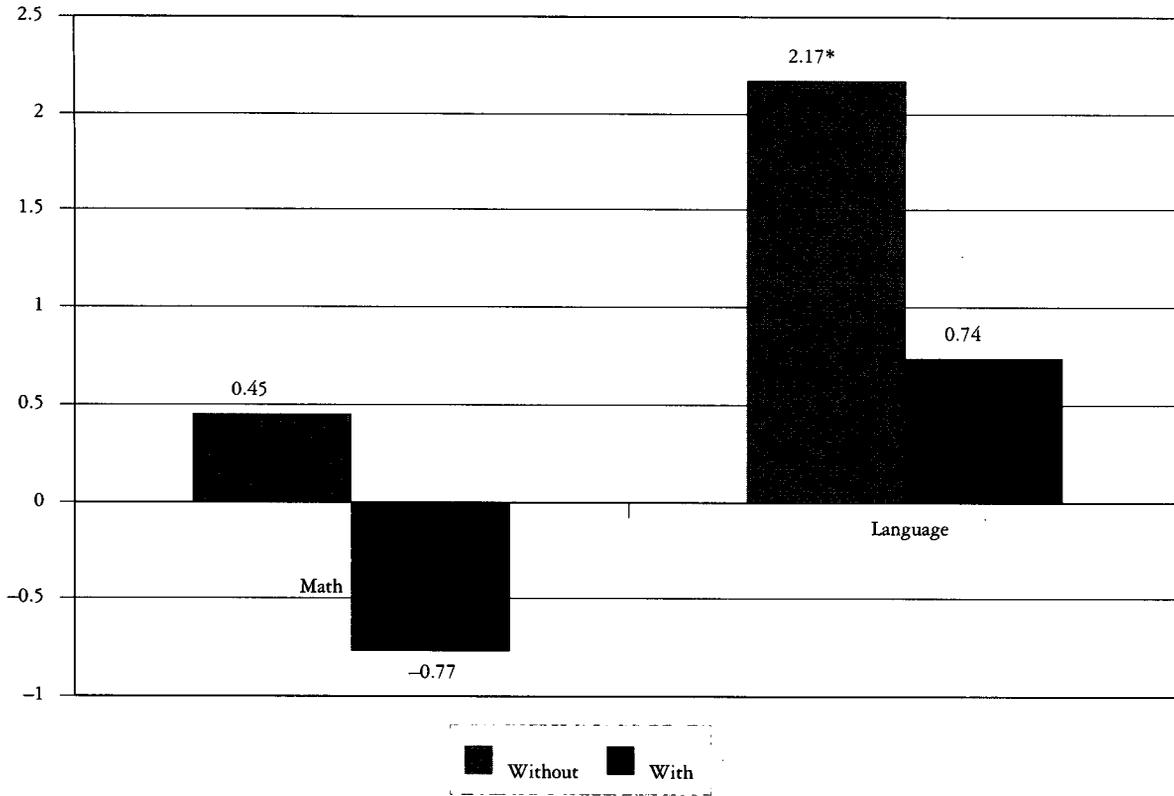
TABLE 4
Nicaragua: Is School the Principal Decision-Maker?
Secondary Schools, 1995 and 1997 (percent)

DECISION AREAS	TRADITIONAL		AUTONOMOUS		PRIVATE	
	1995	1997	1995	1997	1995	1997
Classroom and pedagogy	35	55	44	64	59	73
Personnel	19	25	66	74	79	84
Supervision and evaluation of teachers	64	81	71	81	78	92
Salaries and incentives	34	32	59	59	79	82
School budget and plan	50	67	88	92	88	92
Teacher training	14	45	50	79	50	79

Source: King and Ozler 1998.

FIGURE 2

El Salvador Achievement Results



Notes: Without: without school input and community participation variables; * Significant at 5 percent. Values are in terms of raw scores (averages are 4 and 2).

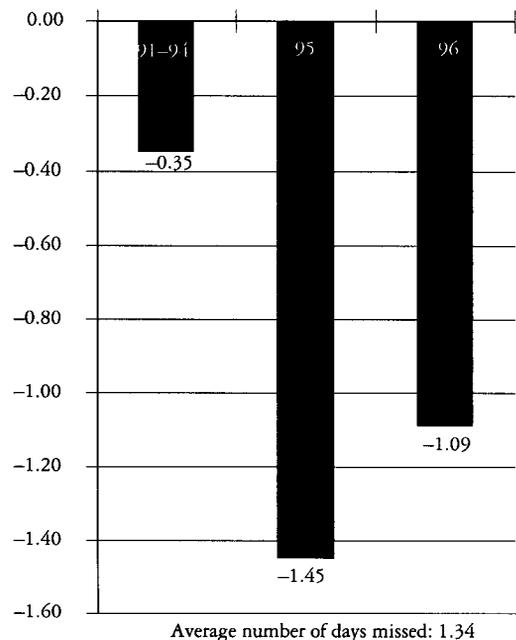
may even learn more in terms of language than their traditional school counterparts (see first column of Figure 2). There are potentially big payoffs in the future because student absences have declined considerably as a result of EDUCO. Overall, EDUCO students have three fewer days of absence per year than non-EDUCO students, and despite being from poorer households, the EDUCO students performed as well on achievement tests as the others. Since this result holds constant for student illness, the researchers believe that this is due to the decline in teacher absences associated with EDUCO (Figure 3). This is not surprising given that EDUCO parents are more involved with the teachers and schooling more generally (Figure 4). Teachers have a yearly contract with the communities in the EDUCO program.

In Nicaragua, the results are a little different. Looking at achievement-test scores, we find the following for schools that are autonomous de jure:

- At the secondary level, there is no statistically significant effect on math or language scores.

FIGURE 3

EDUCO Effect on School Days Missed Due to Teacher Absence



- At the primary level, there is a significant negative effect on math scores, but a positive (though statistically insignificant) effect on language scores.

For schools that are autonomous de facto, we find these effects:

- At the secondary level, a significant positive effect on language scores, and a positive (though statistically insignificant) effect on math scores.
- At the primary level, a significant positive effect on math and language scores.

Thus, being an autonomous school per se does not afford the schools an advantage in terms of learning achievement (nor does it provide a disadvantage). But the de facto behavior indicates that decentralization does have a positive effect on learning, regardless of whether the school belongs to a program.

V. Summary

The decentralization of social services is becoming more popular. This could have important implications for equity because spending on social services is a key redistributive tool of government. Moreover, access to social services such as education and even health reduces poverty and improves social indicators directly.

The effect of decentralizing social services on equity is difficult to ascertain because one cannot, a priori, rule out

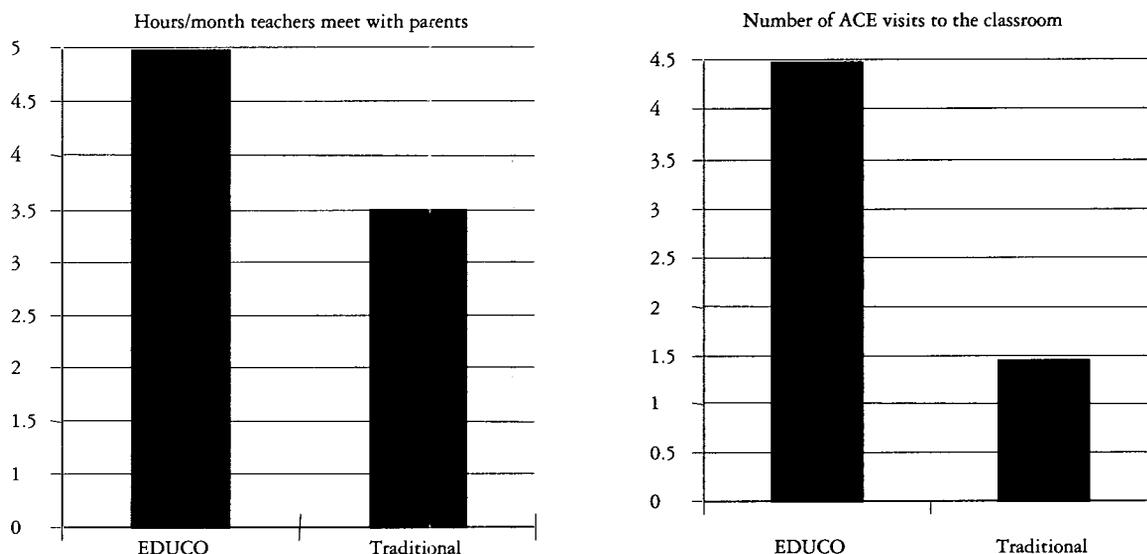
progressive or regressive outcomes. Moreover, there are many types of decentralization, in terms of both function and level of government, and the equity results must consider the mix of both. Thus, it is ultimately an empirical issue.

Unfortunately, the empirical evidence is weak. A rough cross-country comparison for Latin American countries indicates that equity in terms of both access to social services and outcomes of social indicators is independent of the degree of decentralization in financing. More revealing is case-study sectoral evidence from education and anti-poverty programs, because these have been more rigorously evaluated. They indicate that:

- Intra-regional differences in the capacity and willingness to target subsidies to the needy are more important than inter-regional differences in determining overall equity impacts.
- Within jurisdictions, there is a greater likelihood of benign or even positive equity impacts if decentralization results in efficiency gains.
- These efficiency (and thus equity) gains are more likely to be realized at local (neighborhood, district) levels rather than intermediate (provincial, district, even municipal) levels as the former have more of an advantage in terms of the availability of information.

FIGURE 4

El Salvador Local Participation



Annex

Social Spending is the Key Redistributive Tool of Government

Social spending is one of the government's primary redistributive tools. Taxes are often a poor instrument, and social spending tends to be progressively distributed. Decentralizing social spending can thus have major repercussions on equity.

Taxes Are a Poor Redistributive Instrument

Governments perform many functions, and it is difficult to group them neatly into self-contained and mutually exclusive categories. But, at the risk of oversimplifying, one can think of governments as doing three main functions:

First, they raise resources through a variety of means. Central governments rely on a wide range of revenue-raising instruments, from direct taxes on income and wealth to indirect taxes on goods and services that are traded both domestically and internationally.¹¹ In addition, national authorities rely on borrowing and inflation as revenue-raising devices. Subnational entities use a different set of instruments. They normally only have limited use of trade taxes and borrowing but have access to other revenue sources, such as user charges and property taxes, which can be an important source of financing educational services.

Second, governments spend resources. They can do so by providing goods and services, such as health and education, directly. Alternatively, they can use those resources to subsidize the provision by others, such as the private sector or community groups (subsidized hospital care by NGOs are an example). They could also use the resources to transfer subsidies directly to beneficiaries in the form of vouchers or cash.

Third, governments regulate the actions of economic agents. To some extent their ability to do depends on their subsidies and taxes, but they can also use the legal system or coercion to get what they want.

In theory, governments can use all three tools to promote equity. In developed countries, the tax system is an important instrument to ensure that people of equal capacity pay the same (horizontal equity) while people with greater ability should pay more (vertical equity). Progressive income taxes and wealth taxes are prime examples (Musgrave and Musgrave 1980).

Taxes in developing countries are, in contrast, notably unsuccessful in terms of horizontal equity because "the

coverage of tax instruments is spotty and arbitrarily enforced. The tax net may capture income in some formal activities, but not its equivalent in informal or hard-to-tax formal activities, such as professional services" (World Bank 1988, p. 85).

Even in terms of vertical equity, tax systems in developing countries often fail despite the highly progressive rate structures because of the failure to implement.

Aside from implementation, there is the problem of shifting behavior. It is notoriously difficult to assess incidence as economic agents change their behavior (such as how much they buy and work) in reaction to a tax and consequently shift its burden. For example, higher payroll taxes, which are an important source of finance for training, are often levied on firms but can be shifted to workers if the supply of labor is relatively inelastic. Estimating such behavioral changes comprehensively and with the appropriate feedback is tricky business. Many of the results depend on crucial and often bewildering assumptions about the behavior of agents in different socioeconomic classes.

In Latin America, for example, the progressivity of the income tax is supposed to be ensured by very high marginal tax rates for high income levels and exemptions for the poorest. But the reality is very different. The richest do pay more of their income share than the poorest, but the rate is nowhere near the published one. Moreover, the poorest also pay a portion of their income because some of the burden of business taxes are passed on to them, as shown in the first three columns of Table A1. A recent report for Latin America thus concludes that:

Due to excessive distributional considerations in the design of the income tax, and to the difficulties of administration and control that severely limit the effectiveness of this tax, the only way to substantially raise the total tax load is through a broadly based VAT [value-added tax] with few exceptions. This leads to the regressive impact ... in the Chilean and Argentine systems. Hence, countries face the alternative of having either a tax system that is pitifully small but progressive like Guatemala's, or a system that is more effective in its revenue collection capability but regressive [see Column 4 of Table A1] (IDB 1998-99, p. 186).

This is a conclusion that is shared by more general worldwide studies:

In practice it seems that taxes do little to change the overall distribution of income. Their important role in the pursuit of equity is to raise the revenue needed to pay for distributive spending, particularly to alleviate poverty. So, it is public finance broadly defined—taxes and spending together—that matters for equity (World Bank 1988, p. 85).

Social Spending Is Crucial for Redistribution

If the key to redistribution is spending, then social spending has the key role. For one thing, it is a very large share of overall government spending; health and education alone constitute about 15-20 percent of total government spending. But more importantly, such spending is considered to be a key part of the strategy to raise people out of poverty since it provides them with the instruments with which to take advantage of income-earning opportunities provided by growth (World Bank 1990). One should also be concerned with inequality in health and educational outcomes because these are not only instrumental in determining welfare as measured by the money metric, but also may be considered as ends in themselves.

Who benefits from this spending? For true public goods, such as national defense or general government

administration, it is difficult to tell. One might think that such spending was proportional to the population share of each income group; others argue that some groups, such as the rich, may have more at stake and enjoy the benefits more. But most social spending is not on true public goods (spraying disease vectors would be an exception), and it is possible to assign benefits. Most studies find that such spending is generally progressively distributed—certainly more so than other subsidies such as those for electricity or other utilities.¹²

In Latin America, the distribution of such spending in Chile and Colombia is quite progressive, as shown in Figure A1.¹³ In Chile, the poorest quintile of households receives more than 35 percent of total social spending, while the richest quintile receives less than 10 percent. Colombia is moderately progressive, because the figures respectively are 25 and 15 percent. Brazil is somewhat regressive in contrast—the poorest quintile receives only 15 percent while the wealthiest receives 22 percent. For other Latin American countries, incidence of spending is generally proportional—the poorest quintile receives about 20 percent of spending shares. Combined with the fact that they pay much less than 20 percent of revenues raised, the expenditure-tax system can be considered progressive.

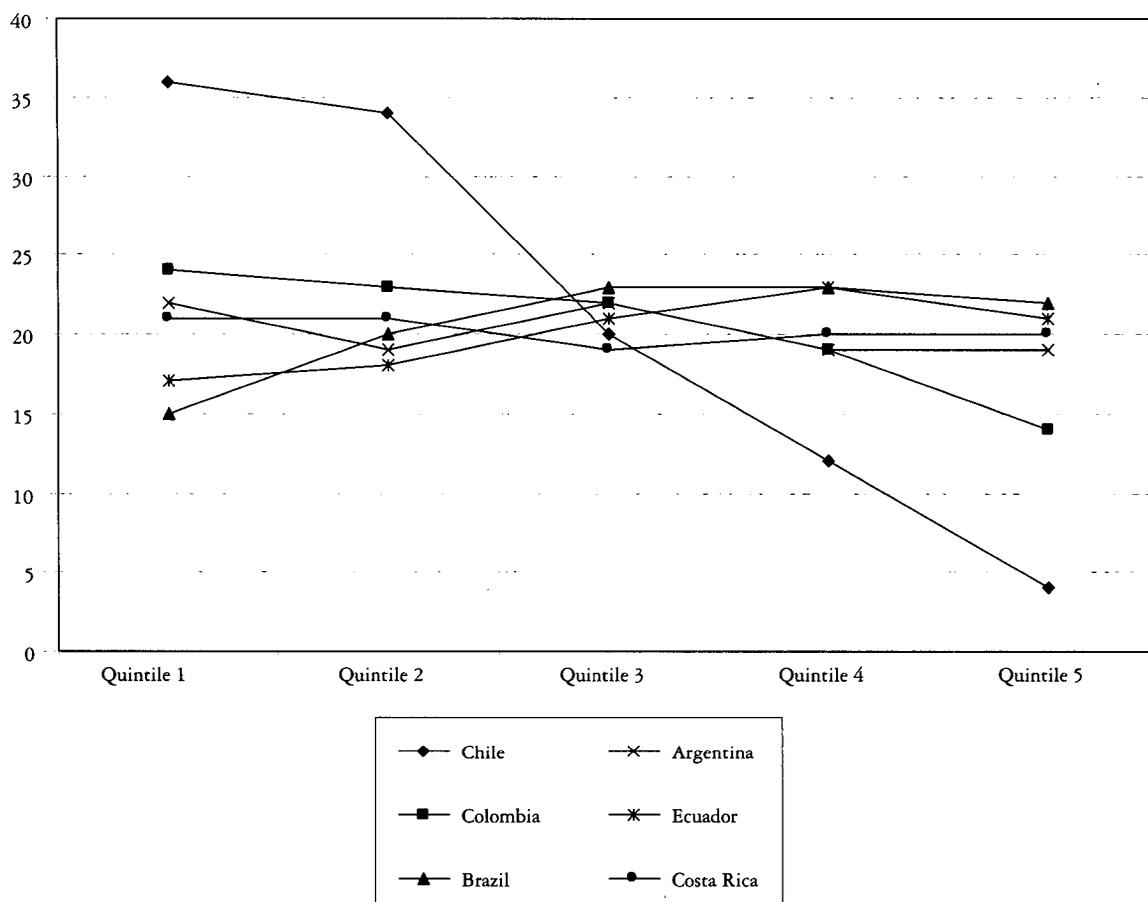
TABLE A1

Madated and Actual Tax Rates

	LEGALLY HIGHEST INCOME TAX RATE	INCOME TAX AS PERCENT OF INCOME OF POOREST DECILE	INCOME TAX AS PERCENT OF INCOME OF RICHEST DECILE	ALL TAXES AS PERCENT OF INCOME: RICHEST TO POOREST
Argentine	33	4	8	1.10
Chile	35	2	4	0.88
Dominican Republic	30	1	6	2.20

Source: Compiled from IDB 1998–99, Table 8.1.

FIGURE A1
Distribution of Social Spending (Health, Education, Social Security)



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Endnotes

1. See Winkler (1991) for a useful review.
2. Horizontal equity means equity among households and individuals who have the same utility. The social welfare function should apply nationwide and should treat all citizens equally. Vertical equity involves a value judgment of households who have different levels of utility to begin with.
3. See Jimenez (1987) for an argument of this regarding pricing policy more generally.
4. The costs are manageable if well-designed and implemented. See Grosh (1994).
5. See Grosh (1994).
6. Although it is better in some countries such as Indonesia, the scope for poverty reduction by allocating transfers through differences in provincial equalization is three times better than in India (Ravallion 1993).

7. The Trabajar program aims to reduce poverty by providing funds for projects that offer short-term work at relatively low wages and that are located in poor areas. The projects are proposed by local governmental and non-governmental organizations who must cover non-wage costs and are given priority according to assessments of how well-targeted they are, what benefits they are likely to bring to the local community, and how much the area has already received from the program (Ravallion 1998).

8. The Ndhme Ekonomika (NE) program is designed to support urban families with no source of income, or rural families with small landholdings. Initially, the NE program was an entitlement conditional on income criteria determined in Tirana, the capital. This was then reformed in 1995 so that it became a block grant to local communities (the commune level) (Alderman 1998a).

9. He evaluated this by finding that the amount of transfers received by a household is related to the residual of what would have been predicted on the basis of observed information.

10. See Bray with Lillis (1988) for a review of the experience in a wide range of developing countries.

11. See World Bank (1991) for a summary of the empirical importance of these instruments in developing countries.

12. This is generally done by expenditure, rather than by benefit, incidence. First rank households by some welfare measure; then use household surveys to compute the use of those different groups of households of the public service (such as the average number of children going to public schools or the average number of visits to a health facility); finally, use the subsidy per unit of use from public budgets to compute how much each group obtains (see Demery 1997 and van de Walle and Nead 1995).

13. Of course, within social services there could be substantial differences. In the Latin American countries shown in Figure A1 spending on basic services such as primary education and basic health care is much more progressively distributed than spending on higher education and hospitalization, which is generally regressive.

Comment

JOSEFINA STUBBS

I. Introduction

Like most of the larger economies of Latin America, Caribbean nations have made modest yet important progress in bringing public policies closer to communities and citizens. Decentralization, deconcentration, and increased public participation in the design and implementation of poverty reduction programs are emerging vigorously throughout most of the region. This is explained from the fact that the Caribbean follows the continent's general pattern. Poverty and exclusion are characteristic, in spite of increased capital flow, relative stability and macro-economic growth.

Participation of economic and political stakeholders and private citizens in the design and implementation of programs aimed at fighting poverty and exclusion is key to ensure governance, equity, and sustainability of our societies. Only through these can the social peace and political stability that sustain growth and allow the insertion of our nations in the new international economic scenario be guaranteed.

The relatively small size of the economies and territory of Caribbean nations, along with their powerful civil society, could become comparative advantages in the quest for equity and broad participation of social actors. In contrast, facts show that the institutional reforms and political practices that would guide these transformations occur slowly and at high transaction costs. However, the creation of the Great Caribbean

Regional Economic Agreement, the internal pressures from the region's civil society, and international funding and cooperation agencies have played a key role in promoting and supporting the region's modest progress related to decentralization and the quest for participatory solutions to poverty.

In the following pages I will explore, particularly for the Dominican Republic, the region's achievements and challenges in the construction of a participatory implementation of poverty reduction strategies and projects. These programs are critical in order to ensure an equal distribution of resources and the transformation of social actors into accountable citizens, who take care of their future through coordination and agreement.

II. Toward a New Consensus

Capital-flow growth, exports, and modest increases in the macro-economies of the region have not reduced poverty or the exclusion of a vast majority of people from the benefits of progress. To the contrary, by the end of this decade and the dawn of a new century, the region finds itself immersed in an ever-growing poverty, which has gone beyond unacceptable levels to become an intolerable situation.

The implementation of structural reforms aimed at achieving a greater balance in the economies has not included mechanisms, policies, or practices aimed at the democratization of growth. As a result, the uniform distribution of goods, services, capital, and knowledge accumu-

lated in the last decades have not reached the vast majority of people. The gap between employed and unemployed grows larger; opportunities of social and economic integration for those who cannot accumulate knowledge and know-how become more limited; the differences between those who define the needs and those who implement the solutions become more obvious. Thus, poverty in the region has become the structural result of the lack of opportunities and the exclusion of many people in the design, implementation, and follow-up of the development plans of Caribbean nations.

The response to poverty is evident. The Caribbean region has one of the highest migration rates in the world, estimated at a regional average of 35 percent. For the Dominican Republic and Jamaica, remittances represent the third source of income of the entire economy. Drug traffic and consumption have become a disease, deteriorating social networks and increasing violence. Street violence in Jamaica has by now become endemic, reaching higher daily averages than cities such as New York. This situation certainly hinders the possibility of strengthening national economies. Political and social instability and violence discourage foreign investment, tourism, and the establishment of transnational corporations that seek labor—all important sources of income for Caribbean nations.

The success of this new service-economy model will be measured by its capacity to introduce the nations' economic actors into new job opportunities, change and consolidate its technical and knowledge-accumulation capacities, and institutionalize the participation of stakeholders in the design and implementation of poverty reduction strategies and projects. The model will have to prove its capacity for reestablishing new political codes and for democratizing the economy.

Decentralization, understood as a devolution of power and resources to communities and regions to identify—within a national framework—development plans and programs for communities and citizens, is an alternative in the making for most Caribbean nations.

III. What We Have Achieved

The Demand for Modernity

With the exception of Cuba, the last three decades have been crucial in the expansion and diversification of civil society. Community grassroots organizations, NGOs,

interest groups and professional organizations have emerged throughout the region. They all share in the demand for modernity.

Social actors of the region are all, in a variety of ways, demanding a new balance between the economy and politics. The tiresome work of small-scale banana producers on the isles of Barlovento is just one example. Concerned about the future of their product and preferential guarantees for market access, banana producer associations have been proactive in influencing international entities and institutions, central and local governments in the search for solutions to the banana conflict in the World Trade Organization (WTO). In addition, they have proposed programs and policies that ensure the gradual diversification of bananas, the basis for banana economies of the subregion.

Unfortunately, and in spite of the efforts by these and other social actors, final decisions will directly affect the economies of small-scale producers dependant on this single-crop farming and for which—in spite of the multiple proposals submitted—central and local governments have no answer. It is estimated that poverty, migration, and drug traffic will increase in the years to come.

In general, throughout the entire Caribbean region, civil organizations are demanding greater participation in the identification of sectoral and collective needs affecting their community, and a more participatory implementation and monitoring of social poverty and exclusion reduction projects and programs.

Progress in Public Sector Deconcentration

There are a great number of experiments where the government has devolved the responsibility for implementing centrally defined policies and programs to the official territorial authorities throughout the Caribbean region. As a step toward transferring power to more local levels, deconcentration of government seeks to bring policies and programs closer to citizens and their communities. Deconcentration also seeks a reduction of the transaction costs inherent to political and priority bargaining in the communities, as well as achieving an efficient delivery of public service and implementation of development policies.

Deconcentration has aided the coordination between community organizations and regional offices of, among others, health, housing and public works ministries. It has for example, helped rural organizations in Dominican Republic obtain services and machinery to repair local

roads, or for plowing land and its subsequent preparation for sowing. Most importantly, deconcentration has begun to stimulate negotiations between local representatives of ministries and the central government. Financial resources had to be negotiated to support the community's plans and demands, as well as the power of the public sector's local representatives to decide and implement projects required by the community.

However, deconcentration still faces many challenges.

First, it is based on a definition of priorities and projects that have not been identified and negotiated by all the stakeholders of a region or municipality.

Second, and inherent to that mentioned above, there is no consideration for stable and institutionalized mechanisms that can enrich the definition of national development policies with experiences and social capital existing within communities.

Third, management efficiency is limited. To the extent that development programs launched by the central government and implemented at the local level do not consider local capacities, local needs and the virtues and defects of the work cultures of different stakeholders, as well as the sustainability of many projects, is easily put in jeopardy.

Fourth, deconcentration does not necessarily have an influence on the radical change to a social-action culture that is imperative to efficient and participatory management models. Political clientelism is still a generalized practice in the public sector. Social control is hindered as municipalities lack control over the selection of public sector representatives and public policies; therefore, the ideal of efficient and accountable community management is only partially achieved.

For the reasons mentioned above, the deconcentration process still has high transaction costs for community members and public sector representatives. Negotiations for service support, resource allocation or changes in sectoral priorities take weeks, months, and even years of discussion to reach agreements. Political, public sector, and community agendas are under constant strain.

Recognition of Town Councils and Local Governments as a Way to Move Forward in the Decentralization Process

Although progress has been slow, Caribbean governments have reacted to the new realities with more or less radical attempts to reorganize the division of labor within the

nation. Most of the countries of the region have become involved in a revision of the constitutional and legal frames that regulate participation and integration of various sectors of society in the design of development policies and programs. Attempts at a more equal distribution of financial resources and revenues collected by central government taxes have also made progress.

Reforms introduced in the structure and mandate of "territorial cells" in Haiti is an interesting case, in the understanding that these are the official structures for participation of municipalities. The reforms were introduced as a means to solve the deep problems regarding consensus and governance that are afflicting the nation. Restrictions to this restructuring have been numerous. The most relevant for decentralization purposes has been the lack of definition of mechanisms that ensure participation, representativeness, and devolution of power for planning and implementing development plans and programs, which can coordinate different stakeholders in the quest to reduce exclusion and poverty in Haiti. Probably the most evident lesson is that reforms to local government structures and levels are insufficient to mobilize social action and originate agreements and discussion for the development of a nation. To the extent that participation processes have not progressed, neither have opportunities for discussion between civil society and the government. Haiti continues to be in standstill.

The Dominican Republic is also an interesting case. Several constitutional reforms have slowly introduced changes in the roles and mandate of municipalities and local governments to ones that facilitate participation and the decentralization of development plans and programs; additionally, budget allocation to town districts (*cabildos*) has increased from 1.5 percent to 4 percent of the national budget. The slow introduction of key changes such as territory distribution, election mechanisms for district representatives, and the definition of mechanisms for coordinating municipalities with other organizations of civil society represents a barrier to progress in the decentralization processes. Notably, this delay results from centralization and political-party clientelism in the administration of municipalities, both at the community and central levels.

The Creation of Social Laboratories

The slowness of institutional changes geared at deconcentration and decentralization of planning and implementa-

tion of development policies has not stopped original initiatives that seek to build new economic and social instances. In this sense, there are numerous efforts throughout the region. Small-, medium-, and large-scale producers reorganize in order to demand and propose new ways of approaching and solving their problems. Urban grassroots organizations experiment with new solutions to problems in the areas of basic service delivery, sanitation, and sustainable environmental management. In almost all cases, issues related to economics, participation, and citizen rights and obligations are integrated.

I would like to share the interesting experience of the Sierra Community Development Project (Cocodesi) in the north-central region of Dominican Republic. In the search for permanent solutions to water issues in the remote communities of the region, the communities and the central government joined efforts for the construction of an aqueduct in the area. The central government donated funds for the materials and construction of the aqueduct, the regional "Water Corporation"—a central government institution—provided the technical assistance required for the design and construction. The community provided labor and is responsible for a fair distribution of the resource, equipment maintenance, and service-charge collection, which ensures maintenance funds. It also capitalizes a portion of the service-charge revenue for unpredictable events and invests 2 percent of the profits in community activities (education, information, and recreation). Thus, efficient coordination of all stakeholders has been able to ensure water-service running water to more than 75 thousand people in the communities surrounding the Central Sierra in Dominican Republic. Communities pay for the service as they take ownership of the initiative.

This experience evidences a new distribution of roles between the different stakeholders interested in searching for solutions to issues that affect communities. Additionally, however, it shows new efficiency models in the provision of vital community services, with private and public local participation. Social capital accumulated by stakeholders has been fundamental in finding long-term and viable solutions to their problems.

IV. In Search of Improved Horizontal Models

Decentralization planned from public offices or small neighborhood entities cannot provide comprehensive responses to the complex needs of a variety of stakeholders

involved in the redefinition of economy and politics. In other words, neither top-down nor bottom-up decentralization can—by themselves—drive government decentralization and the democratization of the economy. Only an integral and horizontal approach with broad participation of the government and its institutions, sectoral stakeholders, grassroots organizations and NGOs, can provide solutions to poverty issues in the region. The adequate context for the creation of new strategic alliances includes the government's decentralizing will, civil society, and its organizations' acceptance of responsibility for participation and their readiness to develop capacities required by such responsibilities.

In the next paragraphs, I will attempt to identify experiences and lessons that can help us find innovative models to improve and increase the efficiency of health, education, and environmental monitoring services. Although limited to and focalized in specific countries and regions, these initiatives are valid to the extent that they can aid in the identification of alternatives and problems.

Health: A Life Issue

Privatization of health-care services has not brought about the expected outcomes, although it has irrefutable advantages. There has certainly been an increase in the supply of health-care services, both in quantity and territorial distribution, in most countries of the region. Regions that had relied exclusively on poorly equipped public hospitals today boast a wide range of clinics and private health-care centers, ready to provide general and occasionally highly specialized medical services. In fact, the number of women assisted by doctors at delivery has increased significantly. Statistically, this is expressed as a significant decrease in maternal mortality during the last five years.

However, this is in conflict with the lack of access of the vast majority of the population to private health-care services. The main reason for this is the high costs of such services. Privatization of health-care services does not appear to have increased the quality of the services provided by the public sector. To the contrary, hospital conditions, installed capacity, and service quality are all obviously deteriorating.

Furthermore, although one would expect private health-care services to be in accordance with their cost, this is not the case. Privatization has been brought about without a definition of basic standards for service quality or physician professionalism and responsibility for the lives of

their patients. In fact, what has occurred has been a proliferation of health-care centers of varied categories, costs, and service quality without clear regulation and mechanisms for control and accountability.

Clearly, the government can still play a role in the regulation of service quality, so as to reach a larger segment of the population with acceptable quality standards. This is valid for primary and secondary health care in public hospitals as well as for private health-care centers. However, there is an even deeper issue at stake. Health-care service supply has expanded without direct connection and coordination within the health sector, between health and other sectors such as education, and between these and the community. There are, however, some attempts to encourage coordination from the health sector in order to deal with issues such as maternal mortality in Dominican Republic.

In the following paragraphs I will share with you the experience of the “*Asociación Pro-Bienestar de la Familia*” (Pro-Familia), a local organization which focuses on reproductive health, sex education, and planned parenthood in the Dominican Republic.

INTEGRATED HEALTH CARE SERVICES: EFFICIENCY AND EQUITY

In their efforts to decrease maternal mortality, Pro-Familia has created specialized primary care centers for pregnant women from marginal neighborhoods of Santo Domingo and Santiago. What does Pro-Familia do? It offers low-cost specialized control and monitoring services for pregnant women in their community clinics. The service includes appropriate standard physical exams and an education program to prepare them for childbearing.

The institution does not offer delivery services. Instead, Pro-Familia establishes agreements with a network of private clinics to provide the service to women cared by them from the onset of pregnancy. Through this agreement, the private clinic assures care to the women with a discount of up to 50 percent of the normal cost of labor. Labor costs which would normally be equal to US\$188 become accessible to women for US\$75. Women pay in partial installments to Pro-Familia, which then pays the health-care clinics for their service.

Private health-care clinics are willing to give a discount on their service in exchange for the guarantee that systematic monitoring of women will reduce the risk of childbearing complications and the cost of post-labor care. For

those women who cannot pay the minimum rate required by a private center, Pro-Familia offers the alternative of the closest public health-care center. Service is provided free of charge for these women. This has disadvantages, as we will discuss later on.

Pro-Familia does not provide childbearing services in the understanding that public and private infrastructure is available to the project in these areas. Post-labor and infant care is provided in Pro-Familia clinics. Planned parenthood education programs and control of cervical uterine cancer is provided as part of the post-labor monitoring, as well as standard immunizations for the newborn.

Community-clinic coordination is facilitated by community educators, who provide and coordinate preventive programs on health matters—including work on contagious diseases such as tuberculosis—identify and refer patients to the clinics for those services offered by them, or refer cases to local hospitals for specialized care.

For women, care offered by the clinics provides fast and prompt access to services that, when available, are located far from their homes and communities. It also ensures them that childbearing will be free of difficulties, with low childbearing costs and preventive primary care for the post-labor stage. For Pro-Familia, care does not require great infrastructure investment, has low operating costs, and guarantees the provision of highly specialized care; it clearly focuses on the pre- and post-labor stages.

Due to the lack of updated and territorial stratification of statistical information, it is hard to say whether this and other programs have directly contributed to the reduction in infant and maternal mortality. In the case of Dominican Republic, it is clear that the reduction of the maternal mortality rate has not been proportional to the number of initiatives aimed at dealing with this problem. Problems in the quality of care and especially labor care are still considerable. However, it has been possible to demonstrate, using internal institutional data, that systematic and early care of pregnant women has reduced complications during, before and post labor, and that on average, women in the program have waited three years between pregnancies.

National Statistics have demonstrated that programs like Pro-Familia have contributed to the “institutional childbearing”; that is, women are increasingly cared by physicians in hospital centers, and fewer women give birth at home, in high risk and inadequate conditions.

It is important to note that the agreement between Pro-Familia and private clinics—pursuant to which the latter offer their care to the institution's patients—sets forth quality standards; the women, as patients, are the ones who evaluate this quality of care. Therefore, if the clinics provide poor quality care, Pro-Familia has the right to annul payments and in the worst-case scenario can terminate the agreement with clinics that violate the established standards. This quality-control system has been impossible to apply in public hospitals. The sole function of Pro-Familia is to refer the pregnant women, with their medical records, to the public health-care centers.

WHAT ARE THE MOST IMPORTANT LESSONS FROM THIS EXPERIENCE?

- **Economies of Scale and Redefinition of Roles**

Success in providing efficient and low-cost care lies in the possibility of broadening and redistributing duties and roles among the stakeholders of the political and social change process. As illustrated in our discussion above, social service provision, as a solution to inequalities, does not in itself guarantee access to such services by the majority of the population nor service quality. The added value of privatization processes could be understood more in terms of an increase in the supply and not necessarily as the reduction of problems in service quality, access, and distribution.

The government still has important roles to play, regardless of the need to assess its management, practices, and policies. The definition of public policies at a national and sectoral level, and the investment in infrastructure required for at least one of the elements of the service network, are key governmental roles. The definition of minimum standards and follow-up mechanisms will undoubtedly have a direct influence in lowering mortality rates and increasing average life span of the population. This should also be a role of the government. In fact, only through the existing infrastructure can institutions like Pro-Familia contribute to the large chain of events required to decrease problems such as maternal and infant mortality in the Dominican Republic, and high-risk at-home childbearing.

The example of Pro-Familia helps us to understand the need to decentralize resources capable of ensuring that hospitals and private clinics, in the areas covered by this project, have the capacity to provide the required health-care services. If these were unable to respond to these needs,

institutions such as Pro-Familia would not have the expected impact.

Therefore, the creation of efficient health-care systems requires policies and resources focused on specific areas and problems. The success of efficient intervention models lies in the possibility to legitimately recognize and integrate the expertise of institutions and organization that work in the area, and to create institutional coordination networks that integrate the private and public sector, the community, and civil society's organizations.

This experience clearly shows us that it is possible, with inter-institutional coordination and community participation, to increase the supply of health care without a need for major investments, ensuring low costs and high quality levels. It is important to note that in small countries and economies, the concept of economies of scale is still an option to professionalize, increase efficiency and ensure access to many basic health care services. Successful implementation depends on a redistribution of roles, tasks and responsibilities among stakeholders, with participation as the key to capitalize, promote, and catalyze all financial, human, and knowledge resources.

- **Efficiency Goes Hand in Hand with Quality**

Economics has understood efficiency in terms of the optimization of results and benefits or welfare, with minimum wastes in efforts. An efficient project should ensure an increase of tangible benefits and materials based on cost reduction and output increase. This definition of efficiency leaves social and cultural costs out of the equation. Therefore, when they are not integrated into development policies and programs, they bring about the displacement and disintegration of social networks. Many social programs have in the medium term been more costly than expected, because social costs and externalities were not included in the initial planning.

If we assume that efficiency does not merely imply reducing costs in the short run but is rather a search for long term solutions, development policy or program quality will also depend on the potential for stakeholders to introduce the sought changes in practices and problems. Thus, efficiency will be achieved only when changes in behaviors, attitudes and values can be attained. Efficiency must also be effective.

Therefore, efficiency cannot be achieved without identifying the changes sought after. All the work carried out by

organizations such as Pro-Familia is useless if the women in the program do not become aware of the need to seek pre-labor care, nor if they continue on a pattern of yearly pregnancies. Educating for change, participation, and citizen awareness and responsibility is part of the equation of efficiency, sustainability, and equality.

Decentralization, inter-institutional coordination, and implementation of citizen education programs, understood in terms of the development of individual responsibility, are also key aspects. Only these can curb paternalistic schemes, clientelism, dependency, and disempowerment of the community. These practices increase the cost of services because the patient, the ill, the student do not become involved in prevention activities, thus making solutions to community problems more complicated. Community violence, diseases, and deaths can be anticipated.

- **Educating for Action**

In societies with a late democratic transition, the transformation of social actors into citizens is relatively recent. In spite of the expansion of civil society in most Caribbean nations, only in recent decades have society's organized groups defined and identified their own citizen roles. A citizen's right and obligation awareness is emerging, based on the practical experience of many of these community organizations. The knowledge and practice accrued are providing new contents to democracy and democratic exercise, including its subject, the citizen.

Education has been key to progress made in the construction of citizenship, participation and capacity to make proposals and participate in the definition of new initiatives. Pro-Familia's example, like many other programs in the region in the areas of rural and urban environmental education, non-formal education, and violence, all indicate the need to educate for responsible citizen action. Once again, coordination and organization between community, schools and family are crucial for citizen education.

What about Municipalities?

The reader may have noticed my almost complete lack of reference to town councils and municipalities in the search for innovative models of equitable and efficient decentralization. With due respect to efforts carried out by many municipalities and municipal officials, municipalities as

efficacious decentralizing and coordinating entities are operating at a limited capacity. Throughout the entire Caribbean region, municipalities suffer from:

- Slow constitutional and legal reforms, which have prevented them from further progress in the coordination with the rest of the community and society in its broadest sense.
- Internal reproduction of political-party conflicts that occur at the national political level.
- Lack of economic resources to operate and monitor, together with community groups, social and economic projects aimed at community well-being.
- Limited institutional and professional skills of municipal officials capable of and prepared for efficient and transparent management of material and human resources, and the shared management models demanded by the population.
- Most importantly, a significant amount of municipalities still consider themselves more in the role of providers of important services, such as garbage collection, than as catalysts of processes that bring together the government, the community, and civil society in the construction of a new societal project.

From this stems the fact that many community coordination efforts and poverty reduction programs are not linked to the municipalities. Just as some municipal programs bear no relationship to the priorities or problems of their communities.

It is essential to accelerate the municipalities' institutionalization and role-clarification processes and to create institutional mechanisms of coordination between these and the rest of the community. The issue of participation and representativeness of municipalities within the municipal structure is key and urgent. It is pressing to speed up institutional reforms that delineate guidelines for a new mode of inserting towns into the municipality, and as links to entities and central structures that define global policies and allocate resources.

Adequate social control will only be possible through the horizontal integration of stakeholders and initiatives where all actors exercise the right to demand accountability and the obligation to be accountable. This also includes municipal officials. The political and transaction cost of this progress is extremely high for Caribbean countries. However, only with progress in this direction can we create the appropriate institutions as future options.

I cannot end this reflection without referring to two other issues. This first relates to employment and the second to financial and technical support, both required for the development of state decentralization models and more democratic economies.

V. Employment as the Basis for Development

Employment is a key element for development and equity. However, employment security has become increasingly hard to ensure on behalf of the government, and to obtain for the majority of the population. The growing unemployment rate and the expansion of self-employment or informal sector has increased in an unorganized manner and at a fast pace in the Caribbean. The Haitian case is the most pathetic.

The transition from an agricultural export production to a service economy has resulted in a crisis in the model and in the employment sources of the region. The new model of services in the tourism industry, for example, has not been successful in integrating the community into the new activities. In spite of the great amount of skilled labor integrated to the sector, its span is limited both in qualitative and quantitative terms.

What I am proposing is an expansion of growing sectors of the economy through the integration and participation of communities, so as to increase employment and extend the profits to those that have been excluded until now. Large hotel and travel chains offer packages at extremely competitive prices. Thus, tourists arrive in the region with all-inclusive travel packages. In general, they do not spend on services and goods that may be provided by the community, do not share in its cultural richness, and frequently buy fruits and vegetables imported from Miami for tourist sale. With the exception of Barbados, it can be said that the great benefits resulting from tourism are not shared with communities, even those communities closest to the tourist environment.

Since services and human resources connected with the tourist industry are not related to surrounding communities, new employees migrate from far away communities and build marginal neighborhoods in the proximity of tourist complexes. This discourages tourism in the long run, and therefore the industry will slowly retreat, taking with it any small benefits it may provide to the macro economy of our nations.

But the Caribbean not only faces problems in terms of the quantity of available jobs, but also in terms of poor

work quality and conditions for workers of both national and foreign assembly industry. The enforcement, monitoring, and continued implementation of codes of conduct recently agreed upon in the United States and Europe, which seek to regulate the quality of work, respect for the environment, and the relationship between industry and community, is a key issue. Communities, municipalities and social organizations concerned with environmental and labor issues should have an active participation in monitoring the enforcement of these work codes. Together with unions, the community will have to focus on reformulating the issue of work quality and worker rights from the perspective of a global economy—and with innovative methods in order to achieve changes required in this area.

Likewise, municipalities and their stakeholders can contribute to the implementation of technical and professional training programs that guarantee new job opportunities to workers. Moreover, communities can also—based on a relevant technical and professional training—create and become involved in potentially decentralized sectors of the economy. Once more, this is the case of the tourism industry and the production of related goods and services.

VI. The Contribution of International Development Cooperation Agencies

International development cooperation agencies have been crucial to the development and organization of civil society, by supporting innovative poverty reduction strategies. They have also strengthened links in the North-South relationship for solidarity, influencing policies, creating strategic alliances between producers and consumers, and promoting technological and know-how transfers from North to South.

Many of the examples cited in this work are related to funding or support from public and private cooperation agencies of Europe and the United States. In recent years, these agencies have become involved and assist municipal initiatives as a way to support coordinated actions in municipalities. In the specific case of the Dominican Republic, the municipality of Puerto Plata in the northern part of the island and Salcedo in the center are both successful cases supported by funds from the European Community and the U.S. Agency for International Development, respectively.

Cooperation agencies have an important role to play in the advance of decentralization and participation processes.

Besides the roles already mentioned, international cooperation must contribute with the following:

- Partial funding of innovative programs aimed at poverty reduction, and through these aid in the creation of citizenship and the exercise of citizen rights and obligations.
- Systematize, spread, and share accrued experiences and lessons learned, as a way to contribute to the replication of experiences.
- Support education and training programs of new capacities that facilitate efficient social action and originate impact.
- Continue to support the coordination of change agents in the North and South so as to expand the scope of changes, which will in the long run affect the globalization processes.
- Support and promote coordination between international public and private funding organizations and the definition of coordinated policies aimed at poverty reduction, which are relevant, viable, efficient, and originate impact.

VII. Conclusions

The aim of this work has been to review experiences of development programs where it has been possible to solve basic problems faced by poor communities through the joint and coordinated action of stakeholders. All the examples here noted, as well as others, indicate that the participation of all stakeholders—particularly those directly affected by the problem—is key to ensure impact, efficiency and sustainability of development programs.

The example provided by the program sponsored by the “*Asociación Pro-Bienestar de la Familia*” (Pro-Familia) reveals that dealing with health issues, such as maternal and infant mortality, requires the creation of networks and coordination within the health system, with other governmental entities, and with the community. The efficiency and effectiveness of the program is determined by the creation of economies of scale, where existing resources are capitalized and strengthened through a chain of analogous elements.

Thus, the added value does not only refer to an increase in supply and the relative decrease in health care service cost, but rather in the greater access to a broader population, the guarantee of acceptable quality standards, and the integration of women and community in primary care of patients and prevention of related illnesses.

In all of the cases mentioned, the search for a solution to specific everyday problems is the driving force for collective social action. Decentralization, participation, and the creation of social agents occurs in the quest for solutions to problems relating to health, water, education, sanitation, housing, job opportunities, and the search for new markets.

In spite of the progress, we still face structural and institutional difficulties, which delay further progress in the decentralization course. Constitutional reforms have been slow. These are fundamental to deepen, broaden, and legitimize the processes of decentralization and citizen participation. The current deficit and the speed at which institutional reforms are introduced are not in accordance with the urgency of coordinated social action required in the practice. Thus, the financial, social, and political costs of decentralization and consensus negotiation continue to be unsustainably high.

The role to be played by international development cooperation agencies is key in order to promote and support the process of institutionalization of democracy and social participation. The funding of innovative programs that can serve as reference points for the construction of new participation models is key. We have the responsibility of ensuring that each project, each program seeking to reduce poverty, ensures integration of the most vulnerable, their points of view, and their capacities.

Many initiatives, projects and programs managed jointly by communities, local authorities, governments and NGOs have not been reviewed here. The effort put into each one of those projects and their outcomes continues to create a future for the region. It is up to all of us to provide the opportunity and space for many others to make their contributions.

III. Sectoral Issues

Education

Education Decentralization in Latin America: The Effects on the Quality of Schooling

D O N A L D R . W I N K L E R A N D A L E C I A N G E R S H B E R G

As we have seen, over the past decade decentralization of government has become common throughout Latin America. The education sector is no exception, and there has been a rapid increase in the number of countries implementing significant decentralization reforms (see Figure 1). At the same time, there has been a worldwide trend to give schools greater decision-making autonomy, in the interest of improving school performance and accountability. School systems as diverse as those in Victoria, Australia; Memphis, Tennessee; and Minas Gerais, Brazil, have given authority to school heads, and then through a variety of mechanisms held them responsible for school performance.

The two types of education decentralization—to lower levels of government and to individual schools—have very different origins and aims. The decentralization of education to lower levels of government has almost without exception been undertaken in the context of a more general decentralization of government, the causes of which vary widely. The decentralization of education to individual schools, on the other hand, has typically been motivated by concerns about poor school performance. Both types of education decentralization are well represented in Latin America, and this chapter reviews the evidence to date on their various impacts on schooling.

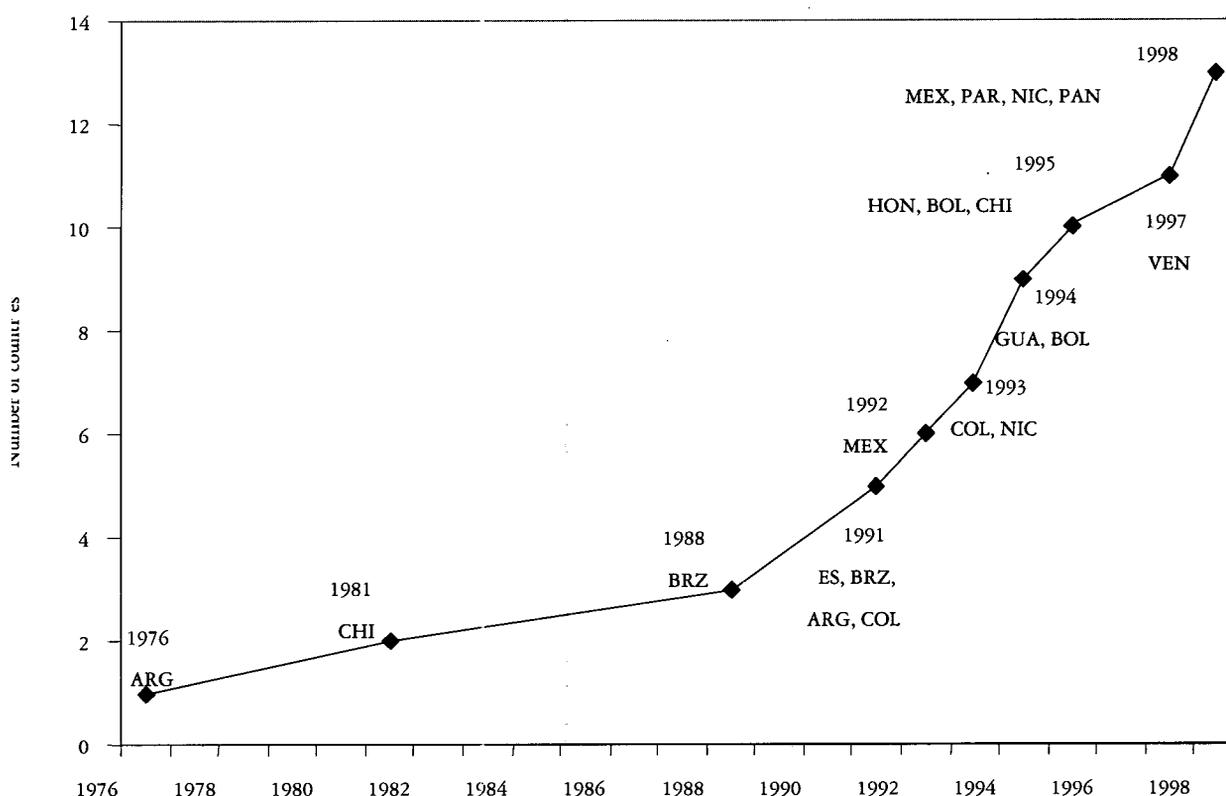
The literature on education decentralization is growing rapidly, but it is still primarily descriptive in nature. Attempts to assess the impacts of decentralization have suffered from weak baseline data and poor research designs, mainly resulting from inadequate data. Weak evaluations are not limited to Latin America or developing countries. For example, Summers and Johnson (1991) reviewed more than 600 evaluations of school-based management in the United States and found only two with an adequate research design.

Several recent studies and evaluations of primary and secondary education, both in Latin America and in other regions, provide the basis for this chapter, of which three

merit mention. The World Bank recently completed several studies on education decentralization worldwide (Fiske 1996; Gaynor 1998); the Inter-American Development Bank sponsored research on the effects of different organizational arrangements in education in Brazil, Chile, and Venezuela (Savedoff 1998); and the Centro Estudios para America Latina (CEPAL) worked with researchers in five countries (Bolivia, Brazil, Colombia, Mexico, and Nicaragua) to assess education decentralization strategies (di Gropello 1998). In addition, this chapter draws on several country-specific evaluations from Latin America and selected evaluations from outside the Region.

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FIGURE 1

Countries Implementing Education Decentralization Reforms**Rationale for Education Decentralization**

The economic rationale for decentralizing education is to improve technical and social efficiency (Winkler 1994). Decentralized decision-making, it is argued, will give local voter-consumers greater voice in the service mix that they receive and, hence, raise their welfare. Presumably, the more local the decision the greater the voter-consumer voice will be—that is, greater at the school level than the municipal level, and greater in single-purpose (for example, school district) than general-purpose governments. If the finance and supply of education is determined locally, the improvement in social welfare will be still greater, for the median voter-consumer will tax himself or herself only up to that point where the marginal tax costs and marginal educational benefits are equal.

However, these arguments presume a world in which democracy works well, and in which all externalities are captured locally. If there is the risk that local elites capture local decision-making, social welfare may not improve; this risk may be higher in societies with little experience in

participative democracy at the local level. If the externalities alleged to result from education, especially basic education, are distributed beyond the confines of the locality, there is a strong argument for a high percentage of financing coming from centralized sources. Ensuring equality of educational opportunity, as measured at a minimum by equality in educational spending, is a further argument for a high degree of centralized financing in countries where income inequality is high.

Improved technical efficiency is the other rationale for education decentralization. Here the argument has several elements. First, to the extent that prices and production processes vary across localities, there are obvious efficiencies resulting from letting local decision-makers allocate budgets across inputs. Second, in situations where the capacity of central-government ministries to monitor and supervise local schools has been weak, devolving these responsibilities to local voter-consumers may increase the accountability of the school for its performance. The interest of local voter-consumers may be higher, if they are also

contributing resources—financial or non-financial—to the school.

A final argument for decentralization is that having many suppliers rather than just one supplier is likely to lead to a wider variety of experiences and innovations. If there are adequate means for communicating and exchanging information on these experiences, a decentralized system may lead to more rapid innovation and change than a centralized one. There is some evidence for this argument in the case of Brazil (Xavier, Sobrinho, and Marra).

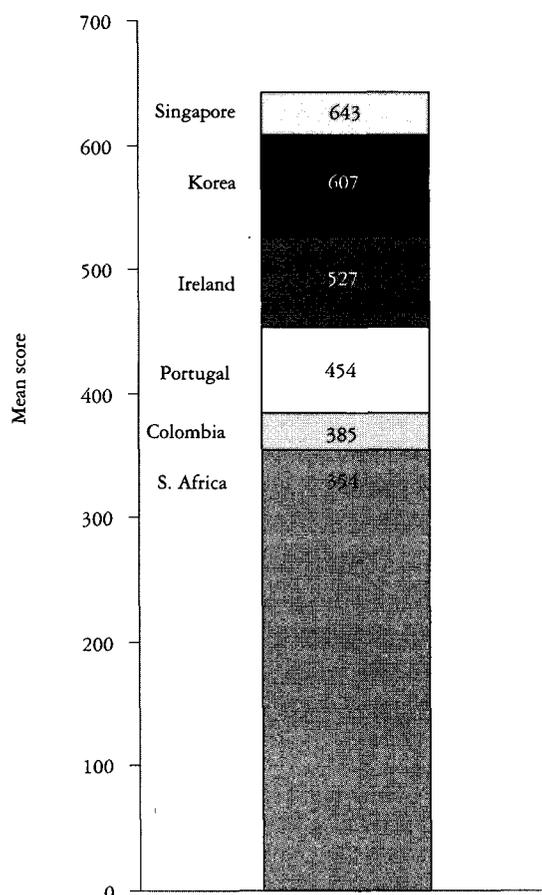
The Educational Context of Decentralization

The problem of access to basic schooling has been solved for most children in Latin America. Now, there is a growing consensus that it is the quality of education that must be improved, especially in the public schools and especially for poor children (Summit of the Americas II 1998). Low quality is reflected in high rates of repetition and dropout and low performance on standardized tests of scholastic achievement. The Latin American and Caribbean countries that have participated in international tests of science and mathematics have scored slightly above African countries and well below East Asian countries (see Figure 2).

In addition, the evidence coming from a United Nations Educational, Scientific and Cultural Organization (UNESCO) test of educational achievement administered in 11 LAC countries shows that, excluding Cuba, the performance of most countries in LAC does not differ greatly, suggesting that most LAC countries would fare poorly on international achievement tests (see Figure 3) (Laboratorio Latinoamericano de Evaluación de la Calidad de la Educación 1999). The low quality of basic education constrains the quality of higher levels of education and puts LAC at risk in its capacity to compete economically with the rest of the world. In addition, while children from all income groups now have access to basic schooling, there remain large inequalities in educational opportunity as measured by quality of schooling. Compared with children from economically advantaged homes, children from poor households are likely to receive lower schooling investments from both the home and the school.

While the rationale for decentralization is at least as much political as it is educational, the proponents of decentralization expect one impact to be improved quality. Other possible effects are changes in efficiency and equity. Due to the importance of raising quality and the limited information

FIGURE 2
Average Math Achievement Test Scores of Eighth Graders,
Selected Countries



Source: International Association for the Evaluation of Educational Achievement (IEA) (1996). *Mathematics Achievement in the Middle School Year: IEA's Third International Mathematics and Science Study (TIMSS)*. Center for the Study of Testing, Evaluation, and Educational Policy, Boston College. November.

available on efficiency and equity, this paper focuses on the impact of decentralization on educational quality in LAC.

Typology

Decentralization takes many forms. It varies by the level of government to which decisions are devolved, the kinds of decisions moved to other levels of government, and the orientation of the decentralization—emphasis on governance changes versus. emphasis on pedagogic changes.

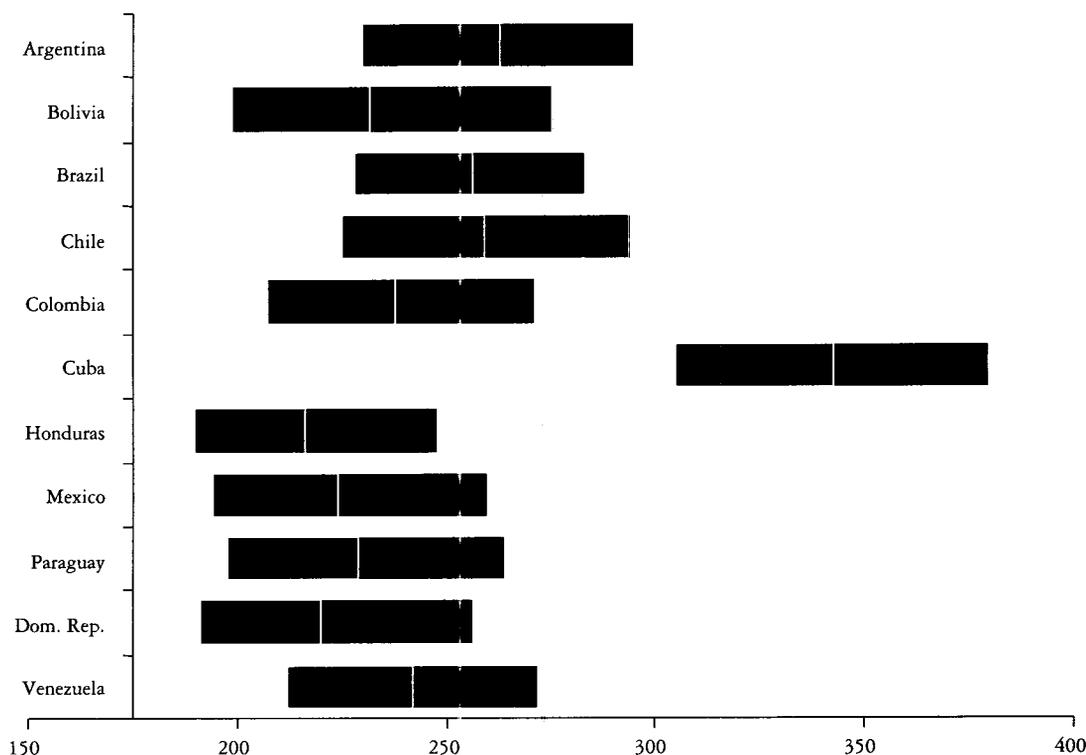
Level of Decentralization

The level to which educational decisions are decentralized ranges from regional and local government to the community and the school. In many federal countries—Brazil, Canada, Germany, India—the states or provinces that make

FIGURE 3

Third-Grade Language Achievement Scores

(Median, 25% 75%)



Source: UNESCO data in PREAL/CINDE 1999.

up the federation have had a constitutional responsibility for education. In other countries—Argentina, Mexico, Venezuela—education responsibilities have historically been situated in the central government, but they have been largely devolved to states or provinces over the past decade.

Local governments quite often have educational responsibilities, especially for primary and secondary schooling. In the United States, most state governments have devolved educational management to single-purpose local governments, or school districts. In other countries—Brazil, Chile, Colombia—municipalities have been given increased educational responsibilities over the past decade.

Finally, some countries have given school councils and schools significant autonomy in managing (but rarely financing) education. The Netherlands is perhaps the best example of a country that has empowered parents to create their own schools with financing and other support from the central government. Recently, in cities like Chicago and Memphis in the United States, it is the school district that has given the school significant management autonomy.

Decision-Making Powers

Some educational functions are decentralized even within centralized systems, and others are centralized even within decentralized systems. An OECD survey of its members, for example, shows that, even in centralized systems, schools make most of the decisions about the organization of instruction. These decisions include choice of teaching methods, textbooks, criteria for grouping students within schools, and day-to-day methods of student assessment. On the other hand, in most European countries, most personnel-management decisions are made at a central level.

The OECD methodology for measuring the degree of education decentralization divides educational functions into four groups: the organization of instruction, personnel management, planning and structures, and resources. For the purposes of this paper, we adapted these definitions to be consistent with Latin American experience and available information. The content of each group is given in Table 1.

TABLE 1

Types of Decisions That May Be Decentralized

<i>Organization of Instruction</i>	Select school attended by student. Set instruction time. Choose textbooks. Define curriculum content. Determine teaching methods.
<i>Personnel Management</i>	Hire and fire school director. Recruit and hire teachers. Set or augment teacher pay scale. Assign teaching responsibilities. Determine provision of in-service training.
<i>Planning and Structures</i>	Create or close a school. Selection of programs offered in a school. Definition of course content. Set examinations to monitor school performance.
<i>Resources</i>	Develop school improvement plan. Allocate personnel budget. Allocate non-personnel budget. Allocate resources for in-service teacher training.

Structure and Content

Just as the composition of educational functions that are decentralized varies across countries, so too does the goal and orientation of the decentralization reforms. In some reforms, local control is the goal, either for political reasons or to strengthen accountability by the schools to its clients. The focus of these reforms is on **structure**—that is, transferring decision-making powers and responsibilities to lower levels of government or to school councils. Implicit in these reforms is the expectation that local control and accountability will improve efficiency, both in the uses of resources and in the match between client demand and the supply of school services.

In other reforms, the goal is improved learning, and the transfer of decision-making powers is simply a vehicle for attaining that goal. These reforms put more emphasis on the **content** of education reform than on the structure itself. Parental participation is valued by these reforms because it is viewed as contributing to the success of education and not because it improves accountability. Matching client demand with what the schools offer is important only to the extent that client demand is consistent with raising quality.

While it is tempting to contrast structural reforms with reforms that emphasize content, this typology is in fact a continuum, with most decentralization reforms encompassing elements of each.

Typology Applied to Recent Latin American Experience

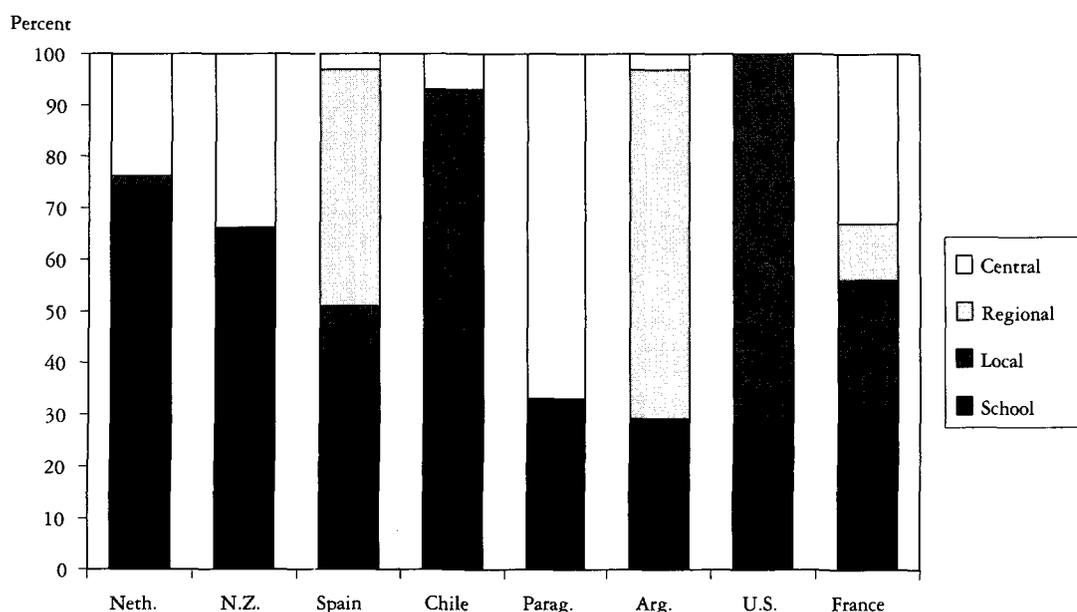
Education decentralization has taken many forms in Latin America and the rest of the world. It always includes the transfer of authority and responsibility from higher to lower levels of government, but it varies considerably in terms of which decision-making powers are decentralized and who receives those new powers. Figure 4 illustrates the wide variety in Latin American and OECD countries in the location of important educational decisions. In addition, since education decentralization is often part of a broader education reform effort, there is considerable variation in practice in terms of accompanying school improvement measures.

In the discussion that follows, the typology will be applied to the experiences of Argentina, Brazil (with a focus on Minas Gerais State), Chile, El Salvador, Mexico, and Nicaragua.

Level of Decentralization

The level of education decentralization varies widely within Latin America. In Argentina, primary and secondary education and the normal schools were transferred from the central government to the provincial governments (in 1976 and 1991, respectively), and today most decision-making authority remains concentrated in the provincial education ministries. In this respect—the con-

FIGURE 4

Level of Decision-Making in Education Sector

Source: OECD 1998.

centration of decision-making authority at the regional level—Argentina presents a unique model in Latin America, although Mexico appears to be quickly evolving in a similar fashion.

Brazil has a long tradition of decentralized education, with most authority concentrated at the state government level. The state's pre-eminent role in secondary education was confirmed by the 1988 constitution, and municipalities were given the pre-eminent role in financing and delivering primary and preschool education. In addition, during the 1990s, some states (for example, Minas Gerais) have transferred significant decision-making authority to the level of the school.

Chile's education decentralization effort is long and complicated. It began in 1981 with the transfer of decision-making authority to the municipalities, on the one hand, and to nonprofit schools, on the other. It continued in the 1990s with the central government's exercising stronger pedagogic leadership and working directly with the schools to bring about school-level improvements.

El Salvador's decentralization effort was not universal but, instead, targeted rural areas where central government schools failed to function during the civil war. Hence, while for traditional public schools educational decision-making remained concentrated at the level of the central

government, the new rural schools, called EDUCO (the Spanish acronym for Education with the Participation of the Community) were given significant decision-making authority and autonomy. The success in implementing the EDUCO model has led to current efforts to decentralize traditional schools as well.

Mexico's education decentralization is a combination of the Argentine and Salvadoran models. The 1993 the Ley General de la Educación transferred most educational decision-making authority for primary and secondary schools to the state governments, but the central government's important role in financing education through negotiated transfers to the states resulted in de facto continued centralization. Real decentralization to the states occurred only in 1998 when education transfers became automatic. In addition, the central government continues to directly operate a system of rural schools, called CONAFE (the Spanish acronym for National Board for Educational Improvement), to ensure learning opportunities for remote rural, and especially indigenous, children. While not nearly as autonomous as El Salvador's EDUCO schools, the CONAFE schools give parents a considerably more important role than is found in the traditional public schools.

Finally, Nicaragua's education decentralization has evolved from an emphasis in the early 1990s on municipal-

ization, to a clear policy in the late 1990s to transfer most important educational management and finance decisions to the level of the school.

Several other countries in the region have also adopted education decentralization policies during the 1990s. Colombia decentralized primary and secondary education to departments (regional governments) and municipalities, and Bolivia is slowly implementing a similar policy. Guatemala and Honduras have followed the model of El Salvador's EDUCO schools. In the region, only Costa Rica, Ecuador, Panama, and Uruguay have chosen to retain centralized educational systems.

Decision-Making Powers

What does it mean that education has been decentralized to a particular level? As noted earlier for OECD countries, several educational decisions, such as choosing textbooks, selecting teaching methods, and responsibility for implementing school improvement plans, tend to be situated at the school level irrespective of the level of decentralization. Others, like setting the core curriculum or administering and reporting results on achievement examinations, tend to be located at the national level irrespective of the level of decentralization. Table 2 illustrates the focus of key educational decisions in several countries in Latin America.

Decentralization is mainly characterized by the locus of decisions on personnel and budgets. The greatest consistency is found around teacher and school director recruitment and hiring decisions, and the budgeting of non-personnel expenditures. Thus, in Argentina and Mexico these decisions are situated at the regional (provincial) level, in

Chile at the local (municipal) level, and in El Salvador and Nicaragua at the school level. Teacher pay decisions are sometimes retained at higher levels of government (as in Minas Gerais, El Salvador, and Mexico), and in most cases are heavily influenced by national policy that sets minimum pay conditions (for example, Chile) or national decisions about education finance (for example, Minas Gerais).

Of course, simple descriptions of decentralization fail to capture important nuances. A case in point is the school improvement plan. Almost every country in LAC now requires that schools or local jurisdictions develop improvement plans, but as a recent assessment of the Chilean experience illustrates, such plans are often carried out as a bureaucratic exercise and fail to meet minimum standards of quality and community participation. When schools do develop plans, they often lack the authority to implement them, as in Colombia. And even when they have the authority to implement, they may have no source of financing.

Another case in point is the allocation of the personnel budget. The multiple constraints of national or regional pay scales, collective bargaining agreements on working conditions, including class size, and national curriculum requirements may translate into little real discretion at the decentralized level.

Structure and Content

Have decentralization reforms in LAC been mainly structural in nature—focused on increasing local control and raising accountability—or have they been more concerned with content and viewed as a vehicle to raise quality? The answer, of course, is not a simple one.

TABLE 2
The Locus of Key Educational Decisions and Responsibilities

GROUP	DECISIONS	ARG	MIN GER	CHILE	EL SAL	MEX	NIC
Organization	Level of decentralization	R	S	L	S	R	S
	Choose textbooks	S	S	S	S	N	S
	Determine teaching methods	S	S	S	S	S	S
Personnel	Hire/fire school director	R	S	L	S	R	S
	Recruit/hire teachers	R	R	L	S	R	S
	Set or augment teacher pay	R	R	L	N	N	S
Planning	Set performance exams	N	R	N	N	N	N
	Implement school improvement plan		S	S	S		S
Resources	Determine expenditures	R	R	N,L	N	R	N,S
	Allocate personnel budget	R	R	L	N	R	S
	Allocate non-personnel budget	R	S	L	S	R	S

N = national, R = regional, I = local, S = school.

The education decentralization experiences of Argentina, Chile in the 1980s, El Salvador, and Mexico can be viewed as mainly structural in nature, but for very different reasons. In Argentina, primary and secondary education were devolved to provincial governments for mainly fiscal reasons. Hence, the goal of the reform was simply to move expenditure responsibilities to the provincial governments. There was little concern as to whether this would lower or raise quality.

In Chile, the Pinochet government simultaneously introduced a modified voucher scheme and municipalized public education to increase competition between schools for students and thereby raise the accountability of schools to parents. In El Salvador, the EDUCO model has put the emphasis on the creation of school councils to receive and manage government funds for the purpose of providing schooling. While the main objective of EDUCO has been educational—to improve access in rural areas—its primary focus has not been interventions to alter the content and raise the quality of schooling. In Mexico, education decentralization has been an integral part of a broader decentralization of powers to state governments in keeping with the political liberalization of the country. Finally, Nicaragua's policy of school autonomy as the principal focus has been giving voice to parents and civil society on educational issues and, in this way, increasing operational efficiency (Arcia and Belli 1998).

In contrast to the cases described above, Minas Gerais and Chile (since 1990) have focused on changing the content of education and raising its quality through decentralization. Minas Gerais granted a significant degree of autonomy to the public schools financed by the state government to define their goals, develop a school pedagogical project, and manage financial resources with the overall goal of improving education. Chile since 1990 has attempted to balance the structural reforms of the 1980s with content reforms to raise educational quality, especially for the poor. While the recent reforms have been top-down in their design and the goals they pursue, they have attempted to deepen the decentralization process and move pedagogic decision-making to the level of the school. For example, beginning in 1992, teachers have been encouraged to work together to develop school improvement projects, which the education ministry funds on a competitive basis. The Teachers' Statute was revised in 1995 to allow school directors to manage funds directly and to provide school-based

financial incentives for performance. Further, beginning in 1997, a competition to fund the best education improvement projects proposed by secondary schools both provides financial incentives for performance and gives school directors full management responsibility for implementing the projects.

Evaluation of Decentralization

While the reasons for the decentralization of education in Latin America are often political or fiscal in nature, from an educational perspective there is the expectation that decentralization will improve schooling outcomes. Schooling outcomes can be defined in a variety of ways, but at a minimum involve measures of the level and distribution of learning and years of schooling attained by schoolchildren.

For three reasons it is difficult to use these measures to evaluate education decentralization. First, time series of these measures are seldom available. Second, these school outcomes usually change slowly in response to any kind of educational intervention, including decentralization. Third, it is very difficult to control for external shocks—ranging from natural disasters and fiscal crises to teacher strikes and changes in national education leadership—that may also influence school outcomes.

Given the difficulty of isolating the effects of decentralization on learning and educational attainment, our approach is to look at how decentralization changes factors known to be related to learning. First, we ask what is the received wisdom on what are the characteristics of effective or high-performing schools. Second, we ask how these characteristics are reflected in the school environment. And, third, we ask how does decentralization directly or indirectly affect any of these factors.

High-Performing Schools

There is a growing qualitative and quantitative research literature on the characteristics of high-performing or effective schools (Mohrman and Wohlstetter 1994; Creemers 1994; Darling-Hammond 1997) that mirrors the much larger literature on successful organizations (Barzelay 1992; Lawler 1992). This literature concludes that high-performing schools are characterized by strong leadership, highly qualified and committed staff, a focus on learning, and responsibility for results. Another set of literature reviews the evidence on the process by which schools improve, and it yields conclusions that are consistent with

the effective-schools research. For example, in an evaluation of school improvements on three continents, Dalin (with others 1994) concludes that essential ingredients in successful reforms are a sustained commitment to quality improvement, local empowerment to adapt programs to local conditions, strong emphasis on school and classroom practice, and strong support linkage between education authorities and the school “via information, assistance, pressure and rewards” (see Annex Box 4.A.1). In the discussion that follows, we group the variables associated with high-performing schools into four characteristics: leadership, excellent teachers, learning focus, and accountability.

Strong leaders have the capacity to effectively develop and communicate a schoolwide and communitywide commitment to a common mission and vision for the school, and to manage the implementation of the school’s improvement plan. The common mission and vision fosters teamwork inside and outside the school, and, most importantly, the process of developing them makes teachers and parents the “owners” of efforts to improve learning. Leadership is especially important in a service industry like education, where the contribution of individual teachers is difficult to measure, and thus difficult to directly reward. In the absence of strong individual incentives, leaders must motivate teachers to improve. These characteristics can be stimulated through decentralization. Table 3 summarizes our findings.

Decentralization cannot, of course, convert school directors who are used to passively following ministerial orders into dynamic leaders overnight, but it can and often does provide a transparent, competitive selection process for

school directors that selects in part for leaders. A good example of this is the Minas Gerais decentralization, which (1) established a procedure for certifying qualified candidates to compete for school director positions, (2) required candidates to present their proposals for school improvements as part of the competition, and (3) empowered school councils to make the final selection of the school director.

Excellent teachers commit to the high goals and standards of the school, have the strong teaching skills required to meet those goals, continually work to improve teaching and student learning, and do their work in a supportive work environment. Teacher commitment is essential to developing the teamwork required for schools to continually diagnose their own problems and devise their own solutions. Teamwork is also essential to permit the sharing of teaching experience required to continually improve teaching practices. Effective evaluations of teaching performance is critical to giving teachers information on what they need to improve and how to improve it. The time required to participate in the management of the school and the improvement of teaching is unlikely to be forthcoming in a work environment where teachers are not given time for these activities within their normal work schedule. In many LAC countries, where double and triple shifts are common, it may be logistically challenging to find the space and time for teacher participation.

Decentralization can contribute to excellent teaching in a variety of ways. When decisions on significant pedagogic matters are transferred to schools, teachers are empowered and motivated to work collectively to improve the services

TABLE 3

Characteristics that Can Be Stimulated through Decentralization

CHARACTERISTICS OF EFFECTIVE SCHOOLS	DECENTRALIZATION VARIABLES THAT CAN CONTRIBUTE TO SPECIFIC CHARACTERISTICS OF EFFECTIVE SCHOOLS
Leadership	School directors are selected by the community using transparent criteria. School improvement plans are developed locally. Resources are transferred to schools for the implementation of school plans.
Skilled and committed teachers	Schools are given the authority to make curriculum and pedagogic changes. Teachers have significant responsibility for developing school improvement plans. Directors are given the authority to provide a substantive evaluation of teachers' performance. Schools are given the authority (and resources) to make their own decisions as to the type of training to be provided to teachers.
Focus on learning results	The school improvement plan emphasizes goals of improving learning (and associated results, such as reducing dropout and repetition). Information on learning at the level of the school is transparent.
Responsibility for results	Directors have fixed-term appointments which may not be renewed if improved learning goals are not met.

delivered to students. When school directors are given the authority to carry out meaningful evaluations of teaching staff, teachers can focus their training on what they need to improve. When resources for training and training decisions are given to the school, teachers and directors can purchase the training they need (demand-driven) rather than the supply-driven training provided by the education ministry.

Excellent teaching focuses on **student learning**. A school system that is focused on learning provides a pedagogy, a curriculum, and resources appropriate to student needs. In most cases, it is the local school and its teachers who are best placed to diagnose and find pedagogic solutions to individual student and collective school learning problems. Different kinds of students—rural, indigenous, poor, urban youth, and so forth—are also likely to have different learning needs with implications for the distribution of financial resources to schools by higher levels of government. Rural children may require smaller class sizes, reasonable commuting distances, or bus transportation. Indigenous children may require more costly bilingual instruction. Poor children may require school lunches and subsidized textbooks.

Decentralization can facilitate and reinforce a focus on student learning by providing the information required to assess learning problems, devolving appropriate pedagogic decision-making to the school, and allocating additional resources to schools with special needs. The visible product of this process is a solid school improvement plan, constructed with the active participation of teachers and the community, and with real possibilities of being implemented. Good information on student learning, and on the value-added of the school, is essential to the diagnosis of learning problems that is an essential part of the school improvement plan. Good information is also essential to monitoring progress toward attaining learning goals. The devolution of appropriate pedagogic decisions is critical to the local design of solutions to local learning problems. Finally, financing is important, both because it is a means of implementing school improvement plans and because it permits the adoption of pedagogy that meets special needs. In particular, in the absence of additional resources, children from educationally disadvantaged homes are unlikely to meet the educational goals required for them to escape their parents' poverty.

Establishing **responsibility for results** provides the incentives necessary for sustained educational improve-

ment. A school system with responsibility for results requires a set of measurable learning goals, up-to-date information on school performance toward meeting those goals, rewards for meeting goals and sanctions for not meeting them, and active monitoring of progress. The actor held accountable is typically the school director or the staff of the school. The actor holding the school accountable may be the education ministry, a school council, or both. In Latin America, the failure by ministries to hold schools accountable is often cited as the rationale for the creation of elected school councils, which have local knowledge of the school but often lack sophistication to systematically evaluate performance.

There can be no accountability at the local or school level in the absence of devolution of authority to make pedagogic and resource-allocation decisions at the local level. Decentralization can contribute to accountability at the local level by devolving decision-making; establishing performance contracts between schools and financing bodies (including central-government ministries and parent-led elected school councils) that specify learning goals; creating information systems, including standardized tests of students' knowledge, to permit contract enforcement; and creation of performance-related rewards and sanctions, including dismissal of school directors. For example, the decentralization reform in the Chicago, Illinois school system replaced tenure for school directors with four-year contracts and required each director to sign an annual performance contract with the system specifying measurable goals for the year. Schools that consistently fail to meet goals may see their director dismissed and teaching staff reassigned (see Table 4.A.2).

The Consequences of School Decentralization

In this section, we attempt to evaluate each of the education decentralization cases discussed in this paper in terms of its potential to raise learning, especially among children from poor households. In some cases, such as Argentina, decentralization was just one component of a larger education reform. In other cases, such as Chile, education reform and changes in decentralized responsibilities have evolved over more than a decade. Given the complexities of evaluating reforms, we do not attempt to separate out the "decentralization" component for evaluation, nor do we try to evaluate the initial reform. Rather, we try to make an assessment of the reform as it looks today.

The criteria for this evaluation are the characteristics of decentralization that the research literature and professional opinion attribute to high-performing schools. Below we give a summary assessment for each country reviewed in this paper; more complete information on each country's education decentralization is given in the Annex.

Leadership

The decentralization experiences reviewed here vary greatly in terms of the extent to which they have created the conditions that may give rise to strong local leadership. Neither Argentina nor Mexico has given school directors any significant authority and responsibility. Chile has recently granted more authority to directors of municipal schools, and of course the directors of the private subsidized schools have long had a high degree of authority. The EDUCO schools of El Salvador are mostly small and often without school directors, and school autonomy is only slowly being granted to the traditional public schools. Minas Gerais and Nicaragua are the two examples where school directors have significant authority, and in the Minas Gerais, in particular, the open selection process implicitly values the leadership qualities of candidates.

Teacher Excellence

Strengthening the teaching capacity of teachers has been a high educational priority for most countries in Latin America in recent years. Argentina has embarked on a major upgrading of its normal schools. Minas Gerais has

emphasized the use of distance education to upgrade teacher skills. Chile has provided competitive grants to universities to improve their teacher training programs and has sent large numbers of teachers abroad to strengthen their teaching skills. Mexico has introduced the Carrera Magisterial to strengthen teacher evaluation and performance incentives.

However, few of the region's efforts to upgrade teaching capacity have been accompanied by in-depth evaluation of teachers, additional compensated time to participate in school activities and prepare lessons, and incentives for teachers to work and learn in teams—all factors that appear to contribute to school improvement (Dalin et al. 1994). Among the countries reviewed here, Chile has the policies best aligned with changing teacher behavior and training. Teamwork among a school's teachers in Chile is encouraged through (1) competitive funding of teacher-designed and implemented school-improvement plans, (2) bonuses (equal on average to one month's salary) to the 25 percent highest-performing schools as assessed using school performance indices, and (3) provision of staff time to participate in professional development circles, with financial support from the education ministry.

Focus on Learning

The emphasis on improving quality and raising student achievement is clear in the Argentine education reform, the Minas Gerais decentralization reform, the evolving Chilean reform of the 1990s, and some of the policies and

TABLE 4

Assessment of Education Decentralization

CHARACTERISTICS OF EFFECTIVE SCHOOLS	DECENTRALIZATION VARIABLES RELATED TO EFFECTIVE SCHOOLS	ARG	MIN GER	CHILE	EL SAL	MEX	NIC
Leadership	Community selects director		✓		N/A		✓
	School improvement plans		✓	✓	✓		
	Transfer funds to school		✓	✓	✓		✓
Skilled and committed teachers	School curriculum authority	✓	✓	✓			
	Teachers develop improvement plans		✓	✓	✓		
	Directors evaluate teachers		✓	✓	N/A	✓	✓
	Schools decide training		✓	✓	✓		
Focus on Learning	Learning goals specified		✓				
	Transparent information	✓	✓	✓	✓		
Responsibility for Results	Fixed-term appointments for directors		✓		N/A		✓
	Competition for students			✓	N/A		✓
	Parents have effective voice		✓		✓		✓

programs carried out in Mexico. It is less clear in El Salvador, where the emphasis has been more one of raising access, and Nicaragua, where the focus has been more on parental participation than on scholastic achievement. However, even in those countries where national education reforms and policies are focused on student learning, the conditions are not always present for effectively creating a school-based focus on learning.

Argentina has adopted an ambitious reform to train teachers, provide sophisticated feedback on individual student performance (at the secondary level), and provide additional financing for children with special needs. However, schools, teachers, and local communities have almost no authority to diagnose their own needs and design their own interventions. Minas Gerais, in contrast, encourages schools to diagnose, monitor, and evaluate; schools are expected to produce school improvement plans, and the state government provides funding for these plans and feedback on student achievement. However, the focus of all this effort is not necessarily specific learning goals, and teachers and community members are not always active participants in the process.

As in Argentina, the Mexican education reform has been guided and driven at the national level. While decentralization efforts have not been focused on improving learning, other components of the reform, including changes in teacher evaluation and pay, and providing additional resources for poor and indigenous rural children, are focused on learning. However, excluding the CONAFE schools, teachers and parents are not yet actively engaged in bringing about learning improvements at the level of the school (Gershberg 1998a).

Chile's reform efforts since 1990 have been focused on student learning, especially for poor children. Teachers have been actively involved in diagnosing their own needs and developing their own school improvement projects. The Catholic University (1998) evaluated the school improvement projects carried out during 1992–95 and concluded that the largest change was increased innovation in teaching practices, especially increased use of interactive learning processes, and increased teamwork among teachers. The evaluation also found that, on average, schools that implemented improvement projects experienced increased student achievement as measured by the SIMCE. However, only 60 percent of all schools experienced achievement gains, reflecting the fact that not all improvement projects were focused

on improving learning, and some projects attempted to simultaneously accomplish too many objectives.

In addition to funding school improvement projects, the Chilean education ministry has provided additional funding for special needs, such as with the P-900 program, which provided extra resources for the 900 poorest schools in the country. Average student test scores are annually published for each school in the country, and the schools making the most progress over time are eligible for financial rewards. While the education ministry could improve the monitoring and evaluation of specific learning standards, Chile has most of the conditions in place to bring about significant learning improvements.

Responsibility

It is in the realm of responsibility for results that Latin American decentralization reforms are found to be most wanting. In Argentina, Chile, and Mexico there is at least one critical element missing for there to be real accountability. In Argentina, performance goals are not specified, systems to systematically evaluate performance are still under development, and no one is at risk of losing a job or suffering lower pay due to the low performance of the school in which they work. Performance goals are not specific in Chile either, and there are few risks to schools that do poorly. The same is true for Mexico. Furthermore, in all three countries school councils are largely nonexistent, so schools are accountable to neither parents nor higher levels of government.

In contrast, school councils are active in Minas Gerais, Brazil, El Salvador, and Nicaragua; school staff can lose their jobs for poor performance in El Salvador and Nicaragua; and school directors are at risk of losing their jobs in all three countries. On the other hand, learning goals are rarely specified with any precision, and the systems for monitoring and measuring school performance with respect to specific goals need considerable strengthening.

Empirical Findings

While rigorous evaluations of education decentralization are difficult to find, a very few do exist. We review the findings to date of evaluations carried out in El Salvador and Nicaragua with the assistance of the World Bank, and we complement these findings with evaluations of decentralization in Brazil and Chile, and in two large U.S. cities—Chicago, Illinois, and Memphis, Tennessee.

The evaluation of El Salvador's EDUCO program by Jimenez and Sawada (1998) compares teacher absenteeism and student achievement in EDUCO schools with that of traditional schools, controlling for student characteristics and selection bias (since the EDUCO schools were not randomly selected). Two results merit attention. EDUCO schools, with their close community monitoring of the school and the potential sanction that teachers will not be rehired, had fewer days of teacher absenteeism than traditional schools, and student achievement in EDUCO schools was no different from that of traditional schools. Surprisingly, the study found no difference between EDUCO and traditional schools in terms of the number of decisions made at the level of the school, which suggests that the EDUCO model may not be fully implemented. On the other hand, EDUCO parents are three times more likely to engage in day-to-day classroom activities than parents in traditional schools, teachers in EDUCO schools spend considerably more time meeting with parents, and EDUCO teachers are much more likely to visit the family to inquire why a student has been absent from school.

In contrast to the El Salvador findings, an evaluation of Nicaragua's autonomous schools by King and Özler (1998) finds that autonomous schools make significantly more schooling decisions than do traditional schools, especially on personnel matters and in determining the school plan and budget. However, even the autonomous schools seldom make teacher training decisions. Another key finding of the evaluation is that the degree of decision-making actually exercised by autonomous schools varies greatly, and there is a positive and statistically significant relationship between the degree of decision-making exercised and student achievement. Furthermore, the strongest positive relationship to learning was found for variables measuring decision-making on teacher staffing and monitoring of teacher activities. Nicaragua also illustrates the potential role of the central government within the context of decentralization: A recent qualitative assessment of Nicaragua's school autonomy discovered that educators strongly welcome the active intervention of the central government in promoting a pedagogy of active learning (Fuller and Rivarola 1998).

The Minas Gerais reform has not been systematically evaluated, but the results of the Brazilian national education test put Minas Gerais at or near the top of student achievement in every grade and subject matter (INEP

1997). The reforms undertaken by the state of Minas Gerais in Brazil have been replicated in part by several other states. In particular, several states have now adopted (1) the establishment of school councils, (2) the direct transfer of resources to schools, and (3) the local election of school directors. Using state-level pooled time-series, cross-sectional data, Paes de Barros and Silva Pinto de Mendonça (1998) have analyzed the relationship between these reforms and a number of schooling outcomes—gross enrollment rates, repetition rates, age-grade lags, and student achievement as measured by the Brazilian national educational test, SAEB. They found statistically significant but mixed results. The establishment of school councils and the direct transfer of resources are associated with increased attendance and reduced age-grade lags, but have no statistically significant relationship to student achievement. The local election of the school director, on the other hand, is positively associated with student achievement gains, but not with the other measures of schooling outcomes.

As noted earlier, Chile has passed through two reform phases. The first, begun in 1981, emphasized changing the structure or organization of education through municipalization and the introduction of competition and choice. A simple comparison of student achievement scores across the 1980s shows a decline in learning, but during this period real per-student education expenditures also declined, making it difficult to isolate the reform effect. However, a 1998 study by McEwan and Carnoy assembled school-level panel data to examine how the degree of competition and choice across municipalities and over time affects public school quality, as measured by changes in student achievement test scores. They conclude that this aspect of Chilean education reform has had no effect on public school quality. This finding confirms the qualitative evaluations made by other scholars that municipalization did not lead to any substantive changes in behavior and achievement in the public schools (Espinola 1997).

The second phase of the Chilean reform began in 1990 and, as noted earlier, simultaneously deepened decentralization and set clear goals of raising quality and equity. In contrast to the 1980s, student achievement on Chile's standardized exam, the SIMCE, increased significantly, both in language and mathematics (Cox and Lemaitre 1999). Nationally, the number of correct answers increased by about 18 percent. However, here, too, it is difficult to sep-

arate the effects of decentralization reforms, such as introduction of school improvement projects, from other reforms (for example, in teacher training), and from significantly increased spending over the decade.

The findings for El Salvador, Nicaragua, and Chile are complemented by two careful evaluations carried out in two large U.S. cities having large populations of poor and minority students—Chicago and Memphis. As discussed in Box 1, Chicago introduced largely structural reforms in 1988, and followed up with a much stronger content-based reform in 1995. A consortium of academic institutions led by the University of Chicago has carefully monitored and evaluated the Chicago reform from Day One. The most recent evaluation report concludes that year-to-year gains in student learning have risen significantly (for example, a 19 percent gain in achievement for fifth graders between 1992 and 1996) since the beginning of the reform, despite the fact that the socioeconomic level of students has been gradually decreasing (Bryk, Thum, Easton, and Luppescu 1998). Earlier evaluations demonstrated, also, that school reform efforts resulting from autonomy are as likely to be initiated in poorer as in richer neighborhoods.

In contrast to Chicago, the Memphis reform has been heavily content-based from the beginning (see Box 2). The evaluation of the Memphis school reform confirmed the Chicago results of sustained improvements over time.

Prior to implementation of the reform, the experimental schools (those subsequently undertaking school-based reforms) had smaller student gains in learning than a group of control schools. After one year of implementation, the gains of the experimental and control schools were the same, and after two years of implementation, student achievement gains in the experimental schools were significantly higher than in the control schools (Ross, Sanders, Wright, and Stringfield 1998). Finally, an evaluation of the Memphis decentralization confirmed that leadership by school directors and teacher buy-in to reforms are critical to their implementation.

Taken together, the El Salvador, Nicaragua, Chile, Chicago, and Memphis evaluations provide strong evidence that educational decentralization can improve learning. What is notable is that those cases demonstrating the largest positive gains have emphasized school autonomy with pedagogic reform, especially true in Chicago since 1995, in Memphis, and since 1990 in Chile.

Summary

Education decentralization is a worldwide phenomenon, and Latin America is no exception. While there are economic and education arguments for decentralization, the particular forms of decentralization in most Latin American countries have been driven more by politics. Given the

BOX 1

Chicago: An Initial Emphasis on Governance

Chicago has adopted two education reforms. The first, initiated in 1988, focused on governance, while the second, adopted beginning in 1995, decentralized some powers and put the focus on improving learning. The 1988 reform created elected, parent-led school councils with the power to hire and fire the school director. The council works with the director to prepare and monitor a school development plan. Tenure for directors was replaced by four-year contracts. Directors were given increased powers to hire teachers, increased discretion in allocating the budget, and increased control over curriculum decisions.

By 1995 there was the widespread perception that educational improvements were not occurring rapidly enough in Chicago. As a result, the mayor took control and named a central district school board and a corporate-style management team. The board was given the right to impose sanctions on poorly performing schools, including disbanding the school council and evaluating and dismissing principals (in conjunction with the councils). One of its first actions was to put 109 of the 557 public schools in Chicago on probation because of poor academic performance. The 1995 reform also established a central body responsible for the review and evaluation of the performance of each school, with recommendations for actions to improve performance. Finally, it increased the budgetary autonomy of each school, including giving each director the freedom to outsource a wide variety of school services.

BOX 2

Memphis: Decentralization Focused on Improving Learning

The schools of Memphis, Tennessee, serve a largely poor and educationally disadvantaged population. Frustrated with the persistently poor academic performance by students, the city decided in 1995 to grant limited autonomy to individual schools with the objective of stimulating school-level educational reforms. Each school formed an advisory school council comprising the director, teachers, parents, and community members. The principal function of each council is a technical one—diagnosing needs, agreeing on reforms, and monitoring progress in student learning—and while it is legally advisory in nature, its opinions are taken seriously.

Each school in the Memphis district was required to adopt a school-based reform from a menu of eight different school restructuring models. While the pedagogic orientation of the models differ, they share several characteristics: increased school autonomy (especially, on pedagogic matters); a common vision of school goals reflected in the school development plan; performance contracts with specific, quantifiable targets between the school director and the central administration; extensive teacher development activities at the school level; teamwork within the school; and constant monitoring of progress, including the use of standardized examinations.

The central Memphis education office continued to play a strong role in setting high standards (for example, all students in grades 3 through 8 must pass set exams in mathematics and science in order to be promoted); mandating minimum standards and core curriculums; facilitating teacher development by offering a broad menu of training options and opportunities; providing additional financing to cover the costs of implementing school development plans (with larger amounts for schools serving the poor); and establishing monitoring and evaluation systems to provide constant feedback to individual schools on their performance.

magnitude of education decentralization efforts in the Region over the past decade and the forms they have taken, it is timely to assess their effects.

The evaluation of decentralization reforms is difficult due to (1) lack of baseline data, (2) incomplete implementation of many reform elements, and (3) lags between implementation and the changes in such factors as behavior and resource allocation, which affect learning. The difficulty in evaluating reforms argues for caution in interpreting results. The lack of much rigorous evaluation of Latin American experiences has led us to rely to some extent on good evaluations of decentralization efforts outside the region for our overall conclusions.

The fact that few evaluations exist of the impact of decentralization on learning outcomes has also led us to an alternative approach to infer impacts by looking at the extent to which characteristics of decentralization reforms are consistent with the characteristics associated with high-performing schools. The fact that two well-evaluated and successful U.S. school reforms—in Chicago and Memphis—have shared the decentralization characteristics professional educators associate with public schools lends credence to this approach. Interestingly, many of the

recommendations made by educators for creating effective schools are consistent with the prescriptions economists might make.

Designing decentralization reforms to improve learning is complicated by the nature of education. For example, it is difficult for any actor external to the school to monitor and hold the school's performance accountable. After all, the outputs of the school are several, and almost all are difficult to measure. Experience has shown it is especially difficult to measure the value-added of the school in producing scholastic achievement (Ladd 1996). In addition, when teachers work in isolation they have the capacity to shirk their duties, with little risk of negative consequences. Finally, strong labor unions and regulatory protection (often embodied in teacher statutes in Latin America) make it difficult to penalize poor-performing teachers even when they can be identified.

To economists, these agency problems argue for a number of solutions. First, intense efforts should be made to provide good information on the performance of schools and teachers, taking into account the complexity of the educational production process. This may require establishing an independent agency to carry out external audits

of schools that go beyond merely identifying outputs, and provide diagnoses of problems and propose solutions as well. Second, school directors should be given a large degree of authority; they have considerably better capacity to monitor school and teacher behavior than do local political agencies, including school councils. Third, teaching should be organized in a way that minimizes shirking and provides peer rewards and sanctions for performance. This requires that teachers share experiences and work together as much as possible. Fourth, given the high risk of shirking, teachers must themselves become the proponents and owners of efforts to improve teaching, including deciding on their own training. Externally imposed (that is, top-down) solutions to educational problems are likely to fail in the absence of an effective communications campaign to enlist the support of teachers.

Of the Latin American reforms reviewed here, two—those in Chile and Minas Gerais, Brazil—entail a large number of the elements that arguably give rise to the characteristics of effective schools. Neither reform has yet been subjected to rigorous evaluation, although the available evidence for Chile is positive. Two other Latin American reforms—more limited in scope than Chile and Minas Gerais—have been evaluated in terms of impact, with somewhat contradictory results. El Salvador's EDUCO program has not yet demonstrated positive effects on learning, while Nicaragua's charter school program has. Nicaragua's reform granted substantial authority to school directors, which Brazilian research has found to be associated with learning gains.

In sum, there is growing evidence that at least some of the characteristics of education decentralization reforms that focus on school autonomy, as opposed to municipal or regional autonomy, contribute to higher-performing schools. Decentralization to subregional governments may also yield some educational benefits by allowing greater innovation and greater flexibility to adapt resource allocation to local prices, but they have not yet been proven.

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Annexes

TABLE 4.A.1

Characteristics of "Decentralized" School System Argentina, Education Reforms 1976–1991

	COMMENT/SUMMARY JUDGMENT
Resource Management	All power is at level of provincial government.
Personnel Management	All power is at level of provincial government.
Governance	All power is at level of provincial government. School councils have no decisionmaking authority.
Choice	No significant choice.
Finance	Provincial government is the financial source of all regular operations of the schools. Central government is source of finance for compensatory education programs.
Pedagogy	Not enough information.
Information	Test scores are publicly available at the level of the schools.
Incentives	Very weak incentives for teacher or director performance.

TABLE 4.A.2

Characteristics of "Decentralized" School System Chicago, IL, Education Reforms 1988–1999

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools must develop school improvement plans. They gained greater control over allocation of the non-personnel budget and receive most of federal Title I funds as discretionary revenue.
Personnel Management	School councils can hire and fire the school director, and directors have increased authority over new hires. The process for firing incompetent teachers already at schools has been streamlined somewhat. Directors can assign teaching responsibilities.
Governance	Councils have a voting majority of parents and can select the director
Choice	Little or no traditional choice plans. Parents can select high schools but schools cannot generally have admissions requirements.
Finance	Schools cannot raise their own funds, though revenues do follow students within the system.
Pedagogy	School directors, in conjunction with the council, can influence the non-core curriculum and have some power of pedagogical approach.
Information	Public test scores and other school-level evaluation measures are readily available, though the public measures do not assess value added. The evaluation is done independent of the school; in addition, the central district has created both an inspector general to investigate financial management and an accountability council to review school performance and determine which schools are failing.
Incentives	Incentives within the system appear to be strong. Directors lost tenure and can now be fired by either the council or the central district for failing to improve outcomes. Teachers are largely still protected.

TABLE 4.A.3

Characteristics of "Decentralized" School System Chile, Education Reforms 1981

	COMMENT/SUMMARY JUDGMENT
Resource Management	Most resource decisions are made at municipal level, including development of a municipal education plan. School directors have newly granted authority to manage funds. Most schools have developed school improvement plans which have been financed by the central government.
Personnel Management	Municipalities have the authority to recruit and hire teachers. Teacher pay is set at the municipal level, but it is constrained by the national minimum pay scale. At the school level teachers can define their own training needs.
Governance	No school councils. Weak parental participation in municipal schools.
Choice	High degree of choice of school for parents.
Finance	90 percent of revenues come from central government, which allocates according to a set formula. Revenues follow students.
Pedagogy	Strong central government role.
Information	Published test score data are available at the school level. Very strong financial auditing tradition but no performance audit is conducted.
Incentives	There is competition for students and competitive grants for school improvement and teacher training which requires teamwork. Salary bonuses to teachers in highest quartile of performing schools.

TABLE 4.A.4

Characteristics of “Decentralized” School System El Salvador, Community Managed Schools (EDUCO)

	COMMENT/SUMMARY JUDGMENT
Resource Management	Community Education Associations (ACEs) devise an annual plan for the school and are responsible for administering funds according to its assessment of the educational needs of the school. They are also in charge of the maintenance and equipment of schools. The selection of textbooks falls under the responsibility of the Ministry of Education.
Personnel Management	ACEs have the authority to hire and fire teachers according to the Ministry’s criteria for selecting teachers, and supervise their attendance and performance. The Ministry is in charge of teacher training and setting a pay scale.
Governance	Creation of ACEs. These are bodies of elected members drawn from the community and are usually parents of the children attending EDUCO schools. ACEs do not select the school director. In most cases the principal works closely with the councils; however some view the ACE as a threat to his or her authority.
Choice	EDUCO schools are located in very remote areas and tend to be the only means for delivering educational services there. Thus parents do not have a choice
Finance	ACEs enter into a one-year renewable contract with Ministry of Education, through which they receive earmarked funds on a monthly basis to cover teacher salaries and operating costs, including school materials. Another source of funds for the school is the “bonus,” which is a small discretionary amount transferred to the school. Both of these funds are based on a formula which considers size of school and number of teachers. ACEs may raise additional funds by negotiating with other government agencies and international donors and by mobilizing local support.
Pedagogy	The EDUCO Coordinating Unit within the Ministry of Education is responsible for aspects of the program designed to increase classroom effectiveness, including curriculum development.
Information	The ministry conducts audits of the ACEs when regional supervisors report the existence of serious problems.
Incentives	Teacher job security is affected by student performance. As a result, the main reasons teachers leave EDUCO and go to the Ministry’s regular system are job stability and related benefits.

TABLE 4.A.5

Characteristics of “Decentralized” School System Memphis, TN, Education Reforms 1995–1999

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools must develop a school improvement plan that includes the strategy for allocating resources to support the chosen pedagogical restructuring model. This model comes complete with textbooks. Non-personnel funds were essentially decentralized to the directors through school-based management reforms that took place before the pedagogically driven reform in 1995.
Personnel Management	The school councils cannot hire and fire the principal, who in turn has relatively limited power over teaching personnel: They cannot really fire teachers, and they have some limited extra control over hiring new teachers. They have some limited power over assigning teaching responsibilities but must remain within union guidelines. Pay scales are set centrally. Professional development is design-specific depending on the pedagogical model chosen, and takes place at both the school and at sites determined by the organizations that provide a particular design.
Governance	School councils are advisory in nature and have a majority of school staff. They do not select the director or any other school staff.
Choice	Parents can choose from among public schools, though this choice is limited by availability, and school neighborhood residents are given priorities. Only magnet schools can have admission requirements.
Finance	Schools cannot raise their own revenues, but funds do follow students.
Pedagogy	The entire pedagogical approach is determined by the model selected by the school. Schools must choose one of the models approved by the central school district, but the range of choices is very wide.
Information	The Tennessee Value-Added Assessment System (TVAAS) is one of the most well-respected evaluation systems nationally. It specifically provides value-added achievement results, which are available to the public on a school-by-school basis.
Incentives	Directors are evaluated heavily based on the TVAAS, and poor performers can be removed by the central district. Teachers, on the other hand, have more substantial job security.

TABLE 4.A.6

Characteristics of “Decentralized” School System Mexico, Education Reforms 1992–98

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools have very little power over resources and thus little ability to put any bite into a school improvement plan. The central ministry pays only for its own textbooks.
Personnel Management	Little or no school-level power over personnel.
Governance	Officially councils exist but they do not function and have few powers.
Choice	No significant choice.
Finance	Schools cannot raise significant revenues and it is not clear that funds follow students.
Pedagogy	Schools have little choice over curriculum and pedagogy.
Information	School-level test scores available for most schools. There are no measures of value added.
Incentives	Very low level of incentives for either teachers or directors.

TABLE 4.A.7

Characteristics of “Decentralized” School System, Minas Gerais, Brazil

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools are in charge of developing a school improvement plan, an aspect of which is to prepare a pedagogical project defining the aspects to be improved in teaching/learning process. Schools also have the authority to select their own textbooks and allocate non-personnel budget.
Personnel Management	The State Education Secretariat/Minas Gerais (SEE/MG) is responsible for establishing the academic requirements and qualifications of teachers hired, promoting them, and providing them with training. Schools are in charge of hiring, determining which teachers will receive training, evaluating teacher performance, handing down disciplinary actions, and firing teachers. Salary levels and benefits are set at the state level. The schools can assign teaching responsibilities. Principals may not be dismissed without an SEE/MG investigation. Professional development is demand driven because the school board (composed in part of teachers and other school staff) has the responsibility of developing training plans for teachers.
Governance	School councils, called <i>colegiado escolar</i> , are elected by the community from teachers, other school staff, parents, and students over age 16. Candidates for principals are first required to take a written exam. Those with the highest scores are asked to present a work program to the community, which then elects the principal by a secret vote.
Choice	No significant choice.
Finance	Bulk of revenue transferred from SEE/MG, however schools may raise additional funds through public or private donations. School revenues are formula driven. Discretionary funds (those spent according to priorities established by schools) are determined using a formula that takes into account the number of students enrolled, the socioeconomic level of the clientele attending the school, and the location of the school. Earmarked funds (materials and services approved by the SEE/MG) are based on a per capita amount multiplied by the number of students, plus a certain percentage according to type of school (full time, special education, and so forth).
Pedagogy	Taking into account basic educational patterns and legal requirements regarding the annual number of school days, each school has the authority to design its own calendar, curriculum, and pedagogical approach, including methods for evaluation and organization of students in classes.
Information	The SEE/MG has established a mechanism of external assessment of the school unit called the Assessment Program of the Public Schools of the State of Minas Gerais. It is a periodical testing destined to measure students' achievement on basic knowledge and skills, and the scores are made public.
Incentives	The election process has given the community the power to replace principals who are not performing according to the community's interests or expectations.

TABLE 4.A.8

Characteristics of "Decentralized" School System Nicaragua, Education Reforms 1993–98

COMMENT/SUMMARY JUDGMENT

Resource Management	School-level resource management increased significantly in some autonomous schools. School directors receive monthly capitation grants to pay teachers and all other major expenses, including utilities. Schools also charge fees (or, rather, voluntary contributions) and any revenues generated are allocated by the school council. Schools can select their own textbooks, but the central government pays only for the ones that it chooses.
Personnel Management	School councils can officially hire and fire the school director and, with greater difficulty, teachers. However, in practice most councils have not challenged centrally appointed directors. There are cases of councils firing directors, but their direct control over the hiring process is more suspect. Still, the incentive for the director to please the council members seems credible. If fee revenue is substantial, councils tend to use it to augment teacher salaries.
Governance	Councils have a voting majority of parents and include the director, teachers, and students. Council members are officially selected based on various objective criteria, but in some schools they are democratically elected while in others they are selected by the director or the Ministry's municipal delegate.
Choice	No significant choice.
Finance	Schools can raise revenues through parental contributions and the annual school budget is determined by number of students enrolled.
Pedagogy	Directors, in conjunction with the councils, have some discretionary power over the non-core curriculum, but it is limited and rarely exercised. Primary pedagogical approach, the <i>metodología activa</i> , is developed and disseminated by the central ministry.
Information	There are no public, school-level measures of value added or other test score results. The central ministry is developing a national achievement evaluation system in conjunction with the World Bank.
Incentives	There are incentives for directors and teachers to raise revenue, and for teacher attendance in those cases where school revenues (which in turn depend to some extent on parent satisfaction) are sufficient to provide bonus pay. Teachers can also be fired by the director, perhaps in consultation with the school council. Overall, the incentives for all staff to perform appear higher in autonomous schools.

FIGURE A.1

Summary

1. **Educational reform is a local process.** The school is the centre of change, not the ministry or the district administration. Schools determine the degree of success, they can block implementation, enfeeble it or bring it to effective life. For schools to improve the quality of their programs effectively, they need to play an active and creative role.
2. **Central support is vital.** The issue for the central ministry is learning to support local schools in their efforts. In other words, how to make demands on support, encourage, empower, enable and build a strong local school. More responsibilities to the individual school presupposes a strong support structure from the system at large, one that must be built around the real needs of schools in development. For the central level it implies that a system of reform and a division of labour is needed to effectively support the local level.
3. **Effective system linkages are essential.** The strategy in complex systems is to identify effective linkages, non-bureaucratic in nature, between the national, district and local levels. For communication within the system to be effective, local empowerment is needed, usually as a consequence of more decentralization. A clear administrative role that combines pressure and support and secures the delivery of needed resources is also required.
4. **The reform process is a learning process.** The process is evolutionary and developmental in nature. It cannot be blueprinted ahead of time. The key to success is to get good data from all parts of the system on a continuous basis, studied and worked on at the school district level, and subsequently at the central level. This implies a competent supervision and monitoring system.
5. **Think systemic and big.** A vision of reform that affects school life substantially will have more effect than a cautious, incremental approach. Any major reforms in complex systems need to build structures and capabilities at all levels. Ad hoc solutions will not work in the long run, only institution-building based on sustained commitment works.
6. **Focus on classroom practice.** The clue is to focus on the dynamics of the classroom and the individual school, since this dynamic to a large extent determines implementation success. It is essential that the supporting materials are of good quality, whether nationally developed and locally adapted, or locally built from the start.
7. **See teachers as learners.** Good materials and facilities are a necessary but insufficient condition. Teacher mastery is crucial for impact on students, and that can best be developed through a systematic local learning process that includes in-service training, supervision and coaching in a collegial atmosphere.
8. **Commitment is essential at all levels.** It is crucial at the central level for sustained effort and the maintenance of needed support structures. It is also essential at the district and school level; however, it cannot be transmitted directly to schools. Commitment at the school level results from empowered successful action, personal mastery that starts with good assistance and develops from practice. In effect, local empowerment builds emotional as well as administrative and problem-solving capacity.
9. **Both local and central initiatives work.** An innovative idea that starts locally (Colombia), nationally (Ethiopia) or with external donors (Bangladesh) can succeed, if programmes meet the criteria of national commitment, local capacity building and linkage, in a configuration that makes sense for the particular country.
10. **Parent and community participation contribute to success.** Parent and community participation lead to commitment and contribute to outcomes, and are essential for the development and maintenance of primary schools in rural areas. Effective participation includes a real role for parents in school decision-making.

Source: Dalin and others 1994.

Health

Decentralization in the Health Sector: The Spanish Example

JOSEP MARÍA VIA I REDONS

The Spanish case offers an example of the challenges facing decentralization in the presence of significant regional idiosyncrasies and strong supranational influences, in this case the European Union (EU). It also raises questions about the role of central government ministries in such contexts. The planning and strategic options being considered for the Spanish Ministry of Health (MSC) offer interesting examples of how such challenges mandate organizational responses at the national level by central government agencies. Lessons learned from the Spanish experience can be important for some of the larger countries in Latin America.

Spain concluded a long period of military dictatorship in 1975 and engaged in a political transition toward democracy. Twenty-four years later Spain is a consolidated Western democracy, a modern and developed country that is fully integrated in international and European institutions. It has just become one of the 11 countries that share the euro as the single currency of the European Union.

The reinstatement of democracy in Spain was possible due to the National Reconciliation Pact between the political right wing (which came from the dictatorship), the democratic center-right, and the left-wing forces, as well as the nationalist Basques and Catalans (both losers in the Spanish Civil War, which took place between 1936 and 1939). The pact that allowed for the transition to democracy would not have been possible without

the legalization of the Communist Party and the drafting of a state model that satisfied Basque and Catalan nationalist aspirations to asymmetric autonomy.

The 1978 Spanish Constitution reflects the change from a very strong centralist and Jacobean tradition to political decentralization, which was accompanied by the corresponding decentralization of administrative services. The implementation of this process during the past 20 years has favored the devolution of responsibilities to the regional level, which has been just as important as that occurring in the most advanced federal models.

This decentralization process stems from the political will of nationalist Basques and Catalans, who claim Spain

consists of four historical nations: Catalonia, the Basque Country, Galicia, and the territories dominated by Castilian culture and language. The democratic transition could not have been conceived without the acknowledgement of the historical rights of these communities, and that acknowledgement transformed into large doses of real political power. Thus, the initial impetus for decentralization came from the need to grant autonomy to the historical nations, especially the Basque Country and Catalonia. The end result, however, was the *Estado de las autonomías* (state of the autonomías), which provides for 17 Autonomous Communities (CCAAAs) in Spain. Eleven CCAAs are of Castilian root, three are mainly Catalanian,

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two are Basque (Navarra, to a larger or lesser extent), and one, Galicia, limits the influence of its culture and language to its own territory. Each community has its own government and parliament.

At the beginning of the process, many of the current CCAAs did not feel the need to become autonomous, although none of them was prepared to forgo the power granted to the Basque Country and Catalonia. As a result, different CCAAs are set up in different ways and have different responsibilities. Currently, there is no mention of turning the process around; the debate is focused on whether the CCAAs should have uniform responsibilities.

The CCAAs are not simply deconcentrated entities; they are complex institutions that have acquired a great deal of the political authority. Consequently, CCAAs can develop policies different from the central administration or other CCAAs. Likewise, they are also responsible for the decentralization of the planning and management of the most important sectors and services.

The Decentralization of the Spanish Health-Care Sector

The decentralization of the Spanish health-care system to the CCAAs, as well as the overall political process of decentralization, is a clear example of devolution. The Spanish Constitution and the CCAAs' different Autonomy Decrees¹ have allowed an effective transfer of planning, policy development, performance, and management from the central government to the CCAAs. Indeed, the degree of autonomy from the central government is very high. The CCAAs are legal bodies with their own budgets and legislative and fiscal power; they are accountable to the population they serve.

Not all CCAAs (nor their health systems) have equal needs, or capacities, or starting points. Neither was the political will the same at first. In fact, it still is not, as demonstrated by the existence of strong nationalist parties in the Basque Country and Catalonia. When analyzing the Catalan health system it will be noted that for historical reasons only 30 percent of hospital beds belong to the government. The rest belong to not-for-profit private institutions. In the rest of Spain these percentages are the opposite. Bearing in mind this reality, it is clear that a homogeneous system would be inadequate and would limit the opportunities for developing a health-care system in the country.

So although the General Health Law (LGS) suggests the creation of a National Health System (SNS), it characterizes it as a group of coordinated health services of the CCAAs. Some Autonomy Decrees in the health sector provide for CCAAs to execute their own regulatory policies with regard to organization and benefits, as well as to take on the management of health services. Both are included in the basic principles established by the state in accordance with Article 149.1.16 of the Spanish Constitution.

The resulting situation for the CCAAs is that all 17 are responsible for planning and regulation, in accordance with the constitutional provisions and the individual Autonomy Decrees. But only seven of them have assumed the devolution of services and the full responsibility to manage them. Because of the reasons mentioned above (different needs, different capacities, and above all an asymmetric political will to assume health responsibilities), as well as a reassessment by the state when transferring the services network, health services in the other 10 CCAAs are managed directly by the state through an institute called INSALUD. Therefore, instead of a unified social security system in Spain, there is a health system characterized by the intervention of different public authorities—the central Spanish government through INSALUD, and seven CCAAs. However, the Spanish General Health Law (LGS) of 1986, which defines the group of health services of the central administration and of the CCAAs, does set the minimum basic principles that the different CCAAs need to adhere to.

It is important to note that when the LGS was passed in 1986, the decentralization process had already begun with the devolution of services to Catalonia in 1981 and to Andalucía in 1984. These communities did not wait for the state to pass the LGS to proceed with their autonomous development. In the Basque Country, Valencia, Galicia, Navarra, and the Canary Islands health transfers took place after the LGS was passed. However, in many cases the autonomous development occurred at a quicker pace than the development of the LGS by the state. This implied that the LGS had to adapt to pre-existing realities. Consequently, the LGS respected the organizational autonomy of each CCAA. We believe the political dimension of the process has had a positive effect on equity in spite of some disagreement, and we will briefly provide evidence for this.²

The LGS also delegates the health protection functions to municipalities in the different CCAAs through control over

the environment. Consequently, town councils and CCAAs share responsibilities for the sanitary control of the environment (atmosphere, water and residual waters, urban and industrial waste); industrial activities and services, transportation, noise, and vibrations; buildings and residences; the distribution and supply of food, drink, and other products that are directly or indirectly related to human use or consumption; as well as control over means of transportation such as ambulances and, cemeteries. This delegation of responsibilities to municipalities illustrates the model of shared responsibilities between administrations, but it is beyond the scope of this paper.

Thoughts on the Process of Devolution of Health Services from the Spanish State to the CCAAs

The Political Dimension

A recent paper (Via, Echebarría, and Subirats 1997), which included interviews with key actors in the National Health System (national and regional health ministers and examiners, among others), portrays a clear consensus that the Spanish Health Ministry (MSC) has acted like a "macro-ministry" of the CCAAs covered by INSALUD rather than as a health ministry for the entire Spanish state. This has put it in a position that is to a certain extent similar to that of regional ministries. Each autonomous health service has its own regional ministry, and the Spanish Health Ministry acts as the "regional" ministry for INSALUD (for the 10 CCAAs that do not have autonomous health services).

At the same time, many of the responsibilities reserved by the LGS for the MSC have been exerted insufficiently or marginally—or simply have not been exerted at all. This is very clear in the case of the "*Alta Inspección*," in the design of the integrated health plans, and in the overall coordination of the National Health System, issues that will be analyzed later on. But by acting as regional ministry for INSALUD, the MSC has been able to retain a certain power and justify its own existence.

After the political decision in the 1980s and early 1990s to transfer health services to the 10 CCAAs that have not yet taken on the responsibilities, the MSC has recognized the need to redefine its new role and will do so in a way that recognizes the plurality of the health system.

However, occasionally the temptation to recover the transferred power or to exert authority through coercive

controls timidly reappears. The Spanish government is considering a reform of the LGS that would mainly affect four areas: insurance and benefits, health-system financing, organization and management, and regional coordination. Some of the first drafts that we have seen are logical and improve the current situation. But others reflect the attempt to recover part of what has been decentralized, which would be very difficult considering the current Spanish political framework: What only concerned Catalonia and the Basque Country at one time now also concerns all the CCAAs to which health services have been transferred. Indeed, the attitude of the subcentral actors vis à vis the center is one of respect and caution (Via, Echebarría, and Subirats 1997).

The power alliances in the Spanish autonomous system cannot be exclusively interpreted from a normative-constitutional perspective, based on the formal and static separation of its responsibilities. The complexity of the existing relations and interdependencies between the different government levels is greater than what is common in federal states because of the existence of CCAAs with strong national identities. For the National Health System, this means that subnational levels are unlikely to allow much coercive control from the center. This is because in some areas the CCAAs have real power. One example is the access to relevant information for decision-making and budgetary autonomy through increasing public debt. In fact, on matters of limiting the debt, the European Union has carried more weight than the Spanish state because of the Maastricht convergence agreements. In this environment, the MSC's role can only be exercised with a wide consensus and the capacity to secure the agreement and adherence of the CCAAs.

From the central government's perspective, the proposed redirecting of the MSC's responsibilities is not risk-free. Once the current responsibilities that have provided the MSC with some significance are removed, the challenge for the MSC will not be an easy one. It will have to find a balance between the excess of interference and the risk of desertion. The success will hinge upon the capacity to effect cultural change and to recognize that the health models are heterogeneous. Some CCAAs have real power within a plurinational and diverse state.

In any case, the Spanish government recently agreed with the parliamentary group of the Catalanian nationalists on the following statement: "The MSC will foster the development of its functions through the creation of added

value as a central and resolving unit of the system, and not through the unilateral exertion of its hierarchical position, or its exclusive responsibilities.”

RECOMMENDATIONS FOR THE POLITICAL DIMENSION:
REDEFINING THE FUNCTIONS OF THE CENTRAL HEALTH
AUTHORITY

1. Transform the *Alta Inspección* into an information, analysis, and evaluation tool of the National Health System.

The *Alta Inspección* is an overall inspection function that legislation bestows on the MSC without specifying how it should be performed. Up to now (13 years have gone by) the MSC has merely carried out a routine, and generally uneventful, examinations of CCAA health systems, with the objective of identifying any possible contradictions with the constitution and the LGS. It is difficult to imagine things changing drastically in the short term.

The *Alta Inspección* should be characterized by its capacity to anticipate problems in the National Health System, to provide information on possible inequities, to identify worsening rates of health problems, to evaluate the results of the system, and therefore to become a high value-added source of information for the coordination and joint management agents (state-CCAA) of the system.

The definition of the goals and objectives of the *Alta Inspección* should be a joint project of INSALUD and the seven autonomous CCAAs.

The agents in charge of the necessary data collection should be responsible for the management of the regional health services, under the criteria covered in the Interterritorial Council³ under the supervision and coordination of the MSC. The MSC should promote the exchange of information, assure that the rules are followed in the data-collection process, guarantee consistency in the identification of irregularities, etc.

Finally, the likelihood that the *Alta Inspección* is incorporated as a valuable element in the administration and management of the National Health System will depend on whether it can draw relevant conclusions for the effective working of the system. This entails setting parameters that enable improvement and drawing conclusions for the whole system and for each specific actor.

2. The MSC should design the basic package of health services for the National Health System.

The Ministry affirms that “the organization of services constitutes a void of the General Health Law of 1986.”

Without a doubt, establishing a basic package of health services implies using one’s own power and exercising the role of health authority. However, these types of decisions have repercussions on public opinion.

Regional health ministers believe that the MSC should exercise that function, especially in light of the scarcity of financial resources in the health system (Via, Echebarria, and Subirats 1997). However, it is farfetched to believe that the MSC can exercise that function unilaterally. It would first require the approval of the Interterritorial Council and hence the 17 regional ministers. Likewise, without an essential package of health services, it is difficult to discuss equity. Determining the equity concept in a decentralized health system entails a political consensus exercise. There is no doubt, however, that the MSC must take the initiative. The MSC is currently looking into establishing selective public financing criteria for the whole group of benefits.

In order to effectively respond to the real and perceived local needs, the CCAAs should provide the basic services or those that can be financed publicly. The CCAAs could increase the scope of the basic package of health services to be financed using transparent technical, economic, political, and social criteria. Citizens in specific communities should finance these additional services through additional taxes, the transfer of funds from another budget line item, or other mechanisms.

3. The MSC should assume the role of stimulating reform and innovation in the health system.

It is clear that in most European countries there is consensus that the public sector should be more entrepreneurial and less process-oriented. Performance agreements will take over, and a certain degree of competition between health services providers will be created. It is likely that within this emerging new cultural framework institutions and health professionals will be compensated on the basis of outcomes and not historical budgets.

The different health systems in the CCAAs will therefore have to choose alternatives and assume the costs and benefits that derive from the management change. Each CCAA will have the responsibility to decide upon a management formula, to advance in the flexibility of human resources management, to stimulate the competition between providers, and to stimulate competition between providers through a capitated or case-mix payment system.

The MSC should not replace the ministries from the CCAAs. However, it should not remain extraneous to the change and innovation process in the health system. The MSC should offer its support to the development of the different processes in the CCAAs, recognizing the diversity of health models that can be developed. This can be done in two ways:

First, from a political perspective, it can help CCAAs reduce some reform costs, especially when these are shared and they can benefit from government support. The fixing of co-payments in specific services and rationing or budgetary control measures are easier to adopt when grounded on a political commitment taken on by both parties. The MSC should act as a catalyst for these agreements within the framework of the Interterritorial Council.

Second, from a more technical perspective, focused on organizational learning, the MSC should act as the center for health-reform analysis and follow-up (in Spain and all other countries). This preempts the sharing of information, the dissemination of studies and experiences, the completion of training and research programs, or the promotion of benchmarking between the different experiences.

The Organizational Dimension

Most of the organizational changes that took place in the system have been described in the previous section. This is because there was a need to illustrate the redistribution of power due to health-sector decentralization in Spain and the MSC's difficulties in redefining its new role.

This subsection will focus on issues such as the changes that took place subsequent to the implementation of new planning mechanisms or overall coordination procedures in the National Health System. It is clear, though, that during the decentralization process political consensus was considered more important than reaching an agreement regarding organizational issues. To a certain extent this has proved to be a handicap.

It should also be noted that the planning problems experienced by the CCAAs when receiving the transfers were not only due to a lack of knowledge. In fact, the centralized and hierarchical planning function was the only one in the system and bears no relation to the current and new planning concept that attempts to be based on the needs of the population. The same happened with the business management function that did not exist prior to decentralization. Administration was carried out according to bureaucratic principles.

Catalonia, the first CCAA to receive the devolution of services, became a champion in the planning field and attained high levels of professionalization of management. To a greater or lesser extent this occurred in the majority of CCAAs that received the devolution of health services. However, it is not easy to determine whether it was due to decentralization or as a result of the country's evolution.

Whatever the reason, the CCAAs for the most part have highly qualified health professionals in the planning and management fields. However, in Catalonia, as in Great Britain, the formalization of the separation of the purchasing and provision functions revealed a notable lack of experience in several areas: the definition of the services to be purchased, the fixing of prices and payment systems, the design and negotiation of contracts, etc. This occurred even if the separation (inadequately structured in the purchasing area) had taken place previously, and the system had been decentralized long before. In other words, problems appeared when the separation was formalized, even if it had taken place informally before.

The organizational changes derived from decentralization are visible, but it is difficult to establish a causal relationship between decentralization and planning, management, and health-services purchasing capabilities.

As expected, the structural conditions resulting from the organizational development experienced by the CCAAs when receiving the devolution of services are not homogeneous. This is by no means negative. Nevertheless, the analysis of organizational changes that have taken place in the different health services⁴ is not meaningful at this time. However, some recommendations for improvement will be made, mainly regarding the coordination between the MSC and regional ministries.

RECOMMENDATIONS FOR THE ORGANIZATIONAL DIMENSION

1. The MSC should design an Integrated Health Plan with the CCAAs based on the government's priorities.

The LGS envisions the Interterritorial Council's approving the Integrated Health Plan, which should take into account the overall health coordination criteria established by the Spanish government, as well as plans of the CCAAs and those developed jointly. In addition, the law established adequate funding for the development. Even if the CCAAs have designed their own health plans, the Integrated Health Plan has not yet been elaborated.

Health planning in centralized systems is usually based on analytical techniques that allocate resources in a hierarchical form from the center. In decentralized systems, the planning rationale is based on political consensus among the constituents. It has been difficult in this case to have a consensus on joint objectives and priorities, mainly because the practical distribution of powers is also in favor of the CCAAs, and because the financing system has remained separate from planning (contrary to the spirit of the LGS).

The central level should establish which services should be provided by health centers that provide services to the whole system in order to obtain economies of scale. Likewise, the MSC should define indicators within an Integrated Health Plan (having previously defined a basic package of health services) that enable the evaluation of health center and services needs. This will allow the evaluation of territorial imbalances, and the setting of action and resource-allocation priorities.

During this process, the MSC cannot unilaterally impose its criteria. However, it should not be just another player, not even a *primus inter pares*. It should exert an *integrating role*, assuring that the whole is greater than the sum of its parts. But there needs to be a financial commitment linked to the results of the planning process for that to occur. It is difficult to obtain coordination and exert authority in a decentralized and democratic system without additional resources to the ones that have already been allocated.

2. The MSC should continue to provide common value-added services for the whole territory through the participation of the CCAAs.

Health-services provision increasingly depends on some technologies, specialties, and other support means that cannot be supplied by each CCAA. This is the case, for example, of certain research centers, medical technology assessments, and some issues linked to health data, epidemiological surveillance, pharmacological surveillance, food control or environmental health. We are mainly referring to functions pertaining to CCAAs that should be transferred to a supraregional level to become more effective. This should not imply turning these functions over to the MSC. The MSC should only exert a coordination function.

The enactment, for example, of European legislation for food hygiene and environmental health reinforces the need to coordinate CCAAs. The CCAAs currently feel more restricted in terms of public health issues by the European

Union directives than by the MSC. On the other hand, the MSC, similar to what the European Union does with the distribution of food shipments between countries, should also coordinate the resolution of these types of conflicts arising among CCAAs, especially when the link between these activities with agricultural and industrial sectors could cause distortions in the market.

3. The general coordination of the health system requires the development and maintenance of transparent and reliable information systems.

The coordination functions of the system should always be based on information. Planning and resource-allocation functions cannot be carried out without complete and adequate flows of information. Likewise, the quality and quantity of shared information is a good indicator of the reliability of the system. In a decentralized environment it is very difficult for coordination to progress without this kind of information.

The LGS assigns responsibility for the development of information systems and the elaboration of statistics of general supraregional criteria to the central government. This has enabled the creation of several information records, but not of a true health information system. The problems concern the nonexistence of an information infrastructure online, as well as non-definition of the model for supraregional data, and the absence of data gathering, processing, and storing standards by the different agents in the health sector.

There is no doubt that this is a pending issue of great importance. Once more, the process should be shared by the CCAAs and the MSC, especially in light of the need for loyalty and clarity in the rules of the game. If this were not the case, the initiative would fail because there would be the perception that each information transfer would cause a threat to each CCAA's autonomy, or to its access to financial resources.

It might be desirable to create a new body linked to the Interterritorial Council of the National Health System in order to guarantee professional and objective criteria in every phase of the information cycle, and also because of the shared nature of the process. A potential concept could be that of an agency in which MSC and the CCAAs would form a consortium. The central and decentralized body would participate in its government organs, and they would share operating costs. A similar model has been adopted in Canada in the form of the Canadian Institute of Health Information.

4. The Interterritorial Council should reconsider and reinforce its structures and operating procedures as the coordination center for the National Health System.

It is clear from previous references that the Interterritorial Council of the National Health System has a potentially key role. As mentioned previously, the Interterritorial Council is a coordinating entity responsible for linking central and CCAA health policies. It consists of the 17 regional ministers and 17 members of the central administration. It is chaired by the Minister of Health and is defined as the permanent communication and information agency for the different health-services centers.

The MSC, responsible for health care in 10 CCAAs, has focused too little on its overall coordinating role for the entire health system. On the contrary, it has placed the Interterritorial Council halfway between (1) a meeting place for health sector representatives that have great independence and few issues to share; and (2) a real joint entity for management and coordination of the National Health System.

The MSC's decision to devolve the health services to the remaining 10 CCAAs in the short term has forced the MSC to reassess the operation and configuration of the Interterritorial Council, as well as its own role as a central ministry. It should be pointed out, however, that the current members of the council have evaluated its operations positively. They say that during the 12 years of the council's existence, there have been relatively balanced non-hierarchical opinions among members, and that agreements have been based more on collaboration and consensus than on imposition from above. This principle should be kept in the future.

The MSC's future role within the Interterritorial Council in reference to CCAA issues should be to provide the necessary information and act as an advisory organization on potential decisions of one or more CCAAs within the system. Its potential role as an arbitrator would only be possible if the affected CCAA gives its consent.

The MSC will need to play a major role in the Interterritorial Council, because it represents the shared position of all Spanish health administrations. However, if devolution of services takes place in the totality of the CCAAs, the MSC would lack its own management and provision tools. Consequently, it would lose its hierarchical position. The MSC will not be able to carry out all of its responsibilities against or without the CCAAs. It will be able to facilitate

decision-making and coordinate the work, but the final responsibility will reside in the Interterritorial Council.

Finally, in those areas where the MSC is the exclusive responsible agency or acts as guarantor of international health commitments, the Ministry would be hierarchically above the CCAAs. It is advisable, though, for the CCAAs to participate in the decision-making process, as they are essential in the implementation of the agreements, even if the MSC has the last word.

The Interterritorial Council should change its configuration. The Parliamentary Agreement for the Consolidation and Modernization of the National Health passed by the Spanish Parliament on Dec. 18, 1977, calls for the suppression of the current symmetric character through the reduction of the presence of the state, and a reasonable reduction of the extensive representation of the state's central administration.

Ultimately, it should be noted that the current experience with the creation of commissions, presentations, and working groups in the Interterritorial Council is one of the most interesting experiences to be analyzed and maintained. It would be desirable to consolidate and strengthen the available resources for these agencies to enable them to constitute a solid and technical base that eliminates rivalry and finds solutions for potential disputes. These agencies should be more concerned about maintaining their flexibility and productivity, and their capacity to adapt to changing circumstances, than about transforming themselves into a more rigid, hierarchical, and permanent structure.

The Economic Dimension

The devolution of authority and accountability for health care to regional governments in a decentralized model does not relieve the central government from all funding responsibilities. The economic dimension of decentralization relates to the way in which resources are allocated to the decentralized levels, and inadequate allocation would completely pollute the process of transferring power. Likewise, it would imply relinquishing responsibility to the subnational levels for a set of insufficiently financed services, human resources, and infrastructures, as well as releasing the central administration from its duties.

In the Spanish case, the devolution of the health services to the CCAAs has not meant transferring responsibilities but not resources. It was never the intention to reduce health expenditures through the regional dispersion of the

deficit. But the process to build the “Estado de las Autonomías” and the devolution of health care have caused some economic problems.

The Spanish health budget is allocated to the CCAAs that have received the transfers, as well as to INSALUD, through a capitated system that has not been adjusted by other variables. This has created a distortion that needs to be fixed in the future, and it is worsened by the fact that the health-care budget has a low priority in relation to the total public budget. Total health expenditures in Spain represent 7.7 percent of the GDP, whereas public health expenditures only represent 5.9 percent of GDP, one of the lowest in Europe. Every time a transfer takes place, the corresponding autonomous government negotiates the economic value of the infrastructure that is being transferred. This negotiation is based on technical criteria but ends up being an element of political consensus. The CCAAs that have received the health transfers have made a big effort to extend and modernize health services in their territory.

In light of the above, it is logical to be concerned about the equity of the system. There are no concluding studies on the matter, but the data on health expenditures per capita, use of health services, drug expenditures per CCAA and hospital visits do not reveal large inequities in access to health services. There is also political consensus on the fact that inequities in Spain have been reduced considerably in the past 15 years. This consensus is supported by the clear equity in access to health services and by other data such as a similar health status of the population in all CCAAs (although health status has no direct connection with access to services). A person’s socioeconomic position, social class (measured by income), education, profession, or any combination of these criteria causes more differences in health status between people in developed countries—mortality and morbidity—than any other known risk factor, such as tobacco (López-Casnovas and Ortún 1998). It is likely that the large redistribution of income that has taken place in Spain in the last decades has enabled a more homogeneous health situation for the population. However, it has also implied an acceleration of the development and modernization of health services, especially in the less wealthy regions, and has contributed to a more equitable access. A recent study, which we will refer to in more detail later, defines the Catalan health system as one of the three most equitable systems in Europe, together with the Dutch and Danish systems.

In conclusion, the economic dimension of the decentralization process in Spain, in health services and in general, shows problems that need to be resolved. These however, do not lead to large inequities in access to health services despite what could be interpreted at first glance. It is actually the opposite.

RECOMMENDATIONS FOR THE ECONOMIC DIMENSION

1. A stable financial framework needs to be guaranteed for the whole Spanish health-care system.

This recommendation is encompassed in the Agreement of the Consolidation and Modernization Subcommittee of the National Health System, approved by the Health Commission in Congress on Oct. 21, 1997.⁵ The large increase in health expenditures is a great concern in Spain, as is in many other countries, because of the difficulty to adapt the public financing capacity to this increase. In this respect, the subcommittee proposed the following:

“a) To establish an adequate and realistic budgetary base as a starting point for the following four years, as well as for the criteria for annual growth rates. The health budget will experience an increase in the next four years in terms of its participation in the nominal GDP. This will be based on an increase of this new financial base that will be proportional to the current needs, and will be realistic vis à vis the future evolution.

“b) To urge the government (prior to the approval of the new financial agreement for the years 1998-2001, and starting from the initial proposals presented) to identify the additional resources to be added to the National Health System in 1998 and following years in the Fiscal and Financial Policy Council, in order to achieve an adequate and realistic budget, and the necessary financing sources.

“c) To identify the sources to finance expenditure deviations, before adopting any measure to define new coverage and services. This will avoid the violation of the principle of financial sufficiency.”

Despite the degree of realism and feasibility of the proposal drafted by the subcommittee, it is evident from the start that there is a financial disproportion, corresponding to the global budget of the Spanish National Health System that needs to be distributed between the CCAAs and INSALUD.

We believe though that even if some of these recommendations are accurate—for example, the one included in Paragraph c—not all of them are realistic. Any attempt to

increase revenues of the National Health System and to contain the health deficit entails linking public expenditure increases to the increase in revenues. However, if the increase of the fiscal pressure is discarded (which is not really feasible from a political point of view), the increase in public revenues is affected by the growth in nominal GDP.

Any increase in health expenditures above the growth of the nominal GDP is not feasible either, considering the current political framework. Therefore, the recommendation regarding the growth of the Spanish public health expenditures globally would be to equate it to the increase in the nominal GDP. This requires transparency in relation with the starting point and an understanding and acceptance of the real aggregate expenditures. During many years the budget was formulated according to the previous year's budget and not to its real liquidity. This practice should be done away with, and there has been a political agreement to do so.

Nevertheless—and even if these requirements are fulfilled—the financial sufficiency of the Spanish health-care system cannot be guaranteed. The CCAAs will have to contribute to the financing of health care in their own territories through their own budgets or a complementary fiscal effort.

2. Once the Spanish health budget is determined on a real basis, it should be distributed to the CCAAs through a capitated system that incorporates adjustment factors according to the different characteristics of the CCAAs.

There are important differences regarding the average expenditures per capita in the CCAAs. Hence, the resource allocation should be adjusted by factors such as the aging of the population, the existence of high technology structures with supraregional coverage, or the income level, as they affect differences among the autonomous health systems. The non-adjusted capitated system represents a clear violation of the equity principle.

The previously quoted congressional subcommission recommends that the government “maintain the capitation criteria in the next financing model for the next four years, as a rule to allocate resources. This criterion could be perfected by other criteria and could include specific resources to finance expenditures for the displaced [i.e., people from one CCAA who are treated in another], for teaching, or other factors that affect the variability of costs between CCAAs.”

3. The CCAAs should finance additional services to those defined in the basic package of health services to be financed by the National Health System.

The congressional subcommission also recommended that “The arrangement and planning of services should be done by law, prior to the Interterritorial Council of the National Health System’s report, and should establish ... planning responsibilities so that the central level (with prior agreement from the Interterritorial Council) fixes a common basic package of health services for the whole National Health System. Health services associated with new technologies, those linked to the invoicing between services, and those that could generate great inequalities in their use if not defined properly will be outlined in more detail. The CCAAs with full health responsibilities will be able to complement this package, establishing additional benefits to be financed with their own resources.”

The MSC has not yet defined the common basic package of health services for the SNS,⁶ but it is expected that this decision will be taken before next year, and that the free benefits, services that will require co-payments from the users, and those that cannot be co-financed will be defined.

The CCAAs will need to decide on the complementary financing for the benefits that are not included in the basic package. This can be done in several ways that are more or less feasible according to political circumstances: increasing the participation of health expenditures in the regional budget, increasing the general taxes in the regional field, implementing an identified health tax, substituting the increase of public revenues for private ones, with measures such as private investment in public infrastructures, the offering of complementary private insurance, or the introduction of co-payments.

In any case, CCAAs have not yet exerted their power to introduce their own taxes. It is important to note that there is a need to revise the general financing system of the CCAAs. If this revision is not carried out, CCAAs might refuse to contribute to the complementary financing of health care.

Nowadays, CCAAs that have health responsibilities receive two types of budgetary transfers from the Spanish government: one related to health care that has already been determined, and therefore can only be used in that field, and the other corresponding to the rest of the regional government’s expenditures. Any hypothetical

solution that does not address the two types of financing systems would not be feasible.

In the case of Catalonia, the situation in relation to the financing system in general (all resources except for health care that is financed separately) has reached an unsustainable point that will require the review of the contribution that richer regions grant to poorer ones. The intention is not to eliminate the contribution. It needs to be reduced to reasonable margins. Catalonia contributes to the central government 12 percent more than the average of the total regional contributions. In turn it receives 24 percent less than what the average Spanish CCAA receives, which results in a negative differential of 36 points.

In the context of the European Union, only the regions of Île de France and of Lombardy in Italy make a greater fiscal effort to the central government of their respective countries than Catalonia.

According to Ros Hombravella (1999), in the 1991-94 period Extremadura received 225⁷ billion pesetas on an annual basis from the Spanish government, which translates into approximately 210,000 pesetas per person, per year—i.e., 22 percent more than the income raised in the region. These figures correspond to 800 billion pesetas, 111,000 pesetas, and 11 percent in the case of Andalucía; 200 billion pesetas, 119,000 pesetas, and 10 percent in Castilla-La Mancha; 272 billion pesetas, 100,000 pesetas, and 9 percent in Galicia; 153 billion pesetas, 140,000 pesetas, and 11 percent in Asturias; 172 billion pesetas, 67,000 pesetas, and a 5.3 percent in Castilla y Le 119,000 pesetas, and 10 percent in Castilla-La Mancha; 272 billion pesetas, 100,000 pesetas, and 9 percent in Galicia; 153 billion pesetas, 140,000 pesetas, and 11 percent in Asturias; in the case of Andalucía it is 500 billion pesetas a year, and in the case of Extremadura, 200 billion a year. Catalonia, Madrid, Baleares, Valencia, and partly Aragón; 153 billion pesetas, 140,000 pesetas, and 11 percent in Asturias; 1 of Catalonia, the balance with the European Union is negative.

It will be very difficult to convince the wealthier regions to introduce any complementary contribution to health care until the general financing system of the CCAAs is revised, and contributions to the center are reduced to reasonable margins.

The Decentralization of the Catalan Health System

The development of health-care systems in the CCAAs, and hence in Catalonia, has fostered the adoption of differ-

ent organizational models that intend to improve the health status of the population, and the efficiency and quality of public health-services provision based on distinct historical and territorial realities. Basic principles of equity and universal access to the system established by the LGS have always been respected. Catalonia was the first Spanish community to receive the transfer of responsibilities in 1981, and obtained its most important legal recognition when the *Ley de Ordenación Sanitaria de Catalunya* (LOSC), was passed by the Catalan Parliament in 1990. This law proposes a specific organizational design through the constitution of the Catalan Health Service (SCS). It also represents the development and adaptation of the basic norms included in the LGS to the Catalan region. The Catalan Health Service is structured in two territorial sub-levels: the health regions and the health sectors, a pure deconcentration of administrative functions, which will not be analyzed.

The organizational dimension (adopted by some CCAAs as a result of their autonomous decision capacity), clearly demonstrates that in-depth changes in the organization of health-services provision have not been limited to the political devolution process from the central administration to the CCAAs. Catalonia adopted more flexible organizational models and more agile business-management mechanisms than the traditional administrative bureaucracies. Catalonia's decentralization of the health services provision function has allowed the development of management autonomy in public health centers, and has fostered the participation of private sector providers in health-care provision financed with public resources.

The LOSC enables the functions of the Catalan Health Service, especially the management and administration of health centers and services, to be delegated to management organizations with their own legal status. These are differentiated from the public administration or exercised through integrated or shared management formulas with public or private entities, or even through associate entities such as cooperatives or corporations. They are formed by health professionals from the public system who can easily resign from their position as civil servants. The goal is always the same: to avoid the traditional and typical public-management formulas that make the execution of a sufficiently flexible human resources and budgetary policy difficult.

Regarding the organizational dimension of decentralization, the Catalan case is a good example of the cre-

ation of appropriate structural conditions and the development of managerial skills in decentralized units. This whole process is not the result of an improvised decision, or the consequence of a political and legislative decision to decentralize (in this case the delegation of the provision function to a third party). On the contrary, the fact that the degree of development of Catalonia, its needs, starting point, and history were different explains the political stance of the majority of the Catalanian parties. They advocated strongly for the decentralization process to take place, and pushed so that norms would correspond with reality. Frequently, many developing countries—and sometimes developed countries, too—wrongly believe that the starting point for any decentralization process is the drafting of a law that forces decentralization. Our experience shows that laws are only enforced if they are adapted to pre-existing conditions. As stated in the title of a book written by Michel Crozier (1984), “a decree does not change society.”

The Industrial Revolution started in Catalonia 150 years before it reached the rest of Spain. Industrialization illustrated problems that had not been perceived previously. The rise of a working class and of trade unions (Catalonia is one of the few regions in Europe that was dominated for many years by anarchist trade unions) forced the state to cater to a series of social needs—among them, health care. At that time Spain was a rural and agricultural country that was very centralized, and Catalonia's different situation and needs were not perceived. Nevertheless, had they been perceived, there was not the sufficient institutional strength to meet them.

The Catalanian citizens did what the Spanish government did not do. Not-for-profit hospital foundations emerged as a result of the financial contributions of a rising bourgeoisie, employers and workers formed mutual societies for providing health services, and institutions like the church at first and the Red Cross later also contributed to the health-service offering. This did not occur in Spain. The Spanish Social Security system was not developed until the mid-1940s in the midst of the military dictatorship. Neither were public hospitals and health centers built all over the country. As private initiative had already made those efforts in Catalonia, the military government was sensible enough not to duplicate the investments. But what was constructed with public resources in the whole of Spain had been built in Catalonia long before through the

private efforts of the local society. This enabled the Spanish internal revenue service not to invest in Catalonia as it did in the rest of Spain.

As a result of a historical tradition in Catalonia, the majority of health providers are not public. The public sector has progressively complemented the not-for-profit private offerings, but in the case of hospitals only 30 percent of beds belong to the government. When comparing the government and non-governmental subsystem contracted by the state, it is clear that the latter is much more efficient than the former. Evidence and not mere theory encouraged the diversification of providers whose origin was determined by history, and that was formalized by the LOSC. Therefore, the delegation of the service provision function to the private providers came first, and then came the LOSC. This is because for many years civil society in Catalonia was much stronger than the central state. The state was perceived as a foreign entity, situated in Madrid and unable to understand and cater to Catalonia's needs. When the trend to separate the purchasing and provision functions appeared in the 1980s in public administration, and more specifically in health systems, Catalonia had already implemented the separation a century before. Catalonia reached the same results through historical evolution that others did through more or less successful attempts to introduce market principles in the health sector, or through the attempt to apply other theoretical principles that were not always successful.

A Brief Description of the Catalanian Health System

The Catalanian government has a Ministry of Health that defines the main political priorities and carries out planning on a macro level. The **Catalonian Health Service (SCS)** is a public entity that stems from the Ministry and is in charge of the operational planning, purchasing, and financing of health services. It does not provide services, as the purchasing and financing of health services in Catalonia is separate from the provision. The provision function is delegated.

At the hospital level there is the Hospital Network for Public Use (RHUP) that combines the traditional Catalanian model of mixed public-private provision. The concept of public use is useful to show that the public or private nature of a health system is not determined by the public or private legal status of the providers. The system

is public because it is planned and financed by the Catalan government, but the providers can be public or private without altering the totally public nature of the system.

The RHUP is formed by two types of hospitals: First, there are those that belong to the Ministry of Health, which represent 30 percent of total hospital beds and constitute the **Catalonian Health Institute (ICS)**, equivalent to the Spanish INSALUD (the network created by the dictatorship in the '40s and '50s). The other hospitals belong to *mutualidades*, to foundations with a municipal base, to the church, Red Cross, etc. All of them are not-for-profit and are grouped in two large associations with a private legal status: the **Unión Catalana de Hospitales (UCH)** and the **Consortio Hospitalario de Catalunya (CHC)**.

The ICS centers are more similar to the public health centers of any country. Personnel are civil servants, and the budget is allocated administratively and historically (i.e., based on prior years' budgets). The ICS has a strong central structure, and its relationship with hospitals and primary health centers is hierarchical, with a small degree of autonomy. There is a sole government body, which is centralized. Currently, ICS health centers sign performance agreements with the SCS. These performance agreements reflect an analogous resource allocation to that of private centers affiliated to the UCH or the CHC. The difference between what they receive from the simulation, and what they actually receive through budget allocation (always higher), corresponds to the operational public subsidy. This subsidy should be reduced every year until they reach their objective—when the total budget they receive corresponds to the services they provide.

All other governmental regulation mechanisms also apply to ICS centers—excessively interventionist regulation instruments, bureaucratic procedures, restrictive and rigid contracting and supply purchasing mechanisms, and previous intervention and fiscalization of expenditures (Via 1996)—and therefore do not allow them to be the best type of enterprise.

The UCH and CHC centers have a private legal status, are totally autonomous, and each one has its own board of directors or governmental body that is independent of the rest. They represent 70 percent of hospital beds. Personnel have the same labor relationship with the centers as they would in any private company, and hence they can be fired in accordance with current Spanish labor law. Instead of

administrative budgets, they have balance sheets and profit-and-loss accounts. The resource allocation is realized through contracts signed with SCS and not through an administrative allocation.

Eighty percent of primary health providers belong to ICS and therefore have the previously mentioned characteristics, and only 20 percent have a different legal status. In the long-term-care sector, practically 100 percent of providers have a private legal status, are generally not-for-profit, and have the same characteristics as the centers that are affiliated to the UCH or the CHC.

The Political Dimension

This chapter, together with the Organizational and Economic Dimension chapters, will not be analyzed in detail, but will include the most relevant issues.

Without a doubt, the most important issue in the political dimension is the fact that the devolution of health authority of the Spanish government to Catalonia in 1981 drew the pressure groups that already existed as a result of the previous delegation of the health provision function to the private sector closer to power, which moved from Madrid to Barcelona, Catalonia's capital.

We sometimes forget that any public-sector reform is mainly a political issue—i.e., a relationship between powerful groups in which each one defends its own arguments, and a final outcome is reached or a political decision is taken as a result of interaction. The Catalan health model is a consequence of a high degree of political consensus achieved by political parties, trade unions, foundations, professional associations, and users of the public health system. The devolution took place in 1981. The consensus obtained in 1985-86 allowed health care to be excluded from the permanent political debate, and in 1990 the LOSC was passed with a 90 percent of approving votes in Parliament, which guarantees that any government can act without modifying the law. When parties currently fight for votes in political campaigns, health care is rarely present as a controversial element. There is great consensus on the model, and it is difficult to offer very differentiated proposals.

The fact that the majority of providers are non-governmental and are associated in groups to defend their interests fosters greater transparency and benefits the democratization of the system. These benefits were more apparent as decentralization, and the devolution of the health

responsibilities to the Catalanian government, drew providers closer to power. The mere fact that in Spain 70 percent of provision is public illustrates the strength of the Catalanian private providers when negotiating in the Spanish context prior to devolution: They were very diluted. In Catalonia they are a majority vis à vis the public provision sector, and their influence has been in general very positive. We must not forget that they are not-for-profit entities, and, therefore, they are more interested in providing an efficient and high quality service than in making a profit.

On the other hand, there is the risk that sometimes the excess pressure exercised on government prevents key decisions to be taken. It is very difficult to identify the exact point at which there are no longer advantages, and disadvantages start to arise.

Catalonia is a European region, in which the welfare state is in crisis. This entails making political decisions that are difficult to explain to the population and that could have a potential negative effect on the electorate. Difficulties could increase, as many of these decisions not only affect citizens' interests but also the interests of the health services providers.

The Catalanian health system needs to carry out some important structural reforms to guarantee its future feasibility in the context of the welfare state crisis. In order to do so it is essential that the political agreement reached in the '80s be renewed. In that case the consensus with the private health-services providers and of the associations that represent them is key to take action.

Finally, we will refer to the effect of decentralization on equity. In this particular case, we will analyze the effect of the existence of a private and public subsystem on equity. First of all, all the steps taken since the transfer in 1981 have been along the lines of equaling both networks. The intention has been to draw ICS closer to private centers and not the opposite. In this respect, a health services map was drawn, taking advantage of all the existing private or public resources; accreditation norms and homogeneous quality standards were defined for the whole provision sector; and the management professionalization principle that was prevalent in private health centers was carried to ICS centers. Personnel in ICS centers are currently civil servants, but management is exercised by a professional manager whose contract is renewed every three years on the basis of results. As was mentioned previously, each ICS center signs

a performance agreement with the public purchaser (the SCS) according to the standards SCS uses to contract private centers. Therefore, even if resource allocation is still based on an administrative and historical budget, it is compared with what it would be were it a private provider. This comparison defines the objective to reduce the budgetary allocation for the following year, and the manager's salary and continuity will hinge upon his ability to make the proper adjustments, increasing the efficiency level and drawing it closer to that of the private centers contracted by the SCS.

In summary, all efforts have been directed toward homogenizing the network by drawing public centers closer to the characteristics of the private ones. A lot has been achieved, but there is still a long way to go. This could cause concern over equity in access and treatment according to whether it was a public or private center. In order to counteract the potential negative effects of the political dimension of decentralization (the delegation of the services provision function to the private sector), several measures have been taken in the organizational dimension.

As was stated previously, the political dimension of decentralization has clear implications for democracy and equity. A recent study (Gallo et al. 1999)⁸ demonstrates that the Catalanian health system achieves a very acceptable degree of equity on an international level. Catalonia, together with Denmark and Holland, has one of the most equitable health systems in Europe.

The Organizational Dimension

The delegation of the provision function implied a series of organizational transformations that were only possible depending on the factors analyzed in the previous chapter on the political dimension. In particular, those related to a greater proximity of providers to government after the devolution of the health responsibilities.

The delegation of the provision of health services implied progressing toward the complete separation between the service purchasing and provider functions, and this entailed several changes. The Ministry of Health had to concentrate on its functions as a health authority, on service planning, contracting, and financing (carried out by SCS). In the final design there should be a complete alienation of ICS, with a complete autonomy of its health centers. They would hence have their own individual legal status or a personal legal status for a group of centers. In any

case, it would be a different legal status from that of the Ministry of Health.

The most important organizational change was the constitution of the SCS as an operational planning, purchasing, and financing agency stemming from the Ministry of Health. Eight years have passed since the constitution of the SCS. There has been a lot of progress, but it has not been easy. To plan according to health needs, and to learn how to translate these into contracts and payment systems to providers (incentive systems for the objectives stipulated in the contracts), has not been an easy task. As mentioned previously, the same occurred in all countries that went through this transformation: the United Kingdom, Sweden, and Denmark.

During the 1980s, while transfers were being received and changes were being made with private providers (ICS was a part of the Ministry), priorities focused on professionalizing management, defining the map of necessary resources, establishing adequate accreditation norms, improving information systems, and, above all, containing costs. But the existing information was insufficient, and providers were not especially interested in improving it. The relationship between the central level (the Ministry) and the delegated level for service provision (affiliated centers to UCH and CHC) was mainly political in this environment. It was defined by the need to obtain consensus on the key lines of reform with providers as well as by the lack of information. Hence, the contents of the performance agreements was very linked to power games, which fostered a vicious circle characterized by an administration that was afraid to lose legitimacy and control capacity, that responded in an interventionist way to outside providers, and that at least formally resisted the interventionist response. This enabled a larger role for the Ministry in the provider organizations, which enabled it to know the providers better and have greater control, but had the disadvantage that providers ended up transferring the risks they had to take on to the Ministry. Providers lost autonomy but, on the other hand, shared risks with the Ministry. When a central government delegates authority, the entities it delegates to, providers in this case, are accountable to the state. Likewise, the ultimate responsibility remains with the central government, the purchaser in this case.

In light of the above, it could seem that this did not occur, and that the delegation of the provision function to external providers was negative. This was not the case. First

of all, and taking into account that things never work out exactly as anticipated, providers are really accountable to the purchaser, and, in effect, the ultimate responsibility remains with the government. On the other hand, we still have not addressed ICS, the association of Ministry providers. As well as the inconveniences stated previously regarding the civil servant links of personnel and the administrative allocation of the budget entailing a higher operational subsidy, there was no contractual relationship. The relationship was hierarchical, but in a system where there was no perception of any risk of losing the contract—neither on the part of the institution (hospital or primary health center), nor the workers. The Ministry, therefore, takes on the whole risk in this case. The financial results on one hand and the productivity and efficiency results on the other have always been better in external providers than in ICS.

One inference is that in a relatively small system (in which devolution drew private providers closer to the Catalan Ministry of Health and hindered progress without consensus), the complete separation of functions and risks to be undertaken by all parts is difficult; another very different conclusion, though, is that delegation should be done away with, providers should be nationalized, and that there should be progress toward a completely public system, even from the provision perspective. Andalucía, for example, took this route, and the results have been clearly worse than in Catalonia.

We should reflect upon this. In the 1980s in the United Kingdom, a man named Einthoven suggested that the Thatcher government break up the National Health Service (the NHS was totally nationalized, even the provision). The proposal was to grant autonomy to providers, separate the service purchasing and provider functions, and to generate competition, using internal markets as a mechanism to improve the efficiency of the system. When the Blair government came to power, it kept the proposal to separate the purchasing and provider functions, to grant autonomy to hospital and primary health-care centers, and to use contracts as a relationship mechanism between the purchaser and the provider, and as a resource-allocation mechanism. The key change, which enabled the application of the “Third Way,” even in health care, was to substitute collaboration for competition—collaboration between providers, and between providers and the purchaser (NHS). It is clear that different ideological reasons advocate competition or collaboration. The real world,

however, shows that reality takes over, and demonstrates that a public purchaser of health services, at least in the European context of the welfare state, cannot be isolated from a group of providers that supposedly need to improve efficiency by competing, and then winning or losing. Hence, collaboration is the most natural formula.

Therefore, the separation of functions, and the creation of the SCS as a purchasing agency were a positive organizational change. In the organizational field, as well as creating the SCS, the Ministry provider (ICS) needed to develop the characteristics of private providers. We have already referred to the contracting of managers and professional executive teams, with a non-civil servant labor link based on results. Contracts are signed for three years and have a part that is variable according to the degree of achievement of the objectives established in the management agreement, with the real possibility of firing people. We have already mentioned that even if resource allocation is still based on an administrative and historical budget, a performance agreement is signed in parallel with the same conditions that are applied in the private sector. This enables a comparison to determine what resources correspond to service provision, and what resources make up the subsidy. This difference is reduced every year.

Together with these measures, legal formulas have been developed to avoid hospitals' and health centers' adopting the ICS organization. Before the Spanish government transferred health care to Catalonia, there were old hospital foundations in some cities that were at first sustained by the population. The technological evolution of medicine and the escalation of costs changed this. In these cases, the attitude of the Spanish government was to close these institutions, claiming they were obsolete, and to open new public hospitals.

When devolution to the Catalanian government took place, there were multiple hospitals in construction waiting to be opened. The new Catalanian Ministry joined in consortiums with the old local foundations instead of placing these hospitals with ICS. In these consortiums the Ministry donated the infrastructure, and the foundations provided the personnel. This allowed them to avoid the civil servant formula and to be regulated by private law, signing contracts with the SCS. The law requires the consortiums' governing bodies to be formed by representatives of the property. In these cases, property is divided between the corresponding local foundation (normally 40 percent),

and the purchaser of services, the SCS (normally 60 percent). This does not support the objective to separate functions and transfer risk from the purchaser to the private provider. Nevertheless, it allows the existence of autonomous hospitals, with their own governing bodies, that escape the inflexibilities imposed by the public administration, and that receive resources through contracts that are evaluated and need to be accomplished.

In other cases there have been partial privatizations through the creation of public corporations. This is an organization regulated by private law that is nearly identical to a private corporation. The only difference is that the board of directors, instead of being formed by shareholders who take on financial risks privately or share profits, is formed by representatives of the Ministry. They need to subsidize losses from the public budget, and they need to reinvest profits in the institution. During recent years a strategy called "selective radicalism" was adopted. This strategy entails transforming units of ICS hospital centers that are well-managed (for example, radiology services of big university hospitals) into public enterprises, taking them out of ICS. This has enabled companies to make profits every year. It is evident that there is a bias in the selection, but it is justified from the point of view that experiences that are bound to fail should not be initiated. The intention is to improve the system and to privatize when the required maturity is reached. In this case, the advantages and disadvantages mentioned for the consortiums are applicable.

As for primary care, 80 percent of which is in ICS's hands, civil-servant physicians of the primary health-care teams can drop their civil-servant status for three years and form a private enterprise or a cooperative. This creates a new legal entity different from ICS that establishes contracts directly with SCS. If they make profits, they can, to a certain extent, divide them among the members of the society or the cooperative. If they fail or decide to abandon this type of model during the first three years, they can return to their public function without any restrictions. After three years, they can still return as civil servants, but it is much more complicated. This is a very recent initiative, and hence only three primary health-care teams have opted for this formula to date. The results are positive and the teams have decided to continue with the experience.

Management information systems should have been changed and improved. This would have reduced (not eliminated) the clear political nature that ruled the con-

tractual negotiations between the administration and providers some years ago. Information reduces arbitrariness and speculation.

For years, the only way to progress in the development of adequate information systems, counting on the necessary collaboration of service providers, was through the commitment not to use the information until both parties (purchaser and provider) agreed that the data were valid. This strategy enabled the improvement of the available data and allowed its use in contracting and the evaluation of contracts by progressively introducing growing levels of accountability. There has been an improvement of epidemiological data, provision-efficacy data, service-cost data, and information on the type of services available with respect to need. There is a balance-sheet center that annually gathers balance sheets and profit-and-loss accounts of all the providers in the system, including ICS. In the case of ICS, this is possible due to the simulation mentioned above that is carried out through a performance agreement. It permits the vision of the results that would be obtained if the resource-allocation mechanisms used by private providers were to be used. This allows the comparison of results between all providers, whether public or private; however, there is currently no agreement between the Ministry and the providers to use this information for decision-making purposes.

The same occurred for a long time with the level of complexity treated in hospitals. First, there was resistance to provide the data, then the commitment was reached not to use it for contracting purposes until validated by the system, and since last year, the payment system to hospitals included the complexity treated.

Finally, this information should be used to carry out an important organizational change in providers. This is probably the main unresolved issue in the Catalan health system today. The intention is to convert the hospital sector, especially the high-technology one located in Barcelona, to alternative resources to hospitalization, such as ambulatory care, home care, or outpatient surgery. This is not only in line with improving efficiency but is also in line with the epidemiological, demographic, and technological evolution, as well as the cost increase of the health system.

There is no doubt that the option to decentralize service provision through delegation to providers with a different legal status from the purchaser has implied important

organizational changes. Some of these are difficult to implement for several reasons, mainly the political dimension of the process.

The Economic Dimension

Delegation is considered to be a means to avoid the inefficiency of government management and to control costs. The Catalan case is a proof of this, but demonstrating it is difficult. If we compare the results of the balance-sheet center (balance sheets and profit-and-loss accounts of the centers),⁹ the level of structural and technological sophistication of the centers, the results according to level of complexity treated, and quality (hospital infection rates, re-entry rates for certain pathologies), the resources allocated per contract, the subsidies received from the Ministry, the health staff in terms of number of professionals per hospital and profile, it can be observed that in general the delegation of the provision function to external entities, regulated by law, has increased efficiency and enabled cost containment.

This could be questionable if we analyze the annual increases of the Catalan health budget since the devolution in 1981. Up to 1992, the increases were high, 11 percent. After that, the budget was frozen, debt was reduced, and production increased. It is clear, therefore, that the political will of the government, regardless of whether the service provision has been delegated or not, determines the expenditure and debt increase. Providers that are not controlled by the purchaser also have the same effect, but it is not the case here.

The devolution of health responsibilities allowed the greater proximity of the responsible politician to the population to have an important impact on the increase of the health budget. The greater proximity of private providers to power at a time of expansion as a result of a political decision fostered the expenditure increase. We should remember that in terms of the participation of the health budget in the GDP, the Catalan health system is one of the least expensive in Europe. The participation is 7.7 percent, and the public participation is only 5.9 percent.

The political decision to increase the health budget during 11 years could have been taken with any provision system. It is the same case with the decision to contain costs,¹⁰ and simultaneously maximize efficiency and equity in the resource allocation system. It could have been implemented much more easily, or at least more rationally, based

on the model that includes the delegation of the provision function to external entities.

For a long time it was claimed that the Catalan health model, based on the delegation of the provision function, was more expensive than the existing model in the rest of Spain, which is based on providers' belonging to the public health administration. This is true if absolute values are taken into account. When the values are correlated with the quantity and technological level of the providers (the wealthiest societies have more sophisticated service resources than the less wealthy ones), and the number of non-Catalan Spaniards who are treated in the high-technology centers in Barcelona are taken into account, the situation is different. Despite the fact that the level of investment for many years was higher than the Spanish average (the transfer of central funds to the CCAAs was realized through a non-adjusted capitated system, which increased the level of debt), Catalonia has been one of the CCAAs that has reduced this debt level more rapidly in recent years.

Finally, if we compare the relationship between health expenditures and GDP in Catalonia with that of Spain, the result is similar (around 7.7 percent). The preliminary results of Gallo et al. (1999) show that the Catalan health system is not more expensive than the Spanish one.

Taking Stock of the Spanish Experience

We must first point out that the decentralization process was the only feasible option to carry out the transition to democracy in Spain. Consequently, the first objective of the process, which was to democratize the system, was very successful.

We have already alluded to the difficulty of evaluating the outcome of health decentralization processes in relation with stated objectives. There are few examples in literature, but this has not hampered many countries from engaging in the process. Our goal with this paper, though, is not to carry out a thorough evaluation. It has also been stated that it is not easy to establish a causal relationship between decentralization, and increases in quality and efficiency. It is easier to do so when referring to accountability, or increase in local participation, to quote some examples.

It is certain, though, that in every decentralization process the units—in this case regional units—should be clearly defined. In the Spanish case they are the 17 CCAAs. Another problematic issue is that the socio-economic characteristics of

these communities have not been identified, which makes the resource-allocation adjustment challenging.

The access of the population to the system has increased tremendously in recent years. It is difficult to establish a causal relationship between decentralization and increase in access. However, local authorities have frequently increased the service offering (at times inappropriately) when receiving the devolution of services and feeling directly responsible to the population.

In the Catalan case, the decentralization of the provision function through the delegation to private providers has facilitated the access of the population to health services, especially to the long-term care sector, and to a lesser extent to the hospital sector. This is because, at least partially, private entities absorbed the investment costs for the construction or reworking of infrastructures.

Access is not limited when seeking care in different CCAAs. This is remarkable considering that budget allocation is based on a non-corrected capitated system. It obviously penalizes the most developed CCAAs, which have a larger and more sophisticated service offering, such as Madrid and Catalonia. No cross-subsidies or compensation mechanisms between CCAAs have been developed up to present.

The decentralization of the Spanish health sector has coincided with an increase in health expenditures. It is once more very difficult to establish a causal relationship. It is evident, though, that closer proximity of politicians to the population has resulted in a more effective pressure to increase the service offering and expenditures. In any case, regional governments have not as yet taken advantage of their authority to levy taxes or introduce co-payments to finance health care. This decision would be accelerated if the MSC would take the political initiative once the whole INSALUD is transferred, and therefore would no longer be responsible for raising taxes. The targets set by the Maastricht Treaty in terms of public deficit, interest rate, and inflation reduction would have been unachievable had the political responsibility not been attributed to an abstract entity called "Brussels."

On the other hand, the Catalan case demonstrates that the option to decentralize service provision through the delegation to private entities fostered cost containment and the increase in efficiency, despite the initial increase in expenditures at the time of the devolution. As mentioned previously, the reason for this lies in the greater proximity

of the responsible politicians to the population. Likewise, the greater proximity of private providers to authorities enabled the budgetary increase because of shared interests.

Overall, it can be stated that the decentralization of the health sector has increased accountability. Accountability and authority are integral to decentralization. Accountability is affected, in part, by the degree of authority and the scope of responsibilities transferred to the regional units (i.e., planning, administration and management, organization, or funding health-care services). Regional units can only be held accountable for those responsibilities over which they have direct authority.

Formally, the existence of the Interterritorial Council for Health and the different regional participation agencies enables an improvement vis à vis the previous situation. For example, in Catalonia the Board of Directors of the Catalan Health Service (the top executive level of this organization) includes representatives of the Catalan finance ministry, municipalities, trade unions, and business organizations. The budget or health plan has to be approved by this council.

There is also an organization for community participation, which has an advisory function and includes municipal, trade union, and business representatives, as well as representatives from consumer and health-profession organizations, universities, and scientific entities. This design is duplicated in two subregional levels. Similar formulas exist in all CCAAs. From this point of view it can be stated that decentralization in Spain has fostered an increase in the indirect participation of the population in the design of health policies and in the setting of priorities and decision-making. It is true that they are not representatives elected through universal suffrage. They are elected from the groups they represent, and some people question whether they adequately represent the population's interests. However, these organizations have enabled accountability that was nonexistent prior to decentralization.

On a political level, accountability is taken from the National Parliament to 17 autonomous parliaments formed by deputies that are closer to the problems affecting the health sector in their respective territories.

The separation of the health purchasing and provider functions, the contractual relationship between purchasers and providers, the need to increase and improve management information systems, and, in general, the other ele-

ments of the delegation of the provision function to private entities (all having their own boards of directors) that took place in Catalonia have fostered accountability.

In the Spanish case, the MSC has not yet managed to benefit from decentralization in terms of redefining national policies and guaranteeing equity between regions. A stated objective of decentralization is to liberate the national body from specific responsibilities that are decentralized so that the MSC can focus on improving these issues.

Decentralization has fostered an important increase of leadership and authority on a local level, has resulted in a greater co-responsibility of regional representatives in the design and implementation of health policy, and, overall, has enabled the adoption of management formulas that have encouraged the increase of efficiency in health services. The Catalan case demonstrates that the option to decentralize the provision of services through the delegation to private providers has increased the responsibility of the providers vis à vis the regional authorities and has, de facto, led to the adoption of more efficient management formulas.

Decentralization has definitely favored an increase in administrative costs. It is partly logical and even acceptable as a trade-off to the achieved benefits. However, costs should not have increased as much as they did. The problem is that decentralization has not meant a proportional reduction of personnel in the central administration. Hence, there are unnecessary duplications. In the Catalan case, however, it has not been demonstrated that delegating the provision function to private entities has increased administrative costs vis à vis managing the ICS public centers directly.

Decentralization has improved equity. Nevertheless, there is still much to be done, especially after a basic package of health services to be financed by the National Health System is designed and the reform of the health financing system is carried out. In Catalonia, the delegation of the provision function to private entities, which consolidated the existence of a private and public service network, has not reduced equity. It has probably been the opposite. As mentioned previously, the Catalan system is one of the most equitable in Europe.

Overall, decentralization of health care can be a very positive and effective strategy for health-care delivery—or not. The long-lasting tradition of decentralization and the

promotion of local control in many European countries are a testament on both counts. On the one hand, decentralization can offer the flexibility to locate authority and accountability for health care at various levels of government, from central to local, depending on the type of activity and needs of the population. National governments can be effective in addressing more centralized issues, such as establishing national goals and priorities and ensuring equity among the regions. The state can become more directly involved in the administration of information systems and, in some cases, highly specialized care delivery institutions. Local governments can become involved in more decentralized activities, such as the planning, organization, and delivery of preventive care, primary health care, and institutional services, where there is the critical mass to do so. In theory, decentralized models allow governments to more effectively monitor and respond to the specific needs of their constituencies by bringing services closer to the people.

On the other hand, decentralization should be implemented with caution. Unless appropriately established and implemented, decentralization, can lead to a fragmented system plagued with problems of access, mobility, and poorly aligned authorities and accountabilities.

Finally, the implementation of decentralization strategies must strive for the systematic transfer and reuniting of authority and accountability factors at different levels. The uniting of these factors will provide regional units with the capacity to exercise their authority and, in turn, promote accountability for their role in the health-care system.

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Endnotes

1. Each CCAA has an Autonomy Decree, which is equivalent to a constitution, that respects the general principles of the Spanish Constitution while being unique to each community. This allows the different CCAAs to assume different responsibilities.
2. See the section below on "Decentralization of the Catalan Health System." There is a reference to a study that has not yet been presented demonstrating that the Catalan Health System together with the Danish and Dutch ones have the most equitable access to health services in Europe.
3. The Interterritorial Council of the National Health System is a coordination entity that consolidates state and CCAA health policies. It consists of the 17 regional ministers and 17 members of the central administration. It is chaired by the Spanish Minister of Health.
4. This issue will be further analyzed when addressing the decentralization process of the health services provision function in Catalonia.
5. The author was consulted as an expert for the Spanish Congressional Subcommittee.
6. See "Recommendations for the Political Dimension: Redefinition of the Central Health Authority Functions," Recommendation 2.
7. 1US\$=156 Ptas.
8. The study is based on a health survey in Catalonia (15,000 people). The methodology used corresponds to the one published as the most adequate (Van Doorsler et al. 1993, Wagstaff et al. 1991, Le Grand 1978, in Gallo, Serra-Prat, and Granados 1999), the same as the inequality indexes of Le Grand and Collins and Klein. The identification of inequalities according to different service levels was possible due to logistic regressions, in order to estimate the impact of the age, sex, needs, and income variables in the utilization of health services. It has been demonstrated that the Catalan health system provides services according to the need criteria. The methodology used allows international comparisons of results, and it places Catalonia in a very good position in the European context.
9. As mentioned previously, they are currently not public due to the agreement between the Ministry and the providers.
10. This decision was mainly determined by the need to fulfill the European commitments included in the Maastricht Treaty.

Decentralization of Health Services in Latin American Countries: Issues and Some Lessons

TARSICIO CASTAÑEDA, GIRINDRE BEEHARRY, AND
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I. A Conceptual Framework

Health differs from education and roads in that there are some goods and services that are almost pure public goods that are both non-rival in consumption (they are not used up when a single individual uses them) and nonexclusive (the benefits cannot be owned by any single individual). Examples are provided in the first row of Table 1. These activities require government financing if they are to have any chance of being provided in quantities sufficient for the demand for them. For such public goods, the question of decentralization opens all the normal issues of decentralization of governmental decisions that are addressed in the introductory chapters.

Some of these activities may be and are treated as local public goods, such as vector control, regulation, or disease surveillance. However, because of the externalities, there are typically minimum central standards so that quality of services and risks from disease are not widely variable across local governmental boundaries. For these public goods, one of the key questions for the public sector, whether national or local, is the adequacy of the services that it finances and the regulatory structure necessary to ensure that local government units or private firms comply with quality standards and recognize the externalities across subnational political borders in a consistent way.

From the consumer/citizen standpoint, individuals may benefit from the pure public health goods and services without even knowing that they exist (e.g., vector control), although they are generally well aware when the services are not adequately supplied. Management of the activity may not include interactions between suppliers and beneficiaries, so the direct client for services may be a government functionary rather than the end user, creating principal-agent issues but also leaving open to cost and quality considerations whether the relevant govern-

mental unit prefers to manage the activity itself or contract it out.

A second set of services in health (Row 2 in Table 1) are rival in consumption but nonexclusive in benefits, such as immunizations. Immunizations may provide "herd immunity," for example, at a level of coverage substantially less than 100 percent. Thus, they provide benefits to people who do not receive the service directly. There is a willingness to pay for the service but also an incentive to free ride; hence, there is a strong rationale for at least partial gov-

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TABLE 1

Suggested Financing and Provision for Different Types of Health Services

CHARACTERISTICS OF GOODS AND SERVICES	EXAMPLES	FINANCING	DECENTRALIZE FINANCING?	PROVISION
1. Pure Public Goods in Health (Non-rival, Nonexclusive)	<ul style="list-style-type: none"> • Health Information • General Health Education • Disease Surveillance • Environmental Health • Vector Control • Regulation (market failures in information and insurance) 	<ul style="list-style-type: none"> • Public: otherwise underfinanced 	<ul style="list-style-type: none"> • Decentralization sensible for local public goods, as long as national standards are maintained 	<ul style="list-style-type: none"> • Public • Contract out (public bureaucracy is the client)
2. Household Health Inputs with Strong Externalities (Rival, Nonexclusive)	<ul style="list-style-type: none"> • Immunizations • Sanitation • Safe Water • Prevention of Communicable Disease 	<ul style="list-style-type: none"> • Public and some Private 	<ul style="list-style-type: none"> • Decentralization sensible for goods with strong local characteristics, as long as national standards are complied with 	<ul style="list-style-type: none"> • Private preferred (reduces principal-agent problem of public provision)
3. Household Health Inputs that are Fundamentally Private Goods (Rival, Exclusive)	<ul style="list-style-type: none"> • Acute Care 	<ul style="list-style-type: none"> • Private • Public management of insurance market failures 	<ul style="list-style-type: none"> • Public versus privately managed insurance • Single versus multiple payer 	<ul style="list-style-type: none"> • Private
4. "Equity Goods" in Health	<ul style="list-style-type: none"> • Acute Care 	<ul style="list-style-type: none"> • Public 	<ul style="list-style-type: none"> • Decentralization feasible if compliance with national standards 	<ul style="list-style-type: none"> • Private

ernment financing or compulsion to force private parties to purchase adequate quantities of the service. In practice, these services tend to receive heavy, if not exclusive, public financing, although some jurisdictions do handle them primarily through regulations rather than through financing (e.g., requiring immunizations before children may enroll in school, or requiring basic insurance coverage).

From the consumer's standpoint, these services require direct interaction between medical personnel and patients (or, for water and sanitation, between the seller and the consumer). A large share of the population actually must consume them if they are to be effective as medical interventions for the population. It is important that the services function in a manner that pays attention to the client. Thus the management of the services at the point of delivery is important.

A third group of services is essentially private goods (Row 3). The government finds itself involved in the financing of these services chiefly because of equity considerations, and as a substitute for insurance markets that fail to develop (Row 4).

In all cases, governments may or may not choose to become involved in the delivery of the services. Even in the realm of public goods, it may choose to contract for activities such as disease surveillance, and its choice should

probably be on the relative quality and efficiency of contracting for the service or providing it directly. As we move from the top to the bottom of the table, though, and the personal consumption of the services becomes increasingly important, the case for government participation in financing rather than providing the service probably increases substantially.

In the history of health-care provision, this distinction between public and private goods, on the one hand, and impersonal versus personal services, on the other hand, has been muddled. As a result, governments and social security institutes have found themselves financing and delivering all kinds of services even though many could be delivered as well or better in a competitive market.

Central governments, having entered the business of medicine, then consider decentralization to be a matter of decentralizing or deconcentrating the management of facilities and personnel, when in fact lower levels of government may not have any advantage in skills, incentives, motives, or negotiating power to improve the management of such services. If a public hospital is decentralized to a province, it may become no less of an employment agency than it was when it was managed by the central government.

In the past 10-15 years, an emerging pattern has been for governments to understand better the distinction

between decentralizing or deconcentrating political decision-making and financing in health on the one hand, and improving the incentive structure for delivery of health services on the other hand. The latter has generally evolved into various ways to separate the financing of personal health services from the provision of those services.

Thus there are three issues in the health sector that need to be faced during a decentralization: What is the role of the government (a) along the public-private good dimension; (b) in decentralizing political decision-making over and financing of the activity; and (c) in choosing how to manage the service.

Decentralization in Latin America has often been promoted for a variety of political reasons (furthering a democratization process, reducing the pressure for power sharing from regions, or following constitutional mandates to increase transfers for subnational governments), and in the belief that decentralization would improve allocative efficiency, accountability, equity, quality, and contain costs. This approach would apply principally to public and quasi-public goods in health, but not necessarily to personal services that are directly managed by governments or social security institutes. In other words, decentralization is viewed as if the only axes of decision were those of political decentralization and financing (Quadrants 5-8 in Figure 1 above). Neglecting the service provision axis narrows the policy tool kit to political and fiscal decentralization, neither of which may be an appropriate instrument to increase the efficiency of service delivery. As will be seen in the review of experiences in Latin America, countries have consequently come up with different solutions along the spectrum of possibilities, with uneven results and a considerable amount of learning through trial and error.

This framework is perhaps too simple to capture the true role of the public sector in health or to fully understand the decentralization efforts that have taken place in Latin America (see, for example, Preker et al. 1999 and Musgrove 1999). However, it emphasizes two simple issues that should be addressed in decentralization policies in health. First, should responsibilities and financing of the high-externality functions in health be distributed across political entities, recognizing that many of these goods would benefit from local customization while also meeting minimum national standards for results (e.g., management of water-, air- and vector-borne diseases)? Second, how can services be improved in historically large, expensive, and

poorly functioning government-owned and -operated delivery systems? While movement along the political decentralization axis may affect service delivery to some degree, this second issue is fundamentally an incentive problem that can be addressed through a variety of actions, such as splitting the financing function from provision, by creating autonomous units, by shifting budgeting from the input side to the output side, by encouraging competition by letting patients choose providers, and so on.

This report emphasizes what has been done in six countries in Latin America (Argentina, Bolivia, Brazil, Chile, Colombia, and Mexico). Section II presents the common elements, organized around which levels of government are responsible for which activities, how funds are transferred from the center to state and local governments, and how responsibility for managing the various inputs (labor, capital, and procurement) has been affected. It is a story of partial political decentralization of what we would call the service functions. Section III addresses the issue of how decentralization reforms have been implemented and the obstacles the process has faced, and it presents some of the results obtained thus far. Finally, Section IV presents some conclusions and recommendations based on lessons learned from the country studies. A synopsis of the decentralization experiences in each of the six countries reviewed is presented in Annex A.

II. What Has Been Decentralized in Latin America and How

Jurisdictionally, Latin American countries can be divided in two groups. The larger countries (Brazil, Mexico, Argentina, Colombia, among others) have a three-tier government system composed of the central government, states, departments or provinces, and municipalities. The smaller countries (Costa Rica and others in Central America, Chile, among others) have two-tier government systems composed of the central government and municipalities. In the smaller countries an intermediate administrative regional level seeks to coordinate municipal projects overlapping two or more jurisdictions. In Latin America, in federal and unitary governments alike, municipalities relate directly with the central government, rather than through their states. In most cases revenue flows directly from the central or federal level to municipalities. In addition, because of constitutional mandates or due to voluntary fiscal coordination laws

(such as in Mexico), states and municipalities have very limited taxation powers (Castañeda 1997a; Macias and Valdes 1999).

Decentralization of health services in Latin American countries has proceeded through devolution or delegation of subsets of functions or responsibilities to different government levels rather than through decentralization of the whole set of key functions to any of the subnational governments. In many cases, functions, such as service provision, are not clearly defined among government levels, making it hard to find who is accountable to whom for those responsibilities. In most cases, except Brazil, Argentina, and to some limited extent Colombia, personnel administration (salary scales, benefits, promotions, hiring, firing, sanctions, etc.) remain at the central level, as a result of negotiations with workers' unions. Limited personnel administrative matters (permits, promotions, etc.) have been delegated to states or municipalities.

In assessing the extent of decentralization and transfer of power and resources to subnational governments, particular attention is paid to the devolution of responsibility and authority to subnational governments over critical inputs such as labor, procurement (medicines and supplies) and investment in infrastructure and equipment. The underlying logic behind many decentralization efforts has been more political than economic, and the choices that have been made therefore rarely reflect the types of considerations expressed in Section I. In the six countries studied in detail for this review—Argentina, Bolivia, Brazil, Colombia, Chile and Mexico—decentralization has been on the health policy agenda for some time.

Responsibilities for Health-Care Services

While central governments tend to retain responsibility for policy-making, overall financing, and operation of highly specialized medical care centers (for treatment of cancer, for instance), states or provinces have often been given responsibility for provision of secondary and tertiary hospital care, and municipalities have been given responsibility for primary health care (in Colombia, Brazil, Chile, and to a lesser extent Bolivia). In big cities or metropolitan areas, all levels of care can be provided by the same jurisdiction. The exception to this rule in the countries reviewed is Chile, where a non-jurisdiction unit (the Health Region) is used for transferring responsibility for

secondary and tertiary care. The selection of a jurisdictional unit, especially if elected by popular vote, is believed to have some merit in that it allows for political accountability. It has the drawback, however, that the unit may be too small to take advantage of available economies of scale.

One practical problem with this division of responsibilities between government levels—with hospitals devolved to states and primary health centers to municipalities—is that it complicates the workings of the referral system, however well it might have functioned previously. This occurs to a large extent because the financial transfers for states and municipalities are usually disconnected, with both receiving direct transfers, often by formula, from the central level to meet their specific service responsibilities. In addition, neighboring municipalities find it hard to develop compensatory economic arrangements to pay for services rendered to their residents in other jurisdictions (Brazil, Colombia, Bolivia, Argentina).

In practice, however, responsibilities among government levels have often been ill-defined or have changed repeatedly over a short period, hampering the consolidation of institutional and other arrangements at subnational levels. In Brazil before the new constitution of 1988, states were responsible for administering state health systems, while after 1988 the main responsibility for service provision and administration was given to municipalities. In Colombia, a 1990 health sector decentralization law was replaced by a more radical health sector reform law in 1993, when the decentralization law was just starting to be implemented.

Table 2 summarizes the sharing of responsibility among different levels of government in the six countries reviewed. The responsibility for the provision of primary health care (which includes a number of goods with strong externalities) is typically devolved to the municipal level. Responsibility for hospital care tends to remain centralized in many countries; Brazil, Chile, and Colombia, on the other hand, have decentralized hospital care along the service provision axis rather than along the political one.

Financing Mechanisms and Basis for Transfers

Most health-care providers (hospitals and primary care networks) continue to be financed by direct historically based budget allocations either through deconcentrated Ministry of Health Offices in states or through earmarked transfers

TABLE 2
Service Responsibilities at Different Levels of Government

GOVERNMENT LEVEL	PRIMARY HEALTH CARE	HOSPITAL SERVICES	REGULATION & PUBLIC HEALTH
Central/Federal	None	Bolivia; specialty hospitals in most other countries	All: regulation, policy generation, financing
State/Department/ Province	None	Argentina, Bolivia, Mexico; Health Regions in Chile	All: some regulation, policy generation, financing
Municipalities	All; Sanitary Jurisdictions in Mexico		
Facilities where purchaser-provider split operated		Brazil (mostly private provision); Colombia; incipient autonomy in Argentina	

to states and municipalities (in Mexico, Bolivia and Chile, and in Colombia to non-decentralized departments). In Argentina, central transfers to provinces are not earmarked for health; transfers from provinces and municipalities to health-care facilities are historically based. Current central government payments are rarely related to production or quality of the service provided—although some countries such as Chile have recently started to introduce payments for Diagnostic Related Groups (DRGs). In Colombia, where hospitals provide services financed through private insurance companies for poor patients, there is now a strong connection between delivering services and receiving payments. Brazil is a special case in that there are relatively few public hospitals; a large share of hospital services are provided by private hospitals under federal fee-for-service and DRG reimbursement schedules (Castañeda 1997c). Decentralized states and municipalities receive formula-based transfers, heavily biased by historical expenditure patterns, to pay for those services.

Transfer formulas to political sub-levels are generally complex and have a large population-based weighting. In Colombia, for instance, transfer formulas include, among other things, the population with unmet basic needs, and adjustments for local administrative and fiscal effort. Per-capita allocations are also being applied in Brazil for a basic level of municipal primary health-care services and in Colombia for insurance for a basic health-care package for the poor. These transfers then become the basis for local governments to finance services, which is typically done on an input-based, historical budgeting approach that ignores output and quality. Chile is an exception: Transfers to municipalities are based principally on service provided, complemented by per-capita allocations.

Some countries use formula-based transfers to finance primary health-care infrastructure and equipment by

municipalities (Colombia, Bolivia, Mexico). In Brazil formula-based transfers also finance current expenditures and investments of municipalities under complete decentralization of service responsibility. Formula-based transfers have several advantages: (a) They are more certain, as they are less dependent on political decisions; (b) they can be used as collateral for investments; (c) they add transparency to the system; (d) they can be used to rectify inequities in spending across subnational units; (e) they can provide incentives for localities to experiment with different forms of service delivery to economize on their budgets.

Although the main financial source is the central or federal government, states and municipalities also contribute and are pressed to contribute more of their own resources. However, states and municipalities have few resources of their own because they lack fiscal powers. In Brazil, for instance, tax and social contributions are a prerogative of the federal government. In Mexico, because of the fiscal coordination law, states share general value-added and other taxes with the municipalities in exchange for the municipalities' not exerting their taxing powers. In Colombia, departments rely on taxes on liquor, alcohol, and gambling, which have been given by the central government to finance health expenditures. All in all, state and municipal contributions for health care (excluding transfers) are less than 20 percent of total health expenditures in most countries.

There is little financial autonomy at facility level. Hospitals are paid the cost of personnel (usually a fixed staff and staff mix provided by law, as in Chile, Mexico, Bolivia, and Argentina), and costs of other inputs and services. Recently, there have been some efforts to finance hospitals and primary care providers on the basis of DRGs, but these efforts have not been fully implemented. Moreover, hospital deficits and debts end up being paid by central or subnational governments (Brazil).

The situation can be summarized as follows: In those countries that operate essentially on the fiscal and political decentralization axes, payments and transfers are made to lower government levels on the basis of past budget history or according to some formula. In those countries where decentralization along the service provision axis has also been made, transfers may be made directly to hospitals (fee-for-service or payment by DRG, as in Brazil) or to municipalities for the provision of primary health care (capitation, historical). In Colombia, which has gone the furthest in recognizing the importance of the service provision axis, an effort has been made to separate financing from provision.

Labor Management

Labor costs constitute a large portion of health-care expenditures. At the hospital level some countries expend over 60 percent in personnel costs. At the primary level labor costs shares are even higher. While the ability to hire and fire has somewhat been decentralized, salary determinations tend to remain centralized, or decentralized at most to the state/department/province level.

In many countries the price of labor or the conditions of employment are controlled not by subnational governments or administrators of health facilities but by the federal or central government, which enters into national negotiations with health-sector unions every year. In Colombia, while labor costs are set nationally, the transfers to subnational governments do not fully reflect the costs, resulting in constant shortfalls, disputes among government levels and financial pressures on local governments. As a result, in Colombia and other countries there is little interest by subnational governments to take up health service responsibilities in their territories because the responsibility is transferred without adequate resources to carry it out or authority to manage the costs.

Table 3 summarizes where the six countries are situated in terms of personnel management. It indicates that the decentralization of personnel management has been relatively unsuccessful. In most countries, subnational governments or health-care facilities have only limited personnel management responsibilities and are constrained by strict national labor codes regarding health-care workers. In some cases, state health secretaries have the power to hire, fire, and transfer hospital directors and staff (Argentina, Mexico, Bolivia). Chile is perhaps the sole case where primary health workers were effectively transferred to municipalities and lost their status as federal civil servants in the process.

Directors of government-owned health facilities have generally little power over their labor input. With the recent introduction of reforms giving more autonomy to hospital facilities, hospital managers are just beginning to receive more power over personnel in Argentina (Abrantes and Díaz Legaspe 1999). In Colombia most public hospitals have adopted the form of "social state enterprises" under Law 100 of 1993, and have a hospital directorate and director who can manage labor contracts, time schedules, and contract services. In other selected cases, the separation of the purchasing from the provision function (involving the autonomization, corporatization, or privatization of public hospitals) has given hospital directors authority to hire and fire personnel. This has been a slow and haltingly implemented process in just a few countries.

Powers to Set User Fees and Dispose of Proceeds

The ability to charge and retain fees in public facilities is another measure of the real extent of decentralization. By law or supreme decree, most countries charge no or nominal fees for primary health care in central or decentralized facilities, and highly subsidized fees, if any, for hospital services and for inpatient or outpatient diagnostic related

TABLE 3
Authority to Manage Personnel by Different Levels of Government

GOVERNMENT LEVEL	SALARY DETERMINATIONS (PRICE)	HIRING AND FIRING (QUANTITY AND INCENTIVES)
Central	Bolivia, Colombia, Mexico, Chile	Bolivia
State/Department/Province	Argentina, Brazil	Mexico, Argentina, Chile (Health Regions), Brazil; Colombia (non-decentralized areas)
Municipal		Brazil (for service providers); Chile for PHC workers; Colombia for decentralized areas
Facilities where purchaser-provider		Brazil (limited autonomy in public hospitals);

activities. Health care is subsidized from the supply side. The ability to set and retain fees in effect implies a change from supply to demand subsidization. The switch to demand subsidization presupposes some degree of separation between financing and provision, and provider autonomy (i.e., a movement along the service management/provision axis in Figure 1). It is, therefore, unsurprising that there should have been little or no progress in the ability of subnational authorities or facility managers to set or retain fees in those countries where decentralization has essentially been carried out along the political axis. In the case of Bolivia, decentralization to municipalities has paradoxically *reduced* the autonomy of health facilities to dispose of fees; the proceeds now have to be remitted to the municipal health authorities. In those countries, on the other hand, where a purchaser-provider split has begun to be implemented, facilities are at least partly able to retain and dispose of the proceeds from service provision (Chile being an exception; there, user fees are collected by the National Health Fund). In Colombia, for example, proceeds from user fees can be used to procure inputs and medicines, and to pay for public utilities and for budget deficits.

Procurement of Inputs and Other Supplies

Procurement of inputs has, in most countries been decentralized to lower levels with facilities gaining increasing autonomy over the purchasing of most inputs. Central warehouses have been abandoned due to past experiences with corruption, poorly managed distribution systems, inability to respond to demand, and high loss rates. Bolivia and Mexico, however, continue to centralize much of this responsibility. (See Table 4.)

Investments in Physical Infrastructure and Equipment

Investment decisions have been one of the few activities that have been fully decentralized in many Latin American countries. While this has quickened responsiveness to local

needs, it has also created problems. First, since all three government levels are allowed to invest in infrastructure and have the money to do so (often earmarked transfers), there is a tendency to over-invest in infrastructure and equipment. Typically, there is no explicit charge for rental of capital and equipment or for depreciation, so there is no countervailing incentive to use capital productively. Second, wherever states and municipalities have not also been responsible for financing personnel, they have tended to overlook the recurrent cost implications of those investments. In those countries it is thus common to find empty health-care facilities because the central government has not filled the new staff slots and vacancies due to central budget constraints. The central government has been even reluctant to allow municipalities and community organizations to fill out those vacancies for fear that those new positions will eventually have to be absorbed by central-government payrolls, as a result of pressures from labor unions.

As judged by the generally low degree of subnational autonomy and authority over critical inputs, the extent of decentralization in most Latin American countries has been limited. Subnational governments and facilities tend to have such a limited control over personnel that it may be impossible to effect substantial changes in quality or efficiency. They are limited in their ability to reduce or increase staff, change staff mix, or introduce rewards systems to attain efficiency gains, change service composition or quality. Although states, municipalities, and even facilities have considerably more liberty for investment decisions in infrastructure and equipment than they have for personnel, they are often constrained because there are no positions to operate new facilities, adding to unused infrastructure and waste. The situation is not uniform, however; those countries that have decentralized along the service management axis as well as along the political axis (Chile, Colombia) have had some success handing over control over inputs, including the ability to hire and fire personnel, to providers. See Table 5.

TABLE 4

Authority to Buy Inputs (Medicines, Supplies)

GOVERNMENT LEVEL	NORMS AND PROCEDURES	PURCHASING AUTHORITY
Central	All	Bolivia
State	All	All except Bolivia
Municipal	All	All except Bolivia and Mexico
Facility	None	Argentina (in autonomous hospitals), Brazil, Colombia

TABLE 5

Authority to Make Infrastructure Investments

GOVERNMENT LEVEL	PRIMARY HEALTH CARE	HOSPITALS
Central		Bolivia, Chile
State	Mexico	Argentina, Colombia, Mexico
Municipal	All except Mexico	Brazil (+ some State co-financing)
Purchaser-provider split operated		Colombia (from user fees)

III. Implementation and Results of Decentralization

Implementation Issues

The implementation of decentralization has been a slow stop-and-go process. Some of the reasons have been political in that directly affected interest groups, such as health sector workers, have seen decentralization as a threat to their union power and as a way for the government to divide them. In most cases, health sector workers have agreed to decentralization or deconcentration only after receiving assurances (usually by law or supreme decree) that labor codes and associated benefits will be maintained for themselves and often for new staff as well.

Other reasons have been economic. Decentralization reforms cost additional money because, at least initially, there is some duplication of expenditure (central government employees are rarely transferred to other locations, for example), there is a need to rehabilitate hospital and primary health-care networks, and personnel must be trained. During the 1980s, when many of these reforms started, there was an acute economic crisis in Latin America. Decentralization and other reform efforts had to be halted due to the acute budget constraints that many countries faced. In Mexico, for instance, while the initial effort started in 1983 with 14 states, the rest of the states were decentralized only in 1988.

Where more radical decentralization reforms have been planned (e.g., Colombia, Venezuela), the cost of accumulated pension benefits for health workers has been one of the main obstacles. Under planned reforms, states take charge of all personnel and payroll (under national civil service codes) and pension benefits. The central government promises to pay all accumulated pension benefits up to the moment of the transfer or when the decentralization law was enacted. Yet, very few countries have been able to make actuarial calculations of these benefits and to pay them as promised.

One other reason for delayed implementation has been the lack of interest of central planning bureaucracies and of subnational governments in carrying out a successful decentralization. Under the notion that subnational governments are incapable of receiving and providing health services, the national government imposes cumbersome and largely unnecessary certification requirements before a subnational government is devolved the responsibility for service provision. Furthermore, those certification requirements are never clearly specified with respect to content, dates, and process, but are left to the interpretation of central government bureaucrats, leaving ample room for discretionary practices and negotiations, and for stopping the process with a change of minister or other policies. In Brazil, Colombia, and Venezuela, for instance, certification requirements include a detailed yearly health operation and investment plan, the development of an information system, the incorporation of health personnel into state or municipal payrolls, and a working referral network. In Venezuela, decentralization agreements with individual states have to be approved by Congress (World Bank 1994). Most state and local plans are never implemented because states and municipalities control few of the inputs, except in the few fully decentralized states and municipalities in Colombia.

In general, there has been a marked lack of interest of subnational governments, with the exception of municipalities, to receive the new responsibilities. This lack of interest results, to a large extent, from the fear that the central government will not fulfill its financial obligations and fears of having to deal with powerful health sector unions. In Argentina, these fears currently also apply to hospitals that are in the process of obtaining autonomy from the provinces.

Municipalities have been much more enthusiastic about receiving health care, especially responsibilities for investment, because they have received new transfers without the responsibility for actual service provision. With the excep-

tion of Chile and Brazil (under complete decentralization) municipalities share the responsibility for primary health-care service provision with the state and the central government, typically without the power to manage personnel (Colombia, Mexico, Bolivia), so that the accountability structure for service provision is blurred. At each level of governance the other level can be blamed as a bottleneck preventing the system from functioning well.

In addition, there is the lack of capacity of subnational governments, especially municipalities, to carry out delegated responsibilities. In Bolivia, for instance, over half of the investment plans are not executed (Hartmann 1999). The problem with capacity is that few if any health workers are transferred to subnational governments to help them meet their new responsibilities, and little is invested in training for those with new and unfamiliar managerial and technical responsibilities.

To this list of reasons why decentralization has not progressed smoothly, it may be necessary to add that of a faulty strategic framework with a mismatch of instruments to objectives, therefore requiring frequent halts and backtracking. After a few reform iterations, Colombia and Brazil seem to have settled for the following matching of objectives with instruments: Achieving higher responsiveness and efficiency may necessitate the corporatization or privatization of the provision of certain health services; equity objectives may best be achieved by directly subsidizing the poor; and cost-containment may require devising appropriate provider reimbursement mechanisms. Argentina, after more than a decade of political decentralization, is supporting the provinces to autonomize hospitals and shift subsidies to the demand side. Chile chose a similar path whereby the preferred strategy for effective delivery of private health goods for middle- and upper-income groups was the separation of financing from provision. Chile has maintained a system that delivers public goods through decentralized public entities and provides publicly operated services for the poor that are financed partially based on outputs.

In Bolivia, Mexico, and, to a large extent, Argentina, decentralization has been driven by extra-sectoral considerations (democratization, sharing of power with subnational levels, reduction of fiscal burden) rather than as an instrument to achieve specific objectives within the health sector. The decentralization efforts in the sector have consequently sometimes appeared misdirected. It is difficult to imagine

that sharing responsibility for factors of production between levels of government, such as in Bolivia, is conducive to improving the delivery of health services. Decentralization in Mexico and Argentina, which has consisted in transferring resources and responsibilities down one level of government, is equally unlikely to improve service delivery or contribute to contain costs. It is likely to reduce equity unless the federal level retains a role in equalizing resources (financial, human) across states. The recent attempts to create a purchaser-provider split in Argentina, in Colombia, and within Mexico's social security system are perhaps indications that policymakers are coming to terms with the limitations of political decentralization for improving the delivery of services.

In a perverse way, the form of the initial decentralization can interfere with efforts to improve the service delivery dimension. Shifting hospital and other assets to the state and local levels, along with the investment budget, provides lower-level politicians with instruments that can be and are put to use for political purposes. Failing also to fully shift control of some inputs, management, and strategy decisions to the same level blurs accountability for results and further distorts political incentives because blame for failures can be shifted. In Colombia, for example, subnational politicians have successfully resisted or slowed elements of the national reform to improve accountability of services to clients (by splitting provision from financing) because of their desire to retain control over hospitals and budgets.

The Consequences of Decentralization

The impact of political decentralization on equity, efficiency, costs, and quality of care has not been documented in a comprehensive or systematic way. Many countries report increases in coverage of services, especially of primary health care. It is not clear, however, whether this is the product of a better responsiveness to local needs or simply because of increases in health expenditures that have occurred independently but concurrently with decentralization. If decentralization has indeed effected a reallocation of public resources toward the financing of public goods, and goods with externalities, then in this dimension, at least, it would have to be considered a success.

What is clear is that political decentralization, especially to municipalities, has allowed an increase in community and NGO participation in service provision and

collaboration between municipalities and those organizations. In community participation, for instance, in Brazil, the Family Health Program (Programa de Saude de Familia, PSF)—which is based on interdisciplinary groups of nurse, physician, auxiliary nurse, and four or five community health leaders, providing primary health-care services to groups of 800 to 1,000 families—was operating in 228 municipalities in 18 states, especially in the Northeast region, by 1996, two years after the program was created. In Mexico, more than 22,000 health committees were created by 1998 to oversee health provision and participate in health campaigns and training. In Bolivia, vigilance committees and grass-roots organizations supervise health provision and municipal expenditures at the local level, although it remains to be seen if these committees are really effective.

Decentralization reforms have resulted in a heavier fiscal burden. To a large extent this is because formula-based transfers to municipalities, and in some cases to states, have been made, in part for political reasons, with new monies rather than with reallocations from existing health expenditures. In Colombia, for instance, municipal transfers, a large part of which has to be spent on health investments, were created by constitutional mandate in 1991 as a fixed, 22 percent of national revenues. In Bolivia, municipal transfers created by the Popular Participation Law are a fixed percentage of government revenues and represent additional resources for social services, including health. Another source of increased net expenditures on health are the budget allocations to pay subnational governments for increased salaries of health staff and accumulated pension and other benefits. Overall, increased expenditures in health have represented more than 2 percent of GDP in some countries (Bolivia, Colombia), although not all the increase can be attributed to decentralization per se.

The coordination-intensive decentralization process may be hampered by the absence of reliable information systems to monitor progress or signs of trouble in coverage, quality of service, and efficiency. Quality and coverage indicators, when available, are indeed often unreliable. Reports of inefficiencies and misuse of funds come from the press rather than from reliable information systems. This situation is unsurprising insofar as a centralized system may simply not produce much information, because the information has little value where there are

few transactions involving money, there is little competition, there is almost no incentive to regulate effectively, and decisions and resources are dictated from above. Decentralization or, for that matter, any reform that multiplies the loci of decisions (autonomization, corporatization, privatization) increase the numbers of transactions, independent decision-makers, and alternatives to consider at each level. Providers can no longer survive without precise and up-to-date information on their cost structure and revenue prospects, and because the public sector needs information to make sure that service and financial standards are being complied with. The amount of information generated is therefore endogenous to the system in place and the incentives it creates. It is therefore not surprising that the information systems that are in place in a centralized system fall far short of meeting the information needs in a decentralized system. Complaints of inadequate information may therefore be a sign of success.

IV. Conclusions and Recommendations

Conclusions

- Health-sector decentralization reforms in most Latin American countries have left management practices and operation of hospitals and primary care networks largely untouched. Key functions such as personnel management decisions continue to be made by central-government authorities as a result of negotiations with labor unions.
- More liberty and flexibility has been provided to subnational governments in procurement (with several exceptions where procurement is still centralized) and in investment decisions. While this flexibility has provided room for responding faster to health services needs and infrastructure, it has also contributed to duplication and waste, as expenditure coordination among government levels has been difficult. New infrastructure and equipment provided by states and municipalities has often sat idle for lack of staff to operate it.
- The above-mentioned division of management responsibilities over inputs for service provision has significant negative effects on accountability for service provision. Nobody, except perhaps the national government (the provincial government in

the case of Argentina), is fully accountable for service provision (amount, quality, opportunity). The perverse result is that responsibility has been devolved, some elements of management has been devolved, some financing has been devolved, but accountability has been dispersed because these are partial devolutions.

- Financing mechanisms for hospitals and primary care networks have not changed with political decentralization. Most service centers continue to be funded based on historical line-item budget allocations with no relation to production or service quality. Those countries that have decentralized along the service provision axis have been experimenting with other systems, such as fee-for-service, DRGs (Chile, Brazil, Colombia) to finance providers. In Argentina, a small but increasing percentage of private hospital budgets comes from reimbursement of services rendered to populations with private or social insurance. The pending issue is whether hospital autonomization is sufficient to induce a change in behavior and increase efficiency. It is argued that deficits or debt incurred by autonomous hospitals end up being paid by central and or subnational governments. Therefore autonomous hospitals do not face credible budget constraints and corporatization or privatization might be preferable.
- While government health service providers in most Latin American countries (except Peru and a few others) are not free to establish their own user fee schedules, most providers collect some fees from non-poor patients (especially insured patients). Centers can use these revenues for basic inputs such as public utilities, medicines and, in some cases, to provide some incentives to workers for better and more services. In other cases, these fees have to be returned to municipalities (Bolivia) or are captured at the central level (Chile).
- Finally, despite the limited extent of decentralization (it has been mainly deconcentration), there are signs that decentralization can bring important benefits. Municipalities—at least the ones that have been the ones enjoying more freedom to allocate and manage resources—have been able to involve and make contracts with communities and

NGOs for service provision or vigilance, and to target services to the poor within their jurisdictions better. This has occurred mainly in big urban municipalities, which have been able to integrate primary and hospital care, such as those in Brazil and Colombia.

Recommendations

Several basic recommendations are suggested by this range of experiences, however partial or narrow the decentralization has been.

- More direct attention should be paid to the question of how responsibilities and financing for health goods with high externalities should be distributed across political entities, recognizing both the benefits brought by local customization of public health programs to meet local demands and the need to meet minimum national standards.
- The effect on accountability of differentially devolving responsibilities, financing, and control over inputs to sub-national levels needs to be corrected in countries that have already partially decentralized or deconcentrated, and the connection between new privileges, responsibilities, and accountability must be carefully designed into future decentralization plans. The intended beneficiaries' access through self-regulatory mechanisms to Hirschman's "Exit, Voice, and Loyalty" to exert influence over the decentralized services must be fully considered in a decentralization strategy.
- The role of the public sector in a decentralized system should be revisited critically. Careful attention needs to be paid to the three dimensions in Figure 1—financing, central-versus-local governance, and provision. Within this framework, it is probably preferable that the public sector create a hierarchy of interventions: adequate finance for public goods (probably at a much higher level than in most countries today); an intensive effort to provide information to governments, providers, and consumers; regulation as a substitute for financing and ownership; financing to correct inequities (preferably through subsidies that follow users and adequate financing in rural areas where health services cost about 20 percent more than in urban areas [World Bank 1995b]); and, as a last resort, direct provision. In

general, provision can probably be contracted out or privatized if this can be accomplished within an adequate regulatory framework, with reasonable transactions costs, and with considerable development of public information and accountability systems. This is a very large "if" and requires sequencing and financing for the various processes involved. The benefits are probably considerable and the costs of acting are considerable, but the costs of doing nothing are probably considerable as well, although difficult to observe.

- If the ultimate aim is autonomization/corporatization/privatization of public hospital services, political decentralization may not be a good transition because it may simply shift resistance to change to local interest groups.
- On the issue of labor relations, the solutions developed so far have not been effective. Difficult decisions need to be made up front in this area, and investment should be made now in attempting to discover options that have not been widely used that could increase the flexibility of localities in managing the cost of labor inputs.
- The cost of the services under the responsibility of states and municipalities should be established clearly and unequivocally, and financing mechanisms to allow the states and municipalities to pay these costs should be developed, while creating incentives for them to reduce costs and improve services.
- It is important to determine the financing mechanism by which resources will be transferred to states and municipalities to finance their responsibilities. Formulas are essential so that the transfer is done transparently and predictably. A large per-capita component in the formula (based on the cost of financing a minimal package of services per person) is a good option, but there must be allowances for correcting equity problems and adequately providing public health programs, which may vary across jurisdictions.

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Annex A

A Synopsis of the Decentralization Process in Six Latin American Countries

Argentina

Decentralization of health services in Argentina, both in the territorial/political sense and in the economic sense, is very advanced, judging by the proportion of the health budget that is executed at the subnational levels and by the decision powers that have been transferred to the provinces. Only about 14 percent of health spending in the public sector is done at the national level; 70 percent is done at the provincial level and another 16 percent at the municipal level. Less than 1 percent of inpatient facilities are administered by the national health authorities, some 70 percent are administered at the provincial level, and 20 percent at municipal level (Gonzalez-Prieto and Alvarez 1999).

In addition, the public sector is not the most important financier or provider in the health sector. The public sector provides health coverage to about 46 percent of the population and accounts for about 23 percent of total health spending in the country. The social security system based on *obras sociales* provides coverage to 47 percent of the population and accounts for 35 percent of health spending. The private sector covers 7 percent of the population and accounts for 42 percent of health spending (insurance and out-of-pocket). The public sector owns about 37 percent of health facilities and 54 percent of hospital beds, while the private sector owns 61 percent of health facilities and 43 percent of hospital beds (Gonzalez-Prieto and Alvarez 1999).

The first wave of political decentralization in Argentina (1978) was understood as decentralization to the provincial, rather than the municipal level. The primary motor for decentralization was the alleviation of the fiscal burden at the central level, rather than a quest for efficiency or equity. Responsibility for running health facilities and budget were transferred to the provinces. The resources transferred from the federal to the provincial level were not earmarked for the health sector; provinces could therefore choose how much they want to allocate to the health sector from their own budgets and from the federal transfers.

The early 1990s brought a second wave of decentralization with the transfer of the last federal hospitals to the Municipality of Buenos Aires, the transfer of some provin-

cial health responsibilities (especially primary health care) to the municipalities and, importantly, the emergence of the concept of the autonomous public hospital (HPA). The scope of autonomy of these hospitals includes their ability to bill *Obras Sociales* and private health insurers for services provided to their beneficiaries and to retain a part of their earnings. This ability has been the primary motor for the different provincial decentralization laws or decrees. In other aspects, the provinces have adopted different models and paths so that the degree and form of decentralization differs widely from one province to the other.

In general, the decentralization resembles more deconcentration because it does not include the transfer of human resources or a legal framework for autonomy. Only Salta envisages a transfer of assets and personnel to the hospitals. Salta had even envisaged that the hospitals would be privatized, but eventually decided to maintain their hospitals under public law. Two provinces, on the other hand (Córdoba and Neuquén), have chosen not to go down the path of hospital autonomy, invoking the fear that decentralization would (a) lead to coordination failures and inefficiency (duplication of facilities and equipment) and (b) lead to discrimination against the uninsured population as hospitals became more and more dependent upon reimbursements from insurers. The low level of autonomy effectively achieved in those provinces that have joined the hospital autonomy program is attributable to similar fears and to worries that decentralization would increase the public deficit (the province being the residual claimant), provoke strong opposition from labor unions, and reduce the political power at provincial level. In a few cases, provinces have tolerated the adoption by some hospitals of some degree of autonomy, in the absence of the legal framework allowing it (e.g., Perico hospital in Jujuy) (Gonzalez-Prieto and Alvarez 1999).

The purchaser-provider split characterizes the larger part of the health sector in Argentina, and the remaining part seems desirous of separating financing from provision. Innovations such as public health insurance for financing health services to the poor and management contracts between the province and its hospitals are currently being implemented and will help to separate financing from provision. The success of this system hinges upon health providers' behaving in a more business-like fashion. Hospital autonomy seems to be the furthest Argentina is currently and hesitantly willing to go to obtain such behavior.

Bolivia

The public sector provides coverage directly to about 30 percent of Bolivians, and through the social security system to another 14 percent. The private sector provides coverage to some 30 percent of the population. The remaining 26 percent either have no access to services or use traditional medicine (Ruiz Mier and Guissani 1997).

Decentralization in Bolivia has been used as an instrument of democratization. After a number of failed efforts in the 1980s, the process was precipitated by the Popular Participation Law of 1994, which provided for the recognition of 311 municipalities. This law also transferred property rights of health centers and medium- and high-complexity hospitals, including national reference hospitals, to the municipalities. The transfer of responsibilities included those of infrastructure-maintenance, equipment, and the supply of inputs. The process was furthered with the administrative decentralization law of 1996, which transferred some personnel administration responsibility to the departmental level. The central ministry, however, continued to be responsible for personnel recruitment and firing, and for negotiating salary levels every year with health sector unions. Decision on the number of administrative and medical staff allocated for public health centers is determined centrally, and municipal governments do not participate in the decision-making process. A new public health model was implemented in 1996 with a view to update the public health system to the new legal framework and actors, and to the current public investment strategies.

One of the particularities of the Bolivian experience of decentralization has been the sharing of roles and responsibilities between the municipal and the departmental levels. While many countries have delegated primary health care to municipalities and higher-complexity health care to departments, the demarcation line in Bolivia has been along the control of particular types of inputs. The municipalities are thus responsible for the maintenance and equipment of the health infrastructure, while the departments are responsible for personnel administration. In this model, municipalities and departments, therefore, each have control on some of the factors of production, and close vertical coordination is needed to ensure effective service provision.

Municipalities and departments additionally have to coordinate up with the national Ministry of Health, which

plays a regulatory role and is responsible for the administration of essential drugs, and down with the local communities to ensure local concerns are factored in. Local health directorates have been created in an attempt to effectively achieve coordination between all the players in the health sector; these are formed by representatives of the municipal government, of the departmental health directorate, and of the local community. The mandate of these directorates includes preparing and proposing annual operational budgets and investment plans for the health sector to the municipal government, negotiating health personnel, and proposing and negotiating health service provision agreements with different actors. To date, these directorates have fallen short of this goal, and coordination fails; all three levels of government have a stake in service provision, so accountability for quality and coverage is diluted.

The decentralization efforts have increased spending at local levels and allowed municipalities to invest more in the maintenance and operation of the health facilities. Only about 12 percent of health spending is done at national level; some 62 percent is done at the departmental level, and the remaining 26 percent at the municipal level. The major source of funds for the health sector remains transfers from the central level. This transfer-based financing system limits the actual degree of autonomy and control over inputs at subnational levels. The new model has also actually diminished financial autonomy at the facility level: Facilities have lost their autonomy to municipalities, which now manage the user fees collected by the facilities. Financial autonomy at the facility level has also been reduced with the implementation of Maternal and Child Health Insurance (1998). Public health providers, which are required to provide free care to pregnant mothers and children under five years of age for diarrhea and respiratory diseases, are typically inadequately compensated for these services by the municipalities.

While there has been a definite transfer of responsibilities to the lower administrative levels in the health sector, there has been little progress in separating the financing from the purchasing functions. Apart from Maternal and Child Health Insurance and Old Age Medical Insurance, health purchasers are not clearly identified. The type and scope of services to be provided are not clearly determined, leading to a disconnect between demand and provision. Health providers, for their part, are not given the instruments to behave in a more business-like fashion. Indeed,

the last few years have seen a reduction in the degree of health facilities' autonomy to retain payments for services provided, and to decide upon resource allocation and medical inputs.

Brazil

The decentralization process in the health sector was initiated in the late 1970s. The initial efforts were aimed at optimizing the use of resources in the health sector, integrating the public sector, reducing power at central level, and strengthening subnational levels. Parallel to the decentralization process, efforts were made to integrate the social security institute that provided health care to urban formal sector employees and their dependents with the Ministry of Health that provided health care to rural uninsured workers and indigents. The integration was achieved in 1988 with the establishment of the Single Health System (SUS).

Unlike Argentina and Mexico, decentralization in Brazil is primarily a municipal affair. The process of enabling municipalities to manage their own health system has been very gradual and has involved a formal qualification process. By December 1996, 137 municipalities, accounting for 16 percent of the Brazilian population, administered their own health systems. These mostly urban municipalities administered some 20 percent of hospital expenditures of the SUS. Another 2,300 or so municipalities (or 42 percent of the total) had gained "incipient" autonomy, which allowed them to participate in planning activities and licensing private providers in their territories; their ambulatory and hospital-care budgets were, however, still prepared and approved by the federal government. For their part, states are responsible for reviewing policy implementation, for monitoring and evaluation systems, and for providing technical and financial assistance to municipalities in their jurisdictions.

In practice, the decentralization process has suffered from a number of shortcomings. The reimbursements to public and private providers have been substantially lower than the costs of services (especially for preventive care). Private participation in the SUS is decreasing as a result of the discrepancy between costs and reimbursements. The expansion of private health plans is also contributing to the diversion of private providers away from the SUS. Municipalities, for their part, receive insufficient transfers (US\$12 per year per capita) to provide the package of primary health care services, surveillance and control of communi-

cable diseases, and sanitation. Decentralization has not altered the fact that most of the funding for the health sector is still from the federal level in spite of the fact that states and municipalities increased tax revenues considerably after the 1988 Constitution. The decentralization process has also been hampered by the fact that the design is complex, especially regarding the prerequisites and certification requirements before autonomy is granted to municipalities.

Notwithstanding the numerous shortcomings of the system, the health system in Brazil has definite virtues. The purchasing side is integrated (reducing the scope for cream-skimming); the purchasing and provision functions are separated; the provision of private health goods is largely done by the private sector (private providers account for more than 70 percent of publicly funded hospital admissions); and the financing of public goods, goods with externalities, and "equity goods" (basic health measures, nutrition, epidemiological and sanitary surveillance, etc) is central, although their delivery tends to be through federal agencies rather than municipalities. Another interesting characteristic of the Brazilian system is the fact that hiring of personnel is done at the state and municipal level rather than federal level.

Chile

The decentralization process in Chile that was initiated in the early 1980s was part of a wider reform process that aimed at introducing market mechanisms in the health sector, at redefining the role of the state, and at decentralizing primary health care to the municipal level (Chile is organized as a unitary system with two government levels, the central government and municipalities). To that effect, primary health-care facilities and personnel were transferred to the municipalities, while public hospitals were transferred to the 26 quasi-autonomous health service units. One of the significant aspects of the reform has been the change in the mechanism for financing public health providers from historically based budget allocations to financing according to the quantity and quality of services provided. The financing for municipal health services was changed from a fee-for-service system to a capitation system in 1994. Simultaneously, the development of private health insurance was encouraged: Private health funds were allowed to operate and collect compulsory payroll contributions to provide private health care.

The issue of the payment of hospital personnel has hampered the efficient implementation of these mechanisms. Personnel are paid according to fixed payrolls, following pay scales and personnel administration rules that are established by the Ministry of Health. With the introduction of new payment systems (payments by Diagnostic Related Groups, or DRGs, and prospective payments), it was expected that personnel services could be included in the fee schedules. This has, however, been difficult to implement. Currently hospitals continue being paid by a combination of supply and demand financing. The issue of primary health-care personnel was solved differently. Their transfer to the municipalities led to their losing their civil servant status. Henceforward, primary health-care workers would negotiate their work conditions directly with the municipalities. In recent years, however, there has been increasing pressure from the labor unions to re-centralize the personnel hiring and management functions.

While municipalities in Chile have relatively more control over inputs than in other Latin American countries, their autonomy is constrained by the fact that the Ministry of Health determines to a large extent their primary health-care spending. The municipalization of primary health-care delivery in Chile has nonetheless been considered a success that owes much to the continued commitment of the Ministry of Health to primary health care, the clear definition of responsibilities for municipalities, the simplicity of the outputs to be delivered, the clarity and simplicity of payment mechanisms, and the improvements in municipal administrative capacity.

As a result of these reforms, the health system in Chile was transformed in several important ways: The share of people covered by private insurance plans had increased substantially (to about 27 percent of the population in 1997); the proportion of hospital beds in the public sector had decreased from 90 to 75 percent; and there was a significant expansion of rural health infrastructure and equipment. Although measures of efficiency are not readily available, there are clear indications that public hospitals are performing better (average hospital stay down, occupancy rates above 75 percent, etc.).

The health sector reform in Chile indicates a judicious use of decentralization. Decentralization is not seen as the principal instrument to increase efficiency in the delivery and financing of secondary and tertiary care. For that purpose, a partial purchaser-provider split is sought instead.

Decentralization of inputs and responsibilities to lower levels of government is, on the other hand, seen as an apt instrument to increase the efficiency of provision of public goods, goods with externalities and of equity goods.

Colombia

During the last 30 years, health sector reforms in Colombia evolved from a focus on deconcentration (1960s) to the decentralization/devolution and privatization (1990s) of service provision. Since none of these reforms was ever fully implemented, the current situation inherits a little from each of the earlier phases. Devolution started in 1990 when the Ministry of Health mandated the transfer, over a five-year period, of primary health-care facilities, personnel and budgets to municipalities, and secondary and tertiary hospital care to departments. The transfer ran into implementation difficulties (burdensome certification requirements, insufficient resources to pay for the cost of decentralization), and only a handful of municipalities took up their responsibilities.

The decentralization process was furthered with Law 60 of 1993 (Ley 60). Transfers to departments for health and education subsequently increased in a significant manner (from 15 percent of government revenues in 1993 to 24.5 percent from 1996 onward). These transfers are administered autonomously in those departments that have been certified. Transfers to municipalities for health, education, and other infrastructure expenditures increased from 15 percent of the central government's current revenues in 1994 to 17 percent in 1997 and is expected to increase to 22 percent by year 2001. The main problem that has been identified with these transfers is that they bear little relation to local health needs or to the costs of services.

In the midst of implementation of the decentralization reform, a more radical reform was enacted at the end of 1993 (Ley 100). The reforms adopted a strategy of separating financing from the provision of services; promoting competition among insurance suppliers and among service providers; providing direct targeted subsidies for the poor; and aiming at providing health services to the population irrespective of ability to pay. Two insurance regimes were created to implement the solidarity principle: a contributory regime designed to cover salaried and independent workers, and a subsidized regime for the poor (a direct subsidy to pay for a basic package of health-care services).

The decentralized character of the new system comes from the fact that the subsidized regime is administered and financed through municipalities. Municipalities are responsible for the identification of poor beneficiaries, for affiliating the beneficiaries with a private or public health insurance company (ARS, *Administradora del Regimen Subsidado*); and for authorizing the payment of the corresponding premium to the ARS. Other decentralized features of the system include the devolution to departments and municipalities of a number of financial, organizational, and personnel responsibilities, with departments having achieved a greater degree of autonomy than municipalities. The area of slowest progress has been vis-à-vis personnel management: The margin of maneuver for renegotiating salary levels and employment conditions has been almost nil. Hospitals are in the process of being converted into enterprises—hospital financing is shifting from the supply to the demand side—but progress has been slow. The process of hospital autonomization has been hampered by lack of clarity as to who will pay the pension debts and within what time-frame, and the conditions, including the state of the infrastructure, under which hospitals will be transferred.

The decentralization efforts in Colombia have been far-reaching and have brought about radical changes in the incentive structure. Among the pending issues are the fact that financing is done through transfers to states and municipalities, and is somewhat unrelated to specific health needs and costs, and the fact that because of political pressures from health workers, public hospitals have had difficulty implementing the switch to demand financing.

Mexico

The public health sector in Mexico consists of several entities. The Ministry of Health (SSA) is responsible for the definition of health sector policies and the regulation, supervision, and strategic planning for the health system, and for the provision of health care for the uninsured population (currently about 42 million people) through its own extensive network of health facilities. Alongside the ministry is the Social Security Institute (IMSS), which provides comprehensive health insurance to some 41.5 million people through its own provider network; 67 percent of IMSS health insurance revenues come from payroll taxes and 33 percent from general taxation.

Another insurance scheme, jointly funded by the SSA and IMSS, brings coverage to an additional 11 million people, mostly in rural and indigenous communities. Parallel social security schemes exist, such as those for the public employees, and for the national Oil Company. The private sector, both on the provision and financing side, is small but growing. Currently some 2 million Mexicans have private health coverage.

The decentralization efforts, initiated in 1983, constituted an effort to share political power with the state governments, to reduce the fiscal burden at central level, to rationalize the supply structure, and to improve management. The process was a gradual one, involved only 14 of the 32 states, and was limited in its scope. The process did not involve either health jurisdictions or health facilities. Resource-allocation autonomy at state level was limited to revenues obtained locally. Budget execution remained highly centralized: The share of state budgets that was executed at the state level was sensibly the same for decentralized states (24 percent in 1995) and for those states that had not been involved in the process (21 percent in 1995) (CEPAL 1998). The period was characterized by rival efforts by IMSS to deconcentrate (more with an eye to self-preservation than to promote devolution).

With the advent of the Zedillo administration in 1994, decentralization was back on the agenda. The sectoral motivations were to increase coverage and improve the quality of care for the uninsured population, and the wider political motivations were to increase the efficiency of public administration. The second phase of decentralization was initiated in 1996; it differed from the first one in that it involved all of the states, and made the sharing of roles and responsibilities between levels more explicit, but resembled it in that decentralization did not reach the level of health jurisdictions or facilities.

The second phase of decentralization brought about the creation of “decentralized public organisms” (OPDs), which are semi-autonomous state agencies whose governing board includes the state governor, a representative of the federal Ministry of Health, a trade union representative, and the state health minister. Clarity has been achieved in a number of areas: Resources from the federal level to the states are allocated according to well-established criteria; the transfer of human resources from the federal level to the states has been negotiated with the national union; infrastructure, goods, and equipment have

been transferred to the states; and municipalities have been given limited responsibilities in the areas of planning and infrastructure. Monitoring and conflict resolution are done by the National Health Council.

With the reform, the states became accountable for all health-care services for the uninsured population, and they obtained control over the execution of their health budgets. The decentralized budget increased from 4.8 million pesos in 1995 to 16.4 million in 1999. The functions of the federal Ministry of Health were concomitantly redesigned and its normative, and planning role strengthened. Spending at the federal ministry level decreased from 12.2 million pesos in 1995 to 9.5 million in 1999.

IMSS has been involved in parallel deconcentration efforts, with the creation of 7 regional directorates in 1995, and 139 medical zones in 1997 (each providing health care to a population between 100,000 and 200,000 people). These medical zones are expected to evolve into budget-holding "medical areas of autonomous management." So far, deconcentration has fallen short of the planned full

management autonomy in such areas as personnel, procurement, equipment, infrastructure, and maintenance. Plans for the current and the next few years, however, hold promises of a purchaser-provider split, involving the development of the purchasing function within IMSS and the introduction of reimbursement to providers through risk-adjusted capitation and DRG systems.

The political decentralization process within the SSA is making slow progress, and autonomy and capacity at sub-national levels are gradually being strengthened. There seems to be little or no progress, on the other hand, separating financing the purchasing from the provision function. The decentralization process in IMSS has been equally slow, but there are more explicit plans to operate a purchaser-provider split. Recent agreements signed with the Ministry of Finance and the Ministry of Auditing and Administrative Development, which aim at financial autonomy and commitments by IMSS delegations to sign agreements with specialty hospitals and medical zones, represent the initial steps toward this split.

Annex B Summary Tables

Service Responsibility at Different Levels of Government

	ARGENTINA	BOLIVIA	BRAZIL	CHILE	COLOMBIA	MEXICO
Central	Policy-making + financing and operating 4 hospitals.	Policy-making + financing + service provision.	Policy-making + financing + operating spec. national hospitals.	Policy-making + financing.	Policy-making + financing + operating spec. national hospitals.	Policy-making + financing + operating spec. national hospitals.
State, Department, Province	Health planning, coordination, hospital service provision.	Health planning, coordination, hospital service provision (with central level).	Health planning, coordination, technical assistance, monitoring.	Health regions are charged with providing tiers 2 and 3 hospital services.	Tiers 2 and 3 hospital services. After recent law, hospitals are autonomous.	All health-care services in the state (hospital and outpatient).
Municipal	Primary health-care services 19% of hospital services.	Primary health-care services (with departments and central level).	Provision of specified health care package. Contracting and financing hospital care.	Service provision of specified PHC activities.	Affiliation of the poor to the subsidized PHC package. Provision of PHC Services.	None.
Public Health Facilities	One autonomous hospital.	No autonomous hospitals.	Brazil has relatively few public hospitals. Private hospitals provide services to the SUS.	No autonomous hospitals.	Autonomous hospitals. Private insurance companies are paid to produce a PHC.	No autonomous hospitals.

PHC=Primary Health Care

Authority to Manage Personnel by Different Levels of Government

	ARGENTINA	BOLIVIA	BRAZIL	CHILE	COLOMBIA	MEXICO
Central	Only in their 4 hospitals.	National civil service regime. Salary negotiations at central level.	State and municipal regimes. State and local negotiations.	National civil service regime. Negotiations at central level.	National civil service regime. Negotiations at central level. However, private contracts can be made.	Negotiations at central level between MOH, Ministry of Finance, and the National Health Union.
State	Can hire, fire, promote health personnel. Governors appoint hospital directors.	Limited administrative matters (permits, transfers within jurisdiction).	Can hire, fire, promote health personnel.	Health regions have limited administrative duties (permits, promotions, etc.).	Governors appoint hospital directors in non-decentralized municipalities. Directors have little power over personnel.	State health secretariat appoints hospital directors. Limited personnel administrative matters.
Municipal	Can hire, fire, promote health personnel.	None.	Can hire, fire, and make contracts with service providers.	Can hire, fire, promote under the labor regime for PHC workers.	Can appoint local hospital directors, if decentralized. Can hire under contract for specific services.	None
Facility Manager	Very limited personnel management activities.	Very limited personnel management activities.	In public hospitals: limited autonomy.	Very limited personnel management activities.	In new corporatized public hospitals: Liberty to hire, fire and contract services.	Very limited personnel management activities.

Authority to Buy Inputs (Medicines, Supplies)

	ARGENTINA	BOLIVIA	BRAZIL	CHILE	COLOMBIA	MEXICO
Central	Norms and procedures.	Central procurement.	Norms and procedures. Buys supplies.	Norms and procedures. Buys certain supplies.	National procurement law.	National procurement law.
State	Norms and procedures. In some cases buys supplies.	None.	Buys supplies.	Health regions buy supplies.	Buys medicines, supplies and equipment. Limits for direct purchases vary with size of budget.	State procurement law. Buys medicines, supplies, and equipment.
Municipal	Norms and procedures. In some cases buys supplies.	None.	Buys supplies.	Buys supplies for PHC.	Buys medicines, supplies basic equipment. Limits for direct purchases vary with size of budget.	None.
Facility Director	Buys supplies.	None.	Buys supplies.	None.	Buys needed inputs with budgeted amounts.	None.

Authority to Make Infrastructure Investments

	ARGENTINA	BOLIVIA	BRAZIL	CHILE	COLOMBIA	MEXICO
Central	Only for central facilities.	Finances and contracts hospital infrastructure.	Only in national hospitals.	Finances and contracts hospital infrastructure and equipment.	Only in national hospitals	Investments in national and big state hospitals (discretionary).
State	Norms and procedures. Decision-making.		Some co-financing of local hospitals.	Health regions depend on MOH.	Investments in Tier 2 and 3 hospitals and co-financing of health-care centers.	Investments in hospitals and primary care centers.
Municipal	Norms and procedures. Decision-making.	Investments in local health centers and posts and basic equipment.	Investments in local hospitals, health centers, and posts and basic equipment.	Investments in local health centers and posts and basic equipment.	Investments in local health centers and posts and basic equipment.	Investments in basic infrastructure.
Facility Director	Autonomy over limited funds for investments.	None.	None.	None.	Can use user fees resources for maintenance and repair.	None.

Environment

Decentralized Environmental Management

S E R G I O M A R G U L I S

Decentralized environmental management has two different and related forms. First, it occurs under the broader political process of decentralization, which aims to give more power to citizens in public decision-making. Second, it is part of an economic and administrative process that aims to gain efficiency by transferring responsibilities from central levels of the public administration to local levels. Naturally, decentralization of an environmental management system (EMS) is a choice of the allocation of responsibilities across tiers of government, which in turn is a key element of the EMS of a country. Decentralized environmental management, therefore, must also be understood in the context of the environmental regulation and institutions that form such a system.

Decentralization of environmental management responsibilities is clearly not desirable per se, because it is only a means to eventually achieve a better EMS. The success or failure of decentralization therefore can only be judged in terms of its effect on the EMS as a whole—better environmental conditions, greater attention to priority problems, more transparent and participatory decisions, a greater degree of accountability by authorities, more flexible and cost-effective instruments, more efficient and effective application of regulations, etc. These features are found in EMSs of countries that are highly centralized as well

as countries that are largely decentralized. However, it is postulated here that under certain conditions, decentralized environmental management does promote many of the desirable features of a good EMS, and it should perhaps be pursued in itself as an objective of regulators.

It is nearly impossible to judge the relative success of the EMSs of various countries in the world to then draw conclusions regarding “optimal” levels and most appropriate forms of decentralization. Institutions are rooted in the larger historic, social, cultural, political and economic values of the societies around them, so models that prove successful in one country may not be applicable or even com-

parable to another. The paper reviews the experience of EMSs of selected Latin American and OECD countries and attempts to correlate the relative success of some key features of these systems to their level of decentralization.

I. Environmental Regulation and Institutions

Successful environmental management involves identifying the most critical environmental problems in a country and addressing these problems in a cost-effective manner, which ultimately results in better environmental quality. In order to facilitate this process, most countries develop a framework of institutions, regulations, and incentives that

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induce economic agents to act in a socially desirable manner. Government involvement in the environmental field is justified due to the public goods nature and the market failures that characterize environmental problems. This is the case even in industrialized countries with established commercial environments.

A prominent feature of environmental problems that fundamentally affects the EMSs of all countries is their cross-sectoral nature. Water pollution, for instance, involves industrial effluents, municipal discharges, agricultural run-off, and a wide range of economic sectors and stakeholders. Environmental regulation, therefore, is intimately related to economic regulation of other sectors. Furthermore, many of the problems originate locally and are felt locally, while others have a much broader regional or even global impact. The physical boundaries of environmental problems rarely coincide with those of existing political constituencies (municipalities and states), so the need for cooperation and coordination emerges—nationally and internationally, vertically and horizontally.

Most countries in the world nowadays have a full-blown environmental ministry, with one or more technical and action-oriented agencies giving support. Full-blown ministries clearly give environmental issues extra prominence and political visibility. This was the case, for example, in Germany in 1987, in Mexico in 1990, and in Brazil in 1992. The creation of an environmental ministry or independent secretariat, however, inevitably generates overlap of responsibilities and consequently turf battles. This is mainly because environmental ministries rarely focus strictly on environmental quality while leaving discharge regulations for the respective sectoral ministries or agencies. When this is the case, as in Chile, a potential conflict of interest arises within these ministries, since their primary responsibility is to boost the respective economic sector, whereas environmental regulation aims to protect the environment. The underlying problem may be that government institutions do not all maximize social welfare, and typically they compete more than they coordinate. Therefore, planning ministries are often left with the responsibility for ensuring such coordination, or national environmental councils are specifically created with this purpose (CONAMA in Chile and Brazil). Unless these ministries have strong political support or CONAMAs have sufficient political clout, environmental regulation is likely to be “captured” by more economic oriented regulation.

In addition to overlaps of responsibilities, the creation of an environmental ministry can induce other ministries to wash their hands of environmental problems, increasing the “police” role of environmental ministries, something most ministers tend to fiercely avoid.

II. Allocation of Responsibilities: Some Key Issues

An environmental management strategy consists of allocating responsibilities across government agencies to ensure effectiveness of policies and the minimization of costs. This means defining “who does what”—i.e., the vertical and horizontal allocation of responsibilities among government agencies together with an incentive system promoting the necessary coordination. Since environmental problems are typically felt locally, states and municipalities are often in a better position to address environmental problems, and thus should have the freedom to choose the most appropriate policies and instruments. This is the immediate rationale for decentralizing environmental management. Such decentralization eventually leads to differences in environmental quality across regions due to differences in population densities, levels of economic activity, income, environmental conditions, and others. However, while this may be economically justified and desirable, it may be politically difficult to sustain on the basis of equity and competitive fairness.

Decentralizing environmental management across tiers of government has many advantages, among which are the following:

- It allows environmental quality and policy instruments to vary across regions according to their priorities for environmental protection and budgetary constraints.
- It facilitates participation, and thus greater political and cultural representation, and transparency of the decision-making process.
- It facilitates a higher degree of ownership of decisions and accountability of local decision-makers.
- It reduces information costs. Residents of a jurisdiction know their priorities better.
- It makes the allocation of resources more likely to be efficient because decisions of local governments tend to better reflect demand for local services.
- It improves competitiveness of governments and enhances more creative and innovative instruments through local initiatives.

- It may simplify bureaucratic procedures.
- It relieves central governments from routine tasks, making them focus on policies.
- It may help national programs reach a larger number of local communities.

Still, decentralization is a mixed blessing in environmental policy for several reasons:

- Local governments may not set environmental standards high enough or may not wish to enforce them properly.
- Decentralization may make it impossible to take environmental actions on a required scale that for the most significant problems is larger than the territory of a municipality.
- The internalization of externalities created by spillovers may become more difficult: An upstream municipality may have no incentive to curtail water pollution if those who suffer are residents of other municipalities.
- Local governments may acquire administrative responsibilities without adequate powers to raise revenues or levy their own taxes, making equitable provision of services more difficult.
- Services may be delivered less efficiently and less effectively in some areas of the country because of weak administrative or technical capacity at local levels.
- Wealthier regions may receive more resources than poorer areas, while local elites may capture better services.
- Coordination of national policies may become more complex, stabilization policies more difficult to implement, and the levels and composition of overall public expenditures and public debt may be destabilized.
- Decentralization may not always be efficient, especially for standardized network-based services.

Centralized, top-down planning decisions made by governments without due consideration to the opinions and well-being of local communities has been one of the major failures of environmental management systems worldwide, particularly in developing countries. This is mainly because these governments rarely have the budgets to honor their planning decisions, and communities feel alienated and are not interested in coming up with more effective and informed solutions. Extensive or “uncon-

trolled” decentralization, on the other hand, can also be very ineffective, because local interests are also in a better position to degrade and deplete the resources faster and more efficiently. This clearly calls for some continuing role for central governments.

The extent of decentralization in policy-making is largely determined by the political system and perhaps the size of the country. Canada has a very decentralized system, in that provinces hold a high degree of power over both policy preparation and enforcement. In the United States, the main environmental authority is the Environmental Protection Agency (EPA), an independent agency reporting directly to the president. Chile has an alternative model, where responsibilities are decentralized horizontally. The aim is to mainstream environmental concerns into all aspects of economic activity. A high-level coordinating body must ensure integration of environmental concerns and avoid capture by individual ministries. Countries like Mexico and the United Kingdom have a high degree of centralization. In Germany, states and local governments only have power if it is expressly delegated to them, although local governments are in charge of the implementation of policies.

The nature of the most serious environmental problems and the type of institutions traditionally involved in the regulation of certain economic sectors also influence the distribution of primary environmental protection functions. In the United Kingdom, for example, environmental protection authority remains dispersed among a number of regulatory bodies (Department of Environment, Ministry of Agriculture, Fisheries and Food, and others) until recently. In Germany, the Ministry for Agriculture retains control over pesticides and landscape issues, together with the Ministry of Health that also has a regulatory role over hazardous chemicals. Conflicts of interest may arise, however, when regulatory and operating functions in the same sector are combined. This used to be the case, for example, in the British Water Authorities until 1989, when the National Rivers Authority (NRA) was established, separating water quality management from the privatized water companies.

Division of regulatory powers among government levels and among government ministries also varies by environmental media. The national environmental agency typically has primary responsibility for the regulation of air and water pollution, hazardous waste disposal, nuclear

safety, and, in many cases, the protection of nature. In Germany, for instance, air quality objectives are determined at the federal level, while water quality standards are set at the state level. However, many environmental issues cut across the mandates of several ministries and agencies. The particular distribution of environmental protection functions in any country will further be influenced by the nature of the most serious environmental problems in the country, and the type of institutions traditionally involved in the regulation of the economic sectors which are the main contributors to environmental problems. Box 1 discusses some key issues in the decentralized management of natural resources. Box 2 discusses

one of the most controversial issues in the decentralization of environmental management responsibilities, which is the transfer of resources to lower levels of government and the earmarking of revenues eventually collected by the sector.

III. Environmental Responsibilities in Selected Countries

This session briefly summarizes the basic structures of the environmental management systems of three Latin American countries plus the United States. The three Latin American countries present varied experiences, while the U.S. system is important as a source of inspiration for many

BOX 1

Decentralization in Natural Resources Management

Non-local groups are often in a better position to appreciate the long-term or large-scale issues involved in resource management, so they are in a better position both to act as disinterested arbiters of local disputes and to force a more comprehensive social approach to resource management. A classic example is the worldwide pressure to protect the Amazon ecosystem and various world heritage sites, where the international pressure has been fundamental to support local efforts.

This non-local perspective fundamentally concerns avoiding or managing conflicts of interest arising from externalities. Such externalities basically have to do with the way resources are managed and how they affect each different level of society. What is internal to one level may be external to another, and payments from one to another could in principle be used to compensate losing parties so that all sides are satisfied. A classic example is farm-level decisions, which are made in light of their own objectives, production possibilities, and constraints. Farmers generally seek to maximize the present value of the stream of expected net returns to agricultural production and resource exploitation. In order to adopt more conservative practices, the issue to consider is whether returns under the optimal social path (i.e., the one that considers off-site effects) are sufficiently greater than returns under the current more degrading path. Similar to agricultural production decisions, individuals and enterprises deforest because it is their most profitable alternative. To get them not to deforest, deforestation must be made less profitable, or other alternatives must be made more profitable through appropriate incentives and regulations.

Local organizations can often be very effective in generating and securing compliance with rules for the use of common property, such as water, common grazing land, or forest, and the management of buffer zones around conservation areas, all of which may be important features of watershed management. Devolving responsibility to local organizations can both externalize some costs of enforcing conservation from the state to local communities, and also reduce costs overall, by creating conditions in which non-local agencies become more efficient and effective through collaboration with local organizations.

In general, the management of natural resources depends on the area and extent of the externalities involved: The larger the extent and geographic spread of negative external effects, the more there is a need to involve stakeholders and government units from higher levels in finding solutions to resource management problems. In other words, the more extensive the externalities, the smaller the degree of decentralization that is optimal.

Source: Lutz (1999)

BOX 2

Decentralized Environmental Taxes? Earmarking Revenues

The appropriate use of the revenues from environmental taxes is, in principle, an issue no different from any other tax. In practice, however, it has been common for environmental taxes to be "earmarked" for expenditures on environmental policy measures, or to be used to raise revenues for environmental agencies or funds. Thus, for example, water charges levied in a number of European countries are earmarked to be used on water quality management, and feedstock taxes in the United States are earmarked for the "Superfund," which finances the clean-up of hazardous waste dumps. Indeed, most of the initiatives to introduce environmental taxes have arisen because of the need to find revenue sources that can be assigned to finance environmental expenditures, rather than for their incentive value.

The "conventional" view of public economics is that earmarking is a potential source of inefficiency in fiscal decision-making, particularly over the longer term. Requiring the revenues from environmental taxes to be used for given purposes would mean that the amounts spent on these purposes would change over time according to the trend in revenues from the environmental taxes, rather than according to an assessment of the costs and benefits of that allocation. Earmarking could also lead to inefficiencies in the pattern of taxation, as the tax rates might be driven by the revenue requirements for the earmarked allocation, rather than by the balance between the costs and benefits of particular tax levels. On this view, there is no reason to believe that "earmarking" the revenues from environmental taxes would lead either to appropriate levels of expenditure on environmental improvements, or to appropriate levels for the environmental tax.

This view of earmarking, however, depends on assumptions about the underlying political and administrative process that may not always be appropriate. Wheeler (World Bank, 1999b) suggests that "pollution charges are effective regulatory instruments because they reduce pollution through incentive effects." While these arguments appeal to economists and policy-makers, they cut little ice with managers of factories and municipal waste-treatment facilities. To them, the charge is simply a tax—a financial sacrifice that they have incurred for the common good. With remarkable consistency across countries, they refuse to support charges until they are guaranteed that the resulting revenues will be spent locally on environment improvement. Most industrialists and local politicians think that money rebated to the central treasury will simply disappear—into private pockets or politically inspired activities that do little to improve public welfare. Because their support is critical for instituting charges, the result is a proliferation of environmental funds dedicated to local environmental projects.

Sources: OECD (1993a) and World Bank (1999b)

other countries and because of its interesting and successful experiences in decentralized management.

United States. In the United States responsibility for environmental matters is divided between the federal government and the states. The Constitution demarcates the powers of the three branches of the federal government as well as the basis for the allocation of authority between the federal and state governments. Environmental laws may be initiated by Congress as well as by the executive branch. The executive branch is responsible for developing environmental policy and implementing and enforcing federal environmental statutes. This responsibility is vested in var-

ious government agencies, of which the U.S. Environmental Protection Agency (EPA) is the most prominent (see Box 3). The courts are an integral part of the process of environmental policy-making, implementation, and enforcement. Not only do they influence the enforcement of environmental regulations, but they also play a strong role in determining their formulation, a feature of marked contrast with most European systems.

The jurisdiction of state and federal authorities is not always very clear and has at times resulted in considerable debate and litigation. In general, broad environmental policy is made by the federal government, while the issuing of

BOX 3

Administrative Structure of the EPA

Within the executive branch of the federal government, the main policy-making body for environment is the Environmental Protection Agency (EPA), which was created in 1970 as an independent agency that reports directly to the president. Although several attempts to upgrade the EPA to departmental status have failed, in practice the EPA administrator has acted as a Cabinet member for the past 10 years.

The EPA has a mandate from Congress to regulate air and water pollution, sewage treatment, drinking water, solid and hazardous waste, abandoned hazardous waste sites, toxic substances, and pesticides. The EPA also reviews the environmental impacts of actions of other federal agencies and translates the policy goals and programs set forth in legislation passed by Congress and signed by the president into standards and regulations.

In addition to headquarters staff, the EPA has 10 regional administrators based across the country in regional offices. They are responsible for coordinating with state and local governments to ensure that regional

permits and many enforcement functions are delegated to the states. The federal government retains implementation and enforcement powers in the management of products such as pesticides and toxic substances, and when environmental impacts transcend state borders. Additionally, hazardous-waste management is largely overseen by the federal government, although this authority may also be delegated to the state level.

Brazil. Brazil's national environmental system, SISNAMA, was established in 1981, and comprises the National Environmental Council, CONAMA (see Box 4); the Ministry of Environment; its federal executive agency (IBAMA); plus states and municipal structures. The Ministry of Environment was established in 1992 and given the primary responsibility for planning, coordinating, and implementing the National Environment Policy. The federal government is responsible for establishing general

guidelines and has exclusive power in the fields of water, energy, minerals and mining, indigenous peoples, and nuclear energy, but a complementary law may authorize the states to regulate these issues as well. In other areas, such as forests, nature conservation, pollution control, and environmental liability, the responsibilities are concurrent. IBAMA is responsible for the coordination and execution of the environmental policy in the fields of nature conservation, environmental control, use of renewable resources, protection of natural ecosystems, research and development of technology, and environmental information. IBAMA is also responsible for managing federal protected areas, the protection of endangered species, and the permit and control of issues of federal interest, including international and global problems.

States are responsible for implementing federal legislation and resolutions of the CONAMA, in addition to

BOX 4

Brazil's National Environmental Council: CONAMA

CONAMA is the leading organization of Brazil's national environmental system, and its main function is to assist the president of the republic in formulating National Environmental Policy Directives. It is composed of representatives from all states, ministries, and federal secretariats, seven class associations, such as unions and federations, and 10 environmental NGOs. Specific mandates of CONAMA include establishment of norms and criteria for the environmental licensing system, establishing national environmental norms and standards, general guidelines and standards related to protected areas, criteria for determining critical polluted areas, and deciding as last instance of appeal on penalties imposed by IBAMA. CONAMA has 10 technical commissions in charge of examining and drafting proposals on norms, standards, and all aspects of environmental regulation, with members elected in plenary sessions.

preparing and implementing their own policies, which include licensing and control of most development activities. Most states have a Secretariat of Environment and a technical environmental agency, in addition to a council or commission of representatives from governments or civil society, replicating the model of the national CONAMA. States have long taken a lead in the management of urban pollution problems, notably in São Paulo, where a solid environmental agency has been established for more than 20 years and has been pushing the national environmental agenda. Except for the largest metropolitan areas, very few municipalities have developed capacity in environmental management; they are fundamentally responsible for zoning, urban solid waste, and noise.

Mexico. Centralization has undoubtedly been the most conspicuous feature of the Mexican political system. The government is currently undertaking a major effort to decentralize federal government responsibilities to state and local governments and to promote mechanisms for greater social participation. A greater involvement by states is beginning to take place, with the creation of state environmental agencies, proclamation of state and local laws, and enhancement of local capacity.

The federal Ministry SEMARNAP is responsible for the preparation of environmental policies, laws, and regulations, as well as for monitoring and enforcement with regard to most natural resources and most sources of problems. The 1996 revised National Environmental Law specifies responsibility for areas of federal jurisdiction and state frontier areas, which in themselves encompass an enormous range of issues and areas. SEMARNAP is divided into three *Subsecretarias* and five “deconcentrated” agencies, of which the most important are the National Water Commission (CNA), which handles essentially all water management issues; INE, which is the main normative agency; and PROFEPA, which is perhaps the single agency most responsible for enforcement of laws and regulations in all areas of environmental management (with some overlaps with CNA), forestry, and fisheries. This includes receiving and investigating civil complaints, promoting environmental audits, and establishing measures, procedures, and deadlines for corrective actions. It also includes the imposition of fines and sanctions, which are collected by and potentially earmarked to PROFEPA itself.

States and municipalities have had no real role in envi-

ronmental management in Mexico until two or three years ago, and this is clearly changing. The new law assigns responsibilities to states and local governments very similar to those found in the United States—namely, implementation of federal (and state) laws and regulations, and excludes issues such as hazardous materials, nuclear waste, and mining, as well as issues in federal areas or ones that involve more than one state. A striking feature of the new law is that the states remain without any relevant role in water management issues and have only a minor role in analysis of environmental impact assessments.

Chile. The legal and institutional framework for environmental management in Chile is mainly oriented toward striking a balance between environmental protection and economic development. The institutional framework is based on the sectoral decentralization of environmental responsibilities and on the existence of a coordinating structure within the executive power. There is no Ministry of the Environment in Chile. Rather, priority has been given to inter-institutional coordination to avoid internal conflicts and preserve the sectoral attribution of each of the ministries concerned.

The National Commission for the Environment (CONAMA) is the state institution responsible for ensuring coordination in environmental management. It is composed of 13 ministers of state and is subject to supervision by the president of the republic. Except in the field of environmental impact assessment, CONAMA has no executive functions, which remain vested in the sectoral ministries. Some limited responsibilities have been decentralized to the Regional Commissions for the Environment.

CONAMA's primary functions lie at the coordination level, in addition to proposing government policies to the president and acting as a body for consultation, information, and communication on environmental matters. Specific environmental legislation and norms are proposed by the sectoral ministries, with only a partial evaluation of their consequences. A flagrant immediate consequence of such a system is a lack of a more integrated, holistic, and global strategy to address environmental problems. The responsibility for inspection and enforcement of environmental laws and regulations belongs to the units and services of the sectoral ministries, of which the most representative is the Ministry of Health. This is an area that is also subject to contention, because environmental issues are not

the primary concern of these sectoral ministries, and they are often antagonistic with these ministries' key objectives.

IV. Main Characteristics of the Various Systems

In evaluating and comparing the EMSs of different countries with regard to their decentralization features, it is important to distinguish two sets of issues. The first is the specific aspect or function of the EMS that is being decentralized. Even though they are inextricably linked, it is possible to broadly separate such functions into (i) the design of policies, (ii) the choice of instruments, and (iii) their implementation and monitoring. The second set of issues has to do with the key desirable features of an EMS with regard to its organization and achievement of results: the *capacity* of its institutions to comply with legal attributions and to promote new agendas; the degree of *independence* of these institutions (i.e., their autonomy for taking decisions); their *accountability*, the other side of the coin of independence; the degree of stakeholder *participation* and *transparency* of the decision-making process; and the level of institutional and policy *coordination*, both with other sectors and across tiers of government.

Except for the degree of independence of organizations, the other four features are strongly linked to decentralization and are discussed below. It is worth noting that all of them are very hard to evaluate. For instance, how does one assess how independently a ministry operates from other ministries and political bodies or from regulated agents, how accountable institutions are to the public, or how transparently decisions are made? There are no straightforward performance indicators for any of these characteristics.

Capacity

The gap between environmental policy objectives and results on the ground can often be traced back to weaknesses in institutional capacity and legislative failures. The constitutions of many developing countries guarantee the right of all their citizens to a clean and healthy environment. The mechanisms to ensure such rights are non-existent, however, with a big mismatch between responsibilities of the environmental agencies and their budgets. The implications are typically overly burdensome implementation requirements and environmental agencies pressed to focus on what appears to be most urgent matters, but without clear medium- and long-term priorities. This is the case even in the United States where, despite the overall

good institutional capacity, legislators have frequently imposed requirements on federal agencies and their regulatory organs that they were simply incapable of fulfilling. An example was the requirement established by the Toxic Substances Control Act for separate testing rules for each chemical, which proved unrealistic. Such discrepancies between responsibilities and capacity are more likely to occur in the adversarial regulatory framework of the United States than in the European practice, where negotiations and consensus-building ensure the implementability of policies before legislation takes place.

The issue of institutional capacity is critically important in decentralization efforts. While a common rationale for decentralization is that local governments are closer to individuals and thus in a better position to respond to their specific demands, it is not clear that these governments and communities have the actual capacity to take advantage of their position and efficiently respond to local demands. Initially, this may be an issue of concern in the decentralization process. However, central governments often use the excuse of lack of capacity for refusing to transfer their authority and budgets to local levels. Sometimes what is classified by national agencies as weak local capacity is in fact a genuine disagreement between local and national priorities and political interests. Also, it is not at all clear that central governments have better capacity than local governments. Many states in Brazil, for instance, are better prepared than federal institutions to handle issues such as licensing and pollution prevention. This may be an expected consequence of the very decentralized nature of the Brazilian pollution management system.

The traditional approach to decentralization has been to build capacity before transferring responsibilities and budgets. The justification is concerns over irresponsible spending, local corruption, and service collapse. It is often even argued that the lack of local capacity may make decentralization ineffective. While such concerns are potentially valid, there is now mounting evidence that the capacities of all levels increase as decentralized services mature, and that in most cases the real concerns are the loss of power. Much evidence also indicates that decentralization increases local participation and hence local government leverage in gaining access to national resources, encouraging the development of public and private planning and management skill.

Participation

Public Access to Information and Participation in Decisions. Citizen participation is a crucial part of successful decentralization. The public has a right to expect that environmental policy-makers will act according to publicly expressed environmental objectives, and that government officials will be able to implement policies. This is clearly best achieved with decentralized systems. What's more, the process of decentralization can itself enhance the opportunities for participation by placing more power and resources at closer, more familiar, and more easily influenced levels of government.

One of the means of allowing the public to influence environmental policy is to regularly release systematic information concerning the environment in a way that is understandable for non-professionals and the public at large. Other mechanisms include

- 1) *Public hearing*, a basic device for formal public involvement mainly used on proposed changes in legislation and policy, and on proposed projects that will affect the environment (including environmental impact assessment reviews). Public hearings form an important part of environmental decision-making in most OECD countries and many developing countries as well.
- 2) *Independent technical advisory committees*, with the purpose of resolving disagreements on the technical aspects of controversial issues. If properly constituted, they should include technical experts representing all points of view. Such committees are frequently convened in the United States.
- 3) *Referendum*, where the public directly decides on a controversial question or proposed law by vote.

In the short run, all these mechanisms can help decentralization achieve improvements in allocative efficiency if local leaders base their decisions on information provided through these participatory channels. In the long run, these limited mechanisms for participation can evolve into closer and more meaningful interaction between citizens and their local governments only if leaders are democratically elected and accountable to their constituents. Box 5 summarizes public participation mechanisms in selected countries.

The Role of Non-Governmental Organizations. NGOs are an important channel for public pressure on government and for counterbalancing the influence of more powerful sectoral ministries. In many countries environmental policies and agencies were established precisely in response to such popular pressure. The role of NGOs varies widely from country to country. In the United States the tradition of citizen participation in such organizations is strong, and large memberships give clout to NGOs that can claim to represent the concerns of a large number of people. The tradition of voluntary philanthropy is much weaker in Europe, and NGOs are often dependent on the financial support of governments. Consultations often occur at the initiative of the government.

There is often good reason, however, for an arm's-length relation between the government and NGOs. NGOs are frequently burdened by their needs for fund-raising, membership, and political visibility, making them difficult partners for governments. Many NGOs focus only on a limited set of issues for which they are trying to gain political support. As a result, there are often legitimate differences of views between these two parties, with some NGOs deliberately seeking to maintain an adversarial relationship with the government. In Mexico, environmental NGOs have a significant role in policy decisions and the management of natural protected areas. It may be suggested that this is a subsector typically captured by the NGO community.

Coordination

Coordination is also critical for successful decentralization. Most "cons" listed in the opening session of this paper may eventually occur if the transfer of responsibilities and budgets to different tiers of government is not reasonably supervised and monitored by central governments and if all agencies involved are not coordinated well. Even when local capacity is strong, the transfer of responsibilities may make the coordination of national policies difficult, particularly in federal systems.

The first level of required coordination is between economic and sector ministries. Most OECD countries have recognized the value of separating regulatory responsibilities for natural resource management from resource exploitation (e.g., by placing regulatory responsibilities in a ministry of environment rather than the ministry of agriculture and forestry). In developing countries this has not always been the case, as in forestry and fisheries exploita-

BOX 5

Consultation and Participation Mechanisms in Selected Countries

United States. Public participation is the hallmark of U.S. environmental policy. Almost all federal environmental laws have required extensive forms of public involvement in their implementation and enforcement. Under the more formal "notice-and-comment" procedures, the EPA publishes a proposed rule in a public document (*The Federal Register*), while also making public all the information and analysis it used in drafting the proposal. After public comment has been received, the EPA must draft a revised regulation to respond to all citizen comments, and then to hold a public hearing to provide an additional opportunity for public participation. Under the 1966 Freedom of Information Act, citizens have the right to any information in the hands of the federal government, subject to exceptions for commercial secrets and national security. Additionally, industry is also required to disclose information such as the amounts of pollution emitted, hazardous substances in use or being stored, and emergency evacuation plans. Similar information must be released under the Emergency Planning and Community Right to Know Act of 1986.

Europe. In Britain, prior to the Environmental Protection Act of 1990 and the Environmental Information Regulations Act of 1992, most information held by regulatory agencies about pollution and the state of the environment was kept secret. There are still no administrative arrangements for direct public participation, including for reviews of environmental impact assessments, and furthermore the existing mechanisms are not well-developed. In Germany, access to official files is only allowed if someone's rights or personal freedom or property are affected by certain decisions. This seriously limits the active participation by NGOs. Consultation in general, both with NGOs and the private sector, is also limited. The closed style of decision making in Europe is gradually changing as a consequence of the European Union directives such as the Assessment of the Effects of Certain Public and Private Projects on the Environment of 1985, and the Freedom of Access to Information on the Environment of 1990. However, many European countries have been slow to change their legislative frameworks to embrace the idea of broad public participation in environmental decision-making.

Brazil. The Brazilian legal system is full of mechanisms providing public participation and awareness in environmental matters. In addition to legal actions by individuals, or groups of individuals, which are to be conducted by the Ministério Público, there are collective legal actions by class associations and public hearings (especially in the review of environmental impact assessments). The public is also represented in CONAMA through NGOs, unions and professional associations, as well as, in some cases, in the preparation of norms and regulations, where specialists and academics are invited to participate. Various mechanisms are also in place to involve the private sector. In addition to CONAMA (through the Confederation of Industries and the Confederation of Commerce, which have a significant presence in the council), an increasing number of instruments rely on a direct collaboration with polluters, such as self-reporting schemes, environmental audits, direct negotiation in the licensing process, and in the elaboration of norms and standards.

Mexico. The new national environmental law introduces social participatory mechanisms, giving individuals the right to call a meeting for information on environmental impact statements, forcing a public meeting in the area of concern to explain the activity and its impacts. Participation is strong in the drafting of policies, laws, and regulations in the area of management of natural protected areas because of the strong culture of protecting the country's very rich biodiversity. Social movements with environmental solicitation are increasingly common in urban areas. In pollution management there has recently been a strong presence of the private sector in the establishment of regulations and in voluntary compliance agreements. In the water sector, nonetheless, CNA retains its monopoly in both regulation and enforcement, with decisions not being transparent and made without consultation with major stakeholders. Partial and limited consultations exist with regard to irrigation policies as CNA attempts to create water basin agencies and commissions.

tion in most Latin American countries. This clearly originates a conflict of interest within such ministries or agencies. But even in developing countries where exploitation and conservation are kept separate, as is the case in most Central European countries, for example, the central environmental ministries and agencies have tended to be ignored by other central authorities. As a result, macroeconomic goals and policies are set with little or no consideration for their potential environmental impact. In such cases it is best to create formal mechanisms for cooperation between the environmental agencies and other ministries and agencies—for example, the U.K.'s "Green Ministers" Cabinet Committee.

In addition to coordination between environment ministries or agencies and ministries or agencies of the major economic sectors, there is a need for vertical coordination between environmental policies and actions of different tiers of government. In Brazil, though the constitution establishes concurrent responsibility over environmental matters, the *Lei Complementar* specifying the attributions of the three tiers of government has not yet been passed. This has promoted disputes between states and municipalities regarding zoning in the licensing process; IBAMA's inspecting firms and industries, parallel with state environmental agencies, in an uncoordinated manner, often causing legal disputes among interested parties; and water-resources' being regulated and "managed" by a myriad of agencies from all tiers of government (state water companies, state environmental agencies, Ministry of Environment, Ministry of Energy and Mining, Ministry of Planning, various municipalities, and others). At the federal level, in particular, there is too little coordination between the various ministries involved with pollution issues, such as Environment, Energy and Mining, Health and Planning. Even within the domain of the Ministry of Environment, IBAMA still establishes norms and regulations (instead of carrying out to its more executive duties), while the ministry itself is not technically organized to completely take over regulatory functions.

In Spain, a Sectoral Conference for the Environment meets twice a year to coordinate national and regional activities. It is chaired by the national minister and includes representatives from all 17 regions. It is responsible for coordinating and harmonizing national, regional and local norms as well as Spain's relationship to the European Union, integration of regional and national plans, coordination of

inspection and monitoring activities, and making agreements on implementation of national plans and allocation of funding. Spain has also established inter-ministerial commissions for specific policy issues, such as climate change and international environmental cooperation.

In Canada, as a result of shared responsibilities for environmental matters between federal and provincial levels, a mosaic of legislative and regulatory instruments has evolved. Such overlaps and duplication of regulations have been criticized by industry. In response to this criticism, the Canadian Council of Ministers of the Environment—the major intergovernmental forum for discussion and coordination on environmental issues of national, regional, and global concern¹—created a Harmonization Task Group in November 1993 charged with the task of developing an environmental management framework for Canada by May 1995. The aim is to review the existing environmental regime and determine a more effective and efficient definition of role and responsibilities between federal and provincial governments with regard to almost all aspects of environmental management. Several other activities will also attempt to streamline environmental regulations. For instance, the 1988 Canadian Environmental Protection Act updated and consolidated federal powers to control organic and inorganic substances, emissions, effluents, waste, and products and processes of biotechnology. The act authorizes the federal environment minister to enter into various types of agreements with the provincial governments principally to avoid duplication of effort. Agreements have been signed with two provinces, and negotiations are underway with others. Other examples include the 1994 agreement between the federal government and the province of Quebec, where all compliance activities concerning the pulp and paper industry would be carried out solely by the province.

As for vertical integration, the role of the states in environmental protection is likely to evolve. However, given the wide differences among the states, the challenge will be to find the right balance between direct federal action and independent state actions. A good example of collaboration is the establishment of independent river basin authorities to deal with the problems that typically extend over the territories of several local jurisdictions. In the United States, interstate water commissions have been formed by voluntary agreements among the states with approval of the federal government to help manage major river basins,

such as that of the Delaware River and Chesapeake Bay. Management by river basin, however, is a marked feature of West European countries, and it is perhaps the best and most successful experience in decentralized environmental management for a specific natural resource. Box 6 presents the French river basin management system.

Accountability

Accountability is the other side of the process of independence of organizations: While independence provides the autonomy and flexibility for institutions to take what they perceive as efficient and effective decisions, they must simultaneously be accountable for such decisions. Accountability is the degree to which governments have to explain or justify what they have done or failed to do. Improved information about local needs and preferences is one of the theoretical advantages of decentralization, but there is no guarantee that leaders will actually act on these preferences unless they feel some sort of accountability to citizens.

Government environmental institutions are accountable for their actions to a number of different agents in a variety of ways. They are accountable to elected government officials in terms of designing and implementing policies that must be consistent with overall government policies, which in turn have been scrutinized and approved by popular vote. To industries, major polluters, and other regulated agents, they are accountable in terms of the appropriate choice of instruments, so that regulations produce environmental improvements and are attained in the most cost-effective manner (i.e., minimizing the costs of compliance imposed on such regulated agents). Finally, government environmental institutions are accountable to the larger population in terms of responding to their real needs, identifying the priority problems, enforcing existing legislation and norms, as well as in terms of overall improvements in environmental quality.

The information is very limited on the specific mechanisms for ensuring all such accountabilities by government environmental institutions. The executive branch with powers to appoint and fire environmental agency leadership have a ready way to ensure compliance with their overall policies. The legislature also may act in defense of its constituents and require consistency of environmental regulation with other government policies and programs (particularly in terms of enforcement). Under the U.S. system of checks and balances, for instance, policy-making

responsibility is split between the legislative and executive branches, which are not necessarily controlled by the same political party. Policies that originate in the executive branch are typically modified substantially by Congress. Congress also oversees the implementation of environmental policy by the executive branch by holding hearings and investigations, and by its annual vote that determines the EPA's and other environmental protection budgets.

When institutional assignments across tiers of government are not very clearly established, the responsibility for ensuring that the overall system functions and that each agency delivers what it is supposed to deliver is also unclear. In the federal countries, for example, the main national environmental agency is responsible for checking the effectiveness of state environmental agencies. But to what extent are they capable of doing this? In Spain, for instance, the central government has an admittedly limited capacity to do this. In Brazil, even when the federal agency (IBAMA) oversees the work of the state agencies, it does not realistically impose any type of sanction or fine; states have the perception that such an approach does not work because it simply does not work in any other sectors (the most dramatic example being found in the financial sector, where until very recently the central bank has always intervened in favor of state banks). In the United States, the EPA has a formal obligation to oversee the implementation of federal laws by states. This has resulted in a significant amount of litigation. Many federal laws require the states to develop plans detailing how the state will comply with federal environmental legislation. In cases where states fail to comply, the EPA may bring them to court after warnings and negotiations.

All the cases ultimately require a system where the decision-making process is transparent, so that all segments of society can exert control over the government's performance. In OECD countries increased transparency and accountability have developed as a result of public pressure. In developing countries the experience of involving all interested stakeholders in the decision-making processes in environmental management remains limited. The trend, however, is to make decisions more transparent and to work in greater partnership with various segments of society. The more active and participatory involvement by NGOs is slowly breaking the resistance of government agencies to work in partnerships. More progress needs to be made toward working in partnership with industries

BOX 6

River Basin Management in France

The French river basin management system has shown its importance because of the various developments operated for more than 30 years. The main success of the system is perhaps the implementation of an efficient working arrangement between the various stakeholders. This process has led to the creation of two major tools in water management: levying taxes in order to find important sources of funding, and implementation of a planning process that is accepted by all stakeholders.

Each river basin in France has a river basin committee composed of locally elected officials, industrialists, major regional developers, agriculturalists, representatives of water distribution companies, fishermen, aquacultivators, associations for the protection of nature, and government representatives. Consultation with stakeholders is essential to ensure the institution of a global water ecosystem and the implementation of sustainable development.

A river basin committee

- is consulted about programs of activities prepared by the river basin agency such as development work;
- gives its opinion on the base and rate of the charges proposed by the agency to finance these activities; and
- can be consulted either by the minister in charge of water or by one of the other interested ministries or by one of the region's "*prefets*" about disputes that can arise between the "departments" and local councils or groups of them, joint syndicates, and public water management establishments, and more generally about any questions concerning the law on water.

The basin committee consists of more than 100 members and has a tripartite composition of one third local authority representatives, one third user representatives, and one third representatives of the state and the regions.

In each river basin there is a basin agency, which is a public administration body endowed with a civil personality and financial independence. Its goal is to facilitate activities related to the basin that are of public interest. To achieve this goal, the agency can levy charges on water users, public or private, with the aim of helping finance projects necessary to improve the resources or to control pollution. This is, therefore, the application of the polluters-pay and users-pay principles—and thus a financial incentive to eliminate pollution and to economize on water.

The agency's board of directors has a tripartite structure much in the same way as the committee, in addition to having a representative of the ministry of environment. There is a close relationship between the board of directors and the committee, as most of the agency's administrators are appointed by the basin committee. Furthermore, the only resources that the agency has to enable it to operate and to finance its programs cannot be put into effect without the agreement of the committee.

The French river basin management system, like other European systems such as the English, German, and Spanish ones, combines decentralized management with uniform standards. The uniform standards are the main feature of the U.S. system, where the main advantage is the simplicity and uniformity of application. By contrast, the French system has far greater flexibility, so that appropriate local standards are set within the national framework, allowing the possibility for setting priorities and realistic environmental targets consistent with available resources. The implementation of a river basin approach, however, requires a level of institutional sophistication that may take time to develop. Therefore, practical systems should perhaps combine basin management with standards. This is the approach being pursued by the new water management system in Brazil.

Sources: Kaczmarek (1998) and World Bank (1998b).

and local affected communities. This is the case of both Brazil and Mexico, but also of other developing countries in Latin America and other continents as well. Box 7 summarizes existing mechanisms in Brazil and the United States that help promote the accountability of environmental institutions.

V. Lessons and Recommendations

Decentralization of environmental management functions is typically and ideally part of a broader political

process of decentralization. The most important underlying condition for successful decentralization is serious political commitment. This means that central governments must be willing to give up responsibilities and budgets (and the political power that comes with them), and local governments must be prepared to take over such attributions, improving the overall level and quality of the services to be provided.

For this political compromise to be reached, it is necessary that a sufficient level of mobilization by civil soci-

BOX 7

Accountability Mechanisms in Brazil and the United States

The *Ministério Público* and accountabilities in Brazil. The *Ministério Público* (MP) is the main plaintiff of public civil action and is a unique agency worldwide. The MP and its attorneys are independent from the executive and legislative powers and have the duty of obedience to the law and protecting people's rights to "sound" environmental quality. Thousands of environmental actions are filed every year and are awaiting judicial decision. The MP is responsible for public civil action and inquiry, but there are other mechanisms for the public to challenge administrative acts and actions. Indeed, since 1985 there are important safeguards regarding the enforcement of environmental protection measures that cover environmental and consumer issues. These safeguards were issued to guarantee compliance with legislation and to protect people's rights to environmental quality likely to be threatened by actions or decisions of government authorities and developers. In addition to the MP, most states have now appointed special public environmental defenders.

The Role of the Courts in the United States. Under U.S. law, the role of the courts is so important that they not only influence the enforcement of environmental regulations, but can affect policy responsibility of the federal and state legislative and executive branches. This enhanced role of the courts presents a stark contrast with most European systems. The three main functions of the courts can be summed up as follows:

(i) *To review environmental regulations to ensure that they comply with the relevant laws.* The courts must ensure that the executive branch has not exceeded its statutory authority in establishing regulation, or that Congress has not delegated excessive or too vaguely defined discretionary powers to the executive branch. Second, they are to ensure that the regulations themselves are in compliance with the statute. And third, they can ensure that the procedures for formulating and implementing the regulation are in accordance with the statutory requirements.

(ii) *To review administrative discretion of the executive branch to ensure that its actions are not "arbitrary and capricious."* Executive-branch discretion in implementing environmental laws has been dramatically reduced in the United States from the early 1970s, when there was little federal environmental statutory law. Informal agency actions have become increasingly vulnerable to court challenge on the grounds that they are "arbitrary and capricious." This has enhanced the power of public interest groups, which have gained legal standing and have successfully challenged administrative discretion in a number of cases.

(iii) *To hear ordinary lawsuits among citizens under common law* that have not been pre-empted by more recent federal or state law. In this regard, courts can force the executive branch to fulfill its obligations under the environmental statutes by enforcing regulations, and can remedy citizen complaints by taking action against violators of existing laws and regulations. Congress has deliberately permitted individuals to pursue environmental grievances through the courts whether or not they are personally injured or distressed. This provision is a powerful factor in determining environmental policy in the United States.

ety be in place at the local level, so that the true benefits from decentralization can materialize. Such mobilization is also necessary to counter the resistance frequently found in central governments' administrations to transfer their legal authority. It is therefore natural that decentralization of environmental management should be associated with broader political democratization that developing countries are increasingly experiencing.

Decentralization of environmental management eventually leads to differences in environmental quality across regions, and this is economically desirable because different regions typically do have differences in population densities, levels of economic activity, income, environmental conditions, and others. The paper presented a number of potential pros and cons of decentralized EMSs, suggesting that the potential gains make the process of decentralization in principle very desirable. Nevertheless, "uncontrolled" decentralization can be very ineffective, because local interests are also in a better position to degrade and deplete the resources faster and more efficiently.

Not all environmental functions can or should be financed and managed in a decentralized fashion, and even when national governments decentralize responsibilities, they must retain important policy and supervisory functions. In addition to political will, environmental decentralization should be made in light of the size of the country, the nature of the most serious environmental problems, and the actual strengths and weaknesses of public- and private-sector organizations of different levels.

It is not possible to define in general what is an "optimal" level and most appropriate form of decentralization, because that depends on the specific institutional structure of the environmental sector. Because institutions are rooted in the larger historical, social, cultural, political, and economic values of the societies around them, models that prove successful in one country may not be applicable or even comparable to another. In any case, decentralized environmental management is clearly not desirable per se, because it is only a means to eventually achieve a better EMS. *The success or failure of decentralization therefore can only be judged in terms of its impact on the EMS as a whole.*

Setting up national environmental agencies has not been sufficient to ensure that environmental concerns are taken seriously within any government. Worldwide, such agencies have frequently lacked real power to oversee the

implementation of environmental policies, perhaps even in countries with strong environmental agencies such as the United States and Germany. The alternative model, where sectoral ministries and government agencies are responsible for the regulation and supervision of economic activities and their environmental impacts, can cause environmental protection to be subordinated to the primary objectives of the sector agencies. The same thing may occur when environmental responsibilities are decentralized to local governments, which may have incentives to overlook environmental issues. Such models require strong capacity to ensure cross-sectoral and cross media integration of the environmental regulatory framework.

The paper proposes that *decentralization is likely to contribute significantly to improving some of the key features of the environmental management systems of most countries.* In terms of capacity, the major concern is whether local governments can actually take advantage of their position and efficiently respond to local demands. Waiting for local capacity to develop before transferring responsibilities and budgets is not the way to go. Local capacity can be built in the process of decentralization, particularly when appropriate programs to increase interaction with private sector are included in decentralization design.

Citizen participation is a crucial part of successful decentralization. Decisions made with greater participation tend to be better informed and more relevant to diverse interests in society than those made only by national authorities. Conversely, the process of decentralization can itself enhance the opportunities for participation by placing more power and resources at closer, more familiar, and more easily influenced levels of government. The environmental sector is perhaps a pioneer and certainly is one of the most successful cases of participation in successful sector management.

Coordination is also critical for successful decentralization. Decentralization efforts may fail tremendously without a reasonable level of supervision and monitoring by central governments as well as a without a good level of coordination between agencies. Even when local capacity is strong, the transfer of responsibilities may make the coordination of national policies difficult, particularly in federative systems. Coordination is required both between economic and sector ministries, as well as across tiers of government. Even in Canada, a country with strong formal

mechanisms for coordination, the underlying cause of good coordination is political will.

Accountability is the other side of the process of independence of organizations. Unless politicians and decision-makers feel some sort of accountability to citizens, there is no guarantee that they will actually act on these citizens' preferences and thus materialize the key advantage of decentralization. It is therefore necessary that local communities be informed about the potential problems and solutions of environmental problems and that their choices are made so that they are binding to politicians.

In both centralized and decentralized environmental management systems, the mismatch between responsibilities and budgets has been one of the major underlying causes of failure, together with the incapacity of environmental agencies to prioritize and restrict the range of issues to address. For decentralization to succeed, it is nevertheless crucial to ensure that the transfer of responsibilities is matched by the transfer of authority to charge for environmental services or by some clearly specified financial transfers from central governments that would finance local systems. Failure to do so will necessarily jeopardize any serious decentralization efforts.

The paper illustrated three cases where decentralization is a key issue. In **natural resources management** decisions are made at the farm level and are typically different from social optimum, so there may be a mismatch between the two strategies. **Integrated river basin management** is perhaps the best-proven example of decentralized management of ecosystems. The success in some OECD countries is now spreading to the developing world, too. And the issue of **earmarking environmental revenues** has strong implications for decentralization objectives. In the case of the environment, the fiscal logic to centralize government revenues must conform to the specific features of the "sector." Experience in various countries and in various sectors suggests that some form of earmarking is necessary, at least in the short term, to launch market-based instruments.

To conclude, setting priorities and selecting flexible and cost-effective instruments is fundamental in environmental policy-making, as is the need to involve the largest possible range of interests. This is particularly important in the environmental field, where information is typically incomplete and the stakeholders are ill defined. The effectiveness of the environmental institutions will be governed more by the degree to which the process is open, accountabilities

are clear, and adequate information is available. In OECD countries, increased transparency and accountability have developed as a result of public pressure. Their specific institutional set-ups are not particularly ingenious—take the U.S. case presented in this paper as an example—but their EMSs do contain key desirable features like transparency, participation, coordination, and accountability. In developing countries, the experience remains limited, but the trend is clearly to make decisions more transparent and to work in greater partnership with various segments of society. Decentralizing environmental management responsibilities to local governments and communities is perhaps one of the best recipes for attaining these goals.

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SEMARNAP and its deconcentrated agencies

<http://www.semarnap.gob.mx/>

Spain Environment Ministry

<http://www.mma.es/>

U.K. Ministry of Environment

<http://www.detr.gov.uk/>

U.K. Environment Agency

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Endnote

1. The council consists of the Environment Ministers from each of the 10 provinces, the federal government, and the two territories.

Roads

Effective Decentralization of Roads: Lessons from the Latin American Experience

J E F F E R Y G U T M A N

Over the past decade a wave of political and administrative decentralization has swept over Latin America. Today, local authorities are publicly elected in almost every country in the region, and local governments are responsible for the execution of a broad range of public functions previously handled by national governments. Decentralization has been pursued as a strategy to improve efficiency in the provision of public functions and to reduce public sector expenditures, based on the principle that policy-makers and public administrators make better decisions about resource allocation when they are closer to the level at which activities take place. However, acting in the opposite direction are the institutional-capacity and human-resource constraints that result from the loss of economies of scale as responsibilities are moved from the national to the local level.

It is easy and often misleading, therefore, to make simplistic statements about the desirability of decentralized sector management. The transport sector, with its “lumpy” investments and combination of national, regional, and local interests, represents a particular challenge to decentralization strategists. Road, rail, port, airport, and mass transit systems all pose complex issues that must be addressed in order to evaluate the costs and benefits of decentralization and the preconditions and strategies for implementing it. In this regard, the road sector has been the focus of numerous decentralization efforts. This chapter will

present the Latin American experience in road management decentralization, provide an analytical framework for the review of these experiences, and propose some directions for the future of the road sector based on the lessons from these experiences.

Decentralization in the Road Management Sector

Roads are an important part of any country's economy. They are a productive asset used for the transportation of 60 to 80 percent of passenger and freight cargo, and they often provide the only form of access to rural communities. As such, roads are at the heart of economic and social devel-

opment. As Latin America continues to move toward regional market integration and strives to compete in the global economy, the extent and quality of its road network will need to grow, providing access to remote regions and increasing the mobility of people and goods within the region. Current road densities are still low compared with those of developed economies, suggesting that access problems still exist and that future extension of the networks will be required.

Roads also represent an important proportion of public expenditures in the region, and in many cases they represent an asset value of up to 40 percent of annual GDP. At the same time, road use generates significant tax revenues

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through the application of user charges such as fuel taxes, road tolls, vehicle registration, and license fees. Road construction and maintenance also contribute significantly to employment, especially in less-developed, labor-abundant countries. Overall, roads are big business, contributing as much as 6 percent to total GDP.

While significant improvements have been achieved over the past four decades in the expansion of road networks in the developing world, the sector confronts a persistent problem of inadequate road maintenance, which results in greater need for rehabilitation and reconstruction investments. Road agencies around the world have generally shown significant ability to build or improve roads, but have repeatedly faced difficulties developing and sustaining adequate maintenance practices. A decade ago worldwide estimates indicated that an estimated 15 percent of the capital invested in main roads in developing countries had eroded. This represented a loss of roughly US\$43 billion, or about 2 percent of the countries' GNP at that time, a sharp contrast with the estimated US\$12 billion in preventive maintenance that would have been required to keep the roads in proper condition (Harral and Faiz 1988). In Latin America, early in the 1990s, it was estimated that it would cost about US\$2.5 billion per year to deal with the maintenance backlog on the region's roads and to prevent further deterioration.

The persistence of maintenance problems cannot be explained solely as the result of a lack of technical capacity to carry out the necessary work programs. The road agencies that have been able to plan, design, and execute the significant number of road investments carried out in the past are certainly technically capable of performing the much simpler tasks of maintaining roads. A more broadly accepted explanation is found in the institutional framework within which roads are managed, and the distorted nature of the signals and incentives these institutions receive. Road administrations traditionally have had a tendency toward a "build" mentality rather than toward maintaining assets, a mentality often reinforced by political pressure. Budgetary resources have tended to be allocated to construction over maintenance, and have fluctuated significantly in response to macroeconomic conditions. Moreover, even when budgetary resources are sufficient, there are inefficiencies in the use of funds, especially in those administrations that depend on "force account"—that is, their own public sector labor force—to constrain results.

Accountability to the road users is muted because the financing mechanism (general budget allocations) is unrelated both to what users pay in terms of taxes and to increased vehicle operating costs of deteriorated roads.

A number of reforms have been applied in Latin America and elsewhere that are directed at improving the accountability of road managers and improving the responsiveness of road agencies to deteriorating road conditions. Decentralization of road agencies—devolving the responsibility for planning, building, and maintaining "non-national" roads to state and local governments—is one reform that has been promoted as a way of bringing road users and managers closer. The objective is to facilitate a greater correlation between the quality of roads that users are willing to support and those that are provided. There are a limited number of analyses of the impact of road decentralization. A World Bank review of 42 developing countries found that where road maintenance was decentralized, backlogs were lower and road conditions better. In the aggregate, the percentage of paved roads in poor condition dropped from 22 percent to 12 percent with decentralization, and the percentage of unpaved roads in poor condition dropped from 33 percent to 15 percent (World Bank 1994; see also Humplick and Moini-Araghi 1996a and 1996b).

Nonetheless, the available experience with decentralization of road management in Latin America shows mixed results. While countries such as Argentina, Brazil, and Colombia have generally benefited from decentralized road management (mostly of secondary and tertiary networks), negative experiences have led to partial reversals of the process in Peru and Bolivia, creating uncertainty about the merits of reform. There are many debates over the reasons for the success or failure of different decentralization experiences, and a deeper look into the nature of road management decentralization is required.

Several difficulties emerge in the attempt to understand the various factors involved. First, there is a need to be clear about which roads and which road management tasks are to be decentralized. Second, there has been little compilation of the experience in road decentralization across countries, and few data are available to assess the impact decentralization may have had on the performance of the sector. Finally, parallel to decentralization, other reforms have been initiated including dependence on contracting of road maintenance in place of using force account, estab-

lishment of road boards and related road funds, and concessioning and long-term, performance-based maintenance contracting, all of which raise accountability and provide “voice” for road users, but whose benefits cannot easily be distinguished from those of decentralization.

This paper seeks to address these issues by proposing a conceptual framework that can be used to understand the implications of road sector decentralization, and by reviewing Latin America’s experiences in road decentralization, in order to identify lessons and directions for the future of the sector. It argues that while decentralization can contribute to effective road management by bringing road users and managers closer together, there are a number of preconditions that must be in place or instituted as part of a longer-term strategy to ensure the realization of projected benefits.

In Search of a Model: The Latin American and Caribbean Experience

In general, three broad organizational systems can be identified for the management of road networks:

- **centralized systems**, in which the network is managed by a single, national road agency (as in the Dominican Republic);
- **deconcentrated systems**, in which regional agencies reporting to the national agency are set up to manage parts of the road network (as in Chile); and
- **decentralized systems**, in which local or regional agencies are placed under the jurisdiction of subnational governments to manage parts of the network (as in Argentina and Brazil).

These organizational systems usually reflect the broader political organization of the country. Countries with a centralized system of government will normally exhibit a centralized road management system. Similarly, countries with a high level of political decentralization and strong subnational governments will usually have highly decentralized road management organizations. A discussion of road management decentralization, therefore, must take into account the broader context of the country’s political organization, as well as country size, population distribution, and complexity of the road network. The major challenge for Latin America is to determine a strategy and establish an appropriate set of policies for countries that are in the process of decentralization. In most instances, decentralization of roads is part of a broader political and fiscal decentralization, with limited attention paid to sectoral

conditions. The lack of an effective strategy for transition in the sector has been the major weakness in most of these initiatives.

What is Decentralization in the Road Sector?

Decentralization in the road sector entails the assignment of full responsibility for specific roads to subnational levels of government. Full responsibility in the road sector involves a combination of road functions, management tasks, and financing mechanisms that are closely interrelated to ensure the integrity of the road network. The first step toward understanding decentralization in the road sector is to clearly define what it is that is being decentralized. This requires the separation, or “unbundling,” of the different building blocks that make up a road management system and that could be subject to decentralization. Thus, our conceptual framework for the analysis of road sector decentralization is based on the separate treatment of three building blocks of effective road management: road functions, management tasks, and financing mechanisms.

Road Functions

Roads are classified in different levels according to their function—that is, the role a road serves within the network and the predominant type of demand by its users. Is it a road that mainly serves a national purpose, such as connecting major cities with key border points for trade? Or is it a road that mainly serves local needs, such as getting locally produced goods to local markets? This distinction helps identify the constituency that cares the most about the characteristics and conditions of that road. Four different levels of networks are identified here:

- **national networks** (primary or main trunk), made up of roads that play a function of national interest that goes beyond the interests of the immediate communities around the road;
- **regional networks** (also known as secondary, departmental, or state networks), consisting of interurban and rural access roads that benefit mainly the broad communities of a region, state, or province;
- **rural networks** (including community roads, tracks, and trails), which provide access to outlying rural communities; and
- **urban networks** (in turn divided into metropolitan and large urban, medium-size urban, and small

urban networks), which include city roads, avenues, and residential streets.

Conceptually, responsibility for a road should be assigned to the level of government that represents the community of users who benefit most from it. In practice, however, gray areas exist regarding the designation of some roads as national or regional, and of others as regional or rural, mainly due to the difficulty in distinguishing among the various users and their travel purposes. Many roads often serve both local and national traffic. Moreover, political considerations often play a significant role in the final designation. Local representatives will often lobby for inclusion of much of their network within the national network, as a means of ensuring national funding.

There are a number of considerations in defining each type of road classification and the political, technical, and financial issues involved. For the purposes of this chapter, the focus is on the national and regional networks rather than on the rural and urban networks. Generally it is accepted by sector professionals that rural and urban roads should be devolved to state or local governments, although there remain issues of financial sustainability of such arrangements. The key debate is over the national and regional networks.

Management Tasks

The second element of road decentralization is the transfer of managerial responsibilities for the roads placed under

the jurisdiction of subnational governments. In the management of road networks, four clearly distinct tasks can be identified:

- **planning** of road investments, which includes the definition of future network requirements and the establishment of priorities for investment;
- **rehabilitation and construction** of roads, which includes detailed engineering and the contracting and supervision of works;
- **operation and maintenance** of roads, which includes periodic and routine maintenance, signaling, and sometimes policing; and
- **formulation of policies and regulations**, including regulation of road characteristics, to ensure network connectivity and safety standards, and ensuring compliance with social and environmental regulations.

Table 1 presents a framework for the consideration of options for the decentralization of management tasks in the road sector. Again, the general principle is that managerial responsibilities for a road should be placed with the level of government most associated with the predominant users of that road, as a means of ensuring greater efficiency in the establishment of priorities and the corresponding allocation of resources.

Concerns are often raised, however, about the lack of technical and legal capacity to absorb these tasks and the loss of economies of scale. Indeed, smaller countries with more limited secondary networks are not decentralizing

TABLE 1

Decentralization Options for the Road Sector

	PLANNING	CONSTRUCTION	MAINTENANCE	REGULATION
National Network	<ul style="list-style-type: none"> • Central 	<ul style="list-style-type: none"> • Central • Concession • Rehabilitation and maintenance contract • Delegation to regional agency 	<ul style="list-style-type: none"> • Central • Service contract to private sector • Delegation to regional agency 	<ul style="list-style-type: none"> • Central
Regional Network	<ul style="list-style-type: none"> • Regional 	<ul style="list-style-type: none"> • Regional • Concession • Rehabilitation and maintenance contract 	<ul style="list-style-type: none"> • Regional • Service contract to private sector 	<ul style="list-style-type: none"> • Regional
Rural Network	<ul style="list-style-type: none"> • Regional • Municipal • Delegation to regional agency 	<ul style="list-style-type: none"> • Regional • Municipal • Delegation to regional agency 	<ul style="list-style-type: none"> • Regional • Municipal • Delegation to regional agency 	<ul style="list-style-type: none"> • Regional • Municipal • Delegation to regional agency
Urban Network	<ul style="list-style-type: none"> • Municipal • Multi-municipal (metropolitan) 	<ul style="list-style-type: none"> • Municipal • Delegation to regional agency 	<ul style="list-style-type: none"> • Municipal • Delegation to regional agency 	<ul style="list-style-type: none"> • Municipal • Delegation to regional agency

road management. Experience has shown that transferring responsibility for roads from one inefficient public agency to another will not provide the necessary benefits. Technical capabilities are required to manage roads, including planning expertise and traffic engineering, investment analysis, engineering design and costing, and works planning. Changes in the use of the private sector have begun to alter the skill mix required in public agencies, reducing some in-house capacity previously considered necessary. Many agencies had depended on their own staff (force account) to carry out maintenance with the inefficiencies associated with excess staff and no fuel or deteriorating equipment. Over the last decade, governments have contracted out such work to private contractors, which has increased the need for contract management skills over works management. There have been similar contracting arrangements for design and other services. This reduces some of the technical demands on decentralization.

Another related option has been to maintain ownership at one level of government while delegating certain road management tasks to another level. Construction and maintenance activities can be delegated from the national to the regional governments in the case of the national network, to take advantage of economies of location. This is especially true in larger countries—as long as sufficient funding is provided by the delegating level of government. Delegation can also take place from the municipal governments to a regional or multi-municipal entity to achieve economies of scale and enhance network coordination. The delegation of maintenance functions to state governments is the more prevalent of these possibilities.

Financing Mechanisms

The third building block of road management is the financing arrangements for the construction and maintenance of the various road networks. It is perhaps the most controversial element, and it is essential for setting the right institutional incentives and ensuring the sustainability of the decentralization process. Perhaps the most common complaint of local authorities about road decentralization is that responsibilities are being transferred to them without the transfer of sufficient resources to carry them out. Without careful consideration of what sources of funding to use and how to allocate funding for the different networks under decentralized systems, the objective of increased accountability can be jeopardized.

There are three major mechanisms for funding roads: budgetary resources, road funds based on assigned user-charge revenues, and tolls.

The dominant source of funding for roads is the government budget. Road users have an impact only insofar as there is an effective representative governance system through which expenditure priorities are determined. The challenge for decentralization, then, is how to handle the transfer of resources to the local government to fund decentralized road management. Currently, the range of methods used, from block grants to earmarked assignment, follows the overall approach to intergovernmental fiscal transfers. Earmarked transfers do allow the national government to monitor the ability and commitment of local governments to meet minimum standards. Full funding through transfers, on the other hand, raises concerns about local commitment. The depth of decentralization can be measured by the percentage of expenditures financed locally. However, with the major user charges coming from fuel taxes, which are mostly collected at the national level and combine local and national road use, it is difficult to exclude some federal contribution except where local governments have a substantial tax base. A mixture of national transfers combined with a significant local contribution, assuming local ability to raise such funds, should offer the greatest balance between local ownership and efficient reliance on user charges. It also provides a basis for the national government to monitor progress and adjust incentives and technical assistance as required.

Road funds are another tool to implement the user-pays principle, although indirectly. The funds are generally financed from revenues generated through user charges collected at the national level, mainly fuel taxes. They are usually established at the national level, and their use is often restricted to maintenance. Formulas are often agreed upon for the allocation of the money among the different networks and the corresponding levels of government. Transport sector professionals have promoted funds as a means of ensuring adequate and stable funding for asset maintenance. Experience, however, has shown such funds to be highly sensitive to macroeconomic shocks. Thus, rather than protecting road maintenance from budgetary fluctuations, in practice the experience has been poor. In particular, finance ministries have complained of a lack of clear accountability in the use of such funds. More recently, a new generation of road funds has been developed that

incorporates a more robust accountability mechanism by creating road boards to manage the funds (see Box 1). The road boards include representatives of the various affected road users and of the public sector, and offer a management framework in which the users have a voice. It is still to be seen how these boards and related funds will evolve over time and whether they will be able to maintain a representative and dynamic exchange between the users and providers of road infrastructure.

Only the toll option offers a clear application of the user-pay principle by being location-specific. Thus, toll roads have been the basis for concessions to the private sector, which is the strictest form of commercialization of road management. Indeed, users in Latin America and elsewhere have given clear signals of their dissatisfaction when faced with what they consider high tolls for a poor level of service. However, tolls are only viable on very high-traffic

segments of the network (above 3,000 vehicles per day). On low-traffic segments, which is the case for most state and local roads, the cost of collection is too high (and therefore inefficient) compared with other tax options.

Road Decentralization in Latin America

Over the past 10 years, the majority of countries in Latin America have decentralized road management responsibilities for non-national roads. Today, approximately 80 percent of the roads in the region are under the responsibility of subnational governments. The exceptions are Chile, which has a deconcentrated road organization, and small countries with a centralized political organization (such as the Dominican Republic, Honduras, and Uruguay). In this section we review some of the Latin American experiences with road management decentralization in order to extract lessons and recommendations for the sector.

BOX 1

The New Generation of Road Funds

Key principles for road fund viability:

- The road fund should be part of a wider agenda to commercialize road management.
- Only road user charges should be paid into the road fund.
- The arrangement must not subtract revenues from other sectors (additional spending on roads must come from extra payments by road users).
- The road fund should be overseen by a representative public/private board with members appointed for three- to four-year terms.
- The road fund should be managed by a strong, independent secretariat, separate from the main road agency.
- Independent technical and financial audits must be carried out.

Key operational features of the road fund:

- Use of funds is usually restricted to financing of maintenance activities.
- The road fund should fully finance the expenditures associated with the national network.
- Regional and municipal road expenditures should be financed only through transparent cost-sharing arrangements that strengthen financial discipline.
- Subsidiary road funds may be set up to finance urban or rural roads.
- Revenues should be collected using a tariff consisting primarily of a fuel tax, vehicle registration fees, a supplementary heavy-vehicle fee, international transit fees, and fines for overloading.
- There should be consistent procedures for raising and lowering the tariffs.

Source: Heggie and Vickers (1998).

Testing the benefits of decentralization is difficult. As indicated earlier, the main weakness in road management has been the lack of maintenance. Thus, the key measure of success would appear to be the condition of the network before and after decentralization as indicated by a series of engineering indexes. While this measure is essential, it is complicated by the need to define what is an appropriate, economically viable condition. Roads with less traffic do not warrant the same level of maintenance or condition as roads with more traffic. One would also want to test the cost or efficiency of maintenance. Here a more qualitative approach is applied. Unfortunately, not enough data are readily available to properly compare the performance of road agencies in Latin America. This is particularly the case where road management decentralization has taken place, since it makes it harder for national agencies to collect and organize data from the various regional agencies. Nonetheless, some clear observations can be made from a review of some of the experiences in the region.

Where Political and Fiscal Decentralization is Well-Established

Road decentralization has worked best when it has been implemented in a country where political and fiscal decentralization is mature and well-established, and where it is treated as part of a set of sector reforms that include (1) a clear separation of institutional responsibilities between different levels of government, and (2) the establishment of adequate mechanisms for the financing of road maintenance and investment. This is illustrated by the Argentine experience.

Argentina has a federal system of government, with 24 provinces. The country's road network is classified into national, provincial, and municipal roads. The National Road Directorate (Dirección Nacional de Vialidad, or DNV) is responsible for management of the national network, while each province has its own Provincial Road Directorate (Dirección Provincial de Vialidad) for management of the provincial networks. Municipal networks, including urban and rural roads, are the responsibility of municipal governments. Each level of government is responsible for financing road maintenance and rehabilitation of its corresponding road network, with resources coming from general revenues and from the revenues generated by the application of road-user charges. Since a fuel tax is applied and collected at the national level, the federal gov-

ernment transfers funds to provinces and municipalities according to a transparent formula agreed to by all and monitored by a Federal Road Council (Consejo de Vialidad Federal). The Council serves as a forum for the coordination of national and provincial agencies, mainly regarding the planning of new roads and the appropriation of earmarked funds from the fuel tax revenues for road investments at the provincial and municipal levels. These transfers account for about 35 percent of the resources used by subnational governments for roads, evidencing the high level of local ownership over the local road networks. Funds for the national network are provided from direct user charges (tolls) and from the national government's general revenue.

Argentina's decentralized system of road management has been successful in ensuring adequate maintenance of the road network at the various levels. The division of responsibilities between levels of government has been stable over the last 10 years, as has been the financing of the sector. At the national level, there has been a clear trend toward increased use of private sector contracting for road maintenance. Current discussions in the sector center on the extent to which concessions can be used for the development of new roads, and on the sustainability of contracts with the private sector in the event of macroeconomic instability and external shocks.

Brazil's experience also shows that when a clear separation of institutional responsibilities is made and adequate financial mechanisms are put in place, the decentralization of road management results in improved road conditions. Brazil is also a federal system, organized into 27 states with strong traditions of regional government. In 1988 a new constitution gave ample powers to the states to raise their own taxes, including a fuel tax. Until then, most taxes had been centrally collected and then partially redistributed to the states; this included fuel and vehicle taxes, which were partly earmarked for roads and redistributed to the states through a formula. The new constitution transferred some taxes to the states and municipalities, including a consumption tax (similar to a value-added tax) and the fuel and vehicle taxes. Earmarked funds were terminated. Expenditure responsibilities, however, remained unchanged. The state governments, now funded through their own consumption taxes and transfers from federal tax revenues (income and industrial taxes), have increased their revenues. However, with surplus labor and high debt plus the disappearance of the inflation tax (after the implemen-

tation of the Real Plan in 1994), few states have had sufficient resources left for investment. Nonetheless, while important regional differences in institutional and fiscal capacity exist, the states have assigned a high priority to road maintenance and rehabilitation, because most of them have been able to raise adequate funds to meet the needs under conditions of important fiscal constraints.

Brazil's experience illustrates the complexities of decentralized road management. In Brazil, the granting of additional fiscal powers to the states was unrelated to the allocation of responsibilities for road management, even though one of the key new revenue sources (the fuel tax) is directly associated with road use. The National Roads Department (Departamento Nacional de Estrada de Rodage) remained responsible for more than 67,000 kilometers of federal roads, even though it had lost the significant revenues from the fuel tax. Between 1990 and 1997, however, the conditions of the federal network improved, reducing the number of kilometers of paved roads in poor condition from 30 percent to 11 percent. These improvements have been financed from federal general revenue, which highlights the priority of the sector relative to other sectors.

A recent review of the federal network based on road functions suggested that about 18,000 kilometers should be reclassified as state roads. This is the next challenge for the road sector in Brazil. The states have shown interest in assuming responsibility for additional roads, but they have expressed concerns about the poor condition of the roads that are to be devolved. There have also been occurrences of states' abandoning portions of devolved roads after being unable to concession them to the private sector or to maintain them on their own. These situations emphasize how difficult it is to establish and maintain a clear classification of road functions while network responsibilities are under different levels of government. In the end, the challenge is to establish transparent financing mechanisms for road management (maintenance, rehabilitation, and new investments) that correspond to the allocation of responsibilities across different levels of government (the principle that "finance follows function") and that provide the right incentives for the behavior of road agencies.

Benefits to National Networks of Devolving Non-National Roads

Both Argentina and Brazil are countries with long-standing traditions of decentralized government, and both have

strong regional governments with relatively high levels of institutional capacity. Naturally, we expect decentralized road management to work best under such circumstances. Elsewhere in the region, decentralization of road management has taken place over a short period of time, usually parallel with or shortly after a broader process of administrative decentralization. Under such circumstances the challenges are greater—and so is the risk of failure. Therefore, prudence suggests a gradual approach, which is supported by the available evidence. Decentralization of secondary and municipal networks as a first step in the process of reform has contributed to the clarification of the roles and responsibilities of the various levels of government, directing political attention from each level of government to the corresponding network level. In this respect, the first positive impact of decentralization of regional and municipal roads is that it serves to keep local politics at the local level, thus protecting the national network from political pressures that tend to divert resources and managerial attention to issues that are not of national importance.

Colombia's experience illustrates this point. In 1993, 32 percent of the road system under the national government was transferred to the regional departments under an arrangement that included agreed financing for operation and maintenance for three years. As a result of this transfer, the national road agency was able to focus on the improvement of the national network. In five years, the national network has become a well-defined system of trunk roads and corridors, and rehabilitation and maintenance practices have improved significantly. This is clearly a positive result from decentralization, even if somewhat counterintuitive. On the other hand, departmental road agencies show weak administrative and technical capacity, and conditions of the regional and local networks remain poor. The challenge under these circumstances is to strengthen institutional capacity and to set up adequate and reliable financing mechanisms at the local level in a relatively short period of time. Otherwise, there is a risk that local authorities may forfeit their responsibilities, or that public pressure may be mounted for the national agency to retake the roads, resulting in the reversal of the decentralization process.

Dangers of Rapid Decentralization

The arguments in favor of a gradual approach to road decentralization are further strengthened by the negative

experiences in Peru and Bolivia, where there was rapid, wholesale decentralization. In Peru, all roads were transferred in 1984 to the recently established regional governments, including portions of the national network that had profitable tolls. The recurrent use of toll revenues to finance activities outside the road sector led to inadequate road maintenance and the decay of key portions of the national network. As a result, in 1991 the national authorities decided to recentralize the national network. While 78 percent of the total road system remains in the hands of the regional and local governments, regional agencies are poorly funded and institutionally weak. Today, they depend heavily on technical and financial assistance (and at times direct involvement) from the Ministry of Transport for almost every important activity. Road conditions in key sections of the national network have improved since recentralization, but the majority of the roads are deteriorating beyond the capacity of the central ministry to respond.

In 1995 Bolivia embarked on a broad process of administrative decentralization. The road sector had been organized in a system of nine deconcentrated districts under the national roads agency (Servicio Nacional de Caminos) that was responsible for the primary and secondary networks and some municipal roads. With decentralization these organizations were placed under the jurisdiction of the regional governments (*prefecturas*). In addition, a number of regional development corporations that had been partially responsible for the tertiary network were pulled out of the sector. The Ministry of Transport was reorganized as a secretariat under the Ministry of Economic Development, receiving an unclear mandate and losing considerable clout and support at the national political level. While the entire network was being transferred to the *prefecturas* at the same time that other sectors were being decentralized, no source of financing other than tolls was provided. Many of the experienced staff of the deconcentrated districts retired or left the sector during the reforms, leaving the departmental agencies with few resources for managerial and road maintenance practices. As a result, road conditions deteriorated to such an extent that in August 1998 the central government decided to step in and retake the management of the national network.

Venezuela is a case of varied results that deserves attention. The Decentralization Act of 1989 brought about broad political decentralization to the country and established the

responsibilities of the municipal, state, and national governments in a number of aspects of public life. With respect to roads, the act established that states could have "exclusive or shared" jurisdiction over all primary and secondary roads, bridges, ports, and airports in their territory. It also established that any transfer of responsibilities from the central government would take place through negotiated agreements, and that the states would annually prepare coordinated investment plans that had to consider the specific amounts to be provided by the central government.

Almost 10 years later, the results of this arrangement have been mixed. Local governments have proven to be better able to manage the road network than was the Ministry of Transportation, but most states face institutional and financial challenges to various degrees, which may threaten the sustainability of the reforms. One of the main problems is that financing for the sector varies significantly from year to year due to fluctuations in the value of oil exports (which are the source of more than 50 percent of total public sector revenues) and to the absence of significant road-user charges. In addition, significant differences exist in the institutional and fiscal capacities of the 23 states. Thus, this demand-based decentralization process has resulted in important discontinuities in the conditions of the national network, because many states have not been willing or able to fully assume their responsibilities. While this is an ongoing process, it is not yet clear whether it will be sustainable over the long run. This experience also highlights the importance of clearly separating the roles and responsibilities of the different levels of government, setting up adequate financing mechanisms for the sector based on road-user charges, and taking measures to preserve the connectivity of the overall road system.

Contributions of Parallel Reforms

In addition to establishing a clear separation of responsibilities between levels of government, road agencies in the region have made strategic use of the private sector for the management of high-volume roads, awarding long-term concessions for their rehabilitation and maintenance. Private sector participation has been sought as a tool to (1) secure adequate technical and managerial capacity for road management (maintenance, rehabilitation, construction); (2) establish clear accountability for performance; and (3) provide adequate financing for road management through commercialization of road use.

As discussed earlier, concessions are the clearest form of road commercialization. In the 1990s more than US\$35 billion has been infused into the road sector through private sector concessions in 13 countries in Latin America. The leaders in this area have been Mexico (53 concessions), Argentina (19 concessions), Colombia (12 concessions), and Chile (10 concessions). The broad experience in the region with road concessions confirms that the commercialization of roads does have a number of positive results:

- Projects are completed on time.
- Modern technologies are applied.
- Higher road standards are achieved and maintained.
- Additional services are provided to users (for example, service stations and emergency attention).
- Additional financial resources are made available.
- Greater clarity is achieved in the analysis of the risk associated with investments.

However, the applicability of this model is limited due to high-traffic volume required to be financially sustainable, even with government guarantees or subsidies. Furthermore, due to the long periods of time required for the recovery of investments (often 20 years), concessions are highly vulnerable to macroeconomic fluctuations and require a clear and reliable regulatory framework.¹

As an alternative to road concessions, long-term, performance-based rehabilitation and maintenance contracts (known as CREMA, from the Spanish *Contrato de Recuperación y Mantenimiento*) were introduced by Argentina's DNV in 1997. The CREMA is a long-term, performance-based contract with a private firm designed to secure funding for road maintenance while creating incentives for cost-effectiveness and timely performance in the execution of works and routine maintenance activities. Since 1997, 61 CREMA contracts have been awarded in the country, covering 12,000 kilometers, with an average cost of US\$11,000 per kilometer per year (including rehabilitation and maintenance). Box 2 presents the key features of this new instrument. The CREMA model is also being implemented in Chile, Colombia, Guatemala, Paraguay, and Uruguay.

Delegation of National Roads

As the capacity of local agencies improves and the national mechanisms for the collection of road-user charges and the allocation of funds across networks become more reliable, national authorities have also considered the delegation of management tasks to regional agencies under performance-based contracts with well-defined sources of financing. For

BOX 2

Key Features of the Contrato de Recuperación y Mantenimiento (CREMA)

<i>Activities include:</i>	Contract combines initial works (rehabilitation of road, signaling, surroundings) with road maintenance activities over the duration of the contract.
<i>Payment:</i>	Contractor is paid a fixed amount for the achievement of predetermined standards for road conditions—usually up to 45 percent for the execution of initial works during the first year, and the balance in equal monthly payments during the remaining period.
<i>Quality standards:</i>	For paved roads: International Roughness Index below pre-established ceiling, no potholes allowed, maximum times established to correct cracks and other problems, execution of agreed maintenance activities, signals, drainage, surroundings, and other aspects.
<i>Duration:</i>	Usually four to five years. Length of contract provides incentives to ensure adequate quality of works, planning, and equipment of the contractor.
<i>Award:</i>	Contract is awarded through competitive bidding to the lowest bidder.
<i>Road agency role:</i>	Delegates operational responsibilities to the contractor (that is, planning and execution of works, selection of technical applications). Role of the road agency shifts to conceptual (and sometimes detailed) design of project, plus supervision and regulation of contracts.

example, Argentina's DNV was revamped in 1992 and given a mandate to gradually involve the provinces in the operation and maintenance of the national network. Since 1995, routine maintenance of about 7,000 kilometers (25 percent of the national network) has been delegated to the provinces through two-year, activity-based and unit-price-paid contracts. To a lesser extent, a similar experience is taking place in Brazil, where the authorities are discussing the merits of completely delegating the management of the federal network to the states. These experiences, however, have come after the states (or provinces) have developed track records of effective management of their regional networks. The experience of the region strongly suggests that considerations about the decentralization or delegation of the national network should really take place after the decentralized management of regional and municipal networks has been consolidated.

Conclusion

It is clear that while the concept of decentralization is accepted as a means of aligning government responsibility for roads more closely to the users, in practice the results have varied widely. Much of the variation can be attributed to the fact that the main impetus for decentralization has come from the broader democratic political decisions that were not specifically designed for any one sector in particular. As a result, the transport sector has had to adapt to the various systems that have evolved. There are countries that have begun to show positive results (for example, Argentina, Brazil, and Colombia), and there are countries that have had to seriously reconsider and retrench (Bolivia and Peru). These cases, however, offer a set of lessons on which to build future initiatives as the broader drive for decentralization spreads throughout the region.

There has been a marked change in the attitudes of most national governments toward the relative importance of maintaining their road assets and the costs of not caring for those assets. In the past decade, Latin American countries have pioneered a wide range of efforts to address road network deterioration through a combination of strategies that has included institutional strengthening, concessions and service contracts to the private sector, increased budgets and dedicated trust funds, and decentralization and delegation of responsibilities to subnational governments. The most striking result has been the visible improvement in several countries of the conditions of the national (pri-

mary) road network. While it may be difficult to attribute this result systematically to decentralization, it does appear, although ironically, that decentralization has played a role by allowing central agencies to concentrate human and financial resources on a more limited network of national roads. Just being able to draw a political firewall between the national versus the local networks seems to provide benefits that are reinforced through the institutional reforms of national road agencies and, in particular, through the move away from force accounts to private contracting.

The evidence of the impact of decentralization on state and local roads, however, is less clear. It could be premature to draw any conclusions at this point, because we are less than a decade into many of these experiences, and the development of local governance and technical and managerial capabilities at the local level takes time. It has been in those countries with more developed forms of local governance that road sector decentralization has been more successful. The danger is that inadequate design of decentralization strategies will lead to frustrations and disincentives that could jeopardize the whole process.

From the experience in Latin America and elsewhere in the world, a number of preconditions can be established as critical to the success of a road decentralization program:

- Decentralization of road management can take place only where there is an adequate level of local governance, in terms of legal, financial, and community participation.
- When there is little tradition of decentralized governance, a gradual approach to road decentralization should be followed, transferring first responsibilities for regional and urban municipal roads, while retaining management of the national network at the national level.
- When decentralizing road responsibilities, the designation and classification of road functions should be clearly related to the assignment of political responsibility for the roads. Thus, municipal roads should be placed under municipal governments, state roads under state governments, and national roads under national governments.
- Similarly, the management responsibilities associated with the roads to be decentralized (planning, construction, operation and maintenance, and regulatory policy) must be clearly allocated, avoiding

overlaps among the responsibilities of different levels of government.

- The mechanisms and framework for ensuring adequate financial resources should also be aligned with the devolution of responsibilities. They should be structured to reflect local commitment to road maintenance and development while allowing for cross-regional redistribution of resources in order to maintain national standards and network connectivity.
- Special attention should be given to the assessment of technical capabilities of the receiving institutions, and the time frame for devolution should recognize the need for the transfer of technology and the dynamics of capacity development.
- A system of monitoring and physical and financial accountability should be put in place, in order to have sufficiently accurate information about the progress made and the difficulties encountered, so that corrections can be implemented in a timely manner.

The process of road decentralization should include formulating an implementation strategy to carry out the reform within a time frame that takes into account the effort required to put these preconditions in place. Within countries, the capabilities of local governments, whether states, provinces, cities, or municipalities, will vary considerably. Experience shows that it is possible to move more aggressively in certain localities, while taking a longer-term strategy for those localities that require support in any of the key areas.

The most difficult but essential elements, however, are the financing mechanism and the design of national-to-local resource transfer mechanisms in line with incentives to maximize the generation of local resources. As has been said earlier, the difficulty arises from the indirect nature of the user-charge instruments for raising road revenues, most of which accrue to the national government and are then

transferred through various approaches to local governments. Moreover, the design of the transfer mechanism must be consistent with the overall transfer of resources under the decentralized regimes, many of which have been criticized for not being sufficient or equitable and are seldom related to road planning and management. This chapter has identified several new instruments that are directed at making such transfers more transparent, and that incorporate the views of the users in a framework that holds road agencies at the national and local level accountable to the public. The challenge will be to see how these various initiatives perform under the strains of macroeconomic and political instability.

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Endnote

1. The rural and urban networks are sometimes put together under the label of local or municipal networks because in most cases they are the responsibility of municipal governments.

Local Sanitation

Decentralization and Municipal Solid Waste Management: Lessons from a Decade of World Bank Lending

C A R L R . B A R T O N E

While solid waste is arguably the most decentralized service worldwide, few municipalities in low- and middle-income countries are doing a good job of service delivery. This paper discusses key issues and problems associated with municipal solid waste management projects, and recommends strategies for addressing the issues. It is based on an analysis of the experience gained through 72 solid waste management projects supported by the World Bank over the past decade, with investments totaling more than US\$1 billion. Foremost among the conclusions is that a more comprehensive policy framework is needed at national and local levels to link public health, environmental, and decentralization policies more closely together so that they are mutually supportive. To improve future projects, more attention should be given to strategic service planning, better institutional arrangements, more efficient operational management, more effective financial management, and improved environmental protection. This paper offers specific recommendations for each of these priority issues. Finally, the paper provides information on the recent establishment of a collaborative donor working group and its program of activities.

Introduction

Municipal solid waste management (MSWM) is an integral but much neglected part of cities' urban environmental management. Although it consumes a major share of municipal budgets—often 10 percent to 50 percent of operational expenditures—solid waste services in the cities of most low- and middle-income countries are unreliable, provide inadequate coverage, interfere with other urban services, and have adverse effects on public health and the urban environment. Finding and implementing cost-effective and affordable solutions requires a strategic focus.

While MSWM is a municipal responsibility in most countries, it has often been neglected. The process of decen-

tralization in many countries over the last decade has raised the consciousness of municipal administrators about the importance of this sector—both because the voting public is now demanding improved urban services, and because the provision of this service represents a major expenditure item for local governments. At the same time, there is increasing pressure on municipalities from state and national environmental agencies to properly dispose of the solid waste that is collected, often in the form of an “unfunded mandate.” There are, however, a number of issues that must be addressed to achieve substantial improvements. An analysis of projects supported by the World Bank helps to identify these issues and offers suggestions for addressing them.

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World Bank Support for Urban Waste Management

Two major reviews of World Bank lending for solid waste management (Bartone et al. 1989; Gopalan and Bartone 1997) provide the data and the historical perspective for the policy analysis presented in this paper. In particular, the more recent report gives an in-depth assessment of the 10-year period from 1988 through 1997, and has provided guidance for recent initiatives to improve the effectiveness of Bank support in this sector.

The first dedicated solid waste management project supported by the World Bank was for Singapore in 1973, and lending has steadily risen since then. During the 10-year period 1988 through 1997, the World Bank provided financial and technical assistance for 72 projects totaling over US\$1 billion. The distribution of projects and funds by major region is shown in Table 1.

Only three of these projects have been dedicated solid waste management projects. Many of them have been components of broader municipal development or modernization projects. Others have also been components of urban environmental management projects, water supply, sanitation and pollution control projects, environmental institution building projects, low-income area development projects, or emergency reconstruction projects.

TABLE 1
World Bank Lending for MSWM by Region, 1988-97

REGION	NUMBER OF PROJECTS	VALUE OF PROJECTS (US\$ MILLION)
Latin America and Caribbean	21	340
Asia and Pacific	20	373
Eastern Europe, Central Asia, North Africa and Middle East	14	240
Sub-Saharan Africa	17	91
TOTALS	72	1,044

Source: World Bank

The majority of solid waste projects or components have included support for solid waste collection activities, about half have supported sanitary landfill development, and fewer than half have taken an integrated approach to municipal solid waste management. The latter are among the most successful and have had the greatest impact at the local level. As an example of an integrated project, refer to the Belo Horizonte case in Box 1.

The lessons learned through these Bank-supported solid waste projects and extensive interaction with clients point to a number of key issues and problems associated with municipal solid waste management in low- and middle-income countries, and to strategies for addressing them. The issues and the strategies are summarized in the fol-

BOX 1

Integrated System of Solid Waste Management in Belo Horizonte

Beginning in 1993, with the advent of a new municipal administration, the *Serviço de Limpeza Urbana* (SLU) of Belo Horizonte formulated and implemented an integrated waste management strategy. Today, just four years later, Belo Horizonte's integrated system is fully functional and is being held up by others as a system to emulate. The SLU strategy included the following three basic modules:

A **technological model**, based on the concept of differentiated management and recycling of wastes, provides an integrated and rational solution for such wastes as construction debris (which makes up 33 percent of the waste stream), organic wastes (25 percent of the waste stream), recyclable materials, and hospital wastes. Thus the technological model includes differentiated collection systems, three materials-recovery plants, two construction debris recycling plants, a composting plant, and the conversion of the BR-040 landfill to an anaerobic bioreactor landfill, which will extend its life from two to 18 years.

The second module focuses on the **modernization of SLU** and includes quality management based on worker participation, the introduction of efficient management instruments, and an intensive human resources development program.

Third, **active citizen participation** is promoted through a permanent dialog between SLU and the community, stressing concepts of mutual responsibility and accountability.

Source: Tavares-Campos and Abreu (1996)

lowing sections. It is encouraging that most of the 20 proposed solid waste projects in the Bank's current pipeline are being designed to take account of these issues and provide integrated waste management solutions.

Issues in Urban Waste Management

Municipal solid waste management is often the most costly and vexing problem for local authorities. There is low service coverage, especially in low-income neighborhoods. On the management side there are substantial inefficiencies at the same time that there are insufficient resources. And in too many places there is still widespread open dumping. The result is a high cost to society in terms of public health and environmental degradation. The following issues need to be addressed if real improvements are to be achieved:

- the extension of service coverage, especially into poor neighborhoods, based on the concepts of demand management and affordability;
- the closure or rehabilitation of existing open dumps while protecting the livelihood and health of waste pickers and their families;
- the introduction of sanitary landfills as the backbone of disposal operations, often in the face of strong social opposition (the NIMBY—Not In My Back Yard—syndrome);
- the integration of complementary systems such as transfer, selective collection, recycling, composting and/or waste-to-energy, where it makes economic sense, together with public education campaigns and incentives for waste reduction at source;
- the definition of better waste management systems for the health-care industry;
- the introduction of adequate user charges and collection mechanisms so as to achieve self-financing, along with needed cost accounting and management information systems;
- the promotion of private sector participation, including micro- and small-scale enterprises, as a response to often weak municipal operational capacity; and
- the development of cooperative mechanisms that would enable municipalities to undertake shared disposal solutions, especially in metropolitan areas.

Strategies for Improvement

To better address this set of issues, progress on five fronts is needed simultaneously. First, an integrated, comprehen-

sive strategic planning framework should be adopted at the national and local levels, especially for large metropolitan areas. Second, better institutional arrangements are needed in the sector. Third, there is a need for more efficient operational management. Fourth is the need for more effective financial management. Fifth, attention should be given to improving environmental protection. Each of these five strategies is discussed in greater detail below.

Strategic Service Planning

Large municipalities and metropolitan regions should be encouraged to undertake citywide strategic planning to design and implement integrated solid waste systems that are responsive to dynamic demographic and industrial growth. Strategic planning starts with the formulation of long-term goals based on the needs of a particular municipality, followed by a medium- and short-term action plan to meet the goals. The strategy and action plan should identify a clear set of integrated actions, responsible parties, and the human, physical, and financial resources required. The citywide strategic plan should match service levels to user demand and affordability, especially for the urban poor. It should also integrate all components of the service system—minimization, collection, transfer and transport, recycling and treatment, and final disposal.

A more comprehensive policy framework is also needed at the national and provincial level. It should link public health, environmental and decentralization policies more closely together so that they are mutually supportive. It should also provide incentives to municipal authorities to deliver better services, recover more costs from users, and cooperate with neighboring municipalities.

For smaller or weaker municipalities, there should be a focus on technical and financial assistance. Also, the economies of scale resulting from grouping smaller municipalities and sharing facilities can significantly affect the affordability of services, particularly disposal operations. The main roles of central authorities should be to establish an appropriate policy and regulatory framework, carry out institutional reforms, and provide technical assistance and access to finance for local authorities.

The overall goal of solid waste management should be to collect, treat and dispose of solid wastes generated by all population groups in an environmentally and socially satisfactory manner using the most economical means available.

One attempt to define a comprehensive framework has been developed as part of a collaborative donor program (described in final section below) on municipal solid waste management (Schubeler et al. 1996). The schematic approach to integrated solid waste management is shown in Table 2. The authors stress that all comprehensive projects must deal with these elements.

An integrated MSWM system starts with the collection and transport operations, and ends with final disposal in a sanitary landfill. These are the essential building blocks of any SWM system. In between, additional operations such as transfer, resource recovery and recycling, and treatment (for example, composting or incineration) are included as needed. Decisions about added operations will depend on both technical and economic or financial feasibility, as well as social acceptability (as household and business participation is essential). These intermediate operations may also require that waste streams not be mixed indiscriminately, which in turn may necessitate household segregation and special storage, collection, and handling of some waste streams—always at increased costs. Whatever recycling or treatment may take place, there will always be significant residuals or rejects that require landfilling—typical recycling rates reach 25-35 percent and may take a decade to achieve, while compost rejects are about 40-45 percent and incineration ash 15-20 percent of the original waste by weight. Markets for recyclables and compost must also be verified. These considerations point out the need for a comprehensive study of options, selecting the best mix of

options based on affordability and cost-effectiveness criteria, and public education and participation as the basis for long-term success.

Better Institutional Arrangements

More effective institutional arrangements involve putting in place inter-municipal and inter-sectoral coordination mechanisms. Especially in metropolitan areas, inter-jurisdictional conflicts are a major concern. In the absence of genuine metropolitan authorities with functional responsibilities for infrastructure planning and management, special agreements often voluntary in nature will have to be crafted among municipalities for the development of shared facilities for transfer and disposal. These agreements must include joint decision-making mechanisms and cost-sharing for operating and financing facilities. Even for smaller municipalities, a shared sanitary landfill is economically attractive because of the high economies of scale and joint cost savings.

On the other hand, there is little need for joint municipal solid waste collection activities due to low economies of scale but significant economies of contiguity. Most municipalities can manage collection services on a disaggregated scale, including the competitive contracting out of collection districts with private haulers.

Another area in need of attention is to provide greater opportunities for public participation in the decision-making process, especially for facility siting. Several Bank-supported projects have suffered major perturbations and time

TABLE 2
Integrated Framework for MSWM

WHAT? (FUNCTIONAL SCOPE)	WHO? (STAKEHOLDERS)	HOW? (STRATEGIC ASPECTS)
<ul style="list-style-type: none"> • Planning & Management <ul style="list-style-type: none"> - Strategic planning - Legal/regulatory framework - Public participation - Financial management - Institutional arrangements - Disposal facility siting • Waste Generation <ul style="list-style-type: none"> - Waste characteristics - Waste minimization • Waste Handling <ul style="list-style-type: none"> - Collection - Transfer, treatment, disposal - Special wastes 	<ul style="list-style-type: none"> • Local government • National government • Service users • Private sector • Informal sector • NGOs • Donors 	<ul style="list-style-type: none"> • Political • Institutional • Social • Financial • Economic • Technical • Environmental

Source: Schubeler et al. (1996)

delays as a result of the NIMBY syndrome, which is as active in developing countries as in industrialized ones. Dealing with NIMBY requires long lead times and the early involvement of the public through information and education campaigns, public hearings, and a real role in decision-making.

More Efficient Operational Management through Private Sector Participation

One of the proven ways of obtaining efficiency gains in solid waste management is through the involvement of the private sector—that is, when the key success factors of competition, transparency and accountability are present (Cointreau-Levine 1994). The private sector improves efficiency and lowers costs by introducing commercial principles such as limited and well-focused performance objectives, financial and managerial autonomy, a hard budget constraint, and clear accountability to customers and to providers of capital. The private sector plays other important roles by mobilizing needed investment funds, and by providing new ideas, technologies, and skills.

There is ample evidence from around the world to support these claims (Bartone et al. 1991). Research that surveyed more than 2,000 cities in the United States, Canada, and the United Kingdom showed that services provided by public monopolies typically cost 25–41 percent more than competitively contracted services. In Malaysia, where many cities engaged multiple collection contractors through a well-defined competitive tendering process, the cost of contractor services averaged 23 percent lower—after taxes!—than the cost of service provided by the local authorities. A study of five major Latin American cities found that private contracting halved service costs through higher labor and vehicle productivity.

A second form of private sector involvement is through the incorporation of micro-enterprises and informal waste recycling cooperatives in the municipal solid waste management system. Research has shown that the promotion of micro-enterprises is an effective way of extending affordable services to poor urban communities (Arroyo-Moreno et al. 1999). The promotion and development of recycling cooperatives also provides a way of upgrading the living and working conditions of informal waste pickers, resulting in higher incomes for them and greater self esteem.

More Effective Financial Management

In countries around the world, the costs of collecting, transferring, and disposing of solid waste are often shared between those generating the waste (i.e., households and commercial and industrial establishments) and governments. Government cost-sharing arrangements include matching grants from higher levels of government and general-fund subsidies from local governments. Matching grants are used to induce local governments to provide a socially and environmentally desirable level of solid waste management, while general-fund subsidies recognize the public good and equity aspects of solid waste management. Despite the prevalence of subsidies, adequate cost recovery is the key to both sustainability and private sector participation in solid waste management.

It almost goes without saying that one of the most important ways to improve solid waste management and finance is to improve the overall management capacity of municipal authorities and the corresponding municipal finance systems. In the latter case, it is especially important to improve cost accounting and financial planning of service, in addition to introducing better cost recovery. Systems for full cost accounting must be established for effective cost recovery by local authorities. These accounting systems must have sufficiently detailed information to measure accurately the costs of operation and maintenance, billing, contract management (if appropriate), debt service, and depreciation—and to distinguish among costs for residential versus commercial and industrial wastes. For these reasons, many Bank-supported solid waste management components are placed within broader municipal development or modernization projects.

User charges are commonly utilized to recover a portion of the costs of solid waste management from those generating the waste. User charges can generate substantial revenues and provide incentives to minimize waste, especially if they are structured so that those who pollute more pay more (the “polluter pays” principle). Although user charges can be imposed at different stages of solid waste management (including collection and disposal; see Table 3), in many cities they do not cover the full costs of solid waste management activities. While citizens and enterprises are generally willing to pay for solid waste to be collected, they are often unwilling to pay the full cost of disposing of the waste in a sanitary manner. Experience in many countries has shown that charging the full costs of

disposal may create incentives for littering and open dumping, especially if the enforcement of regulatory standards (i.e., no dumping) is weak and entities can avoid paying the user charge by disposing of the waste themselves.

Analysis of the financial records of many cities in developing countries shows that current practices for cost recovery for solid waste are very weak (recovery rates of less than 10 percent are not uncommon) and have substantial scope for improvement. Options to recover the costs associated with solid waste management range from instituting or enhancing garbage taxes, collecting tipping fees, or relying on other general revenues (including the property tax and business licenses). Choosing among these options depends upon the relative importance of various criteria: whether revenues are adequate and easily collected, whether the polluter pays for the damage inflicted, whether the option is politically acceptable, and whether payment of the revenue can be enforced. These options and some of their tradeoffs are included in Table 3 below.

Improved Environmental Management

The closure of existing open dumpsites and the introduction of sanitary landfill is an urgent priority everywhere in the developing world. Even where complementary disposal technologies such as composting or incineration (waste to energy plants) are practiced, a landfill is still required and is the backbone of any sustainable disposal system. Given the essential nature of the landfill for final disposal, and the lack of local experience and financial resources for introducing sanitary landfills, central government support in terms of technical assistance and access to financing is needed in many lower- and middle-income countries. Matching grants designed to encourage landfill investments and sustainable operations may be an appropriate instrument to consider, primarily because the environmental damages and benefits tend to spill over into neighboring municipalities and regions.

As has already been pointed out, in the process of planning for and siting any disposal facility it will be necessary

TABLE 3
Options for Enhancing Cost Recovery in Developing Countries

	ADEQUATE REVENUES?	EASILY COLLECTED?	POLLUTER PAYS?	POLITICALLY ACCEPTABLE?	ENFORCEABLE?
USER CHARGES:					
• "Garbage Tax"	Can generate adequate revenues if rates are set based on costs, and are updated as needed	Often collected with property tax; direct collection is expensive (about 10–13% of total costs)	Only to extent that rate depends on surrogate for waste generation, like lot size, property value	Requires political will to set and update rates	Difficult to withhold service for non-payment; inefficient when collected with property tax
• Volume- or Weight-Based Fees	As long as fees are set based on costs and updated as needed	No, requires sophisticated refuse collection system	Yes	No	Leads to dumping behavior without local inspection and enforcement capacity
• Tipping Fees (for use of disposal facilities)	Yes, if based on full costs of investment and operation	Yes, if weigh-bridges are utilized	Yes, if fees are passed on by hauler to waste generator	Municipalities are often reluctant to pay fair share	Yes, but must verify that trucks go to disposal site
OTHER REVENUES:					
• Property Taxes	Suffers from typical weakness in property-tax collection	Yes	No, except to extent that property tax is surrogate for waste generation	Requires political will to collect property tax and update rates	Evasion is common
• Business Licenses	Yes	Yes	No	Yes	Yes
• Utility Surcharges*	Yes	Yes	No, except to extent that energy use is surrogate for waste generation	Not easy to get utility cooperation; often legally challenged	Yes
• General Fund Subsidies (including transfers)	Yes, but at expense of other needs	Yes	No	Low political priority for disposal services	No guarantee that funds will be allocated

* For example, Ecuadorian cities are allowed to apply a 10–12% surcharge to the electricity bill; cities now have sufficient funds to significantly improve services, including contracting out.

to anticipate the NIMBY syndrome and plan for public involvement in siting decisions. Siting decisions also require the conduct of environmental impact assessments and the incorporation of recommended mitigation measures in the final design, construction, and operation of the facility.

Finally, when planning for landfills, consideration should also be given to innovative design options like bioreactor landfill design with methane recovery and utilization. The latter point is particularly important given that the methane that escapes from landfills to the atmosphere is a potent greenhouse gas.

Collaborative Support Activities

In support of the above-mentioned strategies, a thematic group on urban waste management has been established at the World Bank, and a collaborative donor program has been active for several years now. The Bank's thematic group includes urban and environmental specialists and task managers responsible for solid waste management projects. The thematic group has a defined work program aimed at generating, packaging, and disseminating knowledge about waste management that is useful for task managers and clients, and it provides specialist support for project design and a full range of training and outreach activities for upgrading staff and client skills. It also seeks to forge partnerships in these endeavors with waste management specialists and institutions external to the World Bank.

The collaborative donor program is such a partnership, created through the initiative of the Swiss Development Cooperation, the Urban Management Program, and the World Bank thematic group. The program also involves other multilateral and bilateral partners, and a network of developing-country experts, professional associations including ISWA, and specialized non-governmental organizations (NGOs). The program was launched at a workshop in Ittingen, Switzerland, in April 1995 (SKAT 1995). At the workshop, an interagency working group was established, a joint work program agreed, and a conceptual framework (Schubeler et al. 1996) approved.

The second workshop of the interagency working group was held in the World Bank in February 1996 on the topic of private sector participation for solid waste service delivery (SKAT 1996a). A third workshop, held in Cairo in October 1996, focused on micro-enterprise involvement in

solid waste service delivery (SKAT 1996b). A fourth and most recent workshop was held in Belo Horizonte, Brazil, in September 1998, with a particular focus on ultimate disposal options including sanitary landfill, recycling, composting, and hospital wastes (SKAT 1998).

The joint work program of the interagency working group includes the following activities that have been or are being carried out by various of the partners, including the Bank's thematic group:

- a conceptual framework for municipal solid waste management (Schubeler et al. 1996);
- a manual for micro-enterprise development in solid waste management (Haan et al. 1998; Arroyo-Moreno et al. 1999);
- a decision-maker's guide to sanitary landfill (Rushbrook and Pugh 1999; Thurgood 1999);
- a guide for national solid waste sector studies (PAHO 1995);
- a guide for strategic solid waste planning in large cities (ERM 1998);
- a toolkit for solid waste planning in medium and small cities (in progress);
- a handbook for health care waste management (WHO in press);
- a series of short technical notes on ultimate disposal options (in progress); and
- a tool kit for preparing bidding documents and contracts for private sector participation in solid waste service delivery (Cointreau-Levine in press).

The next meeting of the interagency working group will be organized in the Philippines in early 2000 and will focus on strategic planning approaches for integrated waste management.

Concluding Remarks

A few key points may best summarize the above discussion of decentralization and solid waste management:

- Municipal solid waste collection services are the easiest to decentralize even to the sub-municipal level.
- For greatest environmental and economic benefit, cooperative regionalization or metropolitanization of transfer, treatment, and disposal operations is often desirable.
- To become "good environmental citizens," cities should manage their wastes better, and individuals and businesses should collaborate in the effort by

reducing their waste generation and paying the cost of the service.

- The private sector can deliver high-quality services through sound contract or concession arrangements—the municipal government still remains responsible for service provision.
- Governments should consider matching grants to deal with an “unfunded mandate” such as introducing environmentally sound municipal solid waste disposal—because of the externalities involved.

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IV. Local Financing and Management Capacity

Recent Developments in Subnational Tax Regimes

Subnational Revenues: Realities and Prospects

R I C H A R D M . B I R D

I. Introduction

The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. The only “good” local taxes are said to be those that are (1) easy to administer locally, (2) imposed solely (or mainly) on local residents, and (3) do not raise problems of “harmonization” or “competition” between subnational governments or between subnational and national governments.¹ The only major revenue source usually seen as passing these stringent tests is the property tax, with perhaps a secondary role for taxes on vehicles, but not much else other than user fees. Since this conclusion fits in well with the reluctance of most central governments to provide subnational governments access to more lucrative sales or income taxes, it is not surprising that it has become conventional wisdom. Subnational governments almost everywhere are thus urged to make more use of property taxes, and criticized when they do not do so enthusiastically.

Up to a point, there is much to be said for this argument. Unfortunately, that point falls far short of the task facing subnational governments in many countries for a number of reasons. First, the conventional case for property taxes is to some extent flawed. Such taxes are in fact costly and difficult to administer well, and these problems are greatly exacerbated as the tax burden increases. Moreover, in practice, political realities mean that increases in property taxes are often concentrated on non-residential properties that most lend

themselves to tax-exporting, thus undercutting one of the principal arguments for local use of this tax base.

Second, even a well-administered local property tax cannot finance major social expenditures (education, health, social assistance), except perhaps in the richest (and usually largest) communities. To the extent it is desirable for governments to finance from their own revenues the services they provide, either local governments financed by property taxes are confined to providing “local” services (street cleaning, refuse removal, etc.), or they are inevitably heavily dependent on transfers from higher levels of government. This is the pattern in most developed countries,

including even the relatively few in which the property tax is the mainstay of local finance. In most other OECD countries, to the extent they are not dependent on national transfers, local governments impose significant direct taxes on businesses or levy surcharges on national income taxes (Bird and Slack 1991).

Third, the conventional argument does not take adequately into account the existence in some countries of important regional or intermediate levels of government that play a major role precisely in financing social expenditures. Even if local governments can to a considerable extent finance local services through property taxes and

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user fees on residents, regional governments responsible for social services as a rule cannot. The conventional approach, while not firmly grounded in anything except expediency, has been to suggest that such governments are in principle best financed by retail sales taxes. Such taxes are usually assumed to fall mainly on residents.² Moreover, as the United States and Canada have long demonstrated, they are administrable at the regional level—although this argument can obviously not be carried over to developing countries, which have universally found it impossible to administer such taxes even at the national level.

Given the recent move toward decentralization in Latin America (IDB 1994) and the concern frequently expressed about the resulting strain on intergovernmental fiscal relations and the possibility of irresponsible behavior by some subnational governments (Tanzi 1996), the appropriate subnational revenue structure requires re-examination. International experience suggests that subnational governments carrying out important expenditure functions are more likely to do so more responsibly the more they are responsible for raising the revenues they spend. While there will obviously always remain an important role for intergovernmental transfers, especially in countries with wide regional economic disparities, there seems no reason in principle why wealthier regions (including metropolitan areas) should not be able to raise and spend most of their budgets themselves.³

There are, therefore, good reasons to strengthen subnational tax regimes. This paper reviews the usual measures suggested for this purpose. It argues that while many of them have merit, on the whole they seem unlikely to suffice, for two quite different reasons. First, in total the usual revenues assigned to subnational governments are likely to prove inadequate to the task of financing the social services (education, health, social assistance) increasingly being assigned to such governments. Second, some of the conventional recommendations both underestimate the difficulty of increasing local revenues from some sources and overestimate the problems (and the undesirability) of using other sources.

The present assignment of taxes in developing countries with important regional levels of government, such as Brazil and Argentina, is deficient in several respects. The first, and in many ways the most important, problem is that there is a significant vertical imbalance between expenditures and revenues, with consequent implications

for autonomy, efficiency, and accountability. The second problem is that the present confused and confusing system results in significant costs—costs of administration, costs of compliance, and costs arising from tax-induced inefficiencies in the allocation of scarce resources.

In principle, multi-tiered governments work best when taxes and the benefits of public spending are as closely related as possible—when, that is, citizen-voter-consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for (that is, benefit from the expenditures financed by the taxes they pay). Obviously, when citizens reside in several overlapping jurisdictions (local-state-nation) this so-called “principle of fiscal equivalence” (Olson 1969) suggests that they should pay taxes to each level corresponding to the benefits they receive from each jurisdiction. In this framework, intergovernmental transfers would exist essentially to restore this equivalence when, for example, some benefits flow from one jurisdiction to another or (negatively) when some taxes levied by one jurisdiction are in fact paid by persons residing in another jurisdiction.⁴

In addition, however, considerations of administrative efficiency and feasibility may dictate that higher (or lower) levels of government impose certain taxes or carry out certain expenditures even when it is not appropriate to do so on equivalence grounds. Vertical fiscal flows, like those that dominate the intergovernmental fiscal scene in most countries, are motivated largely by this consideration, at least with respect to those flowing to richer jurisdictions. In contrast, if, as suggested here, more adequate subnational taxes are made available, this “fiscal gap” (Boadway and Hobson 1993) argument for transfers disappears. There is then no case for universal intergovernmental fiscal transfers, since in this system the richest units of government at subnational levels should be essentially self-sufficient (Bird 1993a). Any grants from higher levels of government made for reasons of regional equalization in this system should then be clearly inframarginal, so that, as McLure (1999a) notes, all subnational governments would face the full marginal tax price of the spending decisions for which they are responsible, thus yielding the “hard budget constraint” emphasized by such authors as Tanzi (1996).

Good subnational taxes should thus in principle satisfy two main criteria: First, they should provide sufficient revenue for the richest subnational units to be essentially fis-

cally autonomous.⁵ Second, they should clearly impose fiscal responsibility at the margin on subnational governments. The simplest and probably best way to achieve this goal is by allowing those governments to establish their own tax rates with respect to at least some major taxes.

The most immediately important issue facing most larger countries, for example, is undoubtedly the need to develop a satisfactory revenue base for regional governments. One possibility is to permit regional surcharges on personal income taxes. Another promising approach is to establish subnational value-added taxes that are not subject to the well-known problems that have long been thought to preclude such taxes. Such a tax already exists and works well in Canada, and it now seems feasible to implement it even in countries with less well-developed tax administrations.⁶

Another critical problem in many countries is to replace all or some of the various unsatisfactory state and local taxes on businesses that exist in most countries by some less distortionary form of taxation. Recently, a “business value tax”—in essence, a relatively low rate flat tax levied on an income-type value-added base—has been suggested for this purpose.⁷ In contrast with the proposal mentioned in the previous paragraph, which is motivated mainly by the desire to provide more adequate “own” revenues to regional governments and hence to encourage greater fiscal responsibility and accountability, this proposal is aimed primarily at improving the allocative efficiency of subnational revenue systems. It therefore seems less likely to find a welcoming political audience. Nonetheless, it offers a potentially promising alternative to the proliferation of increasing, and increasingly distorting, subnational business taxes that otherwise seem likely to lie in the future of many countries.

Leading up to these two proposals, the balance of this paper reviews briefly the major tax sources usually suggested for subnational governments in developing countries, more or less in order of preference—user charges, property taxes, excises, personal income taxes, payroll taxes, general sales taxes, and business taxes.

II. User Charges

Perhaps the most obvious, and in many ways the most sensible recommendation that can be made with respect to revenue structures at any level of government, is to employ user charges whenever possible. Local and to some extent regional governments, from an economic point of view,

may be viewed in effect as firms delivering packages of local public services to residents. As with all firms, people should want the services enough to be willing to pay for them. From this perspective, the first rule of subnational finance should therefore be: “Wherever possible, charge.” While user charges are likely to be viewed by officials solely as a potential additional source of revenue, their main economic value is to promote economic efficiency by providing demand information to public-sector suppliers and to ensure that what the public sector supplies is valued at least at its marginal cost by citizens. This efficiency objective is particularly important at the subnational level, because the main economic rationale for subnational government in the first place is to improve efficiency. Whenever possible, local public services should therefore be charged for—of course, at prices that are properly set—rather than given away.

At least three types of user charges, broadly defined, exist almost everywhere: (1) service fees, (2) public prices, and (3) specific-benefit charges. Service fees include such items as license fees (marriage, business, dog, vehicle) and various small charges levied by local governments for performing specific services—registering this or providing a copy of that—for identifiable individuals (or businesses). In effect, such fees constitute cost-reimbursement from the private to the public sector. Charging people for something they are required by law to do may not always be sensible—for example, if the benefit of, say, registration is general and the cost is specific—but on the whole there is seldom much harm, or much revenue, in thus recovering the cost of providing the service in question.

In contrast, public prices refer to the revenues received by local governments from the sale of private goods and services (other than the cost-reimbursement just described). All sales of locally provided services to identifiable private agents—from public utility charges to admission charges to recreation facilities—fall under this general heading. In principle, such prices should be set at the competitive private level, with no tax or subsidy element included unless doing so is the most efficient way of achieving public policy goals, and even then it is best to account for the tax-subsidy element separately.

A third category of charge revenue may be called specific-benefit taxes. Such revenues are distinct from service fees and public prices because they do not arise from the provision or sale of a specific good or service to an identifi-

able private agent. Unlike prices that are voluntarily paid—although like fees paid for services that may be required by law—taxes represent compulsory contributions to local revenues. Nonetheless, specific-benefit taxes are (at least in theory) related in some way to benefits received by the taxpayer in contrast to such general-benefit taxes as fuel taxes levied on road users as a class or local general business or property taxes viewed as a price paid for local collective goods (see below). Examples abound in local finance: special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary property taxes related to the provision of sewers or street-lighting, development exactions and charges, delineation levies, and so on. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property—its area, its frontage, its location.

The importance of user charges is greater in principle than the relatively small amounts of money most countries collect from this variegated group of levies. The appropriate policy is clearly to charge the correct price—roughly, the marginal cost. Only thus will the correct amounts and types of services be provided to the right people—that is, those willing to pay for them. Efficiency thus demands user charges be levied wherever feasible. It is often suggested, however, that equity considerations argue against user charges. Although in principle the incidence of user charges is no more relevant than the ultimate incidence of the price of cheese, studies in different countries have shown that the distributive consequences of charging for local public services may even be progressive (Bird and Miller 1989). In any case, attempting to rectify fundamental distributional problems through inefficiently pricing scarce local resources is almost always a bad idea, resulting in little if any equity being purchased at a high price in efficiency terms.

Most countries make much less use of charging at the local level than seems desirable, and many of the charges that are levied are poorly designed from an efficiency point of view. Argentina, for example, is unusual in that, strictly speaking, municipal governments are not allowed to levy any taxes but are restricted to imposing *tasas*, or fees for services. In practice, however, most *tasas* are surcharges on provincial taxes rather than fees for specific services rendered, and those fees that are imposed (at the provincial level) are mostly poorly conceived from an economic perspective.

In the province of San Juan, for example, a wide range of charges is levied for an enormous number of specific services rendered by the judiciary, the registry of commerce, the registry of real property, the inspection of legal entities, the civil registry, the mining department, the transport directorate, the bus station, local transport enterprises, the police, the irrigation department, and the general administration, and even the tax department.⁸ Many of these charges probably cost more to administer than they yield and appear largely to be nuisance levies impeding normal transactions, while none of the rates appears to be based on any rational principle. While there is much to be said for rational use of charges in subnational finance, it is hard to find much rationality in this system. Probably 90 percent of the levies now existing in San Juan—and, in all likelihood, in many other subnational governments throughout Latin America—could be abolished with little loss in revenue and some gain in efficiency. The remaining 10 percent, as a rule, need to be revised after a study of appropriate charging policy.

The sad truth in most countries is that user charges are seldom employed to the extent possible or desirable, and that those charges that do exist are seldom well-designed and consequently seldom produce any significant “non-revenue” benefits. Moreover, it is surprisingly difficult to design and implement “good” user charges, and generally even good charges are not very popular with either administrators or citizens.⁹ In short, user charges are a good idea in principle, but they are surprisingly difficult to implement well in practice. Such charges are thus unlikely to provide anything close to adequate finance for subnational activities in any country.

III. Property Taxes

For decades, local governments around the world have been told that the only appropriate general tax source for them is the real property tax (in effect as a sort of generalized user charge).¹⁰ Unfortunately, such advice is not very helpful in many countries. Contrary to what some seem to believe, the property tax is surprisingly difficult and costly to administer well. It is true, of course, that buildings cannot easily run away and hide from tax officials. But it is equally true that valuation is an art, not a science, and that there is much room for discretion and argument with respect to the determination of the base of the tax. Moreover, although the assessment and collection of property

taxes can certainly be improved in most developing countries, it is difficult to administer this tax equitably in a rapidly changing environment, and it is always difficult to increase revenues from this source very much or very quickly.¹¹

Nonetheless, a low-rate uniform property tax has an important role to play in financing local governments, whether rural or urban. Moreover, other “land-based” subnational taxes—for example, betterment levies (*valorización*) and even transfer taxes—are both feasible and, within limits, desirable.¹² It is unlikely, however, that subnational governments in most developing countries will be able to finance any but “hard” (property-related) services out of property taxes. In particular, without in any way disparaging the potentially more important role that property taxes should play in financing local governments in many countries, if regional governments are expected to play any significant role in financing “soft” services (education, health), as a rule they will need to have access to some more elastic revenue sources.

In any case, the present state of property taxation in Latin America leaves much to be desired.¹³ Argentina, for example, is unusual in the extent to which the provinces, rather than the municipalities, collect taxes on real property. Nonetheless, although there appear to be considerable variations in the property tax from province to province, on the whole it is probably fair to conclude, as in most countries, that while undoubtedly more revenue could be collected from this source, it is unrealistic to look to property taxes either for a substantial increase in revenue or as a source for funding all or most of provincial expenditures on such services as education and health.

The present Argentine system caps property tax rates (differentiated by rural and urban) and further decrees that the tax base in no case can exceed 80 percent of market value. The maximum nominal rates that can be established are little more than 1 percent of market value.¹⁴ The nominal property-tax rates currently in force in most of Argentina are well below these limits, and the effective rates are even lower, given the high degree of undervaluation of even those properties recorded on the rolls.¹⁵ Moreover, the structure of the tax is, as a rule, too complicated, economically perverse, and basically unenforceable. In San Juan Province, for example, urban properties are taxed at rates from 0.55 to 0.75 percent depending on the fiscal value; rural properties are subject to a similar scale ranging

from 0.90 to 1.3 percent; and vacant land is allegedly taxed at 3 percent. Every aspect of this tax is both structurally wrong and complicates administration unduly. Progressive rates make no sense (Bird 1974). Nor does the differentiation between the different classes of property.

Much can be done to strengthen such deficient property taxes. The tax should be simplified and applied uniformly. Cadastral maps should be updated, and valuations made more consistently and currently. Improved use should be made of flows of information from property registries, local building license authorities, public utilities, etc. As Dillinger (1992) has argued, from a revenue perspective, most attention should be paid to improving the “sharp end”—collection and enforcement—rather than the technically more costly (and less immediately productive in terms of revenue) mapping and surveying of the traditional cadastral approach.

Nonetheless, property taxes are not easy to administer, particularly in countries where inflation is endemic, and they are never politically popular owing to their visibility and to certain inherent administrative difficulties. Even in the most sophisticated countries, local property taxes can seldom yield enough to finance local services. No developed country that depends significantly upon property taxes for local fiscal resources has a local-government sector that accounts for more than 10 percent of total public spending (Bird and Slack 1991). Similarly, despite substantial efforts in some countries and considerable foreign assistance, property taxes seldom account for more than 20 percent of local current revenues—or less than 1 percent of total public spending—in developing countries (Bird 1995). The property tax is a useful, even a necessary, source of local revenue, but it cannot easily provide sufficient resources to finance a significant expansion of local public services in any country. Indeed, countries have often been hard-pressed even to maintain the present low relative importance of property-tax revenues in the face of varying price levels and political difficulties.

These facts reflect both the political and the administrative realities of property taxation. One reason for the commonly observed phenomenon of widespread resistance to the property tax is simply that it is a very visible tax. The tax generally has to be paid directly by taxpayers in periodic lump-sum payments. Taxpayers who pay taxes directly to government tend to be more aware of the size of their tax bill than those whose take-home pay is reduced by

weekly or monthly tax deductions. The need to make such periodic large payments may well add to the accountability and responsibility of governments, but it also greatly increases the sensitivity of taxpayers to even nominal increases in taxes. The inelasticity of the property tax has a similar effect. Since the base of this tax does not as a rule increase automatically over time, the periodic nominal increases in property tax bills needed to maintain real revenues when price levels rise require increased tax rates. In terms of political accountability, a virtue of the property tax is that it confronts the people with the cost of government. However, the downside, at least from the government's point of view, is the heightened visibility of nominal tax increases and the accompanying political resistance. Finally, property taxes finance such services as roads and garbage collection. The quantity and quality of these services (or their absence) is thus readily linked to the property tax. When potholes develop in their street, taxpayers are understandably quick to question the taxes that supposedly finance street repair. In short, the very features that make the property tax a good source of local government revenue in principle make it especially vulnerable to political resistance in practice. It is thus not surprising that academics tend to be much fonder of the property tax than the politicians who actually have to impose it.

Other problems result from property-tax administration. As a rule, for example, property is supposed to be assessed on the basis of its market value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Substantial technical efforts are therefore needed before much revenue can be expected from property taxes. Even in countries with well-developed property-tax systems, discrepancies arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons (Bird and Slack 1993). Since taxpayers can easily compare their property taxes with those of similar properties in their neighborhood, such discrepancies lead both to specific assessment appeals and to general pressure for tax relief.

For such reasons, experience around the world suggests that the political costs of reliance on the property tax are so high that no government with access to "cheaper" sources of finance will willingly do so. Both intergovernmental transfers that can be spent as local governments wish and access to taxes on business that can largely be exported

must be curtailed to make property taxes relatively more attractive if local decision-makers are to be confronted more openly with the true economic (and political) costs of their decisions.

Even if this essential structural precondition is met, a number of other policy reforms are needed to turn the property tax into a responsive instrument of local fiscal policy. First, and importantly, local governments must be allowed to set their own tax rates. Few developing countries currently give local governments much freedom in this respect. Second, the tax base must be maintained adequately. In countries with much inflation, some form of index adjustment may be advisable. In other countries, the assessing agency must be provided direct financial incentives to keep the tax base up to date. Finally, as noted above, a series of procedural reforms is often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base (Kelly 1994). None of these steps is easy, but countries wanting to have local governments that are both responsive and responsible must follow this hard road. There are no short cuts to successful local property taxation. Even if what can be done to improve property tax assessment and collection is done, two unpalatable facts will remain. First, it will always be difficult to increase such taxes and to keep their base up to date. Second, as a rule even the best property taxes cannot be expected to provide either sufficient or sufficiently elastic financing to support such costly programs as health and education.

IV. Excise Taxes

Among the other taxes that might be considered at the regional (as opposed to the local) level are excise taxes, payroll taxes, corporate income taxes, personal income taxes, payroll taxes, retail sales taxes, and value-added taxes (VATs). McLure (1997) suggests that excise taxes are a potentially significant source of regional revenue, largely on administrative and efficiency grounds—such taxes are both easily administered by regional governments and lend themselves to regionally differentiated rate determination. Moreover, in terms of efficiency, such taxes, applied on a destination basis, should have little distortionary effect. Finally, it is sometimes argued that there is at least some benefit argument for excises—for example, taxes on alcohol and tobacco to the extent regional governments are responsible for health expenditures, and taxes on vehicles and fuel to the extent they are responsible for roads.

There is, of course, something in all these arguments, although in some instances not all that much. The benefit case for “sin” taxes, for example, is weak in general (Bird 1998), and it is not always that easy to impose regionally differential taxes without serious distortions as well as substantial administrative and compliance costs and dangers of evasion.¹⁶ Indeed, although it is true that in countries like the United States and Canada a significant proportion of state revenue comes from excises, it does not seem particularly desirable to tie state finances in any substantial way to such inelastic levies when the pressure on those finances for the most part comes from very elastic expenditure demands for health and education.

Undoubtedly, the strongest economic and administrative case for regional (and perhaps local) excises is with respect to vehicle-related taxes (Bahl and Linn 1992). Such taxes should certainly be exploited more fully than is commonly the case in most countries. The most important tax on automobiles from a revenue perspective is the fuel tax, which is also the simplest and cheapest form of automotive taxation from an administrative perspective. Much as central governments no doubt appreciate the revenue they receive from this source, fuel taxes can be levied equally well at the state level. Different states could impose different taxes, if they chose to do so, subject to the constraint that they would not likely be able to differ much from the rates imposed by their neighbors, given the mobility of the tax base. Administratively, differential provincial fuel taxes could easily be imposed at the refinery or wholesale level, with the refiner or wholesaler acting as a collection agent for the states, remitting taxes in accordance with fuel shipments.

Fuel taxes are also related both to road usage and to such external effects of vehicles as accidents, pollution, and congestion, although not in any very precise way. To the extent automotive taxation is intended to “price” either the utilization of publicly provided services or externalities, fuel taxes are at best a very crude instrument. Toll roads—privatization, as it were—and an appropriate set of annual automobile and driver license fees can in principle serve this benefit-tax function much better. For example, such fees might be based on such features as the age and engine size of vehicle (older and larger cars generally contribute more to pollution), location of vehicle (cars in cities add more to pollution and to congestion), driver records (20 percent of drivers are responsible for 80 percent of acci-

dents), and especially the axle-weight of the vehicle (heavier vehicles do exponentially more damage to roads and require roads that are more costly to build).

To the extent that it is desired to achieve some redistributive goal through automotive taxation, this can best be done by a national excise tax at the time of initial sale. In contrast the present situation in Argentina, for instance, in which every province levies an array of annual taxes that vary with the year and model of the vehicle, apparently largely in an attempt to levy a “progressive” tax, makes little sense. In San Juan Province, where it takes three newspaper-size pages to set out the details of vehicle tax rates, the tax in principle is imposed at a rate of 3 percent on automobiles, but the values to which this rate is applied vary with the category (named makes), age, and weight of the vehicle. This approach is administratively complex and costly; it is not related in any consistent way to any distributional objective; it unduly penalizes newer (and therefore more efficient) vehicles; and it does not price public services or externalities in any meaningful way. As with other provincial taxes and charges in Argentina, the automobile tax suffers from undue refinement in terms of fine discrimination between very similar bases. The result is essentially arbitrary differentiation with consequent economic distortion, and considerable leeway for administrative and compliance slippage. The commendable desire to make fine distinctions for social purposes may underlie this complex system. But the reality is that this complexity makes the system both economically undesirable and fundamentally unadministerable.

Subnational taxation of automobiles is fundamentally a good idea. Careful study of the appropriate design of the automobile tax system is needed, however (Smith 1991). In most countries, both more revenue and better economic effects could be achieved through a revised system of automotive taxation. Subnational revenues could be still further boosted by giving states access to the fuel tax (through surcharges). Indeed, automotive and fuel taxation appears to be the only commonly available subnational revenue source that, in principle at least, should demonstrate more than unitary income-elasticity, thus matching this aspect of some of the key services (education, health) for which regional—and even local—governments are increasingly responsible in many countries. Nonetheless, even when most fully exploited, automobile taxation alone seems unlikely to do the job.

V. Personal Income Taxes

Since property taxes can only be pushed so far, if more local “own-source” revenue is desired—either to expand the size of local activities or to make local governments more self-reliant—OECD experience suggests there is much to be said for supplementary, or “piggybacked,” local income taxes (Bird and Slack 1991). Like the property tax, such a tax would be visible and would in principle satisfy the criteria of political responsibility and accountability.¹⁷

Among the few countries in which subnational governments both have large expenditure roles and are largely fiscally autonomous are the Nordic countries. It is no coincidence that the best-known examples of local income taxes are in those same countries (Soderstrom 1991). These local income taxes are basically levied at a flat, locally established rate on the same tax base as the national income tax and collected by the central government. In contrast, in Belgium (as in most Canadian provinces) the local surcharge is levied as a percentage of the national tax liability rather than the national tax base. A similar system exists in Switzerland, where most cantons—the intermediate level of government—allow local governments (communes) to levy surcharges at locally established rates on the cantonal income taxes—taxes which are, incidentally, like most U.S. state income taxes, in no way harmonized with the central income tax (Bird 1986). Less well-known is the unique system of local income taxation in Japan. Corporations are subjected to a municipal tax assessed largely on the basis of national corporate taxes paid in the previous year, with the tax base being allocated to the different jurisdictions in proportion to the number of employees. In addition, corporations are subject to a progressive municipal “enterprise” tax based directly on income.¹⁸ When this enterprise tax is applied to individuals operating businesses, its rate varies with the category of business activity (as is also true with the local *taxe professionnelle* in France). Individuals are also subject to both a progressive local income tax on the same base as the national income tax and a poll tax (like the former British “community charge”) levied at a nationally determined per capita rate, which varies with the size of the municipality. Only the latter, however, is levied on non-residents working in the municipality. All these taxes are assessed and collected locally.

Local surcharges on a central personal income tax (PIT) have recently been proposed in several developing and transitional countries, such as South Africa and Hungary

(Bird, Wallich, and Peteri 1995). Although local income taxes have occasionally been levied in developing countries (Bahl and Linn 1992), they are not common. In contrast, in many transitional economies, subnational governments have been assigned significant shares of income-tax revenues. In Russia, for example, a few years ago such governments received all of personal income-tax revenues, in Bulgaria 50 percent, in Poland 30 percent, and in Hungary 25 percent (Bird and Wallich 1993). In none of these countries, however, did local governments have any freedom in establishing the tax rate. The resulting distribution of revenues, therefore, was really a combination of a national tax and a related intergovernmental fiscal transfer based on locally collected national tax revenues rather than a really “local” source of revenue. If local governments are not politically responsible for the revenues they receive, it seems to stretch reality to consider such revenues as local taxes. In contrast, locally determined surcharges can be considered local “own taxes” in that the accountability both for imposing the taxes and for spending the revenues is placed squarely on the local government. In Canada, where the central government similarly assesses and collects the income tax, the provinces can set different rates and therefore affect through their own actions the amount of revenue accruing to them.¹⁹

One reason local governments have seldom been given access to income taxes in developed countries is because of the reliance of central governments on this source of revenue. In developing countries even central governments often have trouble collecting much from the income tax. Shome (1999) has recently noted the weak, and weakening, state of personal income taxes in a number of Latin American countries. The combination of weak PITs at the central level, the difficulty of strengthening these taxes quickly in many countries (Bird 1992), and the reluctance of most central governments to share their taxes with local governments makes it unlikely that any “quick fixes” for subnational revenues are to be found in this quarter. Nonetheless, the possibility of imposing regional (and perhaps in some instances even local) surcharges on personal income taxes should certainly be explored further in most countries. As experience in many countries mentioned earlier demonstrates, although such surcharges might vary from region to region, they should in all cases be levied at a single “flat” rate to avoid both administrative and economic distortions.

VI. Payroll Taxes

A closely related question concerns regional payroll taxes. Payroll taxes at the state level are currently important sources of state finance in Australia and, to a considerably lesser degree, in some other countries such as Mexico and South Africa. Such taxes have several merits, and at least two demerits. Their merits are that they are easily administrable, at least when imposed on large enterprises, and relatively productive at relatively low rates. Their demerits are, first, that they act as a tax barrier to employment in the modern sector and introduce distortions into the factor mix decision (Bird 1992), and, second, that in most countries the payroll tax basis is already heavily exploited to finance central-government social security systems.

To the extent payroll taxes can be made effective on a regional or local basis, so can the flat-rate state personal income taxes already mentioned, which are in practice likely levied on much the same base, without—at least in principle—the factor bias inherent in payroll taxes. Moreover, again in principle, if not so clearly in practice, such subnational PITs can more easily be levied on a destination (resident) than origin (employment) basis (Bird and Wallich 1992), an important factor in considering the potential distortionary aspects of subnational factor taxes (as discussed further in Section VIII below). On the whole, therefore, although the payroll tax certainly calls for closer examination than it has received here, surcharges on a nationally uniform PIT base would seem a more appropriate way than payroll taxes for subnational governments to tax wages in most developing countries.

VII. Consumption Taxes

In many countries, the search for a regional revenue source that is both economically respectable and administratively viable, particularly one with reasonable elasticity, comes down to a general sales tax. Excises, yes—to some extent. But there is not always that much money, and even less elasticity, in this revenue source. Much the same can be said with respect to user charges and local property taxes: Use them sensibly and as fully as possible, but do not expect large (and certainly not easily expandable) revenues from these sources. Payroll taxes are in most countries more than exploited by social insurance funds, and in any case they are not always appropriate for regional taxation. Regional—and perhaps even local—surtaxes on the national PIT make more sense, but are not very promising

in the immediate future given the poorly developed nature of that tax in the context of most developing and transitional countries. Only the general sales tax is left.

The general sales tax now found in most countries is of course a VAT. The retail sales tax once favored as a regional tax (Musgrave 1983), though still in place in most U.S. states, is now an aberration in world perspective. Its future seems dim. The dominance of the VAT has posed a serious problem for the finance of regional governments, however. Most tax analysts have long thought that, so to speak, the only good VAT is a national VAT. There were varied reasons why independent subnational VATs were considered to be either infeasible or undesirable (Bird 1993b). Some emphasized high administrative and compliance costs. Others stressed the possible loss of macroeconomic control and the general reluctance of central governments to share VAT room. Still others emphasized the problems arising from cross-border (interstate) trade. Broadly, the argument with respect to such trade was that subnational VATs were, if levied on an origin basis, distortionary, and if levied on a destination basis, unworkable.²⁰ Experience in Brazil was generally taken to support this negative appraisal.

Brazil was the first country to introduce a full-fledged VAT (Guérard 1973). Indeed, Brazil liked the idea of a VAT so much that it introduced not one VAT but several—one for the federal government (IPI) and one for each of the state governments (ICMS).²¹ It soon became clear, however, that Brazil's enthusiastic adoption of this new tax had resulted in a series of complex technical and administrative problems as to how to apply different VATs in different states (although all are levied at a uniform rate) in addition to a federal VAT. Over the years, these problems were partly resolved in various (and ultimately unsatisfactory) ways. For example, the overlap in taxes was reduced by confining the federal IPI essentially to the manufacturing stage. In part, the problems were simply ignored, perhaps because the resulting distortions in resource allocation seemed unimportant compared with those resulting from inflation. And in part the issue was fudged by various unsatisfactory administrative fixes such as the introduction of some border controls between states.²² Nonetheless, the resulting patchwork quilt—perhaps a better analogy would be a blimp precariously patched with chewing gum—has become increasingly unsatisfactory, and sales-tax reform has again risen high on the fiscal agenda in Brazil in recent years.²³

Fear of difficulties similar to those encountered in Brazil has perhaps been one reason for delaying desirable sales tax reforms in Argentina, where a 1993 federal-provincial agreement (the *Pacto Fiscal*) required the abolition of the provincial gross receipts taxes and their replacement by a retail sales tax by 1996 (World Bank 1996). Although in the end the process was postponed, the ensuing discussion led to proposals from the most important province (Buenos Aires) for a provincial-level VAT and to considerable discussion on the merits and demerits of this approach.

The major revenue source of Argentine provinces has long been an antiquated gross receipts tax levied at various rates on different activities (and an even more antiquated stamp tax). To return to the example of San Juan Province, for example, the basic rate of the gross receipts tax is 3 percent, with rates of 0.83 percent on fuel production, 1.67 percent on fuel sales, 2 percent on construction, 4 percent on tourist services and certain financial activities, 5 percent on certain other financial activities (e.g. insurance companies), lotteries and gaming, sales of tobacco, and advertising agencies, 10 percent on pubs, night clubs and similar activities, and 15 percent on electronic games, pool, cabarets, and places that rent rooms by the hour. In addition, minimum fixed taxes are established for certain activities, including cabarets, parking lots per space (depending on the size of the space!), as well as for places rented by the hour (depending upon the rate they charge).

This tax provides an excellent illustration of what is wrong with existing provincial consumption taxes in Argentina. It taxes a significant number of intermediate business activities (fuel, construction, advertising, insurance, finance). It creates a variety of totally unenforceable distinctions between “disfavored” activities—ranging from cabarets vs. night clubs to the sizes of parking spaces—and imposes ridiculous rates on these activities. Such provisions may make legislators feel good, but they create a nightmare for tax administrators, probably are not enforced, and serve no useful economic or social purpose.

It is thus quite understandable that the *Pacto Fiscal* required the gross receipts tax to be changed to a “retail” sales tax. Indeed, considerable steps have already been taken in this direction. As of 1995, for example, taxes on primary production had been eliminated completely in six provinces and reduced to rates of 1 percent or less in most of the rest, while the tax on industry had generally been

lowered to 1.5 percent (compared with the general rates of 2.5 percent on wholesale trade and 3.5 percent or so on retail trade and services). From the point of view of reducing the economic distortion due to the tax system, replacing these antiquated taxes seems obviously desirable. From the point of view of strengthening provincial revenues, however, the effects of replacing the existing stamp and gross receipts tax seemed less obviously desirable to some.²⁴ Estimates of the revenue-neutral rate of a retail sales tax ranged from 3.5 percent to 10 percent. Adding a retail sales tax at these rates to an existing federal VAT of over 20 percent is clearly not politically attractive.

Gómez Sabaini and Gaggero (1997) have argued that it seems more sensible to replace the independent federal (VAT) and provincial (quasi-RST) taxes by either independent provincial VATs or by a more uniform joint federal-provincial VAT (subject to an overall 20 percent rate limit). Such subnational VATs, they suggest, should be on a destination basis, and they should deal with the problem of interprovincial sales by allocating revenues in accordance with macro-level consumption indicators. This solution would clearly be more feasible with the joint version of the tax.²⁵ It would in any case require a high degree of agreement between the federal and various provincial governments. In contrast, the CVAT proposal discussed briefly below not only requires less such agreement but also affords more provincial revenue autonomy.²⁶

The only functioning destination-base subnational VAT now in existence is that in the province of Québec in Canada (Bird and Gendron 1998). The Québec Sales Tax (QST) and the federal VAT (Goods and Services Tax, or GST) as they now exist in Canada constitute an operational “dual VAT” system with essentially none of the problems usually associated with such systems. The rates of the two taxes are set quite independently by the respective governments. The tax bases are also determined independently, although they are essentially the same.²⁷ From the beginning, both taxes have been collected by a single administration (the Quebec Department of Revenue).²⁸ Taxes on interprovincial sales from one business to another are basically handled by a deferred-payment system very similar to that now applied in the European Union. Exports from Québec, whether to another province or another country, are zero-rated. Imports into the province from other provinces, or from abroad, are taxable, but the tax is assessed on interprovincial imports only when there is a

sale by a registered trader to an unregistered trader or consumer in the province.²⁹ Although special regimes apply to automobiles and a few other cases (Canada 1996), in general no attempt is made to collect tax on interprovincial purchases made directly by final consumers.³⁰

What makes this system work, Bird and Gendron (1998) argue, is the existence of the overriding federal GST as an enforcement mechanism. Audit priorities for GST are established by the federal government, but a final audit plan is agreed with the Québec government, with the latter actually carrying out the audit and reporting the results to Revenue Canada. Since the QST is applied to a GST-inclusive base, Québec has some direct incentive to monitor the GST as well as the QST. On the other hand, although Quebec cannot directly monitor the other end of interprovincial sales, the normal process of GST audit (carried out interprovincially by Revenue Canada) serves as a cross-check to ensure that QST has not been evaded. In effect, the existence of a federal sales tax on a more or less uniform base provides some control over interjurisdictional sales for purposes of both provincial and federal taxes. Reportedly, the system is working quite well.

Canada has thus demonstrated that with good tax administration it is perfectly feasible to operate a VAT at the subnational level on a destination basis, at least for large regional governments.³¹ In principle, it is immaterial whether there are two separate administrations or one—or, if there is one, which level operates it. Clearly, a single central administration and a common base (as in Canada's personal income tax system) would probably be most efficient, but this degree of convergence is not essential. What is critical is either a unified audit or a very high level of information exchange. Most importantly, from the perspective of improving accountability, each taxing government should be able independently to determine its own VAT rate.

But what can be done when there is no realistic prospect of "good" tax administration, and especially not at the subnational level, in the near future? As Varsano (1999) demonstrates, a promising approach is to impose what is in effect a supplemental central VAT, which McLure (1999b) labels the "compensating" VAT or CVAT. This simple proposal has the major virtue of protecting the revenue when tax administration (at all levels of government) is far from well-developed. Specifically, it reduces the risk that households (and unregistered traders) in any state can dodge

state VAT by pretending to be registered traders located in other states.

How might such a CVAT work? Briefly, states would zero-rate not only international but interstate sales, but the latter would be subject to the central CVAT (as well as the central VAT, of course). Domestic sales would thus be subject to central VAT and either state VAT or central CVAT. There would be no need for any state to deal explicitly with any other state nor, generally, would there be any need for interstate clearing of tax credits.³² Registered purchasers in the other state would be able to credit CVAT against central VAT. The results of this procedure are twofold. First, the central government, which first levies CVAT and then credits it, would gain no net revenue from it.³³ Second, the state VAT applied to resale by the purchaser would be that of the destination state. In other words, the results are exactly the same as in the GST/QST case described above—a destination subnational VAT is applied—but the CVAT now acts to protect state revenues from some obvious frauds.

This simple system seems to make subnational VATs quite feasible and potentially attractive in developing countries—at least in large countries in which states have major expenditure roles, the VAT is the principal source of actual and potential revenue, and tax administration is not up to Canadian standards.³⁴

VIII. Business Taxes

Those familiar with subnational tax systems around the world will have noted one conspicuous omission from the preceding discussion—taxes on business. Regional and local business taxes in such forms as corporate income taxes, capital taxes, non-residential property taxes, and such ancient levies as *octroi*, *patente*, and various forms of "industry and commerce" tax are found in most countries.³⁵ Whether or not there is an economic case for such taxes, the political realities of governing in a democratic society are such that virtually any subnational government will in any case wish to impose such a tax. Subnational business taxes are not only widespread, they are also generally popular with officials and citizens alike, for at least two reasons. First, they often produce substantial revenue and in particular tend to be much more elastic than, for example, property taxes. Second, since no one is quite sure of the incidence of such taxes, it is easy to assume, or assert, that they are paid by someone other than local residents.

Since local business taxes are likely to continue to exist, no matter what economists may say, it is important to consider whether the problem is with the very *idea* of subnational governments taxing business or rather with the way in which they now generally do so. As a rule, experts have looked at the distortions and problems arising from such taxes,³⁶ shuddered, uttered some homily such as “don’t do it,” and passed on to things of more interest.

The economic case for local business taxation is simply that it is a form of generalized benefit tax. Such benefit taxes are not only allowable at the subnational level but are indeed essential to the attainment of efficiency. Where possible, specific public services benefiting specific business enterprises should of course be paid for by appropriate user charges. But where it is not feasible to recoup the marginal cost of cost-reducing public-sector outlays through user charges, some form of broad-based general levy on business activity may well be warranted. It is difficult, however, to find any support along these lines for taxing any one input, whether labor (payroll tax) or capital (corporate income tax). Instead, what this line of reasoning suggests is that a broad-based levy neutral to factor mix should be imposed, such as a tax on value-added.³⁷

The most appropriate form of VAT for this purpose would be a “value-added income tax” or a VAT levied on the basis of income (production, origin) rather than consumption (destination).³⁸ Compared with a conventional VAT, such a tax—which shall henceforth be referred to as a “business value tax” or BVT to reduce confusion—has three important distinguishing features. First, it is levied on income, not consumption—that is, it is imposed on the sum of profits and wages, or, to put it another way, on investment as well as on consumption.³⁹ Second, it is imposed on production, not consumption—that is, it is imposed on an origin not destination basis and hence, in effect, taxes exports and not imports. And third, it is assessed by the subtraction (or addition) method on the basis of annual accounts rather than on a transaction or invoice-credit method.

Those who think the optimal subnational tax on business is none may reject this proposal out of hand. But those who think either that there is at least some justification for local business taxation or that, whether we like it or not, there will in any case continue to be such taxes should not be so hasty. While the danger of tax exporting and, more

importantly, beggar-my-neighbor tax competition suggest that it may be advisable to place a floor (and perhaps also a ceiling) on such taxes, this form of business taxation is likely to be less distorting than such existing subnational business taxes.⁴⁰

As a replacement for such taxes, a BVT would improve subnational tax systems in several ways. First, it would be more neutral than most existing local business taxes, which often discriminate against certain forms of investment. Second, it would likely be less susceptible to base erosion. Third, a BVT should nonetheless be more sensitive to cyclical realities than most other forms of business tax (e.g., capital taxes, property taxes). All these advantages would of course apply even if the rate of the BVT were set to produce the same revenue as existing business taxes. Of course, if the rate were set to match roughly the benefits-received basis suggested above, it would generally be lower, and the tax would have the additional important advantages of eliminating inefficient spillovers and encouraging more responsible and accountable subnational governments (Bird 1999).

IX. Conclusion

The approach taken here to subnational taxation in developing countries is based on three simple principles: (1) More attention should be paid to matching expenditure and revenue needs. (2) More effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. (3) Subnational taxes should not unduly distort the allocation of resources.

If regional governments have significant expenditure responsibilities, there are really only two ways these criteria can be met in most countries—through a surcharge on PIT or a surcharge on VAT. The possibility of local income tax surcharges now seems to be broadly accepted. Unfortunately, few developing countries have sufficiently robust central income taxes to offer much hope that subnational governments will soon be able to derive much revenue from this source. A potentially promising alternative answer for subnational revenues, as for national revenues, may be, as developed in more detail in Varsano (1999), to rely on the VAT. At least in the larger Latin American countries with federal features, such as Brazil, Argentina, or Mexico, this path seems to be open. It should be further explored.

A second feature of subnational taxation that has been emphasized here is the importance of developing a less harmful form of subnational business taxation. Most forms of local and regional business taxes found in developing countries—corporate income taxes, trade taxes, business taxes, non-residential property taxes, and even so-called “retail” sales taxes may introduce serious economic distortions in a variety of ways. Nonetheless, there is both an economic-benefit case for some regional and local taxation of business and, it seems, often an overwhelming political need for local leaders to impose such taxes. An approach to this problem that seems worth further exploration is to introduce what is in effect another form of value-added tax—called here the business value tax or BVT. Variants of such taxes already exist in some developed countries. The practical case for replacing the present mishmash of taxes imposed on business by such a tax seems even stronger in the context of developing countries.

Suppose that both these “new” proposals for subnational revenue reform were to be accepted in any given country. The result would then be a “family” of VATs, with a standard invoice-credit destination-principle consumption-type VAT imposed at the central-government level, a CVAT and corresponding state VATs imposed at varying rates on the same base by regional governments, and a BVT (essentially an income-type VAT imposed by the subtraction or the addition method) levied on all VAT registrants by regional and perhaps larger local governments at relatively uniform rates.⁴¹ In addition, of course, all levels of government should apply appropriate user charges, and some excise taxes (particularly those related to vehicles) might appropriately be levied at the regional level. There is also a strong case in most developing countries for more effective local taxation of residential property, and the central government may continue to levy both a corporate income tax and a progressive personal income tax, perhaps, with regional governments imposing flat-rate PITs on the same base, if they so choose.

Much more work remains to be done to develop the details of such a scheme in the concrete circumstances of any particular country. Myriad details of design and administration need to be settled, the relation between different levels of subnational government needs careful thought, and the role and design of intergovernmental fiscal transfers needs to be reconsidered,⁴² as does the appropriate and tolerable level of asymmetry in the appli-

cation of the suggested principles to subnational governments of vastly differing size and competence. Nonetheless, it does appear that three long-accepted principles governing subnational taxation need to be rethought—and largely discarded:

First, the conventional model of tax assignment, which in effect assigns all significant revenue sources to central governments, is clearly inappropriate for countries in which subnational governments, for whatever reason, account for a significant proportion of public sector spending. If such governments are to be big spenders, they must, in the interests of fiscal responsibility and accountability, also become bigger taxpayers.⁴³

Second, subnational VATs are possible. The VAT is the key to central-government finance in most developing countries. Central governments are obviously most reluctant to lose any control over this tax, and this understandable reluctance has, until now, been supported by the conventional wisdom that subnational VATs are not technically feasible. Contrary to what has long been thought, however, such taxes are feasible. Subnational VATs (supported by something like the CVAT as discussed above) may, over time, become the most important source of subnational revenue in at least some larger federal countries.

Third, although the user charge and property-tax package recommended for financing local governments is admirable in many ways, 30 years of experience has made it clear not only that these proposals are very difficult to implement, but that they are unlikely to provide an adequate fiscal base if local governments have major spending responsibilities in the social area. One result has been the proliferation of a variety of bad local and regional taxes on business. A partial answer may lie in the introduction of a “business value tax” (BVT) at a low and uniform rate. While such a tax might first be considered as a replacement for clearly undesirable subnational corporate income taxes, it might also be extended in some instances to replace local non-residential property taxes, with local supplemental rates imposed on the same base as a regional BVT.

Even major reforms along these lines would not, of course, solve all the problems of establishing sound and workable subnational tax regimes in all developing countries. Such reforms would, however, move matters in the right direction.

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Endnotes

1. The classic tax assignment arguments are set out in Musgrave (1983). Recent restatements may be found in Oates (1998) and McLure (1999a). For a review of this literature, see Bird (1999).
2. In reality, most "retail" sales taxes, even in developed countries, fall to a considerable extent on business: One Canadian study, for example, found that one-third to one-half of the retail sales tax base in different provinces consisted of sales to other businesses (Kuo, McGirr, and Poddar 1988).
3. For an earlier statement of this argument, see Bird (1993a). An important implication of strengthening subnational revenues is that the resources accruing to different states or provinces will differ greatly, depending upon their access to the tax base in question. While transfer systems could in principle be adjusted as desired to prevent unduly penalizing poorer regions, the extent to which such adjustments will in fact be made is very country-specific—compare, for example, the cases of Canada and the United States, and Germany and Switzerland (Bird 1986). The interdependence of tax assignment and the design of transfer systems will not be discussed further in this paper, however.
4. Such transfers would, of course, be horizontal, between provinces or municipalities, and not between levels of government.
5. Of course this does not preclude intergovernmental fiscal transfers not only to achieve the usual "spillover" objectives but also, in some circumstances, to ensure the adequate provision of certain services to "national standards." For a suggested design for such a system in Colombia, see Bird and Fiszbein (1998).
6. The Canadian tax is described in Bird and Gendron (1998). Varsano (1995, 1999), Bird and Gendron (1997), and McLure (1999b) contain further relevant discussions.
7. The history of this idea, and various partial examples found around the world, are set out in detail in Bird (1999). An empirical application of this approach to Canada may be found in Bird and Mintz (1999).
8. Law No. 6775 of December 19, 1996 lists six newspaper-sized pages of fees and charges.
9. For further discussion of the theory and practice of user charges, see Bird and Tsiopoulos (1997).
10. The classic arguments for the property tax as a "user charge" may be found in Vickrey (1965) and Netzer (1973). For a modern view, see Fischel (1992).
11. As with the other very condensed reviews of alternative subnational revenue sources in this section, such statements may appear to be unsupported assertions. For the most part, however, they are grounded in decades of experience and dozens of specific examples. For further discussion of property taxes, for example, see Bird (1974) and Dillinger (1992).
12. Such levies are not further discussed here. See Bird (1992).
13. For a somewhat out-of-date overview, see Garzon (1989). Of course, property-tax systems vary widely from country to country. See, for example, Rosengard (1998) and Youngman and Malme (1994) on Chile, Fuentes and Lungo (1999) on El Salvador, Bird (1984) on Colombia, and Dillinger (1992) on Brazil.
14. In principle, there is no reason why *any* maximum needs to be established at all with respect to residential properties—though with respect to industrial and commercial properties there may be a case for a maximum (to restrain tax exporting) as well as a minimum (to restrain tax-base competition, if desired) with respect to industrial and commercial properties.
15. See, for example, the data for Santa Fé, Mendoza, and Buenos Aires reported in World Bank (1996).
16. See, for example, Canada's recent experiences with tobacco taxes (Bird, Perry, and Wilson 1998) and Colombia's departmental tax on beer (Bird 1984).
17. On the other hand, the fact that income tax revenues tend to grow with less political fuss, while presumably good news for local officials, suggests that increased reliance on local income taxes ought perhaps to be viewed with mixed feelings.
18. German municipalities also receive significant revenues from an even more complex tax on businesses (*gewerbesteuer*) levied in part on profits, in part on payroll, and in part on property. See also Section VIII.
19. Note, however, that Canadian local governments cannot levy income taxes of any description. As Bird and Chen (1998) have

argued more generally, there are definitely two distinct worlds of public finance in Canada—federal-provincial and provincial-local.

20. Poddar (1990), in the most thorough early discussion of this issue, had demonstrated that the destination base was technically feasible, although the particular approach he discusses seems unlikely to work well in developing countries.

21. IPI (*Imposto sobre Produtos Industrializados*) is levied by the federal government on industry, and ICMS (*Imposto sobre operacoes relativas a Circulacao de Mercadorias e Servicos*) is levied by the states on agriculture, industry, and many services. In addition, another tax, the ISS (*Imposto Sobre Servicos*) is levied on a gross receipts basis by municipalities on a variety of industrial, commercial, and professional services, and there are also a number of other taxes on financial transactions, retail sales of fuel and so on that are not discussed here.

22. For further discussion, see Purohit (1994) and Shome and Spahn (1996).

23. Some recent proposed reforms are discussed in Afonso (1996), Shome and Spahn (1996), and Silvani and dos Santos (1996). For a recent discussion of the Brazilian situation, see Varsano (1999).

24. This problem seems to have been exaggerated, however, because the new tax, like the existing tax, would also largely be collected at the pre-retail stage. A manufacturer or wholesaler selling a product for 100 pesos to a retailer will actually charge, say, 103 pesos, with the additional 3 pesos being remitted to the government as a sort of “withholding” against the 6 pesos (or whatever) the retailer is in principle supposed to charge when he sells to a final consumer, at, say, a 100 percent markup for an ex-tax price of 200, or 206 tax-inclusive. The retailer will then owe the government 6 pesos less the 3 pesos already withheld for a net tax due of 3 pesos. If, as is all too likely, the retail sale does not come to the notice of the authorities, they have the 3 pesos at least. The mechanics of this system are similar to a value added tax and, as with a VAT, one reason for adopting this approach is to avoid losing all the revenue by making the only taxable act the hardest to control, namely, the final sale. The end result, however, is that in fact the new system will not be very different from the old in the sense that most revenue would continue to be collected from established larger pre-retail firms.

25. This version would be similar to the so-called “Harmonized Sales Tax” (HST) currently in force in three small Canadian provinces (Bird and Gendron 1998).

26. It should be noted that with any change to a destination-base consumption tax “producing” provinces would clearly lose revenue. A credible “revenue guarantee” would likely be needed to make any approach acceptable. Revenue gains (or losses) to particular jurisdictions from tax substitutions are unlikely to have the same magnitude—and may even have different signs—than real economic

changes, but it is clearly the visible revenue effects that dominate discussion of these issues even in developed countries (Keen and Smith 1996), although this important question is not discussed in detail here.

27. It is perhaps not unimportant that a precedent existed for this under the long-standing Québec personal income tax, the base for which is also almost identical to the federal PIT—although in this case, unlike the QST/GST case, the two taxes are collected independently.

28. The federal share is turned over to the federal government after deducting an agreed per-registrant administrative cost. No problems have arisen from such intergovernmental collection arrangements, which are quite common in Canada (although the revenue flow has invariably been the other way in the past—that is, from the federal to the provincial governments.)

29. Note that the federal government does not assess QST on imports at the customs point. This is one of the major differences from the HST system mentioned in an earlier note. Since the federal government has recently agreed to collect Ontario’s RST at the border together with the GST, reportedly in exchange for Ontario’s support of a recent revision in social security, it appears that this issue is perhaps being resolved more on political than on technical grounds.

30. Apart from a very few cases, Canadian provinces have traditionally not worried too much about this problem, because geography ensures that most major population centers are not close to borders with other provinces. The advent of electronic commerce, however, is likely to lead to much more concern with this issue (McLure 1998).

31. As described in Bird and Gendron (1998), Canada also demonstrates that it is perfectly feasible to have several different types of relationships (or non-relationships) between central and sub-national sales taxes, but this point is not pursued here.

32. This assumes that the state VAT rates are lower than the central rate. If, as in Brazil, the state rates are substantially higher, there might be some residual need for a “clearinghouse”—though on an aggregate, not transaction basis—but this would not seem to be a very difficult problem if, as would seem generally advisable, there is central administration of state VATs.

33. Presumably, as in Canada, the central government would receive an agreed—per registrant?—fee for its services.

34. As emphasized earlier, on the whole more homogeneous or smaller countries would likely still seem better advised on the whole to follow the HST approach to sharing VAT revenues. As Canadian experience suggests, it may be possible to apply both HST and CVAT approaches simultaneously in different states.

35. For discussions of such taxes in developed countries, see Pola (1991) and Bennett and Krebs (1988).

36. See, for examples, Thirsk (1982) and McLure (1994).

37. As Sullivan (1965) has documented, the original conception of the VAT, by Adams (1918), was as a business benefit tax. For further historical references, see Bird (1999).

38. For similar suggestions, see Allan (1971), Bird (1979), Head (1996), and other sources cited in Bird (1999).

39. Note that an "income" basis can be applied to gross income, net of depreciation income, or even consumption (add back depreciation and deduct capital expenditures). It is assumed here that the net income basis is the most logical.

40. These arguments are by no means solely theoretical, since there is already some important real-world experience with such taxes, both in the states of Michigan (the former BAT, or business activities tax, from 1953 to 1968, and, since 1976, the SBT, or single business tax) and New Hampshire (the business enterprise tax, or BET) as well as in Italy (the new regional business tax, the IRAP) and Germany (the old "local trade tax" or *gewerbesteuer*). For further discussion, see Bird (1999).

41. Note that since the BVT is imposed on essentially the same base as the gross income that should be reported for income tax purposes, its introduction might also provide an appropriate occasion for the introduction of a uniform and unified tax administration encompassing both VAT and CIT plus business PIT at all levels of government. Such administrative elaboration must, however, be left for a later date.

42. Devolving more taxing authority to subnational governments will mean most in revenue terms to those with the largest tax bases. As noted earlier, if a country is at all concerned with providing relatively equal opportunities for access to key public services, a more explicitly equalizing transfer system may therefore be required (Bird and Fiszbein 1998). In addition, special problems invariably arise with respect to taxing natural resources, especially in countries in which subnational governments are considered to "own" the resources that fall within their territory, but these problems cannot be discussed further here (see Mieszkowski 1983).

43. To repeat, transfer systems need to be redesigned to accommodate different tax assignments, since more access to tax bases means little to subnational governments with few bases to access.

Subnational VATs

Subnational Taxation and Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution

R I C A R D O V A R S A N O

I. Introduction

Many Latin American countries have substantially decentralized government expenditures, but for the most part taxes are still collected centrally, with a large part of provincial expenditures being financed with intergovernmental transfers. Though greater taxation at the provincial level seems to be desirable, the design of broad-based taxes suitable for subnational governments (SNGs) is, as the case of Brazil illustrates, a complex task.

Brazilian SNGs finance most of their expenditures with taxes they raise. Each successive republican constitution—even those enacted under authoritarian regimes—gave SNGs the authority to levy a set of taxes that included at least one important source of revenue. In recent years, Brazilian states have been responsible for approximately 29 percent of total tax collection in the country, while municipalities raised another 5.5 percent. A system of transfers—from the central government to state and local governments, and from each state to its municipalities—adjusts tax revenue distribution so that state and local governments dispose, respectively, of about 27 and 16.5 percent of public-sector total revenue to finance their activities.

Historically, the flow of goods and services has been the base of the main taxes assigned to SNGs. Since 1967, their most productive tax has been a value-added tax (VAT), collected by the states, whose revenue is shared with their municipalities.¹ Services, except communication and interstate and intermunicipal transportation, are excluded from its base and subject to a separate municipal tax (ISS).² The state VAT (ICMS)³ accounts for about one-quarter of Brazil's total tax burden.⁴

Substitution of the VAT for previously existent turnover taxes sharply reduced the noxious effects of Brazilian taxation on the economic system. On the other hand, a subnational VAT whose revenue is almost 7 percent of GDP—then, and still now, a unique case in the world⁵—posed difficult horizontal tax coordination problems.

Severe restrictions, allegedly addressing these problems, were imposed on state tax autonomy. They were partly relaxed by the 1988 Constitution; and another part has been disregarded by states, which engaged in an unlawful but unpunished “fiscal war,” each aiming to attract industrial plants—both new and existing elsewhere—to their territory. Legal restrictions clearly did not solve the coordination problems, which still exist and, as shall be argued in this paper, rest on the ill-conceived tax treatment of interstate trade flows.

Discussion of tax reform is now in progress in Brazil. An important minority argues that simplicity of taxation should be its utmost goal and proposes a “tax revolution” that would drastically reduce the number of taxes and thoroughly centralize their collection. But most analysts,

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although recognizing that present tax system is too complex and needs to be simplified, say that the effects of taxation on economic efficiency and on competitive conditions are the main reform issues. According to their view, though state and local sources of revenue must be preserved—for both economic and political reasons—some limitation on SNG taxing powers is unavoidable to accomplish those objectives.

It follows that the basic question yet to be answered in the tax reform process is political: What is the “reasonable” trade-off between SNG autonomy on the one hand, and economic effects and simplicity of taxation on the other? Provided the answer will not be biased toward a “revolutionary” (very radical) solution, a technical choice will be: Which broad-based tax best suits Brazilian states? Dual VAT and retail sales tax (RST), besides the existent state VAT, are the models presently being considered.

It will be argued in this paper that many of the remaining problems of Brazilian subnational taxation could be solved if a consumption type, destination-based dual VAT⁶ were substituted for both the ICMS and the federal VAT (IPI),⁷ as well as for the ISS. As implementation of the destination principle by zero-rating exports to other states widens an already existent loophole, which is responsible for an unknown but certainly large amount of evasion, we consider an alternative scheme to implement it. This is a simple procedure, with low administrative cost in comparison with others proposed in the literature, which has the virtue of closing, instead of widening, the loophole. Furthermore, the scheme is compatible with gradual transition toward the destination principle, which would avoid sudden changes in revenue distribution among states, a necessary condition in Brazil for the success of any tax reform proposal.

The next section contains an overview of the evolution of Brazil's main sources of subnational revenue. After a short presentation of recent tax reform proposals (Section III), the arguments in favor of the adoption of a destination-based dual VAT are put forth in Section IV, with emphasis on issues related to the current scheme for taxation of interstate trade. Section V details the scheme for treatment of interstate trade mentioned above and compares it with other procedures previously suggested for Brazil. A brief note on possible use of the proposed scheme in other countries closes the paper.

II. A Partial History of Subnational Taxation in Brazil⁸

Brazil's experience shows that the time between the first demands for tax reform and its implementation is usually long, and that, when reform finally happens, it generally falls short of promoting a full revision of existing shortcomings. These events reflect the resistance coming from economic agents, governments among them, who fear, for both individual and collective reasons, the effects of changes in taxation. Slow pace and reconditioning old taxes rather than replacing them, which provide a protective barrier against sudden changes, are typical in the evolution of a tax system.⁹

As a corollary, the current system is never a creature of its own time. Most taxes now in force have remote origins, resulting from changes introduced over decades. As such, they generally inherit many of the features—and deficiencies—from preceding taxes. Strangers to Brazil's tax tradition will find it hard to understand why obvious and seemingly easy-to-correct shortcomings exist.

Federalism in Brazil dates back to the proclamation of the republic in 1889, when provinces of the unitary imperial regime were converted into autonomous states. Separation of revenue sources has been the doctrine since the first Republican Constitution (1891); it established that each state could establish which taxes its municipalities could levy. This rule was changed by the 1934 Constitution, which defined exclusive municipal taxes as well.

Taxes other than those mentioned in the Constitution itself may be created only by the level(s) of government specified by the Constitution. Up to 1965, except in the period 1937-46, both federal and state governments were entitled to exert this residual taxing power. Since 1967 this power has been the federal government's exclusively, provided some very restrictive conditions are satisfied.¹⁰

Since 1965, constitutional provisions not only list taxes to be levied by each level of government but also define some of its basic characteristics; and a National Tax Code and other complementary laws¹¹ provide further specification. SNG tax autonomy, previously almost unbounded, was drastically reduced. A system of mandatory intergovernmental transfers is also defined by constitutional provisions and regulated by complementary laws.

Changes in the structure of the tax system and, in some cases, even in the basic features of a particular tax require for these historical reasons that a constitutional

amendment precede alterations in complementary and ordinary laws. Approval of an amendment proposal requires hard political negotiation within the course of a long and complex legislative procedure.¹² Because any tax reform proposal implies conflicts of interest, concessions must be made that jeopardize its technical qualities and consistency, and slow down the upgrading process of the tax system.

The 1891 Constitution did not introduce any significant change in the tax structure in force during the empire. Because the country's economy was mainly agricultural and extremely open, taxes levied on foreign trade accounted for two-thirds of the public revenue. The federal government was entitled to levy the Import Tax—whose revenue amounted to about half the public sector total—as well as several less important taxes. The Export Tax was given the role of chief revenue source for the states,¹³ despite the opposition of those who had the view that, as an instrument of foreign trade policy, it should be assigned to the central government. Imposed by states on both international and interstate transactions, it was responsible for around 40 percent of state government revenue in the beginning of this century.

It took more than a century of progressive imposition of restraints on state taxing powers before legislation could be enacted that prevented them from using exports to other countries as a tax base. And states still tax their exports to other federate units.

Despite reductions in foreign trade flows due to World War I and, later, to the Great Depression, the Export Tax kept its position as the largest state revenue source up to the mid-1930s. At that time, the 1934 Constitution and several laws introduced important changes in the country's tax structure, starting a new phase in which domestic taxes were predominant. Imposition of the Export Tax on interstate transactions was outlawed; and a 10 percent ceiling was placed on its rates applied to foreign trade. On the other hand, states were given exclusive power to levy a general turnover tax (IVC) which was assessed on outbound trade as well.¹⁴

Under these circumstances, IVC quickly became the main source of state revenue. In the early 1940s, it accounted for 30 percent of total state revenue, while the contribution of the Export Tax dropped to less than 4 percent. The ceiling on Export Tax rates was lowered to 5 percent by the Constitution of 1946. Despite its declining

revenue, states had raised the tax until it was assigned to the federal government by the reform of the 1960s.

Turnover taxation also became the foremost source of revenue for the other levels of government. Limitation on international trade and, thus, on Import Tax dues, imposed by World War II, forced the federal government to resort to a larger extent to domestic tax bases. Participation in its financing of both the Income Tax and the Consumption Tax increased sharply.¹⁵ At the municipal level, the Tax on Industries and Professions, assigned to local governments by the 1946 Constitution, became practically a replica of the IVC.¹⁶ In the early '60s, the Consumption Tax, the IVC, and the Tax on Industries and Professions accounted for about 40 percent of federal, 70 percent of state, and 45 percent of municipal revenues, respectively. They amounted altogether to 65 percent of the country's total tax collection.

Since the early 1950s the Brazilian government had striven to put in place an industrialization process, which could hardly take off with such a burden of cumulative taxation. In 1956 the country started its move toward value-added taxation, beginning with the Consumption Tax. After a transition period, it became, in 1964, the IPI now in force. The same model was applied to transform the IVC into the ICM in 1967.¹⁷ The municipal turnover tax was eliminated, local governments being entitled to tax services and to receive 20 percent of their state's ICM revenue.

The reform carried out during the 1960s, the most comprehensive of all Brazilian tax reforms, was successful with respect to its declared goals of quickly restoring federal finances and sharply reducing the negative impact of taxation on economic efficiency. Although deserving criticism on important grounds—curtailment of SNG autonomy and inequity—it has the merit of starting a new phase in which taxes really are based on economic considerations and aim at economic goals, and are not merely a group of revenue sources.

It should be noted that adoption of the VAT in Brazil preceded its use in all European Economic Community (EEC) countries but France; and that the country was a pioneer in subnational VAT, at a time when speed of information to and within Latin America was very slow. These historical circumstances, associated with the traditional endurance of tax provisions, explain why—in a world where information disseminates fast and VAT is wide-

spread—the quality of current Brazilian VATs lags behind that of most similar taxes elsewhere.

The Consumption Tax was refashioned after its French counterpart, but it took as its model the 1948 version of the tax, which had just been replaced. ICM was conceived upon the IPI legislation and, like the French tax of that time, did not include services in its base.¹⁸ Therefore, unlike VATs of most other countries, both IPI and ICM did not benefit from important improvements introduced in French taxation in 1954 and 1968, which considerably reduced cumulative taxation of inputs. And, of course, no model existed for taxation of interstate transactions, except for the proposal contained in the so-called Neumark Report, which treated the similar problem of taxation of trade among EEC countries (International Bureau of Fiscal Documentation 1963).

The Neumark Report proposed that EEC countries treat trade with third countries according to the destination principle, and that they apply the origin principle to intra-community trade. This scheme, known afterward as the restricted origin principle, would have the advantage of eliminating fiscal barriers at intra-community borders. The report did not explore the economic consequences of the adoption of the restricted origin principle, but suggested that, in order to avoid economic distortions and intricate administrative procedures, tax rates should be the same (or, at least, very close) in all EEC countries. This severe restriction on fiscal sovereignty is probably the main reason for the repeated postponements of the adoption of the scheme, not yet in practice in the European Union.

In Brazil, the restricted origin principle was adopted for the ICM with a flaw, which is, in fact, a concession to tax tradition: Immunity for exports to other countries was granted only to industrialized products, so that states were allowed to impose the tax on their exports of primary goods. And, as supposedly necessary, the autonomy of states to fix their own rates was restrained. Uniform rates were required within each geo-economic region of the country; and ceilings, estimated to approximately replicate state revenues just prior to reform, were imposed on rates. Together, these conditions implied almost uniform rates nationally. Due to the initially high revenue produced by the new tax and to the authoritarian environment, the need for restrictions remained unquestioned, and political reaction to the loss of autonomy was minor.

Instead, the central theme of debates had been the distribution of revenue among states. Since the restricted origin principle favors net exporters in interstate trade—which, in Brazil, are the more developed states—poorer units reacted to what, in their view, was an unfair revenue distribution. The adopted solution was to apply a lower tax rate to cross-border trade, so that revenue coming from these transactions would be shared between importing and exporting states. The portion allotted to each unit depends on the difference between the rates applied to internal and interstate transactions, which has been increased over time to favor less developed states, without much attention to the aftermath of this practice.

No matter how all conceptual deficiencies with the ICM are presented, it cannot be denied that adoption of a subnational VAT was a major breakthrough, which provided states with a reliable revenue source whose effect on efficiency was much milder than that of their turnover taxes. Cumulative taxation was not eliminated,¹⁹ but its burden had become much lighter than before. Unfortunately, cumulative taxation was amplified by federal social contributions created in the 1970s and 1980s and maintained by the 1988 Constitution.

This Constitution, whose development was marked by strong reaction to centralism imposed by military rule, substantially strengthened subnational finances, particularly those of local governments. Influential “municipalist” and “regionalist” groups of constituents showed preference for federal grants rather than SNGs’ own fiscal effort, which resulted in an excessive increase in the amount of mandatory federal transfers to those units. Several proposals intending to improve the quality of SNG taxation were advanced during the parliamentary discussion, but few prospered. Most clashed with the strong resistance to any innovation that could imply a reduction of SNG revenues, even to those associated with other changes that would more than compensate for such losses.

Regarding the ICM, transactions involving fuel, electric energy, and minerals, as well as the provision of communication and interstate and inter-municipal transportation services, were included in its base (the corresponding federal excises being eliminated), giving rise to the ICMS. But a proposal for inclusion of all other services (eliminating the ISS and compensating municipalities with increased participation—from 20 to 25 percent—in the state tax proceeds) was rejected (though the higher municipal share

held). States recovered their autonomy to set the rates applied to intrastate transaction, which might be selective.

A proposal for the adoption of the destination principle both for international and interstate trade (with collection at the origin and a “clearing house” procedure) was rejected, except for interstate transactions with fuel and energy, which were zero-rated (promoting, in the case of fuel, gross evasion). In all other cases, rules for taxation of interstate trade were not changed. Regarding foreign trade, a move was made in the wrong direction: Not only did primary exports remain taxable, but immunity was dropped for part of the industrialized products, so-called “semi-elaborated” (a new category, which would be defined by law). Moreover, a federal transfer, equivalent to 10 percent of the IPI revenue, was created like compensation to SNGs for not collecting taxes on manufactured exports (a rule which was in force since 1967).

ICMS has been in force since March 1989, regulated by norms collectively adapted by states from previous ICM legislation. These norms, as prescribed in the Constitution, would provisionally make up for a missing complementary law. Years later, taxpayers disputed the legality of ICMS assessment in the hardly provisional absence of a law. The threat forced its discussion and, after six months of intense negotiation—SNGs on one side and federal government on the other, with the National Congress acting as the referee—a proposal for regulation of the ICMS quickly passed through legislative procedures, becoming Complementary Law No. 87 of 1996.

Insofar as the quality of subnational VAT is concerned, this law has been the most important piece of legislation enacted in the country. It eliminated remaining subnational taxation of Brazilian exports, putting a stop to the struggle that had lasted for over a century.²⁰ Furthermore, two original deficiencies of the ICM were finally corrected. Capital goods have been exonerated, by providing the buyer with credit for the tax previously paid. And, in 2000 (if implementation is not postponed for the second time) credit will be allowed for taxes paid on all inputs rather than only for those corresponding to inputs embodied in the produced goods.²¹

III. Recent Tax Reform Proposals

Complementary Law No. 87 reduced the quality gap between the ICMS and similar duties in force in other countries. ICMS is now a consumption-type VAT and—

from a national, though not from a state, viewpoint—a destination-based tax. Yet dissatisfaction persists, and further reform is needed to give the subnational tax the contour of a modern VAT.

A non-exhaustive list of complaints includes lack of uniformity in tax rules and rates among states; high compliance costs; hindering international fiscal harmonization; complex and burdensome administration, both to taxpayers and the public sector, due to the existence of two different VATs, a federal and a state one; preservation of some degree of cumulative taxation due to exclusion of services from the tax base; inability to generate a reasonable level of revenue to less-industrialized states; undesired redistribution of revenue among states in the cases of exports to other countries and capital goods purchases; a high level of evasion, part of which is due to the difference between rates applied to intrastate and interstate transactions; vertical inequity; and fiscal war among states competing for new plants, which disturbs state financing, allocation of resources, and harmony in the federation.

There are three groups of critics: those who propose simplification through centralization of tax collection and reduction in the number of taxes (among these, extremists whose banner is the single tax); those who believe the VAT is an inadequate source of revenue for subnational governments; and those who propose that the VAT should be maintained but undergo further improvements. Concrete proposals representing all groups have been under discussion since 1995, when a proposed amendment to the Constitution (PEC 175/95) was presented to Congress by the president.

Tax systems proposed by the first group, the so-called “tax revolutionaries,” are—primarily or totally—made up of a few excise and cumulative taxes (or, in the limit, by a single tax on financial transactions), centrally legislated and collected, and distributed to government units according to a predetermined rule. Though no economically relevant country operates such a system, its supporters claim it is simple and practically evasion-proof and say it is the modern trend in taxation.

Tax revolutionaries ignore the fact that the existing tax structure results from a century’s evolution, and they disdain all recommendations put forward by public finance theory and oversimplify fiscal federalism. Their alleged modernity is but a return to Dark Ages, when taxes were merely sources of revenue without any attention being paid

to their economic effects. Tax revolution proposals point their guns at the ants (the tax administration costs) and feed the elephants (the costs of tax-induced inefficiency). They would be looked upon by tax experts as mere curiosities, if it were not for their strong appeal to non-specialists. On one side, taxpayers feel they pay more than their fair share because tax authorities are unable to control evasion. On the other, the benefits of the revolution tend to be much more visible to politicians than its costs.

The second group proposes federalization of VAT (services included in its base) and substitution of a set of excise taxes for the IPI. Subnational units would derive most of their own revenue from a retail sales tax and have their revenue losses compensated for by larger federal transfers. This proposal, originally developed by the University of São Paulo and the Federal Revenue Office, was presented by the Ministry of Finance in 1997, and has been strongly opposed by states and municipalities.

This proposal must be implemented all at one time, running the risk of losing revenue in the midst of the current fiscal adjustment effort. It requires reinforcement of federal tax administration staff and retraining of those of states, increasing overall administrative costs. Furthermore, the retail sales tax, at least in Brazil, is much more difficult to control and much less productive than the VAT, so that subnational governments would become more dependent on federal transfers.

Representatives of the last group are the PEC 175/95 itself, its revised and expanded version prepared by IPEA in 1998,²² as well as the new Ministry of Finance proposal, presented in December 1998. Though there are important differences among them, all suggest a destination-based general dual VAT as the solution for many of the remaining unsatisfactory characteristics of taxation of goods and services in Brazil.

IV. The Case for a Destination-Based Dual VAT

Value-added taxation proved to be an adequate form of raising revenue in a country with a fast-growing industrial sector, where retail activities were mainly carried out by a large number of small traders and the informal economy was sizable. Thirty years later, Brazilian industry has consolidated; service has become the most dynamic sector; retail activities have concentrated in larger firms, though small retailers, predominant in number, are still responsible for a significant share of the value of sales; and informal

economic relations are pervasive, accounting for almost half of total employment. Openness of the economy has increased in the 1990s and is expected to grow further and faster in the near future.

Of course, taxation must be adjusted to face the new reality. Many neophytes—there is a plethora of self-nominated tax experts in Brazil—claim that adoption of a VAT would be the best solution for the country, without realizing that the problem is just the opposite: There are 28 different VATs in Brazil—the federal one, one in each of the 26 states, and one in the Federal District. They are unable to identify IPI and ICMS as taxes similar to the VATs they see in other countries; and, in some important senses, they are right.

IPI and ICMS are partial taxes, the former on manufactured goods only and the latter on all merchandises but not on services in general. They are highly selective taxes, with many distinct rates applying to different goods; and, in the case of the ICMS, the rate concerning any particular good varies among states while interstate transactions are subject to one out of two different rates, set by the Federal Senate.²³

The federal and the state taxes are ruled by different legal norms, and distinct bookkeeping for each is required from taxpayers. Notwithstanding the existence of a national law that defines its main characteristics, ICMS norms differ among states in several respects. Firms that have several plants and operate nationally must deal with up to 28 distinct sets of laws and consider up to 30 different rates that apply to each good they sell. Legislation has been changing over time and is now so intricate that it is almost impossible for a taxpayer to know it fully and comply with it. Even tax administrators are confused about their own state norms.

Moreover, a complementary law provides a comprehensive list of services that are liable to the ISS. Its rates are much lower than those of the ICMS; but those rendering services are not allowed credits for taxes paid on either their goods or services inputs. In the same way, producers of goods cannot credit the municipal tax paid on their services inputs against their ICMS and IPI liabilities.

Clearly, simplification is a compulsory course for reform. As tax administrations and taxpayers have acquired a solid experience in dealing with value-added taxation techniques, it seems that the logical path to follow is substitution of a dual VAT, with a single national set of legal

norms, for both IPI and ICMS. This change would be consistent with smooth transition and low risk for the fiscal adjustment process now in progress.

Regarding this conclusion, three important questions must be discussed, all somehow related to the issue of SNG tax autonomy:

1. Should the dual VAT be general—i.e., should services, now subject to the municipal ISS, be included in its base?
2. Would states be willing to forgo their current taxing power?
3. Should the destination principle, now fully applied to international trade but only partially to interstate trade,²⁴ be the general rule for border tax adjustments?

Should Services Be Included in VAT base?

There are sound economic reasons for the incorporation of services in the dual VAT base. The ISS and its interaction with taxes on goods raise several problems:

- a) Identification of services by means of a list—what is necessary due to the gray borderline between goods and services—may result in not assessing some of them, particularly if the list is not revised frequently in a world where new types of service often spring up.
- b) The ISS is not fully adequate for Brazilian municipalities. Many have hardly any base to tax. And, as changing the fiscal domicile of a service firm is usually inexpensive and barely interferes with its business, even tiny rate differentials between units may affect their location. This stimulates competition among municipal governments to attract taxpayers (rather than their activities), to the detriment of the finances of all.
- c) Families in the higher income brackets tend to use a larger fraction of their income to consume services. Therefore, if rates on the final consumption of services are lower than those on the consumption of goods, the tax system becomes more regressive.
- d) Intermediary consumption of services, on the contrary, is overtaxed relative to that of goods. Its cost is a component of the price of produced goods and, thus, is subject to the ICMS and the IPI, besides the ISS. As services rendered and used inside the same production unit are not taxed, inefficient vertical integration of production is stimulated.

- e) Exports of goods are not completely exempt. That part of their value that corresponds to the cost of service inputs is taxed.

On the other hand, there are also strong arguments against elimination of the ISS or, at least, in favor of postponing the efficacy of such precept:

- a) VAT assessment of services is far more complex than that of goods. Many types of services require special tax norms that, although in force in other countries, are largely unknown in Brazil. Of course, norms may be imported and adapted; but because no Brazilian tax expert is acquainted with these rules and no possible foreign consultant has factual knowledge of pertinent Brazilian particularities, some learning time is necessary until a VAT on services can be properly implemented.
- b) Substitution of value-added taxation of services for the ISS probably implies that revenue coming from these activities will shrink. Though there are no reliable estimates of the relative importance of services used as inputs in total ISS base, a recent rough appraisal indicates that they account for about 75 percent of its revenue in the city of São Paulo.²⁵ As no tax proceeds will be derived from intermediary consumption of services, rates on other services should be—and almost certainly will not be—around 4 times larger than current effective rates in order to compensate the revenue loss. Since losses amidst a fiscal adjustment process should be avoided, either substitution must be postponed, or other revenue sources must be sought for compensation.
- c) Despite all difficulties, the number of local units that instituted the ISS is no longer small, and overall revenue is far from negligible. In 1996, over 4,000 of the more than 5,500 municipalities were collecting the tax. ISS revenue amounted to approximately 0.6 percent of GDP and represented 36 percent of total municipal own-tax revenue. ISS is an important source of funds, especially for larger cities like São Paulo and Rio de Janeiro, which accounted together for 43.6 percent of total ISS collected in the country.²⁶

A proposal to replace the ISS by value-added taxation of services implies reduction not only in municipal resources, which may be compensated by an increase in transfers, but also in the taxing power of local governments. They will probably oppose the proposal unless they are awarded

another source of own revenue. It cannot count either on strong support from state governments, which show no enthusiasm for the additional revenue—small in relation to total VAT proceeds—provided by the inclusion of services in the VAT base and are well aware of the administrative difficulties resulting from the inclusion. Though the case for a general VAT is strong from an economic viewpoint, a political analysis may prove the proposal unfeasible.

Dual VAT and State Fiscal Autonomy

A basic problem in fiscal federalism is to find a reasonable balance between the need to ensure some degree of financial (which may also mean political) autonomy to SNGs and the need to avoid perverse economic effects of fiscal instruments. "Reasonable," of course, means this is a question that requires a political rather than an economic decision.

The Brazilian experience has been marked by the difficulty in harmonizing these objectives. It displays cycles of lesser and greater centralization of fiscal power that are related to the historical evolution of the political regime. Nevertheless, if cycles are disregarded, the trend shows a reduction in SNG fiscal autonomy, due to a growing concern with the coordination of public policies, with the impact of taxation on productive activities, and, lately, with international fiscal harmonization.

The 1988 Constitution, built upon strong reaction to centralism, though granting states the power to establish their own rates, maintained the previous rule of defining the main features of the ICMS by a national law. In practice, the power to set rates has seldom been exerted. Though rates differ among units, their dispersion is small, for they were fixed at levels close to the fiscal capacity of the population, and reductions are limited by the downward rigidity of expenditures.

It follows that federal VAT legislation, as required by the Brazilian dual VAT proposal, is barely a change from the current situation insofar as state taxing power is concerned. It seems that state authorities are prepared to accept that the central government has exclusive power to legislate on VAT, for they are convinced that present tax disorder hinders economic growth and is thus prejudicial to their own finances.

The question remains whether nationally uniform rates should be adopted for the sake of simplicity and avoidance of distortion, or some space should be reserved for

autonomous determination of each state revenue level. Although state governments do not seem to offer strong opposition to the former solution, they would certainly prefer the latter. So does the theory of fiscal federalism.

Shibata (1967) addressed the question of whether rate uniformity is in fact required, as suggested in the Neumark Report, to avoid economic distortions in a fiscal union that adopts the restricted origin principle. His conclusion was that rates might differ among countries without promoting distortions, provided all apply the same rate to trade with countries outside the union. In a 1979 paper (Varsano 1979, pp. 315-350), I showed that Shibata's result hinges on his assumption that factors of production were immobile between countries, which is unrealistic in the case of unions (or federations). If factor mobility were allowed for, Shibata's solution would bring in factor market distortions.

I argued, however, that a tax-credit type of VAT—the usual VAT all over the world—does not conform to the theoretical tax under analysis, and that, in this particular case (which, in practice, is the general case) the restricted origin principle tax, apart from distribution of its base among countries (or states) and some related questions, is equivalent in effects to a destination-based tax.²⁷

If the tax credit method is used to collect a VAT—each sale being taxed and registered traders being allowed a credit for the tax paid on their purchases—any good in circulation bears only the tax paid in the last transaction. As far as purchases of registered traders are concerned, all previous taxes are successively canceled by the corresponding tax credit, no matter the origin of the good and whether the restricted origin or the destination principle is used for border tax adjustments. The tax has no effect on decisions of taxpayers about where to buy.

If tax rates differ among jurisdictions, households and non-registered traders' decisions about their shopping place will be affected by the tax. But whether the rule is the restricted origin or the destination principle, goods bought within a country (or state) bear a tax assessed at the rate in force in that unit; and goods purchased outside the country (or state) are taxed at the rate of that place. If no tax difference exists in all transactions whether one or the other principle is applied, their economic incentives must be the same. Therefore, the argument for imposing restrictions on rates is no stronger in one instance than in the other.²⁸

Both in the case of the destination and the restricted origin principle, if the real-world VAT were, like its theoretical counterpart, a truly general tax, rate differential among states would provide stimuli to households to consume from the lowest tax jurisdiction. This includes distance-selling, such as the booming electronic commerce, and cross-border shopping, which is important only if sizable markets are situated close to state borders, or if the items being purchased are costly, in which case low taxes may compensate for travel expenses. Aside these stimuli, whose reflection on the supply side is a preference of the relevant retailers for locating their business in low-tax jurisdictions, the rate differential would have no effect on competition.

The demand-side incentives are at least partially counterbalanced by transportation, transaction, and information costs, which tend to be directly related to distance. If they neutralize the incentive, no problem exists; otherwise, they express the cost of the economic distortion introduced by VAT: Real resources are spent to economize on the tax to evade it. The social cost of disharmony in the federation, induced by resentment about revenue losses, should also be considered.

To prevent these effects, distance-selling firms could be required—some administrative cost being incurred to control compliance—to use the place of destination rate in assessing their sales to households. But hardly any control is practical in the case of cross-border shopping; only uniform rates among states would prevent tax effects. A reasonable compromise between autonomy and distortion costs would perhaps be reached if the law established a national standard rate and allowed states to fix their own rates within a range around it. This is the solution adopted by the IPEA/BNDES proposal, which limits the variation, upward or downward, to 10 percent of the standard rate.²⁹

The Case Against Zero-Rating Interstate Exports

ICMS is not a general tax, due to evasion, special assessment applied to small registered traders, and the existence of a sector not subject to VAT. In such a case, tax effects on conditions and location of production are significantly magnified, unless VAT on interstate trade is collected at the origin and rates are equalized.

The incentives affecting purchasers' decisions are of the same nature as those considered for a general VAT. However, two differences exist. First, they affect a much larger set of purchasers, including, besides households, most of

the service sector, small registered traders (who disregard tax credits and pay an arbitrated duty, whose amount is fixed per period or proportional to the value of their sales), and tax defrauders (who understate their sales and, to produce consistent tax account, omit part of their purchases). Second, in the two last cases, the interstate rate set by the Senate rather than the higher rate of the state of origin applies. For these groups of registered traders, if the interstate rate is reduced, the incentive to purchase out of state grows. Contrary to common sense, the destination principle implemented by zero-rating interstate exports is, regarding these tax effects, the worst case.

As there is a larger market to supply, incentives to locate firms, even industrial plants, in a low-tax state are far greater than in the case of a general VAT. Furthermore, if clients are mainly small traders and tax defrauders, it does not matter at all whether the state of location is a high- or a low-rate state. They will always prefer to buy out of state, provided the differential between their own state and the interstate tax rates is larger than the weight of transportation (and other minor) costs in the total value of purchases.

To give a dramatic real example: The largest Brazilian wholesaler is situated in the west of Minas Gerais and its market is mainly in the Northeastern states—between 1,000 and nearly 2,000 miles away. Despite this, as there are plenty of small retailers in these states, he has an advantage over local competitors because the interstate rate is 7 percent while the most common internal rate is around 17 percent. This margin probably enables him even to buy merchandise from an industry located in, for example, Ceará and resell it to a shopkeeper in that state. If the destination principle were implemented and interstate exports zero-rated, there would be no tax differential to be exploited.

A hypothetical wholesaler could do even better. Unless revenue officers are spread all over the state, it is easy to evade controls and simply transfer the merchandise from the industry straight to the small trader. Only the industry invoice would go to the location of the wholesaler, and his invoice would travel back. By the way, in this event, so-called “invoice sightseeing,” the country would be better off due to reduction in transportation costs.

Due to the difference between the internal and the interstate rates, “invoice sightseeing” is also used without any economic value except tax evasion. An interstate sale is simulated, but the true destination of the merchandise is a firm in the same state, which does not register the purchase

in its books of account. Piecemeal evasion, rather than the usual VAT piecemeal collection, continues until the goods reach the final consumer.

Western Amazon states and the Manaus Free Trade Zone are preferential destinations of the invoice both because of the distance from large production centers, which makes controls more difficult and expensive, and of the interstate rate, which is zero in these cases, maximizing return to fraud. In the case of fuel, to which a zero interstate rate also applies, large distributors estimate that they compete with defrauders whose evasion amounts to R\$1 billion a year.³⁰ If interstate exports are all zero-rated, the “invoice sightseeing” business will experience a boom.

It follows that the reason usually presented for preferring the destination to the restricted origin principle—to enable distortion-free (or almost) adoption of non-uniform rates among units of a fiscal union or a federation—does not hold. Restricted origin principle provides, in theory, equal results and, in practice, less distortion than zero-rate destination-based VAT.

Another conclusion is that if the full destination principle is implemented for treatment of interstate trade by zero-rating exports, compliant taxpayers will be worse off, because frauds will be larger in number and value, affecting their competitive conditions and, given equal government revenue, taxes due. To avoid evasion, tax collection at the origin is always best. Finally, though the revenue of less developed states may increase, their economy will probably be worse off, for producers will prefer developed states where production conditions are better, local markets larger, and access to remote markets ensured by rate differentials.

However, the choice of interstate border tax adjustments should also rest on some other considerations. As will be argued next, the destination principle is clearly superior to the restricted origin principle in several aspects.

The Case for a Destination-Based VAT Collected in the Origin

Up to this point, no attention has been given to the distribution of VAT base among the states. As the destination principle is adopted for international trade, ICMS is, from a national perspective, a consumption tax. The role of its interstate border adjustments is, essentially, determination of the distribution of the tax base among states. However, the choice of border adjustments has other consequences; and, unless the destination principle is chosen, unintended

redistribution of revenue among states and other undesirable effects take place.

Substitution of the destination principle for the part-origin-part-destination arrangement now in use would benefit, through redistribution of the tax base, the poorest Brazilian states, which are net importers in interstate trade. It would also correct an injustice of the present regime: Though contributing to an important national objective, a state whose international trade balance is positive and, for this reason, tends to show negative results in its interstate balance is penalized. On one side, its exports to other country are exempt from tax; on the other, only part of the value of its imports from other states generates revenue.

The current interstate taxation scheme promotes unintended redistribution of revenue among states whenever the interstate flow is the last operation or is followed by transactions that are taxed at a lower rate than that flow. Redistribution occurs in plenty of cases. For example:

- a) An industry in Pernambuco purchases a lathe from São Paulo, which taxes the capital good at the interstate rate (7 percent in this case). No tax proceeds accrues to Pernambuco that provides the credit to its taxpayer.
- b) A soy oil exporter located in Paraná imports soybean from Mato Grosso do Sul, paying a 12 percent tax. Its exports to other countries are tax-exempt and Paraná has to allow him a credit for the tax paid on its input.
- c) Santa Catarina decides to tax rice at 2 percent to benefit low-income families. A supermarket purchases rice from Rio Grande do Sul paying a 12 percent tax that is credited against Santa Catarina; and sells it to consumers charging the 2 percent tax collected by this state.
- d) A wholesaler located in Rio de Janeiro buys tomato sauce from Goiás and resells it to a retailer in Espírito Santo. The interstate rate for flows coming from Goiás to Rio is 12 percent. The tax paid to Goiás gives rise to an equal credit against Rio, while its export to Espírito Santo bears only a 7 percent tax.

Redistribution would be avoided in all these instances if the destination principle were applied to interstate trade.

This principle also fares better than the current interstate procedure in case redistributive taxation is pursued by using reduced (or zero) rates for goods whose weight in the budgets of low-income families is high. As tax proceeds of

a state depend partially on its production, units with production concentrated in one or more of these goods might oppose such a policy due to the revenue loss they would experience. Under the destination principle, tax collected by each state depends exclusively on its consumption, which is much more diverse than production, and no state would suffer an unacceptable loss of revenue if this equity policy were implemented.

Yet another advantage of the destination principle is the limitation it imposes on the use of the subnational tax as an instrument of the so-called "fiscal war." State governments grant industries partial or total reduction of the ICMS paid, generally in the form of long-term credit at zero or near-zero interest rate, in order to attract production to their jurisdiction. Though this practice is unlawful unless the concession of the incentive is authorized by all states, legal restrictions have been ignored and have never been enforced. "Fiscal war" has increased in intensity in the 1990s, bringing about conflicts in the federation.

Decentralized industrial policies are inspired by a legitimate aspiration of state governments to expand production, employment level, and income in their respective territories. From the standpoint of any particular unit, concession of the fiscal benefit is generally worthwhile. Unless the industrial plant would be located in the state even in the absence of the incentive, the revenue forgone would not exist anyway; and additional economic activity is induced.

But the dynamics of "fiscal war" are quite perverse. As the practice spreads out—with almost all states providing similar incentives—it loses its efficacy. No inducement exists when taxes are equally reduced everywhere. In this case, newcomers choose their location considering only market and production conditions; and important ones promote a kind of auction in an attempt to get a better deal from the state they had previously chosen. Since the incentive brings in unfair competition between newcomers on one side and firms to which no tax break was bestowed on the other, the latter justly press governments for equal conditions. In financially weaker states, which are the less developed, the level of revenue is hardly enough to provide the tax incentive and, at the same time, the financial services and economic framework lack the necessary quality and quantity to attract new production. After some time, more developed states win all battles of the "fiscal war."³¹

Origin-based taxation provides a base for concession of distortionary incentives—on interstate exports—which would not exist if the destination principle were put in practice. Moreover, importers are allowed a credit for a tax that is nominally positive but is, in fact, refunded to the exporter at the origin. This means that, in practice, the state of destination is the one paying for the incentive that brings into disadvantage its own firms that compete with the exporter. And the risk exists that these firms move to the state that offers the incentive. This is another feature of the "fiscal war": Once it is in place, non-participant states lose.

Adoption of the destination principle for treatment of interstate flows would drastically inhibit "fiscal war." It would cut off part of the base for incentive concession. A state would be able to attract industrial plants by means of tax refund only insofar as their production is directed to their own market.

To sum up, there is clearly a case for the adoption in Brazil of a destination-based dual VAT, provided that states avoid zero-rating interstate exports. The best solution is to tax interstate flows at their origin and to assign such revenue to the state of their destination. Two procedures were proposed in the past, one in 1974 and the other in 1979, which could, in theory, provide such a solution.³²

Both procedures are akin to the Commission of the European Communities (1996) proposal ("clearinghouse" method). The 1974 proposal, presented to the Senate, suggested the creation of a national fund. Tax proceeds would be deposited in and drawn upon the fund by states according to formulas based on interstate trade statistics. The formulas boil down to assignment of the amount of tax collected at the origin on interstate transactions to the states importing goods. The 1979 suggestion, offered for consideration of the Constituent Assembly in 1987, was that taxes paid on interstate trade should be processed on a transaction basis. As both procedures are operationally awkward, none was put in practice.

Regarding the recent proposals for adoption of a destination-based dual VAT in Brazil, mentioned in Section III, the Ministry of Finance's suggestion is similar to that of 1974: Create an institution, where federal and state governments would be represented, to centralize and distribute dual VAT revenue collected by states. Interstate trade statistics would be used for distribution of revenue among states on a destination basis.

PEC 175/95 provided a new solution to the problem of interstate border tax adjustment. It is a simple, low-cost scheme that allows the adoption of a destination-based dual VAT without zero-rating out-of-state sales. Instead, sales are taxed at the origin, therefore minimizing evasion and distortions of the type discussed in the previous subsection. The 1998 IPEA/BNDES proposal presents an improved version of the scheme, to be discussed next.³³

V. The “Little Boat Model”

The proposed procedure for taxation of cross-border trade was conceived in 1995, amid the effort to develop the tax reform proposal that became PEC 175/95. As VAT terminology was barely familiar to many participants of the discussion of reform, a distinctive name was necessary that could both call their attention to the scheme and provide an intuitive idea of how it works. “Little boat model” satisfies both conditions.³⁴

The problem to be solved is that to implement a destination-based dual VAT without zero-rating interstate exports, the origin state’s tax may not cross the border (say, a river, as many a time it happens to be). If it does, a tax credit must exist, to avoid double taxation in the next transaction; and the origin state cannot provide the credit to the importer, who is a taxpayer in another jurisdiction.

But concerning the federal part of dual VAT, state borders are irrelevant. Therefore, a solution to the problem, inasmuch as both exporter and importer are federal taxpayers, is to transport the state tax across the river on board the little boat—i.e., the federal tax. In other words, the state tax on cross-border trade is collected at the origin, embodied in the federal tax, and the central government provides the corresponding credit to the importer. The result is that the subnational VAT reaches the other bank of the river free from previous tax collections and ready to follow its course as a tax of the state of destination.

This simple procedure is able to take care of, automatically and at practically no cost, transactions between registered traders subject to the normal tax regime, which is the bulk of interstate trade. In case the importer is an identifiable household (distance-selling), a non-registered trader, or a small registered trader not assessed according to value added, a different scheme must be used. The state tax is also paid to the central government—but separately, so that total tax collection of this kind may be known. Its proceeds are shared among states in proportion to their respec-

tive own VAT revenues, the distribution of which is like that of a destination-based tax.³⁵

No workable general treatment for cross-border shopping is possible, for the seller cannot identify the buyer’s domicile. In this case, the origin state’s tax applies. But this is an unimportant component of interstate trade, except when state rates are far different or high-price goods are transacted.³⁶

The “little boat model” requires that registered traders distinguish four components of their total sales:

Group 1. Intrastate sales, including those to unidentifiable residents of another jurisdiction (cross-border shopping), to which the federal and the state rates apply.

Group 2. Interstate sales to registered taxpayers, except small traders subject to special simplified tax regimes, in which case the state tax is zero-rated and the federal tax is assessed at a rate equal to the sum of the federal and the state rates.

Group 3. Interstate sales to unregistered traders, small traders excepted from the previous case, and identifiable households domiciled in other jurisdictions (distance-selling), to which the federal and the state rates are applied, but the state tax is paid to the central government (explicit CVAT).

Group 4. Exports to other countries, which are zero-rated.

No special rules are necessary regarding purchases: Taxes paid to the central government are credited against federal liabilities and those paid to the subnational units against state liabilities. Note that this is different from current arrangements: No tax that had been collected by a state is credited against another.³⁷

At the end of each VAT assessment period, each registered trader is liable for three pieces of tax:

1. the net state tax liability (the difference between its state liabilities, except the explicit CVAT, and state credits);
2. the net federal tax liability (the difference between its federal liabilities and credits); and
3. the explicit CVAT paid to the central government, which distributes the proceeds to states.³⁸

As mentioned in the subsection above on “Dual VAT and State Fiscal Autonomy,” according to IPEA/BNDES proposal, states would be given limited power to fix their own rates, within an interval centered in a national standard rate. Interstate sales would always be subject to the

standard rate. Of course, a state may attract cross-border shopping by a rate below the standard. On the other hand, a state that establishes its rate above the standard will probably lose some commercial activity and provide an opportunity for the practice of “invoice sightseeing.” But this is the price to be paid—in all instances, as shown in the subsection—for some degree of state autonomy. However, these effects are much milder than those induced by zero-rating of interstate exports.

To simplify the exposition of how the scheme works, it will be assumed that all states adhere to the standard rate, set at 15 percent, and that the federal rate is 4 percent.

When a taxpayer makes an interstate sale included in group 2, its books of account and invoice will register a zero subnational tax and a 19 percent federal tax. Consequently, the importer will enter no tax credit in its books of account against the state of destination, and a 19 percent tax credit against the federal government. The results of this extremely simple procedure—due to the catch-up effect featured by the tax credit method VAT—correspond exactly to the desired outcome:

- a) The total tax (federal plus state) liability in an interstate sale is identical to the amount that would be charged if the goods were shipped to a purchaser within the state of origin. No loophole exists that could give rise to the “invoice sightseeing,” as would be the case if exports were zero-rated.
- b) The good sold leaves the state of origin free from the subnational tax; but the seller is allowed credit for all taxes paid to its state on earlier transactions, in the same way as for an intrastate sales.
- c) As the good enters the state of destination free from subnational tax, there are no tax credits to be granted by that state; and in the following transaction, state tax will be charged at a rate of 15 percent on a total value, which includes that of the interstate transaction. Therefore, imported and internally produced goods are equally taxed. Should the next operation be tax-exempt (such as exports) or not exist (like in the case of capital goods), the good will remain untaxed, as desired. But, differing from destination-based taxes that zero-rate interstate exports, no transfer of funds from the state of destination to that of origin would occur.
- d) The exporter registers in its books of account a 19 percent tax liability in favor of the federal govern-

ment, which was in part (15 percent) a subnational tax debt. But a 19 percent tax credit is granted to the purchaser and, in the subsequent transaction, the federal tax on the previously imported good (or on the good which contains the imported input) is charged at a rate of 4 percent. As previous tax liability and credit cancel out, the final result is that federal VAT liability corresponds exactly to its share of the tax (4 percent on the value of the new dispatch). This means that the federal government neither wins nor loses. It simply plays the role of a carrier of the subnational tax across the border.

- e) Throughout this process, no intricate obligation is imposed on taxpayers. The accounting procedures are almost the same as those for an intrastate sale and the same overall amount of tax is paid. The only difference between the intrastate and the interstate transaction is that a larger tax liability (or credit) is entered in the federal tax account in exchange for a zero tax (or credit) in the subnational tax account.

In the case of an interstate sale included in Group 3 above, the procedure does not work automatically because no federal tax credit is provided to the purchaser and, therefore, the catch-up effect does not exist. If the subnational tax were embodied in the federal tax, the central government would keep the tax proceeds and their value would not be known. That is why separate payment of this part of the tax is required.³⁹

Another feature of the “little boat model,” very important in the case of Brazil, is that it allows a smooth transition from the current scheme for taxation of interstate trade, part origin part destination, to a full destination VAT. Maintaining the assumption that state and federal rates are 15 and 4 percent, respectively, let us suppose that present interstate border tax adjustments are such that one-third of the subnational revenue derived from interstate exports is assigned to the origin state. Let us assume also that the intention of reform is to gradually reduce the participation of the origin state—say, one percentage point per year—until the revenue is totally assigned to the state of destination.

To reproduce present hypothetical conditions, in the first year the origin state would tax all its interstate exports at 5 percent; a federal rate of 14 percent would be applied to transactions included in Group 2; and operations included in Group 3 would be subject to the 4 per-

cent federal rate and an explicit CVAT of 10 percent. One year later, the origin state tax would be reduced to 4 percent, the federal rate on Group 2 increased to 15 percent and explicit CVAT to 11 percent. And so on, until the sixth year, when the full destination principle would be in force.

At least for the case of Brazil, the proposed procedure is superior to both approaches to the “clearinghouse” method (based on transactions and on aggregate statistics of state consumption or interstate trade). First, its administrative costs are insignificant compared with those of the other method. For taxpayers, accounting and administrative procedures would be less expensive and cumbersome than with the present tax arrangements. For the public sector, no new institution is required to administer the procedure; even sharing of explicit CVAT among states can be managed automatically by the banks collecting the tax. All they need to know is the distribution of state VAT revenue. And this is the only statistical requirement of the method, so that distribution may be based on almost contemporary information.

In contrast, the “clearinghouse” method on a transaction basis, though providing an accurate distribution of revenue among states based on almost contemporary data, bears a very high cost of collecting and processing information contained in invoices. On the other hand, when the method is based on aggregates, information to process revenue sharing always lags. Moreover, no state consumption statistics exist in Brazil, and those on interstate trade are being processed now, experimentally, after an interruption of almost 15 years. The latest available data refer to 1985, and their quality is very poor. As information necessarily comes from less than the universe of taxpayers, only by chance will the value of flows from one state to another as informed by the former equal that obtained from the latter. Of course, these differences mean potential conflicts in the federation.

In contrast to the procedure proposed here, the clearinghouse method has a tendency toward accumulation of unused tax credits by some registered traders. In particular, firms with a large concentration of out-of-state sales and of intrastate purchases will tend to accumulate credits against the state; and those buying chiefly out of state and selling to the local market will tend to accumulate federal tax credits. In fact, this is a problem in Brazil where VAT refunds are not a tradition. But it already exists, and

exporters are the main victims. And states are always reluctant to provide a credit for a tax paid to others.

Of course, the best and simplest solution is to provide cash refunds for creditors. After all, under the destination principle, all credits correspond to previous taxes collected by the same state. But, as argued throughout this paper, Brazilian tax traditions, including this one, are very resistant to change. Until resistance is overridden, some other solutions—which may include a tax credit market—must be found to the problem that, anyway, is minor when compared to that of interstate trade taxation.

VI. Can the “Little Boat” Sail Abroad?

The “little boat model” is a newly proposed solution for a longtime problem. But for the time being it is only an untested method for taxation of interstate trade under consideration by the Brazilian Congress. Its acceptance is contingent on the implementation of a dual VAT, which would itself be a tradition-breaker in the country, where separation of revenue sources has been the sole doctrine for over a century. But unlike the proposed scheme, dual VAT is already under test in the foremost subnational sales taxation laboratory of the world, Canada.⁴⁰

Even if, using the benefits of this previous test, the destination-based dual VAT is, in fact, chosen as the main source of state revenue, the proposed procedure will have to compete for the preference of congressmen with the older but also untested “clearinghouse” method. Though I am sure that “little boat” is a better method, the task remains to convince 60 percent of the members of each house of the national Congress that it is, in fact, the best solution.

The procedure seems to be useful for any Latin American country to which a dual VAT would be suitable—i.e., where the degrees of decentralization of public activities and of industrialization are high enough to warrant the adoption of a complex but very productive subnational tax such as VAT. Argentina, for example, where an unsatisfactory cascading tax is an important source of subnational revenue and VAT already exists at federal level, is a good candidate for implementation of the dual VAT and the proposed procedure.

I believe the procedure may be useful for developed countries, too. Even if it is true, as generally claimed, that tax fraud is a minor problem there, the procedure also protects the economy against types of distortion mentioned in the subsection above on “The Case Against Zero-Rating

Interstate Exports." Canada, the laboratory, could certainly find an empty test tube for the method. And Europe, as suggested by Bird and Gendron (1998), may find the best solution to its problem of cross-border trade in the combination of an EU VAT with the existing national taxes. If Bird and Gendron's conjecture comes true, the little boat would be ready, if it wishes, to sail overseas.

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Endnotes

1. Twenty-five percent of tax revenues belong to the municipalities.
2. Tax on Services of Any Kind (except those included in the base of the ICMS).
3. ICMS is the abbreviation for the Brazilian state VAT, whose full name is Tax on Operations Related to the Circulation of Goods and on the Provision of Interstate and Intermunicipal Transportation Services and of Communication Services.
4. Brazil's tax burden, which had been around 25 percent of Gross Domestic Product (GDP) since 1969 (social security contributions included), increased after the 1994 stabilization plan (Plano Real) and is now nearing 30 percent of GDP.
5. There are, of course, many similarities between the case of a federal country and that of an economic union. It should be recalled, however, that, by 1967 EEC countries were starting their move to VAT and that, up to now, the European Union has not satisfactorily solved its intra-union border tax adjustment problems.
6. Some explanation is in order for those who are not acquainted with VAT terminology. A dual (or two-tier) VAT is a value-added tax whose base is used simultaneously by two levels of government to raise own revenues. A consumption-type VAT has its incidence limited to consumption goods (or, alternatively, with similar results, taxes capital goods as well but allows buyers full credit for the tax previously paid). Under the destination principle, the territorial unit taxes, besides internal flows, its imports but not its exports; in other words, it taxes goods and services used within its territory. Its opposite, the origin principle, implies that the tax base consists of goods and services produced inside the jurisdiction. The unit taxes internal flows as well as exports but not its imports.
7. Tax on Industrialized Products. As hinted by its name, IPI is a partial VAT, restricted to the industrial sector.
8. For a more detailed analysis of the evolution of the Brazilian tax system, see Varsano (1997); for more on the characteristics of Brazil's tax burden, see Afonso et al. (1998).
9. Tax reforms always produce winners and losers and promote instantaneous changes in relative prices; public revenue and its distribution among government units may also be affected. Individually, economic agents tend to support reform insofar as it is an abstract entity. They believe it would benefit the country and, thus—an unwarranted deduction—they would be better off. Soon after a concrete proposal is put forth, many realize that, though reform will bring a net gain to society, they will be among the losers. Opposition—not to the abstract reform but to any concrete proposal—always arises. Collectively, economic agents prefer gradual to sudden changes and tax improvements to replacements (as per the saying "good taxes are old taxes"), for they fear deeper reforms may,

through their effects on prices and public revenue, disturb economic relations and/or public finances.

10. The Constitution of 1937 gave states the exclusive power to create taxes other than those specified in the Constitution. The Constitution of 1946 reestablished the traditional rule. Constitutional Amendment No. 18, of 1965, limited existing taxes only to those it mentioned. Soon after, however, the 1967 Constitution restored the so-called "residual competence."

11. Some provisions of the Brazilian Constitution require their own regulation through what are known as "complementary laws." These are national (rather than federal) laws, which apply to SNGs as well. They must be approved by more than half the members of each House of the National Congress (not just by more than 50 percent of those voting, which is the requirement for an ordinary law).

12. A constitutional amendment proposal presented to one of the houses of the National Congress is first analyzed by a special committee, which may accept, reject or modify it. If approved, the proposal or its modified version is sent to the plenary of the house, where it may be further altered in a process in which two ballots take place. Favorable votes of at least three-fifths of its members in each ballot are necessary for final approval by the house. The approved terms of the proposal, which may be utterly different from the original, is then presented to the other house, where it undergoes a similar procedure. If any change is introduced, the proposal returns to the first house for another round of political negotiation.

13. Besides the Export Tax, states had exclusive power to levy several taxes, such as those on rural and urban properties, on transfers of real estate rights, and the Tax on Industries and Professions.

14. The IVC—Tax on Sales and Consignments—originated from an already existent but federal tax created in 1922, the Tax on Mercantile Sales.

15. By the end of the 19th century, the association of several excise taxes gave rise to the Consumption Tax, a federal turnover tax that, in 1956, evolved to value added taxation and, after further improvements, became, in 1964, the existing IPI. This example—the ICMS and the income tax provide others—illustrates the argument presented in the two first paragraphs of this section.

16. As mentioned in Footnote 13, the Tax on Industries and Professions was originally a state tax. Since the Constitution of 1934, its revenue was shared with local governments, this being the first case of tax sharing in Brazil.

17. The fundamental difference between the ICM, Tax on Operations Related to the Circulation of Goods, and the ICMS is that the base of the former did not include minerals, fuels, electricity, and communication and transportation services, which were subject, "exclusively," to federal excises. Of course, insofar as they are inputs, their

values were also assessed by the ICM (except in the case of minerals, in which a credit for the excise previously paid was granted to ICM taxpayers). That is the reason why the 1988 Constitution included these goods in the ICMS base and eliminated the federal excises.

18. The original French VAT—Taxe Unique Globale à la Production, created in 1948—was replaced by the TVA—Taxe sur la Valeur Ajoutée—in 1954. TVA was generalized in 1968, when the existing service tax and the local tax were eliminated.

19. ICM (as well as ICMS) and IPI produce some cumulative effect insofar as legislation allows taxpayers to credit only tax on inputs that are embodied in the product to be sold (so called physical credit). ISS is cumulative. And interaction of ISS, as well as of the federal excise taxes mentioned in Footnote 17, with IPI and ICM/ICMS also generates cumulative taxation of inputs.

20. A constitutional provision had attributed to complementary law the power to exempt exports other than those for which immunity had been therein assured. The law prescribed also the refund of eventual unused credits relative to ICMS paid by exporters on their inputs. Up to now, no state has complied with this determination, meaning that residual taxation of exports still exists.

21. Complementary law No. 87 had required application of this rule starting in 1998. In 1997, pressure exerted by the states resulted in its postponement.

22. PEC 175/95 was also elaborated under coordination of IPEA. The expanded 1998 version is found in Afonso, Rezende, and Varsano (1998).

23. The applicable rate is chosen according to the origin and destination of the trade flow. Transactions originating in the South and Southeast Regions, except from the state of Espírito Santo, and bound for the North, Northeast, and Center-West Regions, as well as for Espírito Santo, are taxed at 7 percent; all others, at 12 percent. Moreover, interstate trade with fuel and electric energy are zero-rated; and, for regional policy reasons, exports from anywhere to the Manaus Free Trade Zone and, under certain conditions, to Western Amazon states are also zero-rated.

24. A constitutional provision demands that rates applied to intrastate transactions be higher than those set by the Senate for interstate trade. It follows that part of the tax proceeds derived from cross-border flows belongs to the state originating the flow—7 or 12 percent of the value of the traded good, depending on which is the relevant rate (see Footnote 23)—and the remainder to the state of its destination—the difference between the rate applied by the state receiving the good and the interstate rate.

25. This is a preliminary result obtained by the ongoing research "Perfil da Tributação dos Serviços nos Municípios Brasileiros," conducted by Ana Luiza N. de Holanda Barbosa at IPEA.

26. See ABRASF (1998) and Afonso et al. (1998).

27. This statement and the argument that follows disregard financial consequences related to the tax. These depend on the length of tax assessment periods, the dates and financial characteristics of the transactions, and the speed of rotation of stocks. Although they affect economic incentives, they are of second order in relation to the effects of the tax itself and cannot play any role in the choice of interstate border tax adjustments.

28. For a more elaborated presentation of these arguments, which also considers international trade, see Varsano (1979), pp. 328-333. This result is important. Shibata's analysis of the restricted origin principle considers a single-stage tax and, for this reason, does not take into account a fundamental difference between the subtraction and the tax credit method of collecting VAT. It theorizes on the former while the relevant case is the latter. If the subtraction method is used to collect the VAT, the tax assesses the difference between the values of sales and purchases of each registered trader. In other words, the subtraction method VAT is assessed on the value added by each trader. Unless the tax rate is uniform for all transactions, this is different from taxing the value added to each good, which is the result of the tax credit method. If the subtraction method were used, the restricted origin and the destination principle would have different effects. In fact, it would be hardly possible to conceive a workable procedure for adoption of a destination-based subtraction VAT.

29. This is an arbitrary percentage that rates higher distortion avoidance. Its purpose is to provide a starting point for political discussion of the trade-off.

30. This estimate, though not recent, was published in a full page advertisement at *Jornal do Brasil*, a Rio de Janeiro newspaper, on April 4, 1999. To have a standard for comparison, the magnitude of the estimated fraud, which refers to the whole country, is almost twice the monthly ICMS revenue of the state of Rio de Janeiro. Two cases of "invoice sightseeing" that became famous some time ago involved massive exports of sugar and automobiles from São Paulo to Western Amazon.

31. Analyses of "fiscal war" in Brazil are found in Varsano (1997) and Cavalcanti and Prado (1998).

32. The 1974 procedure was proposed by Senator Helvídio Nunes (*Diário do Congresso Nacional*, October 31, 1974, seção II, pp. 5013-5028). The 1979 scheme was put forth by myself (Varsano 1979, pp. 340-341).

33. The original version of the procedure is found in Varsano (1995). The improved version benefited from a discussion of the method with Prof. Charles E. McLure Jr., from which also resulted his "Protecting Dual VATs from Evasion on Cross-Border Trade: An Addendum to Bird and Gendron," mimeo, 1998.

34. For the record: In the first half of 1995, two different tax models, both in some sense dual VATs, were under consideration by the federal government. The usual two-tier tax had been proposed by IPEA/BNDES; and a tax which base would be split, federal government tapping cross-border trade—both interstate and international—and states assessing their internal transactions, had been advanced by the Federal Revenue Service. A meeting was held at the Ministry of Justice to discuss them, whose participants were Minister of Justice Nelson Jobim, Federal Revenue Secretary Everardo Maciel, IPEA President Fernando Rezende, and this author. The discussion on pros and cons of the alternatives was in progress—and tax treatment of interstate trade was clearly the weaker point of both—when confrontation of the models provided me the hint for the proposed procedure, which José Roberto Afonso and I worked into a concrete proposal and named "little boat model" (in Portuguese, *Modelo Barquinbo*).

35. Prof. McLure called the tax corresponding to the proposed scheme a compensating VAT (CVAT), which, I think, is an adequate technical name. It should be noted, however, that two different CVATs are collected, one embodied in the federal tax, as in the previous paragraph, and the other explicitly, as described in this one. Embodied, but not explicit, CVAT gives rise to a tax credit against the federal tax.

36. Vehicles, probably the most important of these items, could be taxed, if convenient, according to their place of registration, owners being required to pay the difference between its jurisdiction and the tax actually paid.

37. It should be recalled that, currently, ICMS taxpayers must deal with four different groups of sales as well (intrastate, interstate at 7 percent, interstate at 12 percent and exports), besides a myriad of special cases. And they have to distinguish interstate sales to registered traders (to which the interstate rate applies) from those to unregistered traders and households (subject to the internal rate). Also, the industrial sector is subject to two different VATs, the ICMS and the IPI. Therefore, the complexity level of the dual VAT, as well as its accounting costs, will be lower than those taxpayers face now.

38. It should be noted that, regarding piece 2, both federal tax liabilities and credits include the value of the embodied CVAT; and, concerning piece 3, no credit for previously paid taxes corresponds to the explicit CVAT liabilities; credits are netted out against state tax liabilities.

39. Alternatively, taxpayers might be required to inform the value of their interstate sales. I think the procedure mentioned in the text is better both because of administrative simplicity and transparency. Furthermore, revenue could be shared daily if so wanted.

40. For an overview of the Canadian experience in sales taxation, see Bird and Gendron (1998).

Comment

H O R A C I O L . P . P I F F A N O

The possibility or advisability of assigning taxing authority in value added tax (VAT) issues to subnational governments has been a matter of debate for several years, especially in the light of experiences in the European Economic Community (EEC), currently the European Union (EU). As pointed out by Bird and Gendron (1998), the traditional recommendation has been not to assign this responsibility to subnational governments (McLure 1994) but instead to adopt a “revenue sharing” system as the simplest and most practical way to do it (Germany, Argentina).

From a political point of view, both macroeconomic considerations and central power reluctance to share or leave room to the usage of such an important tax base have contributed to resistance to the decentralization of this taxing authority. In Argentina—given the decentralization of spending, especially during the last few decades, tax centralism, and the concurrent vertical lags resulting in structural deficits in subnational governments—this matter had to be solved by means of a federal transfer system linked to revenue-sharing agreements, which has aggravated the operation of public finances in multiple areas.

The separation of decisions on spending and its financing has contributed to deteriorated fiscal responsibilities at both government levels; it has led to a strong pro-cyclical system (all central and provincial budgets to the rhythm of national tax collection and strongly linked to the economic cycle);

it has generated opportunistic behaviors and a sort of political cartel of governors who distribute resources on the basis of questionable efficiency and equity; and it has encouraged the dissemination of extremely inefficient and poorly managed forms of local taxation, due to the lack of natural incentives to submit local constituents to the pressure involved in funding of spending expectations of governments on duty. The known subjects in literature on fiscal federalism regarding problems linked to the “common pool,” “*Leviathan*” and “flypaper” effects have been present in the federal revenue-sharing system of Argentina.

The opposite occurs in Brazil: States should abandon a certain degree of autonomy so as to achieve a minimum of harmonization, not only compatible with expectations of the future convergence with Mercosur countries, but also for the soundness of the Brazilian economy, which must minimize efficiency costs of its current tax system.

From a technical standpoint, interjurisdictional arbitrage (cross-border trade) and tax evasion problems in an area where the absence of border problems is assumed, with the consequent enforcement difficulties involved, have delayed the adoption of a pattern of general acceptance in most countries.

In our comments, we review alternatives that have been either technically suggested or tested in some countries or regions, regarding the feasibility of decentralizing the following types of excise tax: the deferred destination-payment system VAT, dual-rate or shared Bird-Gendron type VAT, the shared Varsano type VAT (“little boat model”), the origin-based VAT, the system of additional aliquot part to domestic VAT, the retail sales VAT, the two-stage VAT extending through the wholesale and retail stages, and the modules or business tax.

I will not be able to cover all of this because of time restrictions. Instead, I will submit some ideas on specific issues of the Varsano proposal, mainly thinking in the Argentinean case (in a very egoistic manner) and not in Brazil, especially given the invitation made by the author at the end of his paper for the “little boat” to sail toward Argentina.

Technical reasons that experts have for the predilection for a deferred destination-payment system VAT are well-known when this tax operates in different jurisdictions subject to no border controls and bypasses government compensation mechanisms. Excluding those nearby alternatives (for example, the clearinghouse in its several variants) and focusing on the deferred destination-payment system VAT, let us discuss the *raison d'être* of the Varsano proposal: fraud at destination due to invoice sightseeing.

There is a clear *modus operandi* in administrative-accounting aspects to prevent fraud in the “little boat model.” However, let me mention a few problems, especially from the point of view of the Argentinean case and the goals pursued with the decentralization of this type of taxation to subnational governments—i.e., “achieve effectiveness of the fiscal correspondence principle.”

(1) To the extent that the national tax is operating according to uniform taxing pressure in all jurisdictions, there will clearly be a strong incentive for political pressure in all jurisdictions to set the aliquot at the highest possible level deemed advisable by the central government, and thus capturing the return to any potential additional national leveling aliquot share. The solution to set a general equal and uniform aliquot for the provincial rate in all jurisdictions—even at an average rate with a small permissible dispersion, for example, ± 10 percent (the price to be paid acknowledged by Varsano)—spoils the initial idea of guaranteeing subnational taxing authority. For the Brazilian case, a political agreement will be required to gradually

reduce state rates in interjurisdictional sales and transfer them to the federal rate, so as to converge in a comprehensive destination-based system. *Thus, we are giving up a full independence of states to set independent aliquots, a basic premise pursued by decentralization.*

(2) Each taxpayer will have a different net position with regard to its state and federal tax. There will be positive and negative net positions which, in case of a taxpayer's positive position, will involve cash refunds or some sort of tax credits. These are uncommon in tax legislation and/or administration practices, except for export treatments to third countries. (Argentina provides clear examples regarding difficulties faced by exporters with refunds and the refusal in agriculture to compensate VAT credits with debts for other tax liabilities as with earnings.)

(3) The erosion of assets or loss of tax base of eminently productive or net exporting jurisdictions remains unsolved. Thus, some type of compensation may be required to grant its political feasibility.

(4) The system—like the deferred destination-payment systems—requires the support from taxpayers' accounting, since their records will have to differentiate four types of sales. This typical administrative problem of the deferred destination-payment system VAT will be increased, resulting in a significant administrative burden which is transferred to taxpayers. For small and medium enterprises however, they will involve a heavy burden notwithstanding computer-science progress pointed out by Varsano. Information exchange problems among tax authorities will also increase.

(5) Finally, the most relevant critique regarding all “dual VAT” versions and, of course, including the leveled aliquot schemes is, in our opinion, the circumstance that even though the national and state or provincial aliquots are “identified” in taxing laws, it will be difficult for “involved” taxpayers to clearly know where their taxes will end up and which are the respective subnational and national tax remnants. Even with net balance settlements identified by government level, there is a high probability that the taxpayer's view on a “shared VAT” will erode the effectiveness of the correspondence principle as a basic reason for tax decentralization. Likewise, we must not forget that in the end, it will be businesspersons or officers of registered firms who will liquidate net balances to each government—i.e., a minor share of constituents and not the consumers or owners of factors upon whom the tax will

fall. What I am trying to explain is that citizens will have little clear information or transparency on the opportunity cost of their public-spending requirements to the applicable governments.

Given the above, we are proposing a different solution: *The larger part of the consolidated tax system should not be based on only one "overexploited" source.* (Table 2 clearly shows the current share of VAT in Argentina's overall tax burden.) *Instead, a "range of taxes" can be decentralized.* For example:

- a. A retail sales tax for large and medium taxpayers, together with a module tax for small taxpayers.
- b. A provincial capital-gains tax (strictly speaking, on consumed incomes of physical persons in excess of the non-taxable minimum and with flat rates).
- c. Additional aliquots of the national personal property tax.
- d. Specific excise taxes and fuel taxes.
- e. Finally, the Canadian-type leveling transfer mechanisms.

As final comments:

(1) The Varsano paper is key to understanding the Brazilian case and to evaluating the alternative proposals suggested in literature for the specific case of Brazil. This must be stressed, since Varsano emphasizes the constraints in extrapolating other tax models to the Brazilian case. The same is true regarding the application of the "little boat model" designed for Brazil to other countries, such as Argentina, even though part of my country's governmental sector is working along these lines.

(2) Brazil and Argentina are facing very different conditions in tax decentralization issues. Data contained in

Tables 1 and 2 are clear. Brazil's problem is to urgently harmonize its current extremely decentralized VAT. Argentina's problem is to design a new provincial tax or set of taxes to be decentralized for a currently extremely centralized system. There is a different political nature underlying both problems, and their technical solutions must be based on the applicable scenario. In this sense, I do not reject the Varsano solution as appropriate for Brazil; I only want a different solution for Argentina.

(3) Under a strict technical perspective, there seem to be few options that reasonably encompass the trade-off between tax efficiency and policy efficiency, understanding the latter as the aim of "strengthening the fiscal correspondence principle." This does not mean to "simply collect more resources for subnational governments." The latter could be achieved by simply increasing the primary distribution in a revenue-sharing system of centralized collection.

(4) Important in cases such as Argentina "where the tax decentralization process has not been implemented yet" (a main difference—I must stress again—with Brazil) is the effort to emphasize direct taxation over indirect taxation at the subnational level. Transparency of fiscal decisions would improve, and its impact on the operation of representative democracies is evident in an increasingly decentralized world.

(5) Finally, I believe that a subnational tax system heavily dependant on the sales tax or dual VAT is not the appropriate way to achieve this objective. Efforts to simplify tax systems face a complex reality and for this reason tax systems may also achieve a certain degree of complexity.

TABLE 1

Relative Importance of Own Subnational Tax Collection and Subnational Resources After Transfers
ARGENTINA AND BRAZIL

	ARGENTINA ⁽¹⁾	BRAZIL ⁽²⁾
Own collection or resources before transfers	18.4%	34.5%
Resources after transfers	45.0%	43.5%

(1) Source: Piffano, H. L. P. (1998b). Author's calculation.

(2) Source: Varsano, R. (1999).

TABLE 2

Relative Impact of VAT with Respect to GDP

ARGENTINA AND BRAZIL (1998)

	ARGENTINA ⁽¹⁾	BRAZIL ⁽²⁾
Overall tax burden (TB)	17.6%	30.0%
National	13.2%	19.6%
Subnational	4.4%	10.4%
VAT / GDP	7.2%	7.5%
VAT / TB	40.9%	25.0%
Raw earnings (Provincial) / GDP	2.2%	—

(1) Source: MEOySP and Piffano (1998b); data corrected by revaluation of Argentina's GDP (ME and OSP).

(2) Source: Varsano, R. (1999).

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Local Property Tax

Local Taxes: Lessons Learned on the Implementation of Real Property Tax

JULIO ROBERTO PIZA

I. The Role of Local Taxes in the Decentralization Processes

Among the roles of fiscal policy, macroeconomic stability, and redistribution are typical tasks for the national level, while microeconomic allocation may be assigned to regional and local levels. By allocation, however, we mean more than just spending, since a proper allocation of taxes to the municipal level strengthens local autonomy, as well as helping localities finance their own spending (McLure 1999). Taxes must be allocated to each governmental level that is qualified to spend them. The subnational government has advantages in the delivery of goods and services featuring economies of scale and limited benefit leakage to other administrations.

Due to technical reasons, many taxes are most efficiently collected at the national level (Steiner-Soto 1999). For example, in Colombia between 1991 and 1995, the national government collected 11.7 percent of GDP in taxes, departments collected 1.4 percent, and municipalities 2.5 percent.² For this reason, fiscal and horizontal imbalances have been mainly solved by means of transfers, but also through different tax-sharing mechanisms.

Difficulty in raising revenue has often limited the size of the urban public sector in developing countries, because for governments to be viable they need to raise a substantial share of their own revenue. Thus, strengthening local taxes as a source to fund local spending is a basic tool to enhance decentralization.

Table 1 shows that in 1994, the share of local taxes in municipal expenses averaged 26 percent in a sample of five Latin American countries, while averaging 35.1 percent in the United States, Germany, and Spain, although the percentages in Colombia and Chile are similar to those of European countries.

Local taxes are designed only for collecting revenue, because the local governments are not in a position to pursue stabilization or redistribution objectives. For this reason, local taxes should be associated with benefits received by the residents of a given municipality, which brings the advantages of accountability and democratic control of taxes. However, not all taxes can be allocated at the local

level, because some result in unintended effects, such as the alteration of international trade, distortion of economic activity localization, or transfer of their impact on residents of other municipalities. Other criteria to be taken into account for local tax allocation are administrative efficiency and the need of the applicable expenditure.³

Property taxes—and especially real property taxes—are a key component of the local tax system. However, they have been poorly developed in Latin American countries. In a sample of six Latin American countries, local taxes accounted for only 5.6 percent of GDP.⁴ For this reason, improvement of local taxes and, specifically, of real property taxes must be included within the actions to be taken

TABLE 1

Structure of Municipal Revenues in Some Latin American Countries and OECD, 1994

(In Percentages)

SOURCES OF FUNDS	LATIN AMERICA						OECD			
	BRAZIL	BOLIVIA	COLOMBIA	CHILE	PERU	AVERAGE	U.S.	GERMANY	SPAIN	AVERAGE
Transfers	62.7	54.7	47.8	42.7	58.1	53.2	40.0	26.4	38.9	35.1
Taxes	22.3	22.8	38.8	32.9	13.0	26.0	37.0	34.4	33.9	35.1
Charges and contributions	15.0	4.6	10.4	12.4	13.3	11.1	23.0	39.2	27.2	29.8
Other sources	0.0	17.9	3.0	12.0	15.6	9.7				
TOTAL	100	100	100	100	100	100	100	100	100	100

Source: CEPAL/GTZ Project on Fiscal Decentralization in Latin America

to consolidate decentralization processes. In Table 2, the evolution of the municipal tax structure shows the loss of share suffered by property taxes, particularly due to the decrease of the betterment levy during the past 10 years. This trend was interrupted after 1993 with the self-assessment, the general-benefit levy, and the re-emergence of the local benefit levy.

II. Real Estate as a Source of Tax Resources

Taxes on real estate have the appropriate characteristics to be assigned to the local level—without resulting in distortions—and thus to permit the funding of general community benefits such as maintenance, operation, and improvement of local transportation networks, public safety, sewage systems, sanitation, solid waste management, green areas, housing, community development, and municipal management (Bell 1999).

In fact, real estate is the immovable factor per excellence and thus reduces risks of tax transfer to non-residents. Local control makes these taxes more manageable, further increasing the enforcement of accountability among administrators. Overall, real estate taxes fulfill the conditions of an efficient tax.⁵ They also contain factors that measure the payment capacity of taxpayers and thus allow for the incorporation of tax equity and elements of fairness.

A broad vision of real estate taxes helps to identify various taxes that are either directly or indirectly levied on real properties. In the typology of these charges, distinction can be made among rates, duties, and taxes.⁶ The facts that often create them are construction, possession, or transfer.

Construction is subject to taxes that are inherent in licenses, construction activity, and, sometimes, specific taxes.⁷

Taxes, rates, and duties are caused mostly by the possession or ownership of the immovable good. Betterment levies on properties have been used to totally or partially fund public works, specifically high-cost roads. Sometimes they are combined with vehicle taxes, gasoline surcharges, tolls, and credits.⁸ In Colombia, betterment levies referred originally to specific works have become general benefit levies to finance a work plan which covers the municipality.⁹

Betterment taxes or levies are aimed at financing infrastructure in a delimited area, based on the higher value of properties resulting from productivity gains in land use due to municipal decisions on Land Use Planning.¹⁰ The price of any property, especially in cities, depends on its construction potentialities. Then, agreements among municipal officials and land developers may allow for the financing of a specific project's required infrastructure.¹¹ However, its implementation regarding the property's

TABLE 2

Municipal Tax Revenues in Colombia, 1970-1993

TAXES	1970-79	1980-84	1985-86	1987-89	1990-93
Real Estate	36.4	30.2	30.6	29.3	33.3
Industry & Commerce	28.0	36.4	38.1	41.5	39.6
Valuation	17.6	14.4	10.6	6.2	2.1
Other	18.0	19.0	20.7	23.0	25.0
Total	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance, Dirección de Apoyo Fiscal (DAF)

value as from which the betterment levy may be imposed, and thus the municipal participation, is again complex.

Operations with immovable properties generate many levies. The most important is the income tax or capital gains tax, which results from profits accrued from their sale. But the operation itself is a source of duties, since due to legal requirements it must be filed in the public registry and formally registered with a notary public. This results in registry fees, notary fees, and the registry tax.¹² For this reason, there is a known and generalized trend to avoid these charges by stating lower prices in the sales deed, so as to reduce the basis on which these levies are based. Commonly, this price is the assessed valuation, since official property assessments are clearly lower than the commercial value at which they are actually sold. The income tax is imposed on revenues resulting from properties, as there are rents and leases. Capital taxes, usually complementary to income taxes (and including property taxes), are becoming extinct, but there are complementary mechanisms such as inflation adjustments, presumptive income taxes, or capital taxes that, even though generic in nature, act as an indirect lien on the real property.¹³

The most traditional tax on real properties is the real estate tax. Even though it funds general municipal expenditures, this tax results from a merger of various specific taxes or charges for services rendered by the municipal management. For this reason it has features of a tax with direct benefits for the taxpayer—i.e., it combines both benefit and payment capability taxing criteria.¹⁴

III. The Real Property Tax

Tax Features

The real property tax is the typical direct real estate tax levied both on land and construction, but not, in Latin America, on resulting rents. The tax base is the assessed val-

uation, and rates are low, given its nature as a capital tax. Taxes vary by usage and location of the property—for example, according to socioeconomic strata in case of housings.¹⁵ Municipalities are empowered to grant exemptions for historical areas, public properties, and low-cost housing.

Critical Aspects of this Tax

A. TAX BASE

The value of immovable properties is set by the government itself through its cadastral institutions, usually at national level, by means of a cadastral survey not only for taxing purposes, but also for geographic, urban planning, statistical, and strategic reasons. However, its main role is to set the tax base. Table 3 shows Colombia's cadastral statistics, which do not include the three main cities, which have their own real estate registries. These statistics reflect the concentration of buildings and urban properties, which represent 71.3 percent in value, but just 0.4 percent in area.

The assessed valuation is performed through a periodic revision of a property's physical, legal, and economic conditions. For this reason, it is a complex and costly process. There are technological advances that allow for the use of modern tools like digital maps and aerial photographs to identify characteristics of the areas, which should optimize assessed valuations. However, transactions and alterations of properties undoubtedly require a dynamic updating that is beyond municipalities' capacity. Thus, assessed valuations show a significant lag when it comes to commercial values of properties, for various reasons. On the one hand, there are still highly orthodox methods to assess properties, and attempts are being made to take care of assessments at an individual level. This obviously multiplies the assessment task due to subdivisions of individual properties. On the other hand, the land market is very complex, since it not only reflects the property's individual value, but also

TABLE 3
Cadastral Statistics of Colombia, National Summary 1998

	REAL ESTATE	NUMBER OF OWNERS	SURFACE (HECTARES)	CONSTRUCTED AREA (M2)	ASSESSMENT	
					MILLION \$	(PERCENT)
Urban	4,359,679	5,495,596	312,182.42	341,608,706	45,736,782	71.3
Rural	2,615,474	3,529,556	72,944,645.58	11,715,032	18,407,861	28.7
TOTAL	6,975,153	9,025,152	73,256,828.00	353,323,738	64,144,643	100.0

Source: Data of Instituto Geografico Agustin Codazzi

urban development.¹⁶ For this reason, prices usually increase by more than the rate of inflation, in addition to being sensitive to other exogenous factors.¹⁷

To address this, keeping a real estate registry with updated values would be reasonable. However, this has not been possible for various reasons. Any updating requires an information system that internalizes market fluctuations, transfers, and immovable property alterations recorded in different entities, including values and different identification numbers. Part of this official information is distorted, since transfers are often only partially registered to avoid the resulting taxes; the unrecorded part covers the illegal market of non-licensed construction and properties inhabited by squatters.

Both decentralization of real estate registries and the privatization of registries have been attempted.¹⁸ Even so, assessed valuations still do not reflect the actual value of real estate—and this is the main reason real property taxes are inefficient.¹⁹ There are less explicit reasons, such as the high level of corruption in these institutions, which also partly explain the inability to create and maintain a reliable real estate registry.

For this reason, a 1989 Colombian law allows municipalities to establish self-assessment and private real property tax reports; Bogota became the first city to use this mechanism.

B. RATES

Rates may include staggered tax brackets if they are determined because of their usage, value, or socioeconomic stratum. Since their level is really low, however, the effect of these differences is minor, while the way people understand and apply them is much more complex, especially regarding self-assessments. In some cases, differences are allowed for factors such as area, environmental impact, public or institutional ownership, and location. Reductions of tax liability are also granted to promote timely payment.²⁰

C. INSTITUTIONAL ORGANIZATION AND INFORMATION

Since immovable property is the essence of a private property system, laws in Latin American countries require landowners to file proof of ownership. Indeed, there are multiple legal requirements for the purchase, construction, and transfer of properties:

Generally there are two records, a physical record maintained by the Real Estate Registry Offices and a legal

record maintained by other registration offices. The real estate registry contains the lands with cadastral role and nomenclature identification, which may be subject to rules regarding the processes for division of land and construction. For construction, the law requires a license granted by the applicable municipality. In Colombia, this role was delegated to curators or trustees, a kind of private notaries with public functions. Once the construction has been completed, it must be included in the real estate registry. There are no direct statistics on non-compliance to these rules, but they informally are estimated to amount to 35 percent in cities such as Bogota.

In legal terms, the property must be filed in the Registry Office and the Notary's Office in the deed of purchase, which records the many alterations due to transactions and levies imposed on the property. There are other agencies with their own property registries: the different residential public utilities, to provide them both access and service delivery of electricity, telephone, water, gas, and garbage collection; assessment offices, which build public works and collect taxes; national (income and supplementary) and local (real property) tax authorities, which collect the applicable taxes based on information they have on properties. There may be remarkable differences in criteria for the registry and updating, identification numbers, and value of properties among these agencies. These troublesome disparities result in duplication of roles and unequal information.

D. COLLECTION

In Colombia, tax collection has been outsourced to the financial sector in most large and medium-size municipalities, as has been the general trend among fiscal authorities. This means that cash collection to local tax authorities has declined, helping to reduce corruption.

There are two collection systems: bills remitted to the registered address, and private settlement with the submission of a tax report.

The first relies on an assessed valuation submitted by the Land Registry Office, whereby an official settlement is issued through a bill. There must be a complete and comprehensive data base for this mechanism, since data inconsistencies will be reflected in billing; for example, only properties included in the system receive a bill. Generally, municipalities take a passive attitude, and in the absence of adequate disclosure channels and payment facilities for taxpayers, liabilities increase due to the low voluntary pay-

ment by taxpayers. Information depends entirely on other sources, mainly from the cadastral authority; hence, inconsistencies are directly reflected in the tax administration.

With private settlement, the responsibility to determine the tax base is transferred to the taxpayer through the legal requirement to submit a tax report. Through this report, the taxpayers must report the value of their property—usually by self-assessment—subject to maximum and minimum limits. The minimum limit may be the assessed valuation itself, a percentage of the commercial value, or a minimum value set per geo-economic areas of the applicable municipality. With the first, the tax base will not significantly increase; with the second, it depends on the possibility to cross-reference it with the commercial value; and with the third, an alternate assessment system per independent areas of the real estate registry can be used for taxing purposes. Should the base be extremely undervalued, it is advisable to restrict the taxes' growth to avoid an excessive unexpected increase and defer updating for various numbers of years. This mechanism must be connected to a penalty system for inaccurate reports, as applicable to any private settlement mechanism. The advantages of this method are the possibility of increasing the base both for the value and for the properties; reduced corruption, since taxpayers themselves set the tax base; and furtherance of management activities that may determine additional official values through enforcement and collection processes. On the other hand, administrative costs may increase, since information provided by taxpayers must be contrasted, more disclosure to taxpayers is required, and it undoubtedly involves more consolidated tax administration than billing. Occasionally, both systems may be combined: a general billing system with the alternative to resort to the tax report under given incentives to increase the tax base.

Experience on Self-Assessment in Colombia

In 1993, after 10 years of poor real property tax returns, the self-assessment system of properties by taxpayers themselves was adopted in Bogota, where taxpayers must file a tax report—under penalty for non-compliance—reporting the property's real value in an amount not below 50 percent of its commercial value. It was the first city to use this alternative, and even though its implementation was highly controversial, its fiscal performance was considerable, as per the different indicators. The tax base doubled from 8.9 to 17.7 million (current 1994) pesos; the number of properties paying taxes doubled from 550,000 to 950,000 of the approximately 1.2 million total recorded properties that year; and collection increased two-fold, from 45 billion to 104 billion (current 1994) pesos, as shown in Table 4. It is worth noting that the increased collection resulted from a tax base increment due to new properties that previously paid no taxes and not from a higher individual burden, as inferred from the effective calculated rate. This also means less tax evasion.

From 1993, the city gained a highly positive financial position. It expanded its credit margin and hence public investments. Based on this experience, other main cities adopted the same method, with varying parameters and results.²¹ In Cali and Cartagena, tax collection increased during the first year it was enforced, while in Barranquilla it decreased in constant terms. However, tax administration improved its control capacity and gained experience. (See Table 5.)

IV. Lessons on Implementation

Growth in demand for local services due to real-estate development processes, transfer of responsibilities to municipalities, and structural limitations to finance them with transfers makes the strengthening of local tax collection unavoidable.

TABLE 4
UNIFIED REAL PROPERTY TAX: BOGOTA 1993–1996
(Million current pesos)

CONCEPT	1993	1994	1995	1996
Assessment	8,921,098	17,724,125	22,155,156	30,305,924
Collection	45,662	104,000	128,000	157,635
Taxpayers	550,000	950,000	927,500	1,047,375
Effective rate	0.51%	0.59%	0.58%	0.52%

Source: Ministry of Finance of Bogotá and author's own calculations

TABLE 5

PROPERTY TAX IN CAPITAL MUNICIPALITIES OF COLOMBIA

(Million of constant 1996 pesos)

CONCEPT	1990	1991	1992	1993	1994	1995	1996	1997
Bogotá	48,256.2	60,649.2	81,559.8	81,334.2	151,779.5	155,606.1	161,018.0	190,616.9
Medellín	47,247.8	46,262.3	43,230.1	50,319.5	46,449.2	49,372.0	64,691.0	75,988.3
Cali	20,771.8	22,002.6	25,914.9	34,252.9	42,754.3	53,806.7	78,152.0	56,378.3
Barranquilla	1,711.9	7,173.0	7,623.6	13,565.8	17,244.1	15,585.7	16,572.0	14,544.5
Cartagena	1,102.0	724.1	1,681.5	5,635.8	7,725.6	7,558.1	13,228.0	17,476.2
Subtotal	119,089.7	136,811.2	160,009.9	185,108.2	265,952.7	281,928.6	333,661.0	355,004.1
TOTAL	144,564.1	164,959.4	193,725.2	229,246.9	314,617.8	339,380.5	403,015.0	430,633.1

Source: Contraloría General de la República and author's own calculations

Property taxes undoubtedly have great potential in this regard, but tax base updating problems must be overcome and tax administration improved. Some issues to achieve it, based on the Colombian experience, are the following:

Tax Allocation

If local spending is to be funded mainly with local taxes, the real property tax should be allocated exclusively to municipalities and earmarked for specific expenditures, so as to allow the identification of benefits for which one is paying. This would improve accountability on behalf of the local civil service. For this end, it would be advisable to:

- Promote the use of other real property tax instruments, such as fees or rates for residential public utilities, properties' betterment levy, and percentages in the increase in value to finance infrastructure of urban development projects. Mayors more devoted to their political superiors than to their electorate usually try to avoid the collection of taxes due to the political costs involved.
- Allocate income taxes resulting from immovable properties to municipalities, such as capital gains taxes in the sale of properties and eventually earnings from such goods as rentals, revenues that generally can be controlled within the municipal jurisdiction.
- Allocate the responsibility to determine the land use and the adoption of a land use plan to municipalities, supporting the establishment of percentages in the increase in value and delimiting homogenous areas to determine minimal values for taxing purposes.

Incentives for Local Taxes

In any fiscal effort that considers higher local taxing as a way to improve the amount of collected transfers, then exclusive

tax allocation to local authorities, and its specific earmarking, must allow municipalities to use this instrument and to be accountable before citizens, in such a way as to improve the proper administration and voluntary compliance.

Regarding self-assessment, instruments that encourage its use are the possibility of taking it as fiscal cost of transfer when determining the capital gains earnings subject to income tax, as well as the right to consider the self-assessed value for acquisitions made by the municipality for expansion plans.

Critical Problems**A. ASSESSMENT**

The problem of assessment is not solved simply by defining a tax base. Critical issues are the administrative capacity to enforce actual compliance, the use of available information, and making it uniform, up-to-date, and available to the administration, taxpayers, and other users.

The tax base must be equal to the assessed valuation. But in addition to technologically updating procedures for its determination in large urban centers and rural areas, an integrated information system must be developed with agencies where both physical and legal alterations are recorded—together with a proper market value comparison system—to ensure correspondence between the tax base and the economic reality. That is, both the physical and the legal registries must be consolidated, each of them recording constructions, alterations, and transfers.

The use of certain instruments for taxing purposes must be allowed; even if they are less accurate, they may be simple and efficient to determine the tax. Examples are to levy taxes only on the land to facilitate the setting of prices per square meter in homogenous geo-economic areas; automatic indexing of properties based on land-appreciation indexes; self-

assessment; simplified and presumptive methods to collect en masse the tax on large numbers of low-cost properties of similar conditions, such as low-cost housing settlements, where due to economies of scale it is advisable to administer the tax under more efficient schemes. Hence, the criterion should be an actual tax base determination, even if rates are reduced.

On the other hand, tax costs of real property transactions must be reduced, since accumulation of levies promotes evasion by means of base decreases and impairs the potentials for subsequent controls.

Rates should be flatter and consider fewer factors for their establishment, especially in self-payment systems that require more simplicity and impair evasion possibilities, suppressing tax exemptions and deductions so as to increase tax neutrality.

B. ADMINISTRATION, COLLECTION, AND CONTROL

Evidence shows that local administrations suffer from relevant management restrictions, some of them resulting from the tax base difficulties and information weakness we have mentioned; others from a poor political willingness to collect the tax; and yet others form structural inefficiencies to improve tax management. All of them reflect high evasion levels. Administrative improvements should combine the modification or development of some basic rules and their efficient application, but its actual magnitude will be defined by the administrative management itself. Any tax administration should rely on:

- An efficient information system, with enough flexibility to allow cross-information with the various agencies that manage this information, appropriate controls, and the capacity for prompt self-updating.
- Simple filings and proceedings required for real properties, unifying their identification and using a homogenous tax base.

- The obligation of owners to report physical or legal alterations of their properties as part of their tax report.
- Lower price-statements in sales deed, controlled through verification procedures in notary's offices, financial corporations backing these operations, or follow-up of the sellers' accounts, or else through the power to set sales price presumptions, together with applicable penalty arrangements.
- Focusing enforcement on non-registered properties and establishing an information system that supports the cross-checking of information from the many public and private agencies where properties are recorded for different purposes.
- The establishment of a permanent program to promptly report delinquent debtors, so as to act on them quickly and effectively. The collection role requires an expedited administrative procedure and the use of available legal tools, high delinquency rates, precautionary measures, auctions for the collection of debts, authority to grant easy terms of payment to delinquent debtors, and an extremely quick coercive collection process, associated with a good portfolio classification and efficient management.
- The classification of municipalities according to their size, to grant flexibility to the various procedures according to their own capacity. In large cities, the real property tax and other property taxes should be decentralized and managed through property identification by areas so as to act selectively, with complementary measures such as physical inspection, summons, and eventually presumptive tax determinations. Table 6 shows the composition of municipalities in Colombia and the burden of the real property tax.

TABLE 6

PROPERTY TAX DISTRIBUTION PER MUNICIPALITY SIZE (COLOMBIA) - 1981-1989

INHABITANTS (THOUSANDS)	NO. OF MUNICIPALITIES	PERCENTAGES								
		1981	1982	1983	1984	1985	1986	1987	1988	1989
> than 500	5	66.9	68.8	66.7	65.8	63.6	64.1	63.9	62.9	60.4
200 to 500	12	10.4	9.5	11.0	10.5	10.8	10.0	9.7	7.8	9.8
100 to 200	14	4.5	5.2	5.0	5.8	6.0	5.5	4.8	5.7	7.3
50 to 100	40	3.3	3.0	2.9	3.8	4.4	5.3	5.6	6.7	5.8
20 to 50	218	6.2	5.6	6.0	6.2	6.7	6.8	7.2	8.4	8.2
> than 20	736	8.7	7.9	8.4	7.9	8.5	8.3	8.8	8.5	8.5
TOTAL	1,025	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance, DAF

In conclusion, we can see that large Latin American cities have successfully used the property tax to finance substantial shares of local public spending. Lessons from the best practices are circulating and could be shared more. For medium and small cities, good results have been rare in Latin America, although better results from North America show the possibilities. Getting medium and small municipalities to do more will require not only technical help from larger entities but also a stronger incentive framework, where local tax effort becomes essential for increased resources.

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Endnotes

1. This document mainly relies on the Colombian experience.
2. 1991-93, IMF (1995); 1994-96, own calculations based on the CGR. In *Cuadernos Fedesarrollo* 6.
3. The government level with the best information on its tax base should be responsible for the tax and also the one to define the need of the applicable expenditure to be funded (Shah 1997).
4. Bolivia, Brazil, Chile, Colombia, Peru, and Paraguay. Statistics of several years. (ECLAC/GTZ 1996).
5. Productividad, neutralidad, sencillez, equidad, legitimidad, transparencia, eficiencia y justicia (productivity, neutrality, simplicity,

equity, legitimacy, transparency, efficiency, and justice). (Bell 1999).

6. Taxes must be classified in two categories: Special duties and rates on the one hand, and taxes on the other. The former two clearly conform to the benefit principle, while the tax capacity dominates in the latter. However, local taxes should preferably meet the benefit principle, since the aspect of interest and retribution prevails over economic capacity (Albiñana 1992).

7. In Colombia, an urban delineation tax amounting to 2.5 percent of the work's budget is collected.

8. In the 1998-2000 Development Plan of Bogotá, works partially funded with this charge account for 19 percent of total investments (Plan de Desarrollo de Bogotá, 1998-2000).

9. In Bogotá, a three-year road construction plan was developed in 1993, which covered the entire city and was partially funded with a general benefit levy representing twice the amount of the real property tax of that year.

10. They were established in 1989 in Colombia, but could not be collected due to procedural difficulties. In the new 1997 urban reform, they were linked to land use planning resulting from the extension of the urban perimeter, changes in land use, or construction density.

11. "Betterment resulting from zoning to the benefit of the community is a theoretically simple idea. Difficulties and failures in this sense that occurred in England (Town and Country Planning Act, 1947), in Italy (Concessione di Edificare, 1976), in Spain ("Aprovecho medio") and in France ("Techo legal de densidad") show that this principle is very difficult to implement."

12. In Colombia, profits resulting from immovable property sales are assessed at 35 percent on earnings for companies. For natural persons, they are assessed with a scale rate on earnings, with a 1 percent withholding on the sales value. The registry tax is 1 percent, notary fees are 0.25 percent, and registry fees 0.5 percent of the sales value.

13. Inflation rate adjustments applied to immovable properties represent incomes assessed with the income tax. The presumptive income amounts to 5 percent of equity, which includes real properties. In some countries, capital taxes, including real properties, can be credited against income taxes.

14. In Colombia, real estate, green area and reforestation, socioeconomic stratification, and surcharge for cadastral survey taxes—collected at municipal level—were merged in the Unified Real Property Tax and any other taxes assessed on real properties were prohibited. Due to economies of scale, one unified tax is more efficient than many taxes, for example, to finance environmental improvement and maintenance, public lighting, and community services such as fire brigades, and parks, tree planting, and public road maintenance.

15. In Colombia, rates are set by municipalities ranging between 0.1 and 1.6 percent. For properties with the potential to be urbanized, non-urbanized, and urbanized-but-not-constructed, rates may amount to as much as 3.3 percent. There are six socioeconomic strata used in housings to differentiate rates of real property tax, public domestic utility rates, and betterment levies.

16. Properties depend on their possibilities of construction and, from a financial point of view, this is the reason for the frequent failure of planning and zoning mechanisms. Thus, in the absence of corrective mechanisms, zoning causes changes to property prices and hence to their owners' equity.

17. There was an obvious increase in real estate value in Colombia as a result of the illegal drug-dealing economy (Kalmanovitz 1990).

18. In Colombia, the three main cities have a municipal or district real estate registry, while the national real estate registry covers the remaining municipalities. Since 1995, municipalities have been allowed to delegate this role to the private sector, but little of this has actually happened.

19. Estimates for 1993 reveal that in Bogota the assessed valuations of properties reflect only 20 percent of their commercial value.

20. The rate structure of Bogota combines many factors—socio-economic stratum, usage, area, environmental impact—making it much more complex. Decree 423/96.

21. In Cali, tax was adopted with a minimum value base per square meter and geo-economic areas. Collection increased from 53 billion to 78 billion pesos during 1995-96. In 1997, a deep crisis in construction considerably reduced collection to 56 billion pesos. The tax report was adopted in Cartagena, and attempts were made to apply self-assessment in only one city area. This was not allowed, and collection increased from 7 billion to 13 billion pesos during 1996-97. In Barranquilla, minimum values per geo-economic areas set by the tax administration itself—not by assessed valuation—were applied, resulting in a real term decrease from 15 billion to 16 billion pesos during 1996-97. It recovered the next year. Medellín is the only large city that still continues billing the tax, mainly because its tax base is relatively up to date.

Credit Access

Subnational Governments and Credit Markets: Selected Cases

M A R I A E . F R E I R E , M A R C E L A H U E R T A S , A N D
B E N J A M I N D A R C H E

Introduction

The growing interest of subnational governments in accessing domestic and international capital markets has raised ambivalent reactions among policy-makers. On the one hand, mayors and governors believe that capital markets will bring cheaper and longer-term capital to finance infrastructure projects as well as opportunity for good business. On the other hand, central governments are concerned with the effect it may have on the overall national fiscal situation. The reality shows increasing numbers of cities that have been issuing bonds: During the period 1991–98, there were 120 cases in Latin America, 150 in Europe and Central Asia, 11 in East Asia, and nearly 500 in South Africa. Asia's local bond market is estimated at \$477 billion; Czech municipalities have issued municipal bonds to offset the negative impact of declining transfers into capital outlays. Poland, Russia, South Africa, and Zimbabwe have active bond markets.

Worries that fiscal decentralization may contribute to structural deficits and fiscal imbalances are common in Latin American and other countries. In countries where the main policy priority is to control aggregate public sector borrowing, there is a genuine concern that fiscal decentralization may accentuate this problem. Whenever traditions of fiscal responsibility are weak, accountability is immature, and administrative discipline is poorly developed, there is a risk that lower-level governments may abuse their

borrowing authority, contributing to aggregate fiscal imbalance with accompanying adverse macroeconomic consequences (Bird et al. 1995; Prud'homme 1995; Tanzi 1996). There is a generalized consensus that without a proper regulatory framework, easy access to borrowing (e.g., to debt financing) may lead to aggregate fiscal imbalances.

However, many would argue that with adequate legal framework and with the macro fundamentals in place, local

access to capital markets will be compatible with macro fiscal instability, while promoting the development of an important segment of the financial markets. Necessary conditions include the existence of supervisory authorities; judicial enforceability of contracts and agreements; adequate accounting, disclosure, and reporting standards; and availability of skilled staff.

This paper reviews the experiences of some recent bond issues (including Brazil, Argentina and Colombia) and

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illustrates the dynamics of the capital markets and the regulatory and fiscal impact issues these transactions raise. Part I provides background on the macroeconomic framework, Part II summarizes the bond issues, and Part III identifies the main issues and makes recommendations on the framework that needs to be put in place to guarantee a healthy function of subnational markets.

I. Decentralization, Local Government Borrowing, and National Fiscal Stability

Decentralization has been a reality in Latin America in the last decade. Nations throughout the region have shared responsibilities with local governments, backed by automatic revenue transfers that more than doubled local government revenues, while achieving a democratic transition. Virtually every mayor and council member in about 13,000 units of state and local government is now chosen by democratic vote.

By international standards, however, LAC countries are relatively centralized. For the average OECD country, 35 percent of the public spending is the responsibility of local governments; in the case of LAC, local governments account for only 14 percent of public spending. The situation varies significantly between large countries (where the share of subnational spending is above 45 percent) and smaller ones.

Decentralization has a significant impact on public finances. In some countries, decentralization has been adopted as a mechanism for reducing central government deficits and cutting aggregate public-sector expenditures. For example, central governments in Central and Eastern Europe have turned over highly subsidized activities like housing supply and water provision to local authorities to run at their own expense.

In Latin America, local authorities have secured sufficient transfers or shares of centrally collected taxes to finance services at their current or mandated level. In Argentina, Bolivia, Brazil, Venezuela, and other countries, revenue-sharing commitments for several years into the future were spelled out in national laws so as to reduce the financial risks of decentralization for local governments.

Actually, decentralization in Latin America has favored local-government budgets. In general, the process has started by transferring a larger share of centrally collected revenues to localities, with only a few spending obligations being shifted to local authorities. Only after the transfer of

revenues is well under way has the devolution of services begun. For example, Brazil's 1988 Constitution shifted 6 percent of total public revenues from the central government to the subnational governments. The new constitution did not, however, transfer any expenditure responsibility to states and municipalities. The result: a windfall gain for municipalities but a tightening of the central government's fiscal situation. In countries like Argentina and Colombia the process was similar: Subnational governments ended up with more revenues than additional responsibilities (see Stein 1997; Ter-Minassian 1997).

Why decentralize? Decentralization seems to be primarily a politically driven process supported by increasingly influential local authorities. From an economist's point of view, the most common arguments are those of Tiebout (1961), Musgrave (1969) and Oates (1972), who argue that decentralization would promote a more efficient allocation and delivery of local public services, as well as improving the relationship between local preferences and the provision of local services. Ongoing World Bank work tries to establish the nature and extent of such benefits.

However, decentralization can also entail costs in terms of distribution equity and macroeconomic management. The most serious risk is the fact that local governments may have no incentives to behave in a fiscally responsible manner. On the one hand, expenditures are more easily decentralized than revenues (there are few good local taxes). This difference between assumed responsibilities and own revenues (or vertical fiscal gap) is generally financed by transfers from the central government. Heavy reliance on revenue transfers may weaken the budget constraints of subnational governments. This is especially the case where the subnational governments have borrowing autonomy and the central government cannot avoid bailing them out in case of financial trouble. In some cases, foreign borrowing by subnational governments can ruin a national government's credit in international markets, if the market fails to distinguish between local-government defaults and central government performance.

Three Cases of Financial Autonomy and Fiscal Adjustment

Argentina, Brazil, and Colombia have the three most decentralized public sectors in Latin America (see Table 1), and along with India they are the most decentralized democracies in the world. Subnational governments

TABLE 1
Decentralization in LAC, 1995

COUNTRY	SUBNATIONAL/TOTAL GOVT. SPENDING
Argentina	49.3
Brazil	45.6
Colombia	39.0
Bolivia	26.7
Mexico	25.4
Venezuela	19.6
Uruguay	14.2
Chile	13.6
Honduras	12.3
Peru	10.5
Guatemala	10.3
Ecuador	7.5
Trinidad	7.2
Paraguay	6.2
El Salvador	6.0
Nicaragua	5.2
Panama	3.2
Dominican Republic	2.9
Costa Rica	2.3
Average LAC	14.6
Average OECD	35.3

Source: IDB (1997)

account for about half of public spending in Brazil and Argentina and almost 40 percent in Colombia. In Argentina and Brazil, the 1980s saw the return of democracy, the strengthening of federal practices and also poor macroeconomic performance with unsustainable fiscal imbalances. While national issues were at the core of the fiscal crises, intergovernmental fiscal relations and fiscal management of subnational governments also played crucial roles (Dillinger and Webb 1998). Subnational deficits made a significant contribution to the aggregate public-sector deficit, and stabilization was not possible without a strict control of subnational deficits.

ARGENTINA

In April 1991 Argentina introduced a highly successful stabilization plan (the Convertibility Plan). Among other measures, the plan fixed the exchange rate to the dollar, required that the monetary base not exceed the dollar value of international reserves (which transformed the Central Bank into a Currency Board) and removed the power to devalue the currency from the Ministry of Economy. A difficult fiscal adjustment was necessary to bring down inflation and real interest rates. This was achieved with massive privatization, government layoffs, imposition of a severe budget constraint on provinces, because they were prohib-

ited from borrowing from the provincial banks and the Central Bank.

The effect of this budgetary constraint was not felt until three years later. The Tequila crisis in December 1994 hit the Argentine economy especially hard, leading to an important capital outflow, economic slowdown and substantial reduction of provincial revenues. The crisis was a test for the hard budget constraint put in place by the Convertibility Law. At first, provincial governments faced the fall in revenues by trying to borrow from their own banks and the Treasury. Because the Central Bank was unable to print money or rediscount provincial banks, and the national treasury refused to bail out the provincial governments, provinces ran into arrears, paid staff and suppliers with bonds, and borrowed from the banks by pledging their shared revenues (*coparticipacion*).¹ By mid-1996, provincial debt had reached \$17 billion, compared with \$5 million in 1991.

By the end of 1996, it was clear that the budget constraints were there to stay. With the central government refusing automatic bailouts,² most of the provinces began adjusting their expenditures. First they cut the cost of wages 5 percent in real terms in 1995 and another 5.5 percent in 1996. A small recovery in revenues (4 percent) associated with GDP recovery was enough to cut the provincial deficit in half.

The impact of sub-sovereign borrowing on the national fiscal condition in Argentina was offset by the macroeconomic constraints of the Convertibility Law. Provinces had no choice but to honor their debt-service payments to commercial banks and international creditors because direct transfers of coparticipation revenues secured these payments to the provincial creditors. The provinces did not receive their revenue transfers until after creditors were paid. This created a strain on provincial operating budgets, which led to substantial adjustments in less than two years.³

BRAZIL

In 1997 Brazil's per capita subnational debt reached \$800 per inhabitant. This was the highest in Latin America and one of the highest in the world (Argentina's averaged \$500). This situation resulted from a series of provincial-level debt crises that were absorbed by the central government, without its taking measures to promote or impose stricter rules in subnational borrowing. The first crisis occurred in the late 1980s with the international debt cri-

sis. Brazilian states—which had borrowed heavily to finance infrastructure projects during the 1980s—defaulted on foreign debt, and the federal government (which had guaranteed much of the debt) had to absorb it. The second crisis came when the states defaulted to federal financing institutions (principally CEF). In both cases the states' debt was rescheduled over a 20-year period with generous grace periods on payment of principal and a cap on debt service to current revenues.

The third crisis was a consequence of the 1994 stabilization plan that brought down annual inflation rates but led to high real interest rates. The major default was of state bonds. States were unable to liquidate the bond debt (R\$31 billion), and the federal government authorized the exchange of state bonds for federal or central bank bonds. All state debt (principal and interest) was rolled over, and debt service above the cap was automatically capitalized. By 1996, the bond debt had reached US\$51.7 billion (5.4 percent of GDP). Combined with the debt assumed by the failed state banks, at the end of 1996, the stock of state debt assumed by the federal government totaled US\$123 billion (Dillinger 1997).

From 1997 to 1999, Brazil undertook a more comprehensive approach to the restructuring of state debt, which involved sale of state assets and commitments by states to adjustment programs, but the burden of the ever-growing state debt remained with the federal government. Dillinger and Webb (1998) estimate that Brazil's subnational government deficit due to unpaid interest obligations is more than half the overall public sector deficit.

Since early 1999—in the aftermath of the major financial crisis that led to a major currency devaluation—significant progress has been achieved toward strengthening the subnational budget constraint and improving commitment to fiscal targets. The government program includes (i) guaranteed debt collection, (ii) establishment of financing constraints, and (iii) a new fiscal code (the Law of Fiscal Responsibility recently introduced in the Senate) that will seek to further strengthen fiscal discipline at the federal and subnational level, including the mandatory establishment of fiscal targets and limits on debt. In addition, a constitutional amendment limits personnel expenditures and introduces penalties on non-compliance. The federal government has cut most sources of financing to the states and has completed debt-rescheduling agreements with most states. These agreements require that the states ser-

vice their debt obligations with the federal government, and repayments can now be enforced with recourse to constitutionally mandated transfers as well as to the governments' own revenues.

COLOMBIA

The 1991 Constitution devolved substantial expenditure responsibilities to Colombian municipalities and departments. However, the decentralization process is limited. On the one hand, most of the departments and municipalities lack the institutional capacity to effectively perform the assigned functions (Ter-Minassian 1997). On the other hand, the central government determines norms for expenditures such as education and health, further limiting decentralization. In addition, the role of own-source revenues in subnational financing is very small, and most subnational revenues come from earmarked central-government transfers. In these circumstances the flexibility of the local governments to allocate expenditures is very limited, a fact that constrains the accountability of these governments.

Colombia's case exemplifies how decentralization can contribute to macroeconomic imbalances. Heavily dependent on transfers from the central government, subnational governments have contributed to a deterioration of the overall fiscal position between 1991 and 1996. The largest source of growth in central-government administration expenditures has been current transfers, mainly to the local governments. This reflects the importance that transfers have as a major source of revenue for the local governments and the need to reform the system and improve the revenue-raising ability of subnational governments to increase own-source revenues, which will improve elected officials' accountability to their constituents.

In addition, given the lack of flexibility of the earmarked transfers, and the nationally determined use of transfers, these transfers limit the effective decentralization of expenditures and encourage the use of credit. On the one hand, banks have an incentive to lend based on the strength of constitutionally increasing transfers from the nation and on the fact that local governments have earmarked resources that they are unable to use. On the other hand, local government have inadequate incentives to raise own-source revenues and have easy access to debt financing. In fact, subnational borrowing has increased rapidly—at more than 50 percent per year in nominal terms. During

the same 1993–1996 period, local-government debt doubled from 1 to 2 percent of GDP.

The Ministry of Finance has taken several measures to curb the growth of subnational debt:

- Higher collateral requirements were imposed. In 1995, the amount of revenues that might be used as collateral increased from 130 percent to 150 percent of the guaranteed loans.
- Credit institutions have to increase their ratio of net worth to loans to subnational governments.
- In 1997, the Law of Subnational Debt established a system of warning signs based on stock and flow indicators of subnational governments and specified the central government entity that must approve the requests. The indicators are (i) interest payments as a percentage of operating surplus, and (ii) the stock of debt as a percentage of current revenue.

Why do Local Governments Borrow?

Part of the responsibilities of local governments is to provide basic services. For that they need to invest in infrastructure. Pressure for investment is particularly heavy in urban areas undergoing rapid migration. It is estimated that Asia alone will need to invest \$280 billion a year over the next 30 years (Brockman and Williams 1996). Some of the investment will come from private sources; however, publicly financed infrastructure will continue to be necessary, especially to finance public goods. Traditionally, central governments would take care of this type of investment. However, the move toward decentralization implies that subnational governments will need to raise the funds.

To finance these investments, local governments can use local taxation (e.g., property taxes) and current savings. But these may be insufficient to finance all infrastructure investments. So they turn to debt as a supplementary source. In principle, there is much to be said for financing infrastructure through debt. Roads, schools, and pipelines have long useful lives, and debt spreads out costs of infrastructure to match its useful life.

But where can they borrow? The experience of industrial countries suggests two basic approaches: municipal bonds and municipal funds. *Municipal bonds* are often used in the United States and Canada (subnational bond debt is about \$7 billion in these two countries). There, the markets are stable, the macroeconomic situation has created conditions favoring long-term investment, capital markets

are developed, and the rules and laws are known and enforced. In most developing countries the conditions are the opposite. Long periods of macroeconomic instability discourage long-run commitments; the legal framework is often faulty in its capacity to protect investors, and information is not transparent. However, in spite of these problems the markets for subnational debt are expanding quickly. Some experiences have gone awry (e.g., in several Brazilian states and in Istanbul in Turkey), but other places are genuinely interested in creating strong laws to protect investors on subnational debt and favor a healthy subnational capital market.

Municipal funds and *banks* have been used in Europe. They were initially financed by the central government and tried to substitute for the reluctance of private capital to finance small municipalities.⁴ More recently, Municipal Development Funds (MDFs) have been set up in many developing countries. Under an MDF, the central government bears the ultimate risk of municipal default. Some governments have insisted on prudent lending standards and strict debt-service enforcement. Others have suffered high levels of default. Recently MDFs have been encouraged to include private participation or even to be sold to private interests.⁵

Bonds, banks, and MDFs can operate simultaneously, as they do in the United Kingdom. In all cases the success of the financial instrument depends on a stable macroeconomy, a legal framework defining the rights of lenders and borrowers, and a supply of long-term savings. Central governments, specifically, will need to adopt a legal framework for municipal borrowing and defining the rights and obligations of lenders and creditors, and a procedure for municipal bankruptcy.

The Need for Controls

Controls over and regulation of subnational borrowing and debt stock are needed to avoid excessive indebtedness at the local and national level. Some controls apply to the design of the intergovernmental fiscal relationship trying to reduce the cases that may favor excessive dependence on the central government or lack of clear accountability. These examine such needs as (i) having responsibilities and tax-raising power correspond, (ii) guaranteeing stable and predictable transfers from the center, and (iii) avoiding concurrent responsibilities so that the failure of one level of government will not translate in additional effort from the

other part of government. Other types of controls focus directly on the total amount of debt or borrowing, and are discussed below.

Regulatory Framework and Direct Controls. Regulation of subnational borrowing is especially needed in new democracies due to the lack of a clear boundary between national- and local-government liability. This causes subnational defaults to be passed on to the national government and can ruin the national government's credit in international markets when local governments default. To address these risks, central governments may want to limit annual or accumulated deficit or stock of debt and impose controls on specific debt instruments. Table 2 summarizes the main controls used in Latin American countries to control the borrowing by their subnational governments. Some of these controls include:

- *Prohibiting borrowing* (Chile). This has the advantage of eliminating excessive borrowing but at the cost of

severely restricting the investment capacity of state and local governments, unless funds are made available in some other fashion.

- *Imposing restraints on local-government deficit, or on total debt stock.* Only Colombia has a limit on total debt.⁶ Most of the others either have no quantitative control on total debt or use the debt service/revenue ratio to control outstanding debt.
- *Setting limits on the ability of subnational governments to use their future claim on intergovernmental transfers as a guarantee for new loans.* While these arrangements reduce the cost of financing by transferring the risk to the national government, it limits the ability of the market to signal an unsustainable fiscal position until the guarantee is exhausted.
- *Installing a proper framework to allow for project finance.* Subnational governments should be able to pledge the cash flow of a development project to secure

TABLE 2

LAC Countries - Controls on Subnational Borrowing

COUNTRY	BORROWING MUST BE AUTHORIZED	DEBT NUMERICAL CONSTRAINTS	CONSTRAINTS TO USE THE DEBT	CAN USE TAX SHARING AS GUARANTEES?
Argentina	Yes, by central government in case of foreign debt	Debt service <20-25% of revenues	For investment and reforms	Yes
Bolivia	By central and local governments		For investment	Yes
Brazil	By national and state governments		For project	Yes
Chile	Prohibited			
Colombia	Domestic: by local legislation. External: by national legislature	Debt service <40% of current revenues; debt/current revenues <80%	For investment	Yes
Costa Rica	Domestic: by local legislation. External: By national legislature.	Debt service <10% of municipal revenues		No
Dominican Republic	Domestic: by local legislation. External: By national legislature.	No	No	No
Ecuador	No authorization required	Debt service <20% of revenues	For investment	No
El Salvador	No formal authorization required	No	External: for investment	
Guatemala	National legislature		No	No
Honduras	Domestic: by local legislation. External: By national legislature.		No	No
Mexico	States and municipalities are not allowed to contract external debt	Some states limit debt service of municipalities to 35% of revenues	For investment	Yes for municipalities
Nicaragua	Yes	No	For investment	No
Panama		None		No
Peru	No authorization for domestic or external unless the guarantee is required	Established annually	Investment	No
Uruguay	By national legislature	Determined in the annual budget		No
Venezuela	Special law. Not authorized to borrow abroad	No	No	No

Source: IDB (1997).

finance. However, clear default rules should be enacted to clarify property rights and restrict the possibility of bailouts.

- *Refraining from bailing out subnational governments* to convey the image of independence and the fact that the market should be responsible for its own decisions when lending non-guaranteed money to subnational entities.

Regulations are not always effective and can easily be violated. However, they are especially important in the case of foreign borrowing. Foreign markets may not distinguish between the default of subnational governments and default of the central government. Control in this case would be required to prevent local governments' defaults from undermining the central government's own external borrowing. In addition, allowing local governments to have their own foreign debt can only complicate foreign exchange management. For most of the other cases, the best regulation would be for the central government to see local-government borrowing as a private transaction

between a local government and a lender and refuse to bail out local-government defaults.

II. Summary and Lessons of Six Bond Offerings

This section briefly summarizes the six domestic and international bonds issued by subnational governments in Argentina, Brazil, and Colombia. The cases were drawn from the universe of subnational bond issues sold in the Latin American domestic and international capital markets between 1991 and 1997, as indicated in Appendix 7.

We selected the cases to represent large and small bond offerings in domestic and international capital markets under different macroeconomic situations as described in Part I. The cases also form the basis of the lessons learned about subnational capital markets presented at the end of the report. Table 3 provides a summary of the cases, which is followed by a short discussion of their salient features. Appendixes 1 through 6 contain more detailed descriptions of each case.

TABLE 3

Summary Description of Subnational Bond Issues

PROVINCE / CITY	AMOUNT	PURPOSE OF THE ISSUE	MARKET	ISSUE DATE	MATURITY DATE
Buenos Aires (City)	US\$500 million in series	Refinance city's debt stock	Eurobond		
First Issue	US\$250 million	Refinance city's debt stock	Eurobond	4/11/97	4/11/07
Second Issue	LIT 100,000 million	Refinance city's debt stock	Eurobond	5/23/97	5/23/07
Third Issue	US\$150 million	Refinance city's debt stock	Eurobond	5/28/97	5/28/04
Fourth Issue	LIT69,000 million	Refinance city's debt stock	Eurobond	6/10/97	1/6/00
Guaymallen (City)	US\$2 million	Public works	Domestic		
Series One	US\$1 million	Gutters	Domestic	12/1/96	8/1/99
Series Two	US\$1 million	Street pavement	Domestic	7/1/98	7/1/99
Ibague (City)	Pesos 8 million	Civil works	Domestic		
Series One	Pesos 4.8 million	Road and transport infrastructure	Domestic	7/1/96	7/1/01
Series Two	Pesos 3.2 million	Road and transport infrastructure	Domestic	7/1/97	7/1/02
Mendoza (Prv)	US\$125 million	Refinance province's debt	Eurobond	8/2/96	7/25/02
Rio de Janeiro (City)	US\$125 million	Refinance existing debt	Eurobond	7/12/96	7/12/99
Valle del Cauca (Prv)	Pesos 50 billion	Debt restructuring	Domestic	12/26/96	12/26/03
ISSUE PRICE	INTEREST RATE	COLLATERAL	RATING		
Buenos Aires Par, discount or premium	semi-annual at 11.25% annual at 10% annual at 10.5% annual at 9.5% annual at 10%		B1 Moody's / S&P BB-		
Guaymallen: Par Ibague: Par	DTF + 3.5% DTF + 2%	Treasury Bonds Gasoline Taxes	AAA S&P and domestic rating agency A+ Duff & Phelps, Colombia		
Mendoza: 100% Fixed Re-Offer Rio de Janeiro: 99.96% Fixed Re-Offer	Fixed at 10% per annum Fixed, at 0.375% per annum	88% Oil Royalty Unsecured Liquor Sales Tax	BB Duff & Phelps Int. / AA- Duff & Phelps Ntl. BB Duff & Phelps / B+ Standard & Poor's A by Duff & Phelps		
Valle del Cauca: Par					

The Cases

City of Buenos Aires. The City of Buenos Aires issued U.S. dollar-equivalent 500 million Euro Medium Term Notes (EMTN) in the international debt markets. The EMTN program allows the issuer to offer the notes with maturities from 30 days to 30 years in a variety of currencies. The city took advantage of good market conditions and sold all the notes in four series within two months. The first series comprised a US\$250 million tranche with a 10-year maturity. The notes were sold via the 144a private placement market in the United States at an interest rate of 11.25 percent, about 370 basis points above the 2006 U.S. Treasury Note (the benchmark). The remaining series of notes were denominated in Argentine pesos, U.S. dollars, and Italian lira, with maturities ranging from three to 10 years. The note proceeds were used to refinance the city's debt stock and the liabilities of its bank, Banco de la Ciudad de Buenos Aires.

Municipality of Guaymallen, Argentina. The municipality sold two series of US\$1 million bonds in the local Mendoza market. The notes were sold in 1996 and matured in 1999, within the current mayor's term. The municipality had planned to offer three series of the notes, but the finance director did not want to extend the note maturities beyond the term of the current mayor (1999). Therefore, the last US\$1 million series was canceled. The notes were secured by the central government revenue transfers (coparticipation) and were also collateralized by U.S. dollar-denominated Argentine treasury notes. The collateral gave the notes a AAA rating and provided local investors with sufficient comfort to allow the underwriters to sell them primarily to retail buyers in the Mendoza area. The note proceeds were used for public works improvements.

City of Ibagu e, Colombia. The City of Ibagu e sold two series of five-year notes in 1996 and 1997 denominated in Colombian pesos. The notes are secured with gasoline taxes collected by a special trust created by the city. The trust collects the gasoline taxes and pays the debt service on the bonds. This trust mechanism and a sufficient debt service coverage ratio (gasoline taxes to total debt service) allowed the issue to receive an A+ domestic rating from Duff & Phelps, Colombia. The city offered the first series of notes at an interest rate of 3.5 percent over the benchmark DTF,⁷ which then declined to 2 percent over the DTF for the second series. The first series paid a higher rate because of the uncertainty associated with the viability of the trust mech-

anism. This uncertainty was reduced for the second series as reflected in the lower interest rate. Proceeds of the notes were used for road and infrastructure improvements.

Mendoza Province, Argentina. Mendoza issued its inaugural international bond in August 1996 with a US\$125 million six-year offering. Oil royalties paid by oil companies secured the bonds. Much of the due diligence for the bond issue was focused on the legal issues for the oil royalty payments. These issues included the terms and conditions of the oil concessions, the validity of oil company permits, the relevant hydrocarbon laws, the province's rights to the oil royalties and other revenues sources, as well as the validity of the collateral documents and arrangements. The bonds were priced at 403 basis points over the 2002 U.S. treasury notes at a fixed interest rate of 10 percent and sold to U.S. institutional investors in the 144(a) private market. Proceeds from the bonds were used to refinance the province's existing debt.

The City of Rio de Janeiro. The purpose of Rio's US\$125 million three-year note issued in 1996 was to help the city refinance its existing short-term debt. The notes were a general obligation of the city and were not secured by any dedicated revenues or collateral. Because of the general obligation structure, the due diligence process required that the city present detailed information on its economic base, financial operations, and management. The city's financial statements had to be converted to international accounting standards.⁸ Investors showed much confidence in the city as they bought the bonds at a price that was only 25 basis points higher than the price of an equivalent sovereign bond. This relatively low spread to an equivalent sovereign issue reflected the comfort investors had in the city's general financial condition. The bonds were 2-3 times oversubscribed at an interest rate of 10.375 percent and a yield that was 403 basis points over the benchmark 1999 U.S. Treasury note.

Department of Valle del Cauca, Colombia. The Valle de Cauca offering had a structure similar to the Ibagu e bond issue: a dedicated tax revenue source to secure the bonds. However, in the Valle del Cauca case the tax revenue was liquor sales rather than gasoline sales. Similar to Ibagu e, a trust mechanism was established to insure that the tax revenues were first used to pay debt service on the bonds before passing them on to the department. Unlike Ibagu e, the Valle del Cauca bond received an A rating, one notch below the rating of the Ibagu e issue. This might

have been due to a different trust mechanism. In the Valle del Cauca transaction, the department retained collection responsibilities, whereas the Ibaguè bond required the trust to collect and deposit tax revenues for debt service payments. The 50 billion Colombian peso seven-year Valle del Cauca bond issue was sold in part to refinance more costly debt from FINDETER, a government agency that funds municipal loans. The remaining bond proceeds were used for capital improvements.

Analysis, Lessons Learned, and Recommendations for the Further Development of Subnational Capital Markets

This report now analyzes the six case studies from several perspectives. First, it examines whether they were unsecured general obligation bonds or bonds secured by specific revenues and why these particular structures emerged. It then identifies the constraints on Latin American local governments in accessing the domestic and international capital markets and provides some suggestions on how to alleviate these constraints. The constraints include (i) lack of local-government creditworthiness and poor institutional capacity, (ii) lack of an adequate regulatory framework and

supervisory authorities of the domestic capital market, and (iii) lack of development of the domestic capital market. From these observations, a set of recommendations is made.

INTERNATIONAL BOND STRUCTURES

Bonds can either be secured by a dedicated revenue source or another form of collateral, or they can be an unsecured “general obligation” with payment of debt service based on the “full faith and credit” of the issuer. Whether or not some form of dedicated revenue source or other type of collateral to secure the bonds was necessary for the issuers in these case studies depended on the recognition of the issuer’s name by investors and the perceived importance of the city within the country. It appears that many international emerging-market investors develop their view of a subnational entity primarily by their assessment of the sovereign’s credit rating and their general knowledge of the subnational issuer.

Name recognition is also directly related to investor perceptions about moral hazard—the willingness of the sovereign to bail out the sub-sovereign when a bond defaults. To gauge the moral hazard, investors look at the sovereign’s behavior regarding bailouts of sub-sovereign domestic and

BOX 1

The Importance of Marketing and Management

The importance of marketing. When issuers are raising funds in the capital markets, they are simultaneously selling a product. In a local government the product is the economy of the city and the financial creditworthiness of the local government. Deutsche Bank, IBM, or Walt Disney can have easier access to the capital markets than Banco de la Pequeña y Mediana Empresa, Computadores Reunidos, or Moya Films. This doesn’t mean that the three companies cannot access the capital markets, but they need to undertake marketing. In the financial markets this means road-shows, presentations, bilateral meetings, and good and timely urban economic and financial information.

Budget. The size of a jurisdiction, the frequency of its issues, and the liquidity of the secondary markets are very important in public issues and, to a lesser extent, in private placements. To access the American market, the amount of the issue has to be at least US\$100 million. The average is above US\$200 million. Private placements in the European market can be smaller, but the need to be at least €25 million.

As a consequence of marketing and size, only the most important cities and regional governments of LAC can access the international capital market through general obligation issues.

The example of the Basque Country is well-known, but for a bad political situation. In the first half of the 1990s the Basque Country successfully raised public issues in the European, Japanese, and American markets. The main goal was to introduce its name to the world as a peaceful country. For this reason, these issues meant the possibility of road-shows, presentations, bilateral meetings, media, etc., that permits the Basque government to talk about the good situation of the Basque economy, its good infrastructure, skilled labor force and so on (the Basque Country has approximately 2.4 million inhabitants).

international obligations. Fear that the sub-sovereign will contaminate the name of the sovereign in the capital markets drives the latter to bail out sub-sovereign deadbeats. This is detrimental to subnational fiscal discipline, and is a scenario that is much more likely to occur with larger well-known municipalities. The smaller subnational issuers are politically and financially less important and cannot always rely on bailouts. However, from a bondholder's point of view, the lack of additional security in the form of a dedicated revenue source or some other collateral is offset by investor perception that the sovereign will bail out the municipality in case it gets into trouble and cannot make its debt service payments. The case studies seem to demonstrate, although it is difficult to prove, that an implied government bailout was priced into the international bond issues for the "general obligation" bond structures.

In addition to name recognition, the underwriters of the case studies had to take into account the issuer's desire for future bond sales to determine the appropriate bond structure. In the case of Buenos Aires, its goal was to diversify its borrowing sources when general liquidity in the marketplace began to tighten because of the Tequila crisis. Restructuring its outstanding short-term debt was also an important consideration, but the need to find additional funding sources was paramount.

The primary lesson learned from the case studies is that cities of LAC can access the international capital markets with general obligation type of bonds if :

- a) they have a credit rating of international independent agencies,
- b) they present good economic information about the city and timely financial information about the local government through road-shows, advised by financial intermediaries with a good international reputation, and

- c) the budget size of the city permits investors to believe that the city will be present in the market with some frequency.

They also can access the capital markets through private placements and revenue bonds.

DOMESTIC BOND STRUCTURES

The change from general-obligation to revenue-type bonds has contributed to the development of the local but undeveloped bond market. In addition, the newly created purchasers of local bonds such as pension funds, mutual funds, and other institutional investors are more sophisticated and are aware of the history of local-government general-obligation debt and the political influences that control repayment of the debt. They now require additional security to purchase bonds. These factors have led to the further evolution of "dedicated revenue" types of structures as demonstrated in the Ibague and Valle del Cauca issues in Colombia (gasoline and liquor taxes) and in Guaymallen in Argentina (government treasury bills and coparticipation revenues). We expect that dedicated revenue funds will continue to be the primary bond structure for local bond market issues in the near future, especially small- and medium-size municipalities. This will most likely be the case as central governments increasingly shift from a paternalistic financial and political policy to one of decentralization and local fiscal control.

We expect that the dedicated-fund type of revenue bond structure will continue to evolve. As decentralization proceeds, local government should be given new taxing powers and the ability to raise revenues for specific purposes. These new sources, such as a gasoline tax, can be used to secure bonds issued for a specific improvement, like road pavement in the Ibague case. Taxpayers are more willing to absorb the additional cost for gasoline if they can see the

BOX 2

Moral Hazard or "Big Brother"

Bailouts or moral hazard are known in the capital markets as the "big brother." The creditworthiness of the City of Barcelona is a consequence of the economy of the city and the financial performance and management, but also as a result of its big brother, the Kingdom of Spain. This effect, more than the name, is related to the importance of the local government in the economy of the country. Investors know that there is not an automatic bailout, but they wait for some kind of support from the National Government. For example, when Spain became a member of the European Community, Moody's upgraded Spain from AA2 to AAA, like Germany and France, because they think that Spain will have some implicit bailout, if it is needed.

direct benefit of their tax payments. This rationale can also be used for other types of taxes that local governments may be authorized to levy as the process of decentralization evolves. They will require new revenue sources to fulfill service mandates imposed by decentralization. These revenues can then be used to secure bond issues and legal structures developed to insure that an independent third party collects the revenue and distributes it to the bondholders.

CONSTRAINTS TO THE DEVELOPMENT OF SUBNATIONAL CREDIT MARKETS

The following analysis of the constraints in subnational credit markets allows us to summarize the findings of the case studies, as well as make recommendations toward their future development.

a) Credit Ratings and Credit-Rating Agencies

Credit ratings have become an essential element of international bond issues and are used more frequently in domestic bond offerings. The case studies indicated that credit ratings were an integral part of the bond offering process. We expect that credit ratings will continue to play a central role in the development of subnational municipal markets for both domestic and international bond issues. However, several problems related to international and domestic credit ratings were apparent in the case studies.

International ratings required a more stringent set of rating criteria than the domestic ratings. This is probably due to the fact that international investors have used credit ratings for several decades to complement their own credit risk analysis and have clear expectations as to the depth and quality of the rating process. Domestic ratings, on the other hand, were done for a variety of purposes. Ratings are necessary in Colombia for regulatory purposes and in Argentina as a disclosure gesture to inform investors about the financial condition of the municipality. There are a wide variety of domestic credit-rating agencies that use different methodologies for their credit ratings. A standard has not developed, as one generally finds in international ratings, but the international ratings also have significant differences in analytical approaches between rating agency companies.

One of the findings of the case studies that demonstrate the importance of the rating agencies in the development of the domestic capital market was the Valle del Cauca

issue that used dedicated liquor taxes to secure the bonds. The details of the structure were developed jointly by the financial adviser, the underwriter, and the rating agency. They defined the most appropriate mechanisms for revenue collection and distribution to bond holders. In the industrialized economies, rating agencies frequently dictate specific bond covenants and terms and conditions for the issuer to achieve a certain rating goal. In the case of Valle del Cauca, this method was applied, and we expect to see it occur more frequently.⁹ However, unless relatively standard criteria are developed among the rating agencies to achieve certain credit ratings, this process can send confusing signals to the domestic market. It may be worthwhile to establish a self-regulatory mechanism among the private rating agencies to develop a set of rating guidelines for municipal bond issues, although competitive business pressures may prevent cooperation among these companies.

Ideally, the credit-rating process for international and domestic bond issues should be the same except for the obvious issues associated with sovereign-related risks such as foreign exchange, currency convertibility, and legal matters associated with particular bond structures. Analysis of the municipality's financial operations (financial statements, budget, liquidity, operating balance, etc.), administration, economic base, debt management, and political factors should use the same general obligation debt criteria for all issuers. Financial criteria for dedicated revenue debt should also be the same (e.g., tax forecasts, debt service coverage ratios, etc.). However, even among the international credit-rating agencies, there is a difference in methodology in assigning a rating because of a different emphasis on the certain factors. Some factors may have more weight in the rating than others. Nevertheless, a self-regulatory body or a government regulatory agency could prepare credit-rating guidelines for international and domestic bond sales.

The case studies indicated that credit ratings in the domestic market appear to be more of a regulatory requirement than a service requested by investors, although this is beginning to change as ratings become more common. The structure of the bond issue also plays a role in whether or not a rating is necessary, as does the issuer's perception as to whether the cost of the rating is needed to place the bonds.

One of the factors that distinguished the international credit ratings from the domestic ratings appeared to be the quality of the information provided by the issuer to the rat-

ing agencies, especially financial statements. The underwriters in the international bond issues were concerned about the quality of the financial statements and in one case had them audited by an external accounting firm using international accounting standards. In another case the financial statements were converted to international standards as part of the due diligence process. This did not appear to be the case for the domestic ratings. The due diligence process for the international issues required that the underwriters restate the financial statements using international accounting standards. This was a costly, lengthy process and could have been used by the municipality to initiate a change in its accounting standards. But this opportunity was lost, as neither the underwriter nor the issuer had any incentive to change its accounting standard, especially if the resulting standard did not conform to legal auditing requirements. Developing appropriate accounting standards is a major issue that has to be tackled at the national level so those municipalities have an incentive to change. National governments should develop a public administration accounting plan. Local governments that implement the plan could then access the domestic market more easily and probably the international market as well.

b) Institutional Development and Capacity

An important factor contributing to the success of the bond issues studied was the level of staff development and their experience in municipal financial management. Most staff members did not have any experience with bond issues and recognized the need for external advisers and underwriters to assist in the process. However, the way in which the external advisers were used depended on the ability of the municipal administration to understand the details involved in preparing for the offering: gathering financial statements and statistics, rating agency presentation and strategy, securing regulatory applications and permits, preparing the offering circular, etc. The most time consuming activity was organizing financial statements and financial performance information and presenting it in a format acceptable to the rating agencies. This was especially difficult for the international bond issues, as the staff had to first understand the need for presenting financial statements using international accounting standards and then provide the support to the underwriters to complete the conversion. Preparation for domestic issues was simpler, but it still required, in some cases, a reorganization of

the municipal accounts to produce a financial statement. The lack of adequate financial accounting and reporting systems is a major impediment to the efficient development of both the international and domestic bond markets. A good supervisory authority (e.g., the U.S. Securities and Exchange Commission) could publish guidelines of the legal and financial information that local governments have to provide, assuring transparency.

Another area that will require substantial effort to facilitate development of the subnational capital market is the need for disclosure and due diligence standards for offering circular documents. There is a huge gap between the quality of the offering circulars used in the international issues and the disclosure provided for domestic investors. A self-regulatory body should develop some basic standards for domestic capital market issues that follow the standards used for international issues. The most important guideline is the need to prepare adequate financial statements, as discussed above. The guidelines should take into account the cost of securing the information to insure that small- and medium-size municipalities are not prohibited from entering the market because of excessive bond preparation costs. The World Bank may consider a grant or loan fund for a country to support the organization of a self-regulatory body and the preparation of disclosure guidelines for the municipal bond market. It may also consider a special fund to provide assistance to municipalities to prepare disclosure documents for municipal bond issues. This effort can be started with a pilot program such as the "city assistance" strategy.

c) Development of a Professional "Infrastructure" for Domestic Bond Issues

Both the international and domestic bond issues had a variety of external advisers and professionals to assist in the preparation and placement of the domestic and international offerings. They managed the due diligence process, prepared the rating-agency strategy and presentation, and incorporated changes to the bond structure in response to rating-agency comments. Bond market professionals also prepared the offering circular, developed the pre-sales strategy, and negotiated the bond price with the issuer and investors. The municipal staff gained valuable experience in following the details of a bond offering.

Although the professionals were hired only to assist the municipalities in the bond-offering process, the staff lost

the opportunity to make general improvements in their financial management systems that would accelerate the development of the municipal markets. Municipalities may consider expanding the role of the external advisers to prepare a checklist of items the municipality should improve based on the disclosure and accounting guidelines developed by a national bond professional association or self-regulatory body, as proposed above. Ideally, however, the checklist should be made by a regulatory and supervisory authority, who are political independent and can serve the general purpose of improving the capacity of the subnational government.

The pricing of domestic offerings has to be based on competitive bidding, with a supervisory authority taking care that the process is transparent and that there is no trading on inside information. If the domestic market is incipient, then a self-regulatory body could provide valuable assistance in the pricing of domestic offerings. Due to limited bond volume, a small secondary market, lack of regulations regarding bond underwriters' guidelines, and a variety of other factors, pricing of domestic bond issues in small markets is not very transparent. Municipalities do not know if they are receiving a fair price for their bonds (this is also the case for international offerings). For example, in one of the domestic issues with two tranches, the period to sell the first tranche was long, indicating a need to increase the price to attract investors. The second tranche sold off to a single investor in a short period, indicating that the price might have been too low (or the interest rate too high or the bond discount too great). The second tranche probably sold much more quickly because the bond security (a dedicated revenue source) was understood by the market, and it was willing to purchase the bonds at a higher price the second time around. In an international issue the initial offering price was two to three times oversubscribed, indicating strong demand or a low price with a spread to the equivalent U.S. treasury security of about 400 basis points. The spread declined to 225 basis points in the secondary market, demonstrating either a bullish market for emerging-market debt or a high initial price—probably a combination of the two factors. In both of these cases the issuer had no way of knowing whether it received a fair price because of the lack of pricing data. To obtain better information about pricing, a self-regulatory body could help establish rules for the dissemination of municipal bond

prices in the primary and secondary municipal bond market. Municipal officials could also hire independent financial advisers to negotiate the pricing of bond issues with underwriters.

The case studies also pointed to another difficult issue regarding professional services: How do the municipalities know what kind of professional assistance they need for the bond sale and what they should pay for that assistance? Most of the professionals hired for the case study bond issues were retained on a negotiated basis.¹⁰ Municipalities should consider the competitive selection of bond professionals. This makes the selection process more transparent and also provides the municipality with competitive pricing for professional bond services. In the selection of financial advisers, underwriters, etc., it is very important to take into account their reputation in the capital markets. The credibility of the local government improves if a good financial adviser or underwriter works with the local government. When a local government has a good reputation, the process can be the opposite: A financial adviser wants to work with the local government, because it improves the adviser's reputation.

Municipalities may also consider hiring a financial adviser prior to selecting a bond underwriter, as was the instance in some of the case studies. The financial adviser should provide the city with a long-term debt management strategy and an initial bond structure based on that strategy. The adviser can also do a significant amount of preparatory work for the bond issue. This includes organizing the financial statements and other documents to submit to the rating agencies, obtaining regulatory approvals for the bond issue, and preparing terms of reference and a tender document for the competitive selection of the underwriter.

d) Regulation of the Subnational Capital Market

Part I of this paper discusses the need for greater fiscal regulation of subnational bond issues. The focus of this regulation is to ensure that subnational governments are fiscally sound and do not threaten a country's macroeconomic stability. This type of regulation is more closely associated with improving the financial condition of a municipal government before the central government allows it to issue bonds in either the domestic or international markets. The basic premise is that municipal borrowing should not occur if it creates an additional financial burden on the cen-

tral government. The best way to avoid a negative impact on the national government is to require limits on total outstanding debt, as is the case in Colombia. Part I of this paper also discusses other ways to maintain the financial health of municipalities.

Regulation can also include controls on the parties involved in bond transactions. The controls should insure that taxpayer revenues are used properly and municipalities are paying a fair price for their bond issues. This type of regulation was briefly discussed above in regard to guidelines for due diligence and disclosure documents, accounting standards, and bond pricing.

There are several options for developing bond-transaction regulations and regulatory bodies. One option is to establish a self-regulatory body like the Municipal Securities Rule Making Board (MSRB) that regulates the municipal bond market in the United States. This non-government entity comprises representatives from the municipal bond industry (primarily underwriters), public representatives, and government agency representatives. It provides guidelines for the preparation, sale, disclosure, and secondary trading of municipal bonds. Another non-government association, the Government Accounting Standards Board (GASB), promulgates accounting standards. However, neither the MSRB nor the GASB has the legal authority to mandate changes in the management of the municipal bond market. This remains with the Securities and Exchange Commission, a government agency that regulates the broader securities market.

Another option is to delegate self-regulatory activities to other players in the nascent domestic municipal market—commercial banks, non-government organizations, trust organizations—whoever represents the interests of the parties involved in the market. International emerging markets have self-regulatory bodies, such as the International Securities Dealer Association to maintain standards for Eurobond issues.

It may be premature to establish a self-regulatory body for the municipal market until the market reaches a certain volume of transactions or the central government establishes debt limits for subnational governments to maintain macroeconomic stability. Nevertheless, the World Bank and other national and multilateral organizations interested in the further development of subnational capital markets should begin to consider how to regulate municipal bond transactions to avoid potential corruption, insider

trading, and other negative behaviors that can severely damage an incipient municipal market.

e) Price Volatility, Market Demand, and Investor Perceptions

The extent and duration of price volatility can sometimes be used as an indicator of the maturity of a market (breadth and depth of the primary market and volume of secondary trading) and the overall credit quality of the market participants. Price volatility in the international and domestic capital market for sub-sovereign debt has many causes. The underlying cause is the lower credit quality of the issuers (after controlling for macroeconomic conditions) and narrow secondary markets. Uncertainty about the ability of issuers to make debt-service payments combined with political uncertainty about their willingness to pay is the basis of the volatile conditions. This general condition applies to both the international and domestic capital markets.

The case studies demonstrated the volatility of both the international and domestic markets, but each has its unique cultural characteristics. In the international emerging markets, bond prices of debt from the developing countries seem to move in blocks for regions and the market as a whole. They generally go up with good news, such as progress on fiscal and monetary reforms, reduced inflation, currency stability, declining budget deficits, etc. Prices go down when there is bad economic and political news: currency instability and potential for devaluation, deteriorating current account balances, anticipated budget deficits, changes in critical cabinet ministers, etc. International investors have begun to discriminate between countries and reward good economic policy with higher bond prices. But investors seem to move in a herd and punish most countries with lower prices during a crisis, such as the recent turmoil created by the problems in Asia. Latin American officials have criticized emerging-market investors for failing to distinguish between emerging market regions, such as Asia and Latin America, not to mention the lack of discrimination within a region.

Extreme volatility in the international capital markets will continue for some time until the developing countries improve their credit condition and achieve solid investment grade ratings, in the A to A+ range. Until that time, the markets will continue to move more on changes in political uncertainty, such as the election or appointment

of government officials who change or reverse appropriate economic policy. They will also remain volatile until investors feel confident that economic policy will improve credit conditions measured by indicators such as General Government Balance/GDP, General Government Debt/GDP, Net Public Debt/Exports, etc.

As mentioned earlier, name recognition and the perceived credit condition of the sovereign issuers plays a significant role in the pricing of subnational debt. Sub-sovereign debt will follow the lead of the sovereign in the capital markets, as demonstrated by the case studies. When the volatility of sovereign bonds subsides, investors can begin to discriminate between countries with higher or lower credit ratings rather than indiscriminately punishing all countries when a severe problem arises in one country. Once this sovereign discrimination takes place, investors can then differentiate between sub-sovereign entities with different credit ratings. However, this will most likely not occur for some time. High volatility in the sovereign market will remain until the major economies in a region achieve stable investment grade ratings. In the meantime only internationally recognized cities and regions will be able to access the capital markets on an unsecured or general obligation basis, with some occasional exceptions.

The case studies demonstrated that name recognition, size, and management were the most important factors in determining the price of the bond issues (after taking into account the sovereign credit rating). Even with good financial indicators, a sub-sovereign entity that is not recognized by investors will pay a higher price and may not be able to access the markets at all unless it uses a dedicated revenue source to secure the bonds. These factors will act as natural obstacles for sub-sovereign governments seeking capital in the international capital markets and will most likely close the market for medium- and small-size issuers in Latin America.

Market demand and pricing in the domestic markets has a different cultural base from the international capital markets. The case studies illustrate that investors are skeptical about the willingness of elected officials to repay debt obligations, not to mention the ability of these entities to service their debt. They are also skeptical that newly elected officials will honor the obligations of a previous administration. In one case, the third tranche of a bond issue was canceled because the current administration's term was completed prior to the repayment of bond prin-

cipal. The finance officer was concerned that the new administration would not honor the obligation of the previous administration. This occurred in a municipality with a good financial record.

Most of the domestic investors who are familiar with the operations of sub-sovereign governments rely more on their feelings of trust in the entity's *willingness* to pay rather than its *ability* to pay, especially in the medium- and small-size municipalities. This occurs for several reasons. First, it is very difficult to accurately determine the financial status of small- and medium-size municipalities. The accounting systems used by these local governments usually are not capable of forecasting the municipality's future cash position. The entities are managed by crisis, as financial officers scramble to find the funds to meet critical payments such as payroll and essential vendors. This circumstance requires investors to demand bond structures that isolate the revenues used for debt service from the local-government administration. This has resulted in the "dedicated revenue" bond structure described in the first part of this section. We expect that dedicated bond structures will be the most common form of bond issued in the domestic capital markets until investors feel secure that the culture of municipal political and financial management changes. These changes are slowly occurring as local officials are held more accountable to voters and financial management becomes an important political issue.

III. A Road Map to Understanding Subnational Capital Markets

The case studies, although not representative of capital markets generally, provide some interesting lessons and confirm some of the key factors that have to be in place before one thinks about local access to capital markets. Subnational bond markets can be an important source of credit, as they are in the United States and Canada. However, some basic conditions are required as a prerequisite for successful development of a local government capital market:

Macroeconomic Balances and Regulatory Framework. The macroeconomic situation should be stable; macroeconomic instability increases the risk of long-term commitments. One of the reasons for the long-established success of municipal bonds in the United States and Canada is the stable macroeconomic situation there, which has led to an important component of long-term savings and investments.

- Subnational borrowing should be clearly in line with macroeconomic requirements. This may require strict limits in subnational debt, including banks, bond issues, municipal development funds, etc.
 - The regulatory framework should be transparent and enforceable and adapted to the circumstances of the local government. Access to international markets should be disciplined, and the impact of exchange-rate risk clearly evaluated.
 - Access to the domestic market should be promoted and regulated in parallel with the development of long-run sources of savings.
 - Intergovernmental fiscal relations should be predictable and stable and should lead to a stable flow of revenues to the subnational governments. (The case of Vietnam exemplifies the problems associated with lack of a clear intergovernmental fiscal framework. See Box 3).
- Developed Internal Capital Markets. Before any subnational capital markets can be created, the country's capital market needs to be in place and functioning. This requires six conditions:
1. *Market regulatory and supervisory system.* The regulations and the authority that supervise all the participants of the market must be put into place. Two well-known and successful models are the U.S. system, based on a complete and exhaustive regulation, and the London system, based on contracts and agreements supported by a group of good lawyers in the City. The U.S. and British systems are different, but both have in common the judicial enforceability of the contracts.
 2. *Skilled personnel.* Skilled and pragmatic personnel are needed for the supervisory authority, issuers, brokers, and portfolio managers. Special consideration has to be made in the training of financial advisers, because financial knowledge is not broadly diffused among private investors. Investors should be familiar with the system; there is a need for a secondary market so that investors can sell their assets prior to maturity (increasing the liquidity of otherwise illiquid assets).
 3. *Market organization.* The market can be, physically, a place where brokers meet to buy and sell securities, according to the regulations of this market. The

BOX 3

Intergovernmental Relationships in Vietnam

The Vietnamese system of intergovernmental fiscal relationships has been in flux over the past 10 years. The central government established a new budget law in March 1996 and amended it in May 1998. Before the law, assignment of revenues to the various levels of government changed from year to year; expenditures were guided by negotiation and political influences. The 1996 law established some structure. It defined the revenue authority and expenditure responsibilities of the various levels of government administration. As expenditure responsibilities were decentralized to a much larger degree than the tax authority, a substantial vertical gap remains to be filled. So far no decisions have been taken on how to transfer new tax-raising power to local governments. In addition, the implementation of the new budget law appears to exhibit some of the discretionary elements of the previous arrangements, at least in some of the provincial cities. Data are poor, and indicators vary according to the source.

In 1995, Ho Chi Minh City became the first city to access the capital markets in Vietnam. It placed a revenue bond to finance a toll road. The bond had a maturity period of 3 years and was placed with an interest rate of 17 percent per annum. The Bank for Investment and Development of Vietnam (BIDV) in Ho Chi Minh City was part of the team preparing the terms of the bond and its issuance procedures. The BIDV was also the biggest buyer of the bond. The bond had some particular characteristics: Its coupon was fixed at an inflation-adjusted figure. The buyers were banks and public companies. There was no credit rating and no underwriters—the bond was bought by the Peoples' Committee Agency.

future is an information system that integrates the clearing system, the spot market, and the derivative market. New software does not need to be developed—the Swedish and the Australian stock exchanges use software developed by a Swedish company; the Spanish stock exchange use the software of the Toronto Stock Exchange. The main problem is the communications network, and the implementation of the information system depends of this infrastructure.

4. *Rating agencies and bond insurers* should be encouraged to play their role informing the public of the risk of the operations.
5. *Market size.* The most important factor in developing a subnational market is to develop the national market, helped by regulations, and also supervision, which permits the development of insurance companies, mutual funds, pension funds, etc., which, in turn, permit savings in long-term funds. The critical points in this process of creating long-term savings structures are the following:
 - a) When mutual funds, pension funds, or other institutional entities begin to be successful, one may face a risk of excess demand for securities, price increases, and more incentives for additional offerings. This situation, together with lack of skilled personnel, may cause serious problems for the market.
 - b) The development of a capital market needs the support and collaboration of the domestic banking system. The international banks that know this business and compete with the domestic banks can help accelerate the development of the capital market and, in particular, the process of collaboration with the domestic banks.
 - c) The national Treasury has a leading role in the development of the domestic capital market. Not only does it set the regulatory framework, but its own behavior in capital markets sets the benchmarks against which the prices of other issues are fixed.

d) The national government may be in a situation of competing with local governments to issue bonds and finance their deficits. This may lead to a conflict of interest, especially, if the market is narrow. A regulatory framework well-defined and transparent is essential to prevent discriminatory positions of the central government.

6. *Liquidity.* A sub-sovereign can raise funds at good prices in the capital markets if its issues offer liquidity. The problem cannot be resolved only with the implementation of market makers. It depends on the budget size; size means being frequently in the market. The alternative is usually more expensive, because a premium is paid for not being liquid. But private placements can introduce the sub-sovereign into the market and prepare it for future public issues.

Local Governments should have a good fiscal and management system and capacity to generate consistent and strong revenues. They can improve their attractiveness to borrowers by

- instituting accounting, auditing, and disclosure standards that are compatible with international standards;
- improving the quality of their collateral by allowing central governments to deduct debt service directly from intergovernmental transfers or by pledging a specific tax or other revenue source to service debt on a specific loan; and
- making sure that loan contracts can specify that the payment of debt service on a specific loan will be given contractual priority—or prohibiting a municipality from issuing additional bonds backed by the same revenue source until a specific debt is retired.

In many countries with shallow domestic capital markets, those conditions may not be present. The first problem is the quality of municipal or subnational management and accounting, which is often poor and incomplete. The second problem is the shortage of long-term savings, as decades of hyperinflation have destroyed any habits of regular savings. Regulation and economic policy can also be an impediment. Examples are controls over interest rates or impediments against the development of institutional sources of savings such as pension funds and insurance

companies. Finally, the legal system may not be prepared to deal with default, and local governments may not have the ability or the authority to raise taxes, as these fall under the central government's control.

Over the long term, national governments should address constraints on the domestic capital market. To mobilize private long-term savings there is a need to eliminate interest-rate caps; remove regulations that restrict the growth of insurance companies, mutual funds, and pension funds; improve the quality of information in the market by enabling regulatory authorities to evaluate the financial health of institutions and facilitating the development of private rating agencies; and strengthen legal frameworks. Finally, there is a need to make local governments more attractive to potential lenders. Central governments can strengthen a local government's revenue position by assigning broad tax bases to local governments and freeing local governments to determine tax rates. Local governments can, in turn, render themselves more attractive to bondholders by using this power prudently. For example, by keeping tax rates low, they leave headroom for increasing rates if necessary.

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Endnotes

1. These transfers are appropriated at the source by the public bank (*Banco de la Nación*).
2. In only a few cases did the central government assist some provinces—by making grants and paying salaries in arrears.
3. The Provincial Structural Adjustment Loans negotiated by the Bank with selected provinces aimed to support the provincial governments' implementation of these adjustment programs.

4. In their initial years many of them (including Credit Local de France, the Spanish Banco de Credito Local, and the British Public Works Loans Board) financed their operations through loans from the central government. In effect, central governments used their strong credit standing to raise money cheaply in capital markets and lent the proceeds to municipalities through the MDF.

5. Under Colombia's FINDETER program, private banks originate all municipal loans and bear the full risk of default, with the government's acting merely as a second-tier bank to provide liquidity. The Czech Republic's MUFIS acts along similar lines. (Indeed, many European MDFs have shifted to market sources to finance their operations and are in the process of privatization.)

6. Colombia is the only country in Latin America that has a regulatory framework in place to control the indebtedness capacity of municipalities in accordance with their operating surpluses. A 1997 law identified three levels of indebtedness known as the "street light system," which establishes three levels of emergency by following two economic indicators: the first one measures liquidity, and the second one measures solvency. The latter is only used for the "red level," or for highly indebted municipalities. The "red level" represents a danger in the capacity to repay the debt (Perry and Huertas 1997).

7. DTF is the baseline interest rate set by the central bank; sub-national governments are not allowed to negotiate interest rates directly in the market.

8. If a sovereign or a sub-sovereign like Rio de Janeiro registers the bond issue with the U.S. Securities and Exchange Commission, the sub-sovereign has to fulfill Schedule B. This means that the sub-sovereign must not change its accounting principles. (Private corporations have to fulfill Schedule A and change their accounts to American accounting principles). The Eurobond market requisites are less restrictive than those applied by the SEC. As a consequence, Rio de Janeiro had to change its accounts to international accounting principles, because the accounting plan was not good and the financial advisers asked for the change.

9. The international rating agencies try to assess objectively the local government's creditworthiness, but as all processes of evaluation, they apply a lot of subjective appraisal. They try to solve the problem through evaluation meetings that participate a team of different experts

10. Selection of underwriters for international issues was done on a "competitive-negotiated basis," with price as the primary selection criterion.

Financial Resources of European Local Governments: Budgetary Structures and Borrowings

M A R I E - A L I C E L A L L E M A N D F L U C H E R

During this session we have heard from Mila Freire and Marcela Huertas on their views of how local governments do or could access capital markets in order to meet their financial needs for infrastructure investment. They have demonstrated, using significant examples, the complexity of the mechanisms and underlined the necessity for an efficient institutional and regulatory framework to secure the issuing local authorities' commitments.

To expand on the subject, I will present the results of a survey on European local financing, highlighting the existing institutional and regulatory framework and indicating that in the European context most funding for local governments' needs comes from specialized institutions, although some of these local governments have succeeded in raising their resources directly from bond issues on the market. In this case, the issuing local governments are very large entities with a greater financial power than average. This seems to indicate that the choice of direct borrowing or borrowing through specialized institutions must rely on a number of considerations, including the specific structure and function of the local-government sector, and the history and evolving roles of the bank and financial sector within each country.

Needless to say, there is no "miracle solution"!

First, let me introduce the European local actors from whom our references come; second, I will "explain" local governments' financial capacity; then I will elaborate on their access to credit; and finally, I will put forward some suggestions to strengthen the borrowing context for the triple benefit of the local borrowers, the central government, and investors.

I. The Scope of the Study

At its current stage, the survey covers 25 countries, including the 15 countries in the European Union (sometimes referred to collectively as "Western countries") and 10 Central European and Baltic countries (sometimes referred to

collectively as "Eastern countries") for which we do not always—or at least as yet—have all the data required to carry out a systematic cross-sectional analysis approach.

Local public actors in Europe fall into three main categories:

1. Federated States

These consist of 16 German *Länder*, nine Austrian *Länder*, the three Belgian regions, and three communities and the Brussels region. As these units are empowered with sovereign responsibilities that are specifically identified as such in their national constitutions, they are not strictly speaking local governments.

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To ensure consistency, the financial data on them have not been incorporated here with data on local governments; to do so would have led to an overestimation of the local-government financial and technical weight by adding sovereign missions to local ones. However, not doing so has in turn led to an underestimation of the territorial activity in all three countries, given that local governments in the strict sense of the term are no longer required to carry out those duties assumed by the states. As far as Austria is concerned, the situation can be said to be an intermediate one. As it was not possible to distinguish between local and national data for the city of Vienna, which is both a *Land* and a local government, the weight of the local sector is certainly overestimated.

2. Private Law Local Public Companies, with Public Or Public/Private Capital

Each of the 15 EU countries has developed its own, sometimes unique, system (such as the mixed economy companies in France), which generally use a variety of formats (SA or AG, SARL or GmbH in Germany and Austria, for example) that allow local governments to provide urban public services while simultaneously lightening their day-to-day managerial load and maintaining control. To date, there are more than 11,000 local public companies in the EU (Table 1) representing a turnover of €120 billion and a million jobs.

The difficulty of collecting exhaustive data on these companies, given that their accounts are not consolidated at the national level and their budgets use private accounting prac-

tices that differ from those used in public accounting, made it impossible to include them in this comparative study. To further complicate matters, the European municipal company sector is currently undergoing a sea change as a result of the ongoing privatization of public services in most countries in both the Western and Eastern European groups.

3. Local Government Units Proper

They belong to three distinct tiers: regional, county, or municipal. Five of the 25 European countries studied (Italy, Spain, France, Ireland, and Poland) have all three (Table 2). Most of the other EU countries, plus Hungary and Croatia, have both county and municipal tiers, while most Central European countries, plus Finland, Austria, and Luxembourg, have only the municipal tier (Table 3).

The size of European local governments varies considerably (Tables 4 and 5). For the municipal tier alone, the average size ranges from 64,000 to 34,000 inhabitants in Lithuania and Portugal, to 1,600 and 1,500 inhabitants in France and the Czech Republic.

With the exception of France, EU countries have recently gone through a period of mandatory local government amalgamations to create larger municipalities, as opposed to Central Europe, where the trend in the past 10 years has been toward the breaking down of municipalities.

The study only looks at those local governments, in the strict sense of the term.

II. Financial Power of European Local Authorities

An initial measure of decentralization can be drawn from the relation between total local government spending and the GDP of the country (Table 6). Based on this yardstick, we can see a certain equilibrium between Western and Eastern Europe in that there is a relative dispersion among the countries. If we take the Finnish local government as an illustration of the Scandinavian model, we can see that the local government has an expenditure level that is roughly equal to a quarter of the country's GDP. At the other end of the scale, some Central European local governments, along with France and Belgium, have spending levels that are less than 10 percent of GDP.

This contrasting picture is the result of differences in the scope of their responsibilities. While all European municipalities are responsible for basic public services (water, sewage, refuse, etc.) and often local public trans-

TABLE 1
Local Public Companies in Western Europe
(Ref. 1998)

COUNTRIES	LOCAL PUBLIC COMPANIES
Austria	1,450
Belgium	225
Denmark	224
Finland	325
France	1,305
Germany	3,500
Greece	660
Ireland	N/A
Italy	1,000
Luxembourg	<10
Netherlands	N/A
Portugal	82
Spain	1,018
Sweden	1,834
United Kingdom	185
TOTAL	>11,000
Norway	>1,500

TABLE 2

Local Authority Structures in the European Union

(Ref. 1998)

Spain	17	comunidades autonomas	43	provinces	8,097	municipalities
France	22	régions	96	départements	36,559	communes
Ireland	8	regional authorities	34	counties	80	districts
Italy	20	regioni	108	provinces	8,104	comuni
Germany			426	Kreise	16,121	Gemeinden
Belgium			10	provinces	589	communes
Denmark			14	amtskommuners	275	kommuners
Greece			54	nomi	1,033	koinotites & dimi
Netherlands			12	provincie	548	gemeente
Norway			19	counties	435	municipalities
Portugal					275	municipios
United Kingdom			135	counties	319	districts
Sweden			21	landstings	289	kommuns
Austria					2,359	Gemeinden
Finland					452	kunta
Luxembourg					118	communes

(Federated States not included - Parent country only: Denmark, France, Netherlands, Portugal)

TABLE 3

Local Authority Structures in Central Europe

(Ref. 1998)

Poland	16	voivodies	373	powiat	2,489	gminas
Hungary			19	counties	3,150	
Croatia			21	counties	542	
Bulgaria					262	
Estonia					254	
Latvia					563	
Lithuania					56	
Czech Republic					6,233	
Slovakia					2,871	
Slovenia					192	

TABLE 4

Average Size of Municipalities in the European Union

(Ref. 1997)

COUNTRY	AVERAGE SIZE OF MUNICIPALITIES
Portugal	34,200
Sweden	30 900
Netherlands	27,000
Denmark	19,100
Belgium	17,200
Finland	11,200
Greece	10,100
Italy	7,000
Germany	5,000
Spain	4,800
Austria	3,400
Luxembourg	3,400
France	1,600

TABLE 5

Average Size of Municipalities in Central Europe

(Ref. 1997)

COUNTRY	AVERAGE SIZE OF MUNICIPALITIES
Lithuania	64,300
Bulgaria	28 000
Poland	15,000
Slovenia	8,800
Romania	7,700
Croatia	6,800
Latvia	4,400
Estonia	4,000
Hungary	2,700
Slovakia	1,700
Czech Republic	1,700

TABLE 6

Weight of Local Authority Expenditure in Relation to GDP
(percent) (Ref. 1997)

COUNTRY	PERCENT
Finland	24
Italy	14.7
Hungary	13
Lithuania	11.7
Austria	11.3
Germany	10
Latvia	9.4
France	9.1
Estonia	9
Poland	8.3
Czech Republic	8.2
Belgium	7.5
Croatia	6.7
Bulgaria	6.1
Slovenia	5.1
Slovakia	4.3

port, only some are responsible for costlier missions like education (in 10 of the 25 countries, local authorities are responsible for teachers' salaries), housing (often the responsibility of Eastern municipalities, but except for the Netherlands and Sweden, not of EU local governments), hospitals (funded by Scandinavian local governments, to a certain extent by their Italian counterparts, and the responsibility of some Eastern local governments).

These variable responsibilities are also the underlying reason for the difference in another measure of decentralization: the ratio of total local government spending to total public spending. To date, this ratio has not been worked out for all the countries concerned. As far as Germany and Austria are concerned, we incorporate the total amount of the Länder, Kreise, and municipalities' expenditures in the total public expenditures' amount. They are respectively 47.2 percent and 66 percent, well above the average usually given for the OECD countries (35 percent). On the other hand, our calculations confirm, except for Finland whose ratio is 36 percent, a much lower level compared with the OECD data. Further studies will explain why. They already demonstrate a higher level of decentralization for some local authorities in Central Europe (Poland, Hungary, Croatia, Estonia) than is the case for a majority of Western local authorities (Table 7).

The structure of local resources is another essential indicator of local financial power (Tables 8 and 9). When Western countries are ranked according to the weight of taxes in local government resources as a whole, they fall into three groups.

TABLE 7

Local Public Expenditure/Total Public Expenditures
(Ref. 1996, unless otherwise stated)

COUNTRY	EXPENDITURE
Austria	66 *
Finland	36
France	18.5
Germany	47.2 *
Italy	26.4
Portugal	11.7
Spain (autonomous communities)	18.1
Bulgaria	13
Croatia (Ref. 1997)	28
Estonia (Ref. 1997)	24
Hungary (Ref. 1994)	28
Poland	24
Czech Republic (Ref. 1997)	19
Slovakia (Ref. 1995)	12

* Länder included

Scandinavian local governments, along with their French and primary and secondary Spanish tiers, belong to the first group: Taxation represents a significant share of their revenue, with more than 45 percent of their resources being of fiscal origin. On the other hand, Irish, British and Dutch local governments, are in Group 3, with limited tax powers and less than 20 percent of their revenue coming from taxes. These figures deserve confirmation by analyzing the effective capacity of local governments to set their own tax levels (base and rates): Western local governments generally have room for maneuver, unlike their Eastern counterparts where most local government fiscal revenue comes from taxes shared with the central level, often on an extremely erratic basis (Figure 1). When only specifically local taxes are taken into account, all Eastern local governments are in Group 3.

Most significant taxes collected by European local governments belong to three major types:

- **Real estate taxes**, collected in all countries except Sweden (Table 10). They represent a significant share of local-government revenue (excluding borrowing) for eight Western countries. However, in Eastern countries, with the exception of Poland and Slovakia, their share is still low, although growing annually.
- **Local tax on personal income** (Table 11) is a major source of revenue for Scandinavian local governments. It also plays a significant role in Belgian local government budgets and in those of the autonomous Spanish communities, based for the latter on a transfer basis

TABLE 8

Local Authority Revenue Structure in Western Europe

(Ref. 1995)

	GRANTS	TAXES	FEES	LOANS	OTHERS
Sweden	15	59	19	2	5
Spain (municipalities and provinces)	31	53	2	12	2
France	23	52	9	10	6
Denmark	18	48	19	2	13
Finland	23	45	17	2	13
Austria	17	42	18	11	12
Belgium	42	32	9	9	8
Luxembourg	32	31	23	3	11
Portugal	47	31	10	8	4
Germany	51	30	4	9	6
Greece	63	27	8	2	0
Italy	62	21	4	3	10
Ireland	57	16	21	<3	97
Spain (autonomous communities)	70	16	1	11	2
United Kingdom	66	13	11	4	6
Netherlands	46	7	9	10	28

TABLE 9

Local Authority Revenue Structure in Eastern Europe

(Ref. 1997)

	GRANTS	SHARED TAXES	LOCAL TAXES	FEES	LOANS	OTHERS
Poland	40	25	17	15	1	3
Czech Republic	22	34	16	10	3	15
Slovakia	17	23	14	6	8	32
Hungary	32	12	9	14	2	31
Bulgaria	35	56	5	1	>1	3
Estonia	22	48	5	14	8	3

FIGURE 1

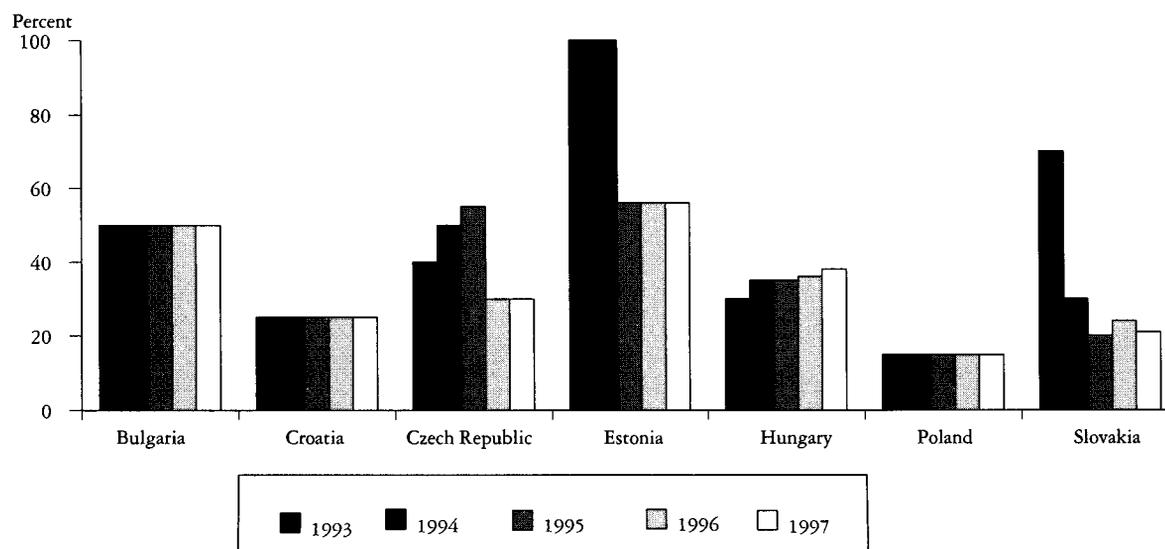
Municipal Share on Personal Income Tax (PIT)

TABLE 10

Real Estate Tax

Total Local Revenues Excluding Loans

A SUBSTANTIAL PART FOR SOME EU MUNICIPALITIES (REF. 1995)

Ireland	17%
Belgium	16%
United Kingdom	14%
France, Portugal	12%
Italy	10%

A GROWING REVENUE FOR EASTERN EUROPE MUNICIPALITIES (REF. 1997)

Poland	11%
Slovakia	11%
Croatia	7%
Estonia	5%
Hungary	<5%
Czech Republic	3%
Bulgaria	<1%

TABLE 11

Local Tax on Personal Income

Total Local Revenues Excluding Loans (Ref. 1995)

A MAJOR FINANCIAL RESOURCE FOR SCANDINAVIAN LOCAL AUTHORITIES:

Sweden	60%
Denmark	40%
Finland	40%

A GROWING IMPORTANCE FOR LOCAL AUTHORITIES OF TWO OTHER E.U. COUNTRIES:

Belgium	16%
Spain (for autonomous communities)	

A non-stabilized revenue for Eastern European local authorities

with the central state retaining the lion's share. It represents the common core of transferred taxes between Eastern states and their local governments.

- **Taxes on economic activities**, which are not, or at best only marginally, based on a profit criteria and represent a source of independent tax revenue in half of the EU countries (Table 12). In Luxembourg, for example, this tax represents 30 percent of local government resources excluding borrowing. This type of tax (in addition to the profit-based corporate tax that is generally shared with the state) does not seem to exist in Eastern local governments.

III. The Funding of Local Government Projects

The structure of European local government spending by function again reflects the differences noted earlier in terms

TABLE 12

Local Tax on Economic Activities

Total Local Revenues Excluding Loans (Ref. 1995)

APPLIED IN 7 COUNTRIES AS A PROPER LOCAL TAX

in Luxembourg	30%
in France	20%
in Germany	13%
in Belgium	8%
in Spain	8%
in Portugal	4%
in Italy	3%

AND IN THE UNITED KINGDOM AS A TRANSFERRED TAX, WHOSE SHARE IN THE LOCAL AUTHORITY REVENUE IS 16%

of responsibilities carried out. Scandinavian and Eastern local governments, which have a wide scope of responsibilities including education, health and housing, earmark most of their budget for operating expenditures, reaching levels of 83 percent in Sweden. The opposite is true in France or Portugal, where local governments focus on funding major projects for which they are not required to fund the management costs (mostly taken over by the state).

Greater involvement in project funding among European local governments almost always leads to an increased recourse to borrowing (Table 8). Four countries fund more than 10 percent of their budgets from borrowing (France, Spain, Austria, and Netherlands). On the other hand, borrowing represents only 2 percent of the Scandinavian budgets, and the same is true of most Eastern local government budgets (Table 9).

All local governments are legally allowed to borrow, subject to more or less strict prudential rules (Table 14). Western local governments are all allowed to take out bank loans or to go directly to the bond market. In six out of 15 countries (Belgium, Denmark, Finland, France, Netherlands, and Sweden), central-state approval is not required before using credit facilities, and in all the others the approval process is generally a formality. In five countries (Germany, Austria, Netherlands, Ireland, and Luxembourg), however, local governments are not allowed to borrow in foreign currency loans. The advent of the euro, now the domestic money for 11 countries, has meant that this restriction has essentially disappeared, although it has not been altogether eliminated. Some national legislation restricts borrowing to fund investment; this is true in Austria, France, the United Kingdom, and Denmark, where

TABLE 13

Borrowing Regulations in Eastern Europe

COUNTRY	COMPULSORY STATE APPROVAL				LOANS EXCLUSIVELY FOR CAPITAL PURPOSES	LOANS FOR ANY PURPOSES
	FOR BANK LOANS		FOR MUNICIPAL BONDS			
	IN FOREIGN CURRENCY	IN DOMESTIC CURRENCY	IN FOREIGN CURRENCY	IN DOMESTIC CURRENCY		
Bulgaria	yes	no	yes	no	X	
Croatia	yes	yes	yes	yes	X	
Czech Republic	no	no	yes	yes		X
Estonia	no	no	no	no		X
Hungary	no	no	no	no		X
Poland	not allowed	no	not allowed	no		X
Slovakia	no	no	no	no		X
Slovenia	not allowed	yes	not allowed	yes	X	

TABLE 14

Prudential Rules

COUNTRY	RATIO LIMITATION	OTHER
Bulgaria	new loans <10% of own revenue	6 months before local elections borrowing forbidden
Croatia	ceiling fixed annually by the ministry of finance foreign currency debt <10% of local expenditure of N-1	
Czech Republic	No	No
Estonia	Outstanding debt plus new loan <75% of total revenue debt service <20% of total revenue	
Hungary	New loans <70% of own revenue	Income tax and grants can not be affected to debt reimbursement
Poland	debt service <15% of forecast revenue Outstanding debt <60% of forecast revenue	Several other ratios
Slovakia	No	No
Slovenia	New loans <10% of own revenue Debt service <5% of total local expenditure	

the rules are even more specific, with borrowing restricted to profit-making activities (energy, sewage, waste management, etc.).

When the borrowing is short-term, it usually has to abide by very strict rules concerning both amounts and duration. Although it is not generally the situation, most Western European countries have defined a weighting framework to control borrowing. As an example I will mention Denmark (where new debt is less than 25 percent of the annual investment expenditure for the country), Italy (where the debt's interest is less than 25 percent of the previous year's budget), and Portugal (where annual debt repayment is less than 25 percent of the Financial Equilibrium Fund). Also, some countries put a ceiling on the debt annual amount (Austria, Germany, the United Kingdom), and others control the balance of the total local budget (France).

Borrowing by local authorities is, by far, less controlled in most Central European countries, where laws have been progressively put into place over the decade. Now there is a trend to tighten the laws, sometimes on a very strict basis. Where there is a ratio of debt to revenues (Figures 2 and 3), the ratio is usually at a very low level (debt service is less than 20 percent of the total local government revenue in Estonia and 15 percent in Poland). To this day, the ratio does not appear to have limited the borrowing capacity; it will probably be appropriate to raise it when the borrowing has reached its full dimension within the local investment strategy.

The figures related to the European local authorities' outstanding debt show a great difference in the local authorities' behavior depending on the geographical area where they belong. While borrowing has been used frequently for financing investments in the West, it is seldom

FIGURE 2

Outstanding Debt in Western Europe (in B Euros)

(Ref. 1998)

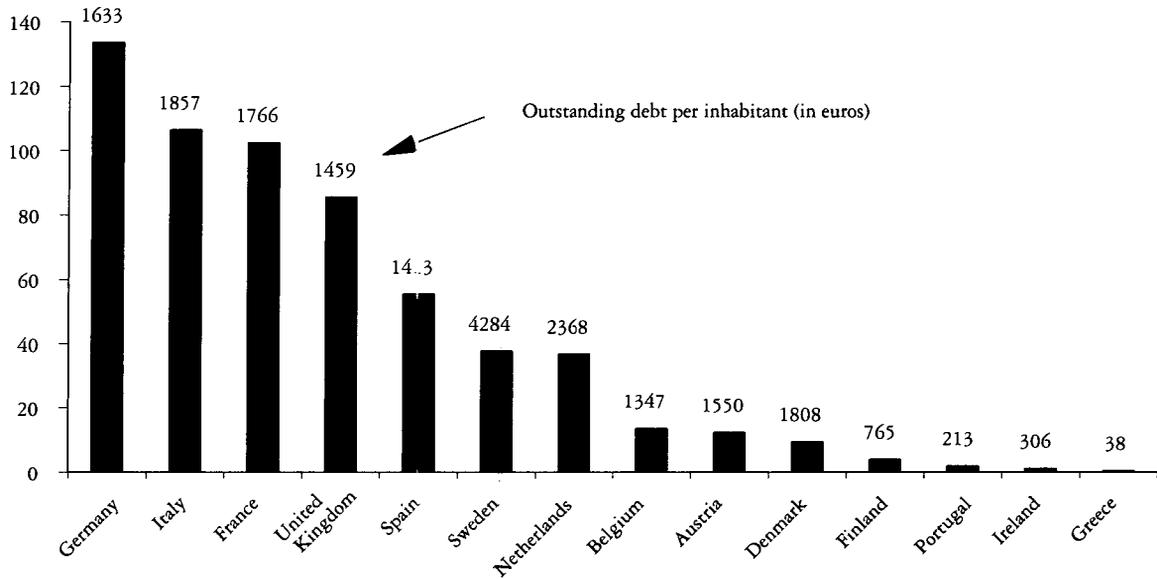
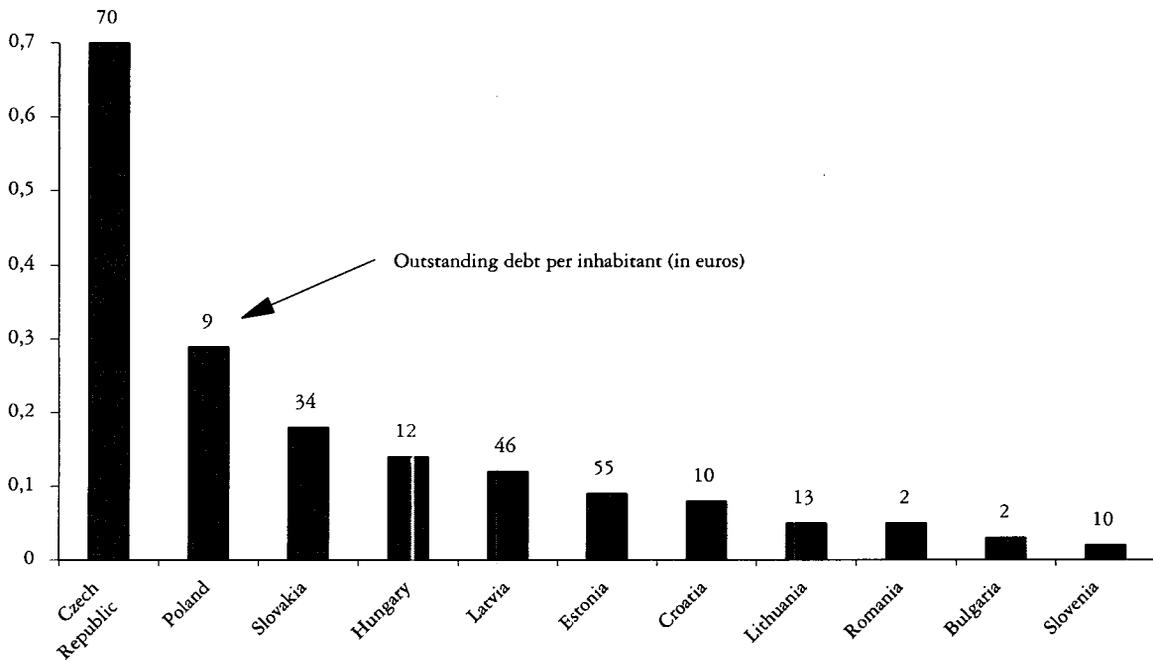


FIGURE 3

Outstanding Debt in Eastern Europe (in B Euros)

(Ref. 1997)



used (but is now growing) in Central Europe. The European Union local authorities' total credit liability (except federated states) represented about €600 billion at the end of 1998; it is less than €2 billion in the Central European countries analyzed.

Several reasons, most of them obvious, explain this gap. Among them can be noticed the difficulty of accessing credit for the Eastern local authorities. Credit supply in the Western banking system, made up through history, makes available lending instruments to the local authorities, within a partnership between banks and their customers. In the majority of the EU countries, we can notice that there is a leading bank that specializes in credit to local authorities (Table 15). By contrast, as far as we know, specialized banks do not exist in Central Europe except Slovakia (PKB), and credit supply is sometimes in the hands of a very few universal banks (OTP in Hungary, PKOpb in Poland, Ceska Sporitelna in the Czech Republic). The existing lending instruments do not take enough into account the specific needs and debt profiles of the local infrastructures.

Another explanation could be that the credits granted to the local authorities benefit from a favorable weighting Cooke Ratio (0 percent in Germany, Sweden, Finland, Denmark; 20 percent in other countries). At this stage, three Central European countries (Hungary, Poland, and the Czech Republic) have just agreed to a 20 percent weighting ratio for the local sector, whose effects should be felt on a short-term basis.

Last but not least, the explanation comes from the duration of terms of available credits—generally long-term credit in the West, but mostly short- or at best medium-term in the East.

In the European Union, the local public sector's debt is composed mainly of lending from banks. One of the main reasons is the favorable financing offered by banks, either because of the banks' historical know-how or because of the increased competition between banks, which results in the lowering of interest rates. According to our estimates, at the end of 1998, bond issues represented less than 10 percent of Western European local authorities' total outstanding borrowing. In recent years, a trend to develop this market has been noted in Spain and Italy: the demand on the bond market comes in fact from Tier 3 (autonomous communities and regions) or from very large cities. On the contrary, in Germany and in France, where bond issues were frequent some years ago, they are much less in use now.

In Eastern Europe, direct access to financial markets appears more in fashion, although it comes mainly from international bonds issued by two capital cities: Prague, which issued twice for a total amount of €0.41 billion and Budapest for €0.077 billion. We noticed that progressively other big cities have been applying for an international rating, Poland being the main example (Table 16). Issuing bonds is, to a certain limit, a possible solution, but only for large cities; the bond market does not answer the local investments' financial needs coming from local authorities, which represent most of the demand.

IV. Suggestions to Strengthen Investment Financing

Although there is today a big gap between investment policies and funding practices of Western and Eastern European local governments, we have seen over the current

TABLE 15

Specialized Banks Remain Leader in Most EU Countries

COUNTRY	LEADER BANKS	MARKET SHARE	
		40%–90%	>90%
Austria	Caisse d'Épargne	X	
Belgium	Crédit Communal de Belgique		X
France	Crédit local de France	X	
Germany	Caisses d'épargne et Landesbanken	X	
Greece	Caisse d'Épargne et consignations		X
Italy	Cassa de Depositi e Prestiti	X	
Luxembourg	Caisse d'Épargne	X	
Netherlands	Bank Nederlandse Gemeenten (BNG)	X	
Portugal	Caixa Geral de Depositos		X
Spain	Banco de Credito Local	X	
United Kingdom	Public Works Loan Board		X

TABLE 16

Bond Issues (in M Euros) or Recent Ratings: Eastern European Cities

COUNTRY/CITY	1994	1995	1996	1997	1998	1999
Bulgaria						
City of Sofia (B)						50
Czech Republic						
City of Prague (A-)	210					200
City of Ostrava (A-)			38			
Estonia						
City of Tallinn (Baa1)*			44		15	
Hungary						
City of Budapest					77	
Latvia						
City of Riga (BBB-)				X		
Poland						
City of Krakow (BBB-)				15	34	
City of Lodz (BBB-)				X		
City of Szczecin (BBB)						X
City of Wroclaw (BBB)						X
Slovakia						
City of Bratislava (BBB-)**		39				

Credit rating: Standard & Poor's (Foreign Currency)

* rating: Moody's

** Japan Credit Rating Agency

decade a progressive adoption by Eastern European central governments of some key rules applied in Western countries and, simultaneously, a start of infrastructure investment at the local level in the East.

First and foremost, let us underline the existence of a strong and effective regulatory framework aiming at limiting the risk either for the borrower or for the lender. In addition to those regulations whose objectives are mainly to set up an adequate ceiling on credit, in relation to the financial means of the borrower, and to restrict the credit allocation to productive investments, I would like to stress the considerable importance of thorough upper-level supervision of local budgets.

To be effective, these regulations and controls need transparent and clear accounting standards and auditing standards and practices, which give more confidence to any investor willing to participate in the local sector financial market. This is a reality in Western Europe; it is starting to materialize in the East.

As we have heard, and as you well know, rules for effective funding of local governments are numerous. I just wanted to point out some of them, from the point of view of a banker analyzing the counterpart risk.

Finally, and please forgive me if I happen to think so because I am a European and from a bank lending to local

entities, I would like to stress strongly that most local governments, mainly in emerging countries but also in the so-called developed countries, lack the critical mass to borrow directly from the market, whether in terms of volume to be issued, or in terms of human resources—i.e., competent staff to prepare and follow the issue. I think the message from the experts at the World Bank leads toward the same idea. Local governments must find their necessary financial and technical support among professionals. The lending financial entities or the arrangers can offer this service.

Certainly the local banking system will also have to considerably strengthen itself to reach the level at which it can offer adequate credit to local infrastructure needs. Being conscious that it is not yet the case everywhere, I will just conclude by indicating my company's readiness to assist in the development of the market for funding local governments' investments needs, including specialized financial institutions and in particular supporting the evolving role of Municipal Development Funds.

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Capacity for Local Accountability

About Transparency in Local Management

MARIO ROSALES

Development Arises, Sprouts

In cities and districts, we conceive of development as a process of liberation and setting social energies and capabilities into motion to solve local problems, provide services to communities, and originate stable production processes. In this regard, development sprouts, arises, bursts from beneath and is at least a potential in any human community.

The role of government is basically subsidiary to the tasks undertaken by communities themselves through their various organizations and the market. The government regulates, helps to trigger, and encourages development processes; it also intervenes to correct any potential imbalances in the distribution of available opportunities and resources among the various societal segments existing in the territory.

One of the concerns regarding government—which ideally should be neutral to carry out public or general welfare actions—is that it is closely linked to the social and political process and is therefore conditioned by it. Hence, its structures tend to reflect societal disparities. Thus, there must be a political and technical driving force to constantly correct authority- and resource-concentration at public structures—with a strong multiplying effect toward the private sector—so as to efficiently compensate inequalities of society as a whole.

Power shows a spontaneous trend to concentrate. Just as physical nature is not geometric, social nature is also irregular, and power concentrates. This partly explains the reluctance to change. In this sense, any political decentralization and strengthening of local government levels means an effort of social will that seeks to redistribute power and resources. In this way governments come closer to people and communities, and they help correct social inequities, structural imbalances, and environmental damages caused by growth processes. The local sphere is the natural space where public and private interactions occur to balance the social process. Municipalities are the most appropriate institutional framework for this cross-connection.

Decentralization Liberates Development Potentials

Decentralization is thus justified not only on philosophical and democratic-political ethic grounds, but also on the conviction that an improved distribution of power and resources within communities and territories frees a large amount of development potential. Consequently, it shows greater efficiency than centralism, particularly in a period of increasing complexity and changes of social processes resulting from the combined effect of technical progress and globalization. Today, societies are difficult to rule “from above.” This results in the quest for self-regulation formulas, with broad citizen participation, involvement, and commitment.

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Proactiveness now prevails over the traditional logic of government's responsive action. In the past, the government acted on problems once they had occurred—to apply corrective policies. Now the speed and complexity of the social process demand preventive actions and agreements between the government and society. Without the help of citizens, cities will not be clean; environments will fail to be preserved if people do not take the responsibility for safeguarding them; no efficient public health services will be in place if citizens fail to behave in ways that protect their own bodies. The current option for effective fiscal policies means the incorporation of communities into public welfare actions—i.e., their permanent involvement and participation.

Substitute Transparency and Democratic Transparency

The transparency required in public management to increase efficiency is directly related to this. However, there are two approaches. Although they are not completely conflicting, they certainly demand a preferential option or strategy: the point of view of a substitute or emulated transparency or supervision, and that of a democratic or authentic transparency. Under the first approach, the system will provide its own surveillance through the creation of control systems, monitoring, and indicators that are almost always vertical, technocratic, and prone to tampering because of their origin and nature.

Many events in Latin America prove the obscure nature of substitute controls: governments monitoring themselves, bureaucrats supervising each other. There is a trend to excess formalities in administrative processes, to technocratic complexity, to organizational nomenclature. There are hundreds of examples. Multiple control systems of officials watching over each other in endless chains; competing funds that are sectorally or regionally pre-allocated, without consultation with or understanding by their beneficiaries; complex and incomprehensible indicators to assess policy outcomes; targeting systems of social program lacking transparent supporting criteria.

Summing up, we face ever more intricate public policy designs in view of increasing social complexity. These result in complicated, sectoralized, uncoordinated and thus often highly inefficient policies. It's a matter of placing oneself in the position of thousands of intermediate or small municipal authorities or officials in Latin America—

poorly staffed, and lacking technical, or financial resources—for which national policies are incomprehensible, elitist, lacking clear priorities, and, hence, difficult to implement and have little or no local impact.

The second control approach is mainly social and is exercised from the social basis: by local civil society and citizens. It involves the regular dissemination of information to communities. Thus, the concepts of transparency and accountability are relevant. In this way, people can always be aware of what is going on within the public sector. There are no black boxes; spaces can be observed and socially controlled. Accounts are rendered directly to citizens. Authorities are mainly supervised and regulated from within the civil society. Of course, internal fiscal controls are not removed, but they are smoothed and complemented. This also allows for simpler administration—with speedier and more flexible public management—thus helping to decrease bureaucracy.

Conditions for Transparency

Transparency assumes the existence of certain conditions. First, there must be confidence in the autonomous capabilities of communities and citizens to seek and manage their development. A poor people's bank in Asia is an outstanding example that the poorest social actors can do things right.¹ This proves that through non-traditional technologies, the poorest can be excellent qualified borrowers—even better than traditional wealthy clients. Another example—this time institutional—is a remark by a Canadian mayor who, when discussing the operation of Chilean municipalities, commented that efficient public management could be achieved with scarce resources. Indeed, he pointed out that he could not believe a local government could operate with such limited resources—sometimes, a neutral view of an external agent is required to become aware of the efficiency of local performance.

An additional condition is the unconditional support to autonomous local capabilities and thus a wave goodbye to paternalism. The importance of a participatory project relies less on the work itself, but on liberating people's initiatives, capacities, and energies by stimulating their confidence. Traditional poverty reduction projects based only on the allocation of assistance and subsidies—which when poorly applied result in addiction and habituation—are replaced by or complemented with employment self-generating projects.

A third condition is the development and systematization of useful information and its dissemination, socialization, and availability to everyone. For the sake of transparency, democratization and simple information is required. Thus, descriptive and easy-to-understand indicators must be developed. Good examples are the well-known inflation indicators, which everyone understands and uses, and the simple UNDP human development indexes. These rely on a broad conception of development that was translated into a simple and effective methodology.

A fourth condition is that central authorities must renounce political or technical evaluative rankings about local or regional governmental efficiency. The development of standardized and comparative performance indicators of regional or local governments replaces citizen control with technocratic evaluations. One thing is to deliver information, socialize data bases, extend general development indicators to the citizens; however, to compare regional or local management outcomes is something very different. Only citizens can assess their authorities. This may be carried out through various means, the vote being the most important one.

In addition, the development and application of simple community-participation tools and procedures in the exercise of local public administration are required. Many of these can be found.

- General policies, such as mandatory local development plans based on full citizen involvement in Bolivia, established in a domestic law on “mass participation.”

- Techniques such as the “strategic and participatory planning” based on simple display instruments applied in Ecuador or Central America by IULA-Celcaedel.
- Instruments such as municipal budgets that have community approval or “*orcamentos participativos*” developed in Brazil by citizen referendum.
- Local municipal projects mobilizing grass-root energies and initiatives, such as paving streets through a community-wide participatory process in Chile.

These practices are democratic management methods that involve high capacities to multiply community resources. They all rely on the development of democratic cultures to exercise authority.

Any self-sustained and transparent local development is ultimately based on the creation of confidence settings that allow and stimulate people to behave in a socially mutually binding manner. This allows citizens to behave naturally as active agents of public policies. It can be seen in the behavior of citizens of developed countries, where they care for public spaces, respect transit regulations, and regularly pay their taxes. And of course, this demands irreproachable behavior on the part of their authorities and calls for a proper use of everybody's resources.

Endnote

1. See “Hacia un Mundo Sin Pobreza.” Andrés Bello, ed. Santiago. 1986.

Comment

G O N Z A L O D A R Q U E A S E V I L L A

In a recent presentation to the Council of the Americas in Washington, D.C., the U.S. Secretary of State put forth a challenge: “If we do not ensure that the globalization process continues with a human face, we will run great and unnecessary risks.” One of the key dimensions of assuring change with a human face is to incorporate participatory mechanisms into all dimensions of governance. As with globalization, decentralization also requires a deliberate participatory strategy. In Latin America participation is of critical importance given the vast gaps in income distribution. Furthermore, the Asian experience of the late 90’s points to the need to assure economic growth without pervasive incentives. “As we have seen in Asia,” wrote Andrés Oppenheimer, “a vigorous economy can rapidly make a turn if measures are not taken to end problems such as favoritism, corruption, and lack of public accountability in the civil service.”¹

This presentation seeks to present the importance of including participatory mechanisms in decentralization processes, drawing from lessons learned in four initiatives currently being undertaken in Latin America. It is in this context that we seek to understand key dimensions of transparency and participatory strategic planning in during decentralization.

Process Context

The municipal participatory process described in this paper (i.e. the “experience”) develops within the framework of the following programs:

- PRODEP Project, Support Project for the Decentralization in Paraguay, USAID-DAI.
- NEXUS Municipal Project, Guatemala, USAID-DAI.
- SACDEL project, Ecuador, IULA/CELCADEL-FCM.

The key to this experience lies in the participation of organized civil society, which allows decentralization to be operational at a local level. This allows the sharing of political power and resources with major stakeholders, based on social agreement as the highest form of citizen participa-

tion—understood as involvement in decision-making and co-responsibility for implementation.

Basic Problems

The starting point of these processes is to initiate a co-management process in order to address the most important and common problems in our countries, which need to be dealt with at a local level:

1. *Poverty* with all its consequences: unemployment, malnutrition, maternal and infant mortality, illiteracy, violence, crime, poor sanitary conditions, lack of access to basic services and housing, and environmental deterioration, among others.

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2. *Democratic fragility*, i.e., the existence of authoritarian, paternalistic, young, weak, fragile and clientelistic processes.
3. *Corruption*—that is, the illegitimate use of power that leads to destruction of social and institutional trust.
4. *Social inequity*, because we live in the paradox of globalization and pre-eminence of the market: Wealth and poverty have increased simultaneously; the market activated the economies but was unjust and inefficient when it came to distributing wealth.

Basic Principles that Sustain the Process

It becomes increasingly imperative to establish basic principles at a local level, so as to set forward on a path to consolidate basic principles of community coexistence and welfare, such as participatory democracy, freedom, solidarity, governance, social and gender equality, local integrity and transparency, construction of citizenship, social trust, right to employment, basic services, and collective infrastructure.

Central Ideas

Municipal strategic planning is based on the concept of decentralization as a democratic reform of the state and as the basis for economic and social stability; the involvement of organized civil society in public decision-making appears as a fundamental means of promoting this process. Additionally, there is the need to create a new link between civil society and the government, bringing governmental structures and demands of the community closer.

The experience carried out arranges its intervention around four central ideas. First, it starts from the fact that municipalities need to address local issues in a comprehensive manner and not only address efforts to the provision of services, but also promote local production and employment as the backbone of the new management. Emphasis is placed on the following main ideas:

1. Democratization and Decentralization of Local Management

Values of democracy must be recovered so that democracy can be direct and participatory, and can support decentralization as a mechanism for democratizing political power and improving the use and allocation of public investment.

The intention is to promote democratization of local management through the definition and enforcement of policies and strategies that include the organized community in the solution of its problems, valuing the representation of neighbors in a co-management process conducive to local autonomy.

2. Strengthening of the Local Economy

The strategy of this experience is aimed at improving the community's quality of life and, therefore, to triggering strong actions to fight poverty and support local economic development and job creation. Support for economic development implies the promotion of a set of actions aimed at strengthening and diversifying the production base through the creation of local conditions that can attract investment, improve competitiveness, and originate competitive advantages so as to achieve local economic and social well-being.

All local stakeholders are responsible for promoting the local economy. In this context, the municipality acts as a promoter and facilitator of initiatives that stimulate local economy development. Local production agents gather around the debate over production and employment, supported by the mayor and councilors who prepare their strategy, manage the programs, make strategic alliances, and assess progress.

3. Transparency, Visibility, and Equity in Decision-Making and Resource Allocation

This experience, by its own nature, makes actions and decisions totally visible, making it clear who becomes involved and undertakes a shared accountability and who doesn't, which results in a participatory self-management. Transparency clearly influences the reconstruction of social and institutional trust, which are deeply affected by clientelistic political systems and corruption. An improvement in the image of authorities, community leaders, and the community occurs when they become deeply involved, resulting in changes that can have a demonstrative effect for the strengthening of the process.

It is important to open up two-way communication channels between the municipality and its communities, to gather people's opinions and keep them informed of progress and barriers. This aims at the construction and maintenance of a transparent relationship, thus favoring institutional trust and facilitating governance.

4. *Strengthening Municipal Institutions*

The municipality is the closest and best tier for promoting sustained development of its community. Success will depend on the political will, institutional capacity, and attitude for recognizing and incorporating active participation of all stakeholders in a transparent, democratic, and sustainable process. The municipality is the coordinating and driving organism for this experience, with the most important responsibilities and leadership. Therefore, its institutional structure needs to be strengthened to address such a challenge.

A discussion forum, which carries out self-diagnosis and prepares, implements, and evaluates strategies, needs to be created within the municipality. This forum will comprise the mayor, who will act as chairman, plus councilors and municipal directors.

Instrumental Objectives

According to the experience carried out, success depends on the achievement and consolidation of three instrumental or intermediate objectives. Without these, progress and change are impossible to achieve at a local level.

1. *Changes in and strengthening of the attitudes of local authorities, community leaders, and the community itself.* Intervention at the local level has to demonstrate progress, and one of the most visible and verifiable changes is modification of attitudes, from paternalistic, authoritarian, and vertical to participatory, democratic, transparent and strategic. It is a long-term vision with the goal of a clear attitude toward planned, democratic, and sustainable change.

2. *Institutionalization of the co-management and citizen participation process and agreement on resources through a participatory budget.* The specification of this objective is essential to determining its success or failure, as well being the hardest to achieve. In a municipality undergoing change and progress, a participatory management system must be put in place, incorporating the hallmark of local agreement: the participatory budget, which provides legal support to the social contract between authorities and community. The participatory budget is based on agreements and common support between the three levels that take part in the process—the *gobernación*, the municipality, and local community organizations.

Formalizing community organizations also strengthens institutionalization. Therefore, legal assistance must be

provided to organizations to obtain legal status and manage public resources. This promotes self-organization; otherwise, they may be excluded from their benefits.

A further aspect that promotes institutionalization is the territorial and sectoral organization of community discussion forums, taking advantage of the existing institutional setting, strengthening and promoting it. Care must be taken to prevent the replication of efforts and organizations and the creation of the institution prior to the institutional framework. Furthermore, accepted channels of citizen representation in the territory must be validated.

A local government instrument must be agreed upon and provided to the municipality, with a long term vision: the participatory strategic plan (PSP). This plan is prepared by the local team and approved by the municipal assembly, incorporating the participatory budget, which then becomes a municipal ordinance, legally supporting the social contract and ensuring its operation. The PSP is an instrument, a means, a guiding point—and not the final objective of the experience.

Basic Assumptions

This experience incorporates three basic concepts, or premises, which allow the consolidation of the proposed intervention:

1. **Competitiveness** in terms of production, to allow economic welfare, and in service provision to achieve social welfare.

2. **Complementarity** through strategic alliances, to boost strengths and neutralize weaknesses: associations between municipalities, involvement of NGOs, universities, private, public, local, regional, national, and international organizations.

3. **Social agreement** through deliberation processes between the authorities and the community, which lead to voluntary agreements, decreasing friction as all stakeholders assume responsibility for mistakes and successes.

Participating Community Levels

Four community levels participate:

The Municipal Assembly, which is made up of all the community leaders and qualified informants, as well as local authorities (approximately 200 or 300 people). The municipal assembly is the largest community-driven organization. It meets three times during the intervention period to get information, discuss, decide, and supervise:

- a. The municipal assembly initiates the process, with strong democratic roots to share the responsibilities among all stakeholders, define a future vision, constitute sectoral discussion forums, and set up the local development committee. In other words, to determine the community structure that will lead, coordinate, carry out and assess the plan.
- b. In the intermediate phase, the municipal assembly acknowledges the competitiveness diagnosis—that is, comparative advantages at the local level (what the municipality has), and competitive advantages (what each sector of the municipality is lacking in order to be competitive), as well as the municipality's resources. In this way, there is transparent information for informed decision-making, decreasing risk and increasing the possibility of success.
- c. At the end of the preparation phase of the local government instrument—PSP—the municipal authority meets to hear the plan and the participatory budget, to approve it, and to ask the municipal council to declare it a municipal ordinance. Additionally, in such meetings authorities must render an accounts report and carry out the social audit required to supervise and consolidate the intervention.

The Territorial or Neighborhood Organization. Work with both urban and rural territorial organizations, i.e., neighborhoods and communes, is emphasized because of their strong identification with the territory, which strengthens management in their sphere of influence. Each one formulates its self-diagnosis, and its immediate and mid-range strategy, prioritizing projects for the participatory budget, negotiating neighborhood and municipal contributions, and assuming joint responsibility in the entire project management, execution, and operation cycle. Simultaneously, immediate actions or small projects are carried out. All of this leads to participation and results in a demonstrative effect, strengthening the community's credibility.

Functional, Sectoral or Trade organizations. Each trade organization is organized into work committees or discussion forums and also carries out a self-diagnosis and sectoral strategy, as well as resource management and project execution, assuming a joint responsibility with the municipality in the management of each sector: production, health, education, etc.

The Local Development Committee is the driving force of economic, social and physical-environmental

development. It is composed of the mayor, who acts a chairperson, the chairpersons of the discussion forums, and one councilor from each forum. The committee's function is to watch and manage the entire participatory and strategic process, as well as coordinate, promote, and evaluate its progress, support the discussion forums, and coordinate management with intermediate levels—that is, *gubernaciones* and departments, as well as other institutions and organizations with the objective of carrying out strategic alliances to support the process. The process must be supplemented with consistent interventions aimed at strengthening the social organization, upon which the sustainability of proposed changes relies.

The Departmental Development Committee. In the expansion phase, it is important to set up a regional or departmental committee, composed of the governor, the department's mayors, and institutional leaders. Its function is to construct and promote the regional-departmental strategy based on local strategies, agree on the use of regional resources, coordinate, support, manage, and assess the process with a comprehensive departmental vision.

The Strategy: Planning-Action Process

Credibility depends on community verification of small or great changes relating to their lives. The intervention must show progress; therefore, after agreement is reached, action must follow.

Agreed planning and joint accountability is required, initially with small actions in every neighborhood, so as to trigger participation. It must be kept in mind that acting on short-term community demands is not enough, since the process may disappear once the community has satisfied them. Therefore, participation must be sustained through strategies and mechanism that ensure its institutionalization.

The experience begins with an inventory of local organizations and their leaders, that is—of the existing local institutional setting in order to boost and support it. These are organized into work committees or sectoral discussion forums, which require three types of support for their sustenance: a) **Political**, on behalf of authorities, incorporating one councilor per forum to coordinate with the municipal council and strengthen the committee's management capacity. b) **Technical** through their own local team, since the forums carry out projects. c) **Financial**, as seed money

provided by the participatory budget, which serves as a counterpart to obtain complementary resources.

In order to ensure their consolidation and continuation, the discussion forums require strong leadership from the community as well as the mayor. Most often, they organize around critical issues: production and employment, health, education, women, youth, neighborhood commissions, and others, according to the needs of the community. Sustainability is strengthened through the participatory budget and the increasing formalization of community organizations.

Discussion forums, with support from the technical team, prepare the competitiveness diagnosis and the sectoral strategy, and manage its execution and assessment.

Basic Condition to Begin the Process

To be successful the process must serve as an example of best practice at a local and regional level. Therefore, it cannot be implemented in a non-discriminatory way in the entire country, but rather in a selective and progressive way. Hence, municipalities with democratic and honest mayors, who are willing to open their doors to joint efforts, to respect differences, and to share decision-making in their community, need to be selected.

Expansion

One of the goals is to build local and regional capacity to expand the process. The experience carried out proves that a local decentralization strategy must be coordinated at an intermediate or regional level to ensure its sustainability, because the institutional weakness of most municipalities does not guarantee its efficiency. Thus, strong political support is required to manage and put pressure on other levels, as well as technical assistance. There needs to be training geared at institutional strengthening, and a regional-integral vision to make an efficient use of local and regional resources in coordination with national policies. The building of regional capacity is important in order to ensure replication of the process in other municipalities.

Universities and NGOs play a key role in the support and expansion phase. Strategic alliances are required from the outset, to carry out their inclusion from the methodological customization phase in order to build capacity at a local and regional level; their involvement supports a sustained system and facilitates its expansion.

Conclusions

- The process showed great adaptability to the reality of municipalities in the countries involved. In their opinion, it is an unprecedented fact that is difficult to go back on, once the community has realized its right to decide on its own and not have others decide for it.
- The experience carried out showed the possibility of progressing in local and regional level governance, through the involvement of the different levels and sharing responsibilities for a common goal.
- This experience became accessible to small municipalities with limited capacities and resources, due to its low costs and simplicity. It helped to build their own capacity, as they became the leaders, creating a sense of community ownership that supports institutionalization.
- The main intent is to promote and honor the status of citizenship, which is the condition that a community gives to its members, defining their rights and obligations. Therefore, in the future, a municipality will not be counted by the number of inhabitants but by the number of citizens.
- To support and consolidate this experience, the legal framework for decentralization must be in place. Otherwise, we face the risk of having this right be limited to municipalities that have democratic mayors who are willing to share political power with their community.
- The demonstrative effect has been a key factor in convincing other municipalities and departments to become involved, as well as initiating a major expansion phase.
- The nature of the process induces communities to, in the future, demand greater quality when choosing authorities, as well as community awareness about public issues and citizen solidarity.
- No final outcome was obtained, but rather the beginning of a process, the design of a path, through the agreed plan. The challenge now is to walk this path, for which local institutions were promoted and strengthened.
- One of the aspects most appreciated by the community is the opening up of democratic spaces where they can express themselves, discuss their problems, identify solutions, and work with the authorities to

improve their conditions. In many cases, this is the first occasion where this has happened.

- This experience resulted in a systematized methodology adapted to the reality of the municipalities and countries involved.
- Within the context of the intervention carried out and in the case of Paraguay as part of the demonstrative effect in the municipalities that make up the program, up to now there have been around 500 community projects, around 6,500 leaders and neighbors have participated; 250 territorial community organizations and 50 trade organizations grouped around the forums have been involved; on

average, 50 percent of the program's municipal budgets were agreed upon, effective community contributions were counted as approximately 1,500 million *guaraníes*, or the equivalent of \$500,000 in one and a half years; around 2,000 projects were identified and prioritized; municipalities now have their agreed government instrument (PSP) and at the moment, 90 percent of municipalities involved are in the institutionalizing phase of the process.

Endnote

1. Andrés Oppenheimer, *El Comercio*, Quito, Ecuador, May 8, 1999.

Comment

JOSÉ ROBERTO RODRIGUES AFONSO

I. Fiscal Federalism in Brazil

Trend Toward Tax Decentralization

During the past few years, there has been a clear trend toward fiscal decentralization throughout Latin America, which is directly related to the consolidation of democracy in the region. Decentralization is the outcome of a process whose major impacts differ among countries depending on their specific political and institutional frameworks and economic settings. Below are some brief comments that illustrate the Brazilian experience and the activities of the *Banco Nacional de Desenvolvimento Econômico y Social* (BNDES).

Brazil is both formally and in practice organized as a federal republic. The country is carrying out a unique decentralization process because the federation has been established constitutionally not only as a union of states (intermediate governments), but also of municipalities (local governments). Thus, subnational governments cover 26 provinces and the Federal District (intermediate level) and more than 5,500 municipalities (local level), all of which have a *constitutional status as members of the Federation*. The Constitution of the Republic, the foundation of the Brazilian Federative Agreement (*Pacto Federativo Brasileiro*), defines in detail the tax jurisdiction and revenue sharing in tax income for each level of government.

The Brazilian federation features remarkable specific characteristics. On the one hand, subnational governments are highly involved in the direct raising—and even in the assignment—of fiscal income, as well as in the payment of active personnel and other current expenses and fixed investments—including budgeting—with minimum interference from the central government. However, the country still shows high socioeconomic, regional, and household disparities, pays a high price to keep national unity, and relationships among different government levels are difficult and uncoordinated.

Brazil's fiscal decentralization was deepened in recent years in the midst of extremely adverse political, economic,

and social crisis conditions. On the other hand, the basic motivation of fiscal decentralization was always clearly political in nature. The process was not led by technical or economic rationales; it did not arise from any planning, nor does it follow a designed strategy with well-thought-out policies aimed at greater efficiency in governmental actions. Constitutional changes were linked to the country's democratization and were imposed on the central government by the national legislature. Needless to say, no organized national plan was previously prepared for the rearrangement of the Brazilian federation. Neither was there any agreement entered into among the heads of the three government levels.

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Moreover, the recent decentralization process is the continuation of a long-run historical trend. We can see a clear increase in the relative weight of local governments, even in the reform of the military. This movement was further emphasized by the impacts of the 1988 tax reform. Ten years later, in the final division of the tax "cake," the provinces kept their same position, and the portion lost by the national government was entirely transferred to municipalities. The main outcome of the decentralization movement, then, was an increased share of local governments in tax income and expenditures. The national government is restricted from providing exemptions to local taxes. Decentralization of taxes does not depend on fiscal policies or on the guidelines of the central government, which further deepens the link between federalism and democracy.

In the meantime, there are still common coordination and planning failures and also fragile internal tax arrangements. From a tax standpoint, an urgent task is to improve coordination among different government levels.

Municipalization

Never before in the postwar era has the local government level been so important in the national division of income. After the tax reform, the more than 5,500 Brazilian municipalities—the sector with the greatest increase in direct collection—have their main source of income (near 69 percent of the total) in taxes on services and urban properties. Services have an approximate share of 13 percent. Own income more than doubled between 1988 and 1997 and increased from 0.7 percent of GDP to 1.6 percent. Taking the National Consolidated Budget as a reference, we can see that the own collection of local governments amounts to US\$12.6 billions, while provincial transfers amount to US\$16.1 billions. Total available income amounts to US\$40.1 billions.

Municipalities spend approximately 43.1 percent of the budget in personnel. Total investments were 10.2 percent, out of which 17.1 percent and 20.5 percent, respectively, went to health and education expenditures. In the search for spending efficiency, concern has arisen regarding the possibility of constant control either by the public authority that transfers the responsibility or by the service beneficiaries. This leads us to the principles of political accountability and social control. In the former, the possibility is being proposed to make decision-makers and officials accountable for their eventual errors, omissions, or neglectfulness in the performance of their jobs. The latter, the

principle of social control, closely related to accountability, refers to the systematic follow-up of outcomes to ensure a minimum level of equity and efficiency.

II. Outstanding Aspects in Decentralization and Social Control

Mass Participation

A further stage of the recent Brazilian tax decentralization is the heavy increase of mass participation. This participation is not limited to the electoral system—i.e., voting to elect the heads of the executive and the members of the legislature. Just as in the fiscal decentralization process, this participation does not result from a coordinated and negotiated effort, but basically from isolated and successful initiatives, which ends up encouraging its dissemination.

There is an increasing direct participation of civil society representatives, organized in professional associations and NGOs, that render services directly to individuals and communities. Thus, they are better positioned to exercise an efficient control of the services provided by the local government and also to address the demands of public utilities' users in a timely way. Professional associations and NGOs also lead and supplement government efforts, especially in the areas of primary education, public health, the environment and even in emergency situations.

Finally, there are many experiences with the so called *participatory budget*. Before resources are assigned for investments, meetings are held with neighborhood organizations to select local priorities. The Internet is also being increasingly used to disseminate updated public management information. Several municipalities have recently created their own web sites for such purpose.

Local Taxing and Accountability

To provide local governments with solid own-taxing competence and encourage greater collection of such taxes entails the participation of local communities in the supervision of governmental actions, thus allowing the consolidation of democracy and the build-up of citizenship. This is especially the case in small municipalities with a rudimentary tax base; tax payment strengthens the assimilation between the taxpayer and the citizen.

A greater share of own resources in the municipal budget tends to promote political participation in the decision of the amount to be allocated to different policies and in the

definition of priorities. This implies greater confidence in political decisions and their acceptance by the constituents.

III. BNDES Actions to Support Modernization

Credit to Improve Taxing Capacity

The increasing share of locally generated own or direct income to fund subnational government spending is one of the main elements to motivate and shape community participation in this process and to improve public resource allocation efficiency. In simple terms, participation and social control are expected to be directly proportional to local- and intermediate-government budgets, financed with rents collected from taxes or otherwise, decided or legislated, collected and managed by the local authorities themselves. This is the principle that guides a series of recent Brazilian initiatives, such as those of the BNDES.

By the end of 1997, the *Banco Nacional de Desenvolvimento*, a financial development institution controlled by the government of Brazil, created the Program for Improved Taxing Capacity of Local Governments (PMAT, *Programa de Capacitação Tributária de Governos Locais*). Its ultimate goal is to update tax management and improve the quality of public spending and is aimed at achieving a sustainable local development. Its goals are:

- To support fiscal reform of municipalities.
- To strengthen municipalities' own income, reducing the floating debt ratio.
- To increase the amount of non-negative resources for social investment.
- To support, complement, and modernize fiscal, financial, and equity management of municipalities, as well as their health and education management.

BNDES expects to have 55 percent of municipal tax income and to cover 24 percent of the population. The expected return is 15.5 percent annually (calculated for a sample of 19 municipalities).

Banco Federativo (Bank of the Federation)

BNDES also implemented an Internet site—the Banco Federativo (<http://federativo.bndes.gov.br>)—for the general public, as a space to exchange and disseminate information regarding finances and the management of provincial and municipal governments, in order to improve public management in Brazil. By the end of 1997, the organization of the Banco Federativo forms part of a set of activities of BNDES

performed under the guidance of the Ministry of Planning. These activities are aimed at disseminating information on public finance, seeking to promote efforts so as to reduce fiscal deficit and strengthen the Brazilian Federation. The site includes data, information exchange, and dissemination of statistics, news, research, and management experiences.

The site is organized in several banks. First of all, the *Bank of Studies* consist of information, research, and papers by national and foreign experts related to the following issues: Privatization, Taxing, Financial Management, Budget, Deficit, Borrowing, etc.

There are statistics in the Bank of Statistics regarding

- tax collection (federal, provincial, and municipal),
- constitutional transfers (allocation of federal and provincial taxes),
- available income (“thermometer” of decentralization), and
- public accounts (central government, provinces, municipalities, public sector): current values at constant prices, in shares of GDP, per capita, etc.

The News Bank is a selection of news, articles, and interviews on the public sector. The Bank of Experiences includes stories on management experiences in the various areas of the public sector (taxing and financial management, health, education, urbanism, etc.). The site also includes a list of financial and research institutions, official agencies, and other sites related to public sector issues.

There is also a Debate Forum for the exchange of information among institutions. Its access is restricted to members (previously registered municipalities, provincial governments, governmental agencies, and other institutions provided with access codes).

Currently, the site receives an average of 2,000 monthly visits.

IV. Challenges and Outlooks

Bill for Fiscal Accountability

When we talk about tax decentralization, the need for a responsible attitude on behalf of the legislature in every reform can never be overstressed. In the quest for efficiency and consolidation of changes that result from the implementation of co-funding schemes of local governments and streamlining of the decentralized spending, the legislature must be present in every stage of the process and in the three levels of government. In other words, to achieve the

desired goals, the involvement of the legislature in this process is considered as critical. Otherwise, there is great risk of creating a fearful enemy that will fight against any change, with a reasonable chance of being successful. In order to guarantee an alliance with the executive and with the general society, the alliance must be implemented so as to "close a deal." This is the perfect moment for the legislature to recover forgotten roles, such as regulatory activities and the representation of community interests.

In this context, we want to call attention to several bills currently under discussion in the National Congress (constitutional amendment bills), which form the so called Tax Reform, as well as the government project being discussed in the National Congress (supplementary bill), the Act on Fiscal Accountability (*Ley de Responsabilidad Fiscal*). The latter establishes principles, rules, and procedures for an accountable fiscal management system at the federal, provincial, and municipal levels. This way, local governments will receive treatment similar to all other entities of the federation and will be subject to legislation.

The Act on Fiscal Accountability introduces new concepts, such as those of transparency and accountability, and consolidates existing rules and procedures—i.e., constitutional provisions, laws, resolutions of the Federal Senate. It also confirms constitutional principles governing public finances and the behavior of officials entrusted with its management. These principles are mainly as follows:

- prevention of excessive and recurrent deficits (balance between community expectations and own actual income);
- restrictions of public debt to a prudent level, compatible with the actual tax income and net equity, thus allowing for a safety factor to absorb unexpected impacts;
- preservation of an adequate public net equity to allow a safety factor to absorb unexpected impacts;
- transparency in the preparation and dissemination of budget and accounting documents, in simple and clear phrasing.

Tax Reform Proposal

In order to modernize the country's tax system, the National Congress is also discussing a series of proposals

for a constitutional amendment. In general terms, we can say that most of them seek to harmonize the system with other international systems and to simplify the currently very complex obligations. The Tax Reform also seeks to:

- keep the current division of tax income;
- reduce fiscal evasion;
- strengthen own capacities, removing obstacles for fund-raising within local governments (provinces and municipalities);
- reduce dependency on transfers;
- promote greater transparency of fiscal accounts, facilitating social control and community participation in the process.

The Tax Reform has a greater chance of being successful if there is an institutional framework and the appropriate procedures that clearly establish interests and result from political consensus.

V. Final Remarks

In the quest for efficiency in public spending through decentralization, some guidelines must be followed, such as flexibility, staggered approach, transparency in decision-making, public assessment, and linkage with central macroeconomic policies.

The political nature of the decentralization process is closely linked (either as a cause or as a consequence) to the wave of democratization experienced in the continent. In this process, the most relevant factor of political participation (in fact, a point of consensus among the authors who have discussed the issue) deals with the reforms of the electoral and political party systems, as well as with the establishment of public elections at the intermediate and local levels of government to choose the appropriate leaders of the executive and generally also the members of the applicable legislatures.

After their return to democratic regimes, in most Latin-American countries no more than six elections have been carried out at the intermediate and local government levels; in fact, some countries have only recently begun this process. Anyway, regarding fiscal decentralization linked to democratic consolidation, direct participation of user groups should be encouraged in order to extend political accountability and social control.

V. Closing Session

Closing Panel

Challenges of Decentralization: Accountability, Efficiency, Equity, and Financial Soundness

The panelists were

José Antonio Ocampo, Director-General of ECLAC;

Joaquín Vial, Chile's Budget Director;

Santiago Levy, Mexico's Undersecretary of Finance; and

Guillermo Perry, Chief Economist of the World Bank's

Latin America and Caribbean Region.

Raul Troncoso Castillo, Chile's Minister of Interior, wrapped up the session.

J O S É A N T O N I O O C A M P O

Minister of the Interior from Chile, members of the governing table, I want to begin by thanking Guillermo Perry, in particular, for this invitation to participate in this reputable annual seminar of the World Bank on Latin American and the Caribbean, and to seize the opportunity to present some thoughts on this topic, based on works carried out by CEPAL and on personal experience.

I am strongly convinced that economic and social efficiency are indisputably linked with the political development of decentralization. I believe that all economic, social, and political arenas offer a means to improve the provision of services by the state to its citizens, to attain better information systems, and to make those who provide these services more accessible to the people. Therefore, I share the acknowledgment that decentralization is a healthy process that is gaining its appropriate standing in the policy of many governments in the region.

I must also point out that decentralization is a means to an end, rather than an objective in and of itself. In other words, it is efficient to decentralize so that those who provide public services are made accessible and accountable to those who receive the services. That applies to entities such as schools and health centers, and need not stop at the level of towns, provinces, or regions. Therefore, it is important, as well as it is obvious, that decentralization processes must be accompanied by good mechanisms to evaluate economic, social, and political objectives. This is the question of accountability on which I will present a few thoughts before concluding.

My second observation has to do with a challenge, and the main reason why there is an important group of economists who distrust decentralization: the risk of macroeconomic instability. I must, then, give priority to what I call "macroeconomic control," and to the design of institutions that make the efficiency gains from decentraliza-

tion compatible in economic, social, and political terms with “macroeconomic control.”

I want to refer, first, to the topic of regional indebtedness, which is, in the end, the nucleus of the problem of macroeconomic equilibrium. The costs of macroeconomic disequilibrium manifest themselves in the accumulation of debt. Therefore, the way debt is controlled, directly or indirectly, will determine how much risk public deficits pose to the aggregate economic situation. In this matter I believe there is no doubt that it is necessary to develop tools to control the level of debt created by regional entities. As far as most Latin American countries are concerned today, I do not think that a very liberal system with institutional controls and good market information mechanisms would be compatible with the objectives of macroeconomic equilibrium. Nor do I think that economic policy is capable of preventing rescues of bankrupt regional entities.

To illustrate, there are no sound markets for government debt bonds. Therefore, there is no assurance that market mechanisms and theoretically pure economic policy that promises not to rescue bankrupt entities will work. As a result, we need to see clear, fixed regulations that establish regional debt limits. A case in point is Colombia, where we approved a law that allows what we call a system of “traffic lights.” There is a “green traffic light” of debt regulation, in which there is not a single restriction on the regional entity; there is a regulatory mark of caution, a “yellow light”; and there is a regulatory prohibition of debt, a “red light.” Within established degrees of “caution,” the regional entity is autonomous, but upon surpassing the limits of “caution,” a plan absolutely prohibiting new debt is put in place.

The third topic, which is also related to the previous, is the system of transfers to subnational entities. There are three reasons why I think the system preferred by governments in the region is not the best from both economic and political perspectives. I am referring here to the system of sharing in the national income, generally established as a combination of a fixed and variable proportion of domestic income. I would say there are three reasons why this system is not optimal: First, it takes away from the autonomy of national tax policy; in other words, we lose a degree of freedom during fiscal adjustment, because any additional income generates an additional expense. We have witnessed this effect in Colombia, where each tax

reform has generated an additional expense that, so to speak, creates the effect of a “dog that bites its own tail.” In such cases, the tax reform does not achieve the intended objectives because of the concomitant adjustment in expenditures.

The second problem with our transfer systems is that they tend to be pro-cyclical, and increasingly so, according to the analysis we have been undertaking. Pro-cyclical revenues in turn generate pro-cyclical expenditures. And we see that one of the most pressing necessities of Latin American economies today is to design systems that reduce the dependence of expenditures on temporary revenues from boom periods. In other words, we must generate stabilization mechanisms for tax revenue that are stronger, along the lines that we have been working on in Colombia. To reiterate, we believe that a system that ties expenditures to revenues is essentially pro-cyclical, and that such a system is incorrect economic policy.

Furthermore, without delving into theoretical debates, suffice it to say that a system in which those who spend have only a minor responsibility over generating their own revenues does not provide the correct incentives. Nor does it generate a culture of fiscal responsibility. We should be instituting systems where, if major expenditures are needed, those benefiting from the investment are asked to support it and generate its financing in this way, through economic policy that transfers responsibility.

And that is my fourth point: Greater autonomy should be given to regional entities to generate revenues. Such a system would combine minimal links with national income, while giving greater autonomy to the regional entity so that it generates its own revenue, which is a function of the political game between the local government and the people. The local government must follow the same game that exists at the federal level. In other words, there will be countries that will want to have a larger state. Then they must, in the political game, ask their citizens to support them in order to have a larger state. This amounts to a fundamentally political process requiring political support. The same process must occur at the local level. There will be towns and provinces that will want to have other government services financed by the local government—cases where governors and mayors must go before the people and ask for their support in order to bring in greater revenues. We firmly believe that such mechanisms generate economy policy that is more efficient and a decen-

tralized system that is more satisfactory than some systems that depend on shares in the national income.

The fifth point relates to the problem of equity. There is no doubt, based on experiences that have begun to shape Latin America, that decentralized systems generate a tendency toward inequity; subnational regions with better financial power tend to become better developed than regions with lesser financial power. It is absolutely clear, therefore, that redistribution must be a pillar of any system of transfers, in order to safeguard equity considerations. When I speak of redistribution, I mean both the sharing of income and the sharing of the power to manage. In other words, the main role of national entities in a decentralized system becomes less as providers of services and more as supporters of those who organize the provision of services—local and regional governments. In such systems the focus of energy must be directed to support those regions that are being left behind and to constantly monitor how the process of decentralization is contributing to regional equity within countries.

And that brings me my sixth point, which, fortunately, has been chosen by the Bank as one of the central themes

of this forum: the topic of accountability. This is one of the large vacuums of all economic development systems of the past, certainly in this Latin America region, but not solely in this region. The development of operating mechanisms that allow us to measure the efficiency with which government services are being provided, and to evaluate whether the tools of community investment are being promoted or not, is one of the basic arguments for decentralization. As we proceed with decentralization, the impact on equity must be evaluated, both within and between regions.

Finally—and I have left this topic till the end—one of the big themes, obviously, is the relation between private- and public-sector provision of social services such as education and health care. Especially when it comes to poor consumers, the provision of these services will continue to come from the government in almost all the countries for the foreseeable future. Here, the question is not about encouraging competition in a market that may not exist or function well. Instead, the question is how to guarantee efficient and effective provision of such services by the government. Thank you very much.

JOAQUÍN VIAL

Thank you very much, ministers, Mr. Treasury Inspector, directors of the World Bank, the International Monetary Fund, friends. We have enjoyed two days of discussion and very in-depth analysis of the topic of decentralization and accountability. One of the things that arises from the analysis, I believe with a lot of clarity, is that decentralization, in the first place, is a means to an end. The importance of decentralization is validated by its capacity to increase the efficiency of public service provision by the quality of services provided, as well as by its creation of a democracy that is more vital and more accessible to the people, converting its recipients into active members of the public concerned with the advancement of equity. And in this regard I may have to contradict José Antonio. I think

that here there are no guaranteed results. I think that one of the important conclusions from our discussions is that this is a process, and that effectively we will be able to advance in all of these areas as long as things are done correctly. A little of what we have been discussing is how we can do things the best way possible.

I believe that it is also very clear that this is a process in which the federal and the local governments play fundamental and complementary roles. Decentralization is not the substitution of the local government for the central government. I believe that that has also been made crystal clear in many of the discussions we have had in these days. This is particularly evident when one puts responsibilities in perspective. And here, I think, one can distinguish between

macro and micro responsibilities. If we think of macro responsibilities as being associated with the central government, and we think of micro responsibilities as being more related to local governments, this could give us an interesting framework for discussion. The topic of decentralization can then be seen as one of a conveyance of functions and of responsibilities from the centrally based to the locally based.

Not all the functions are transferable, nor are all the responsibilities fully transferable. At the aggregate level, there are certain responsibilities and functions that are intrinsic to the central government and must remain so. Some can be transferred without necessarily making a transfer of responsibility. The responsibility still remains with the central government, but under rules and conditions—or, one can say, “contracts”—that are very clear and explicit, in a way that effectively sets out very clearly the obligations of the local entities.

What are some of these aggregate functions and responsibilities that, in my judgment, are macro and remain in an almost inherently with the central government? First, there are the aggregate framework of financial policies and the aggregate limits of expense and debt; and obviously here a central vision is fundamental for the coherence of the policies. Because of the way decentralization can dilute this responsibility and fragment it, it is almost inevitable that the coherence of macroeconomic fiscal policies is lost. Second, I believe that there is a function, a role, and a responsibility that central authorities face in matters of inequity at the national level, which have an intrinsically regional dimension that is inescapable, but cannot be decentralized. Funds allocated to any given region are by definition not allocated to other regions, and such decisions are made by the central government. Finally, I believe that in the general realm of public policy, but particularly insofar as social policy is concerned, there are certain definitions that the central government must establish to allow for proper decentralization of activities at the level of regional or local governments. Examples are definitions of standards and criteria for evaluating payments, along with a range of parameters that must guide the allocation of resources and the evaluation of how they are used by the people who

assume the new responsibilities. These functions must be carried out at the central government level.

On the other hand, there are functions and responsibilities that are inherent to local government. Among these is the channeling of efficient and active participation of the community and its base organizations in the articulation of public policy, particularly social policy; in the management of activities and functions transferred from the central government, as defined by contracts and regulation; in the dissemination of information related to accessing public services, so that people are aware of what resources and services are available to them. Also, we believe that an essential responsibility at the local level is to guard equity—no longer at the national level, but at the very level of the community. The problems of inequality and inequity are not only at the local level; they are also in the interior of the very regions and local governments.

I would say now, in very general terms, the great challenge that arises—and it is what we have been trying to discuss in this conference—is to define those areas, tools, and forms for the transfer of functions from the central government to the regions. And now, in fact, decentralization is a process, and what we have to look at is how to do it, what things we are going to decentralize and with what responsibilities, and with what means and regulations. From the point of view of the local governments, this also poses a very important challenge, in terms of developing their own authorities, in order to be able to manage policies, to channel participation, and to channel information to their own communities. In that regard, our impression is that this is also a very important area. When you begin to assert the standards, institutions, and forms that are required for a fair and sound decentralization, you see some demands that are created by the local authorities that many times make these projects not so profitable, and then priorities are shifted to other activities.

I would say, in very general terms, that summarizes my main thoughts on this seminar. I simply wanted to finish by congratulating and thanking the World Bank for having chosen our country to have this seminar, for the excellent quality and level of the participation of all the guests, and, for sure, for the tremendous effort put forth. Thank you very much.

SANTIAGO LEVY

Good afternoon, Minister Troncoso, members of the Chilean government, the World Bank, and the International Monetary Fund. First of all, I would like to thank, once again, the World Bank for the invitation to be at this conference, and in particular Guillermo Perry for giving me once again the opportunity to speak to you. I have been asked to incorporate some final thoughts following the discussions that we have all had in the last two days. And in the time that I have been allotted, I think that there are four observations that could be relevant as the final part of this conference.

First, I feel that it is important, from the methodological point of view and from the point of view of the design of public policies, that we can advance a little more in the measurement of results and in the measurement of objectives. There has been ample agreement in these last two days in this conference that the objective of decentralization is to improve the effectiveness and efficiency in public services. However, with all honesty, our empirical base is very poor, very incomplete. With all due respect, it transpired from some of the analyses that were presented yesterday and today that we do not have a systematic database at the national level, and much less a comparative database at the international level, to measure the efforts that are being put forth in the process of decentralization. The definitions across the countries are different. The results are different. In the comparisons that we see in the documents that were introduced, it is very difficult to really know what is the percentage of expenses that one level of government undertakes, a second level of government, and so on. We need more empirical data to be able to conduct a more serious analysis and be able to measure results, to know whether we are really going in the right direction or not. I believe, personally, that here the World Bank has an immense comparative advantage in its ability to obtain data from all the countries in Latin America and its analytical ability to make the different translations of the different definitions—and to be able, as well, to have a dialogue with each government and have an important database. I know that it is not the most interesting thing in the world to make method-

ological observations. However, I feel that it is important to do so if we want the topic of decentralization to be taken with the seriousness it merits.

My second observation is one that in one form Joaquín touched upon. I think it is very important that we differentiate between decentralization and regional development; they are not necessarily the same things. Our countries, or at least mine, is divided into states, and the states divided into municipalities, sometimes due to the whims of history and not through a purely logical economy. However, the flows of economic activity follow a logic that many times transcends the municipal level or transcends the state level, and it is important that we have tools separate from decentralization in order to resolve the regional problems. I will explain. In the case of Mexico, for example, the free-trade pact is generating very important gravitational forces that cause economic activity to concentrate in the north of the country, without any clear distinction between particular states, or even whole regions. I would venture to guess, without knowing details, that Mercosur will pull more economic activity toward the south of Brazil, because companies look to minimize transportation costs in deciding where to locate, and because there are economies of scale, particularly in the manufacturing sector, that induce the endogenous processes of the concentration of economic activity. This is not resolved with the matters of decentralization that we are discussing here. And it is important that with decentralization, the national states, as Joaquín was stating, maintain tools that permit going beyond the individual municipalities or individual states, and invoke, in the end, more ample actions toward national development—and permit the maintenance of an important balance in the development of economic activity of the countries. An important challenge, however, is to prevent decentralization from aggravating regional disequilibrium. Federal governments need to maintain the authority to be able to have regional development that is balanced, and they need to have the tools to be able to achieve that.

A third observation is related to the matter of extreme poverty. It was strange that there was no report nor group in this seminar that focused on the matter of extreme poverty. When we speak about the welfare network, about the famous "safety nets," what government will take care of them? Who reinforces the welfare network? What level of government is responsible for doing that—the municipal level, the state level, or the federal level? Much of the decentralization that we have been talking about these two days refers to matters of education, to matters of health, and to matters of services that are intimately related to the fight against extreme poverty; but it is not clear that decentralization, per se, generates a minimum standard for all the inhabitants of a country. And we want all Chileans, independent of what region they live in, and all Bolivians and all Mexicans and all Argentines to have something that commonly identifies them as a citizen of a country, with an access to a common base to factors of well-being, and that allows them to have a standard that takes them out of extreme poverty. And the provision of certain services, without any type of intervention on the part of the federal government, cannot ensure that that will be attained. It can induce programs and undesirable migration processes of the populous in country, or be generated strictly by way of public policy, and can, if one is not careful, aggravate the problem of the fight against extreme poverty. I believe, then, that we have to make the thread a little thinner when we speak about the decentralization of health and education. It could be that in the decentralization of educational services, the federal or central governments maintain a role in specific programs to take care of certain populations. These can be programs for basic education run by the federal government that have common standards and financing at the federal level. This is not incompatible with a decentralization on a grand scale of the majority of educational services. The same, I would suggest, is important to do in matters of health services and the development of the social framework. And so, the challenge we have now is to find a division of work between the federal, state, and municipal levels of government that allow the attainment of the promises of decentralization and at the same time not impede our progress in the fight against extreme poverty and allow us to reach, for all inhabitants of a country, the well-being that we desire. And here we have to find then the adequate balance between decentralization and educational, health, nutritional programs, in the area of schools, etc.; they probably will need to continue being centrally regulated and financed.

I end with a fourth thought. I think that the fourth challenge that we have in the matter of decentralization is to find a balance between a purely economic decentralization process, understood to be the transfer of financial power and resources to the responsible municipalities from the responsible states in certain matters, and an institutional and political development that will sensibly go along with those processes. We have to think that decentralization is a redistribution of substantive power, and that there will be economic participants that can be affected by important interests in the process of decentralization. I think of the national labor unions. I think of the federal bureaucracies. I think of the mechanism of accountability. I think that the challenge that we have is to find constructive outlets so that also the national labor unions find advantages and not become the opponents to the processes. We have to transform the logic. We have to transform the vision. We have to give them training. We have to give them important outlets, make them important substantive participants in our national life, if we want them to be co-participants and not opponents to the process of decentralization. The same with our federal bureaucracies, which will have to be transformed. José Antonio was also commenting on the challenge of accountability. It probably is one of the hardest that we have, and that is a strictly political process. What is the mechanism in which the municipalities and the states maintain and present accounts for the resources they are receiving? Some of our countries, at least Mexico, are countries with a weak tradition in the matter of accountability; and so it is difficult to think that that weakness is not reflected, at least, in an initial process in the lack of accountability at the state and municipal levels of government. I think that what we want with decentralization is to send responsibilities and resources to the states and municipalities, and not open any more windows in the search for income. This implies that we have to look for prudence in the political development with the speed with which maybe we will be able to design financial transfer mechanisms and mechanisms for the transfer of resources to the states, so it is a balanced process.

I think that the matter of decentralization is substantially more complex than the challenges that we have faced in matters of open trade and privatization, because it implies a redefinition of powers and the very authorities of the states. It is going to be slower. It is going to be more difficult. And in Mexico, we believe, it will give us very good results. Thank you very much.

G U I L L E R M O P E R R Y

A well-known Colombian politician said that decentralization is not bad, nor good, but just the opposite. Here in this conference, in my opinion, we have arrived at a less skeptical conclusion.

There are three criteria with which one can judge—and must judge—a decentralization process. The first is political: Our conclusion is that decentralization is intimately tied to the consolidation of the democratic process. As democracy deepens, subnational authorities demand a greater decentralization of power to the different regions and localities. And, though there are risks of capture by local elites, the way this process takes place, in general, tends to deepen the democratic process. It appears that we have no doubts about the benefits of decentralization from this point of view.

The second criterion is efficiency and quality in the provision of services. Here, the conclusion is that the impact of decentralization depends on the structure of institutions (institutions in Douglass North's sense: norms and rules that constrain agents' behavior) and the incentives they generate. I refer both to the incentives granted to the authorities, such as governors, mayors, and national executives, and to the incentives granted to agents of service provision—to hospital directors, school directors, teachers, doctors. The particular structure of those incentives may or may not induce appropriate behavior. Our conclusion is that decentralization must go *beyond* the local authorities, to agents of service provision, with adequate accountability mechanisms, to be successful in increasing efficiency and quality.

And the third criterion is macroeconomic stability. Here the answer is not clear either. The results can be bad, in the sense that decentralization can compromise stability, or it can be neutral. It also depends on the institutions that are created to prevent the risks in this matter.

We have concluded at the Bank—as we state in *Beyond the Center: Decentralizing the State*, the book distributed in this meeting—that the fundamental institutional matter for decentralization is to make a clear match between

“*authority*” and what is called in English “*accountability*,” which does not translate well into Spanish but could be described as “the responsibility for something and to somebody.” By the former term we do not just mean authority in the legal sense—that is, who has the legal authority to make the decision—but authority in the sense of who has sufficient financial, technical, and human resources to do something. Insofar as agents are assigned the right to make decisions, such as decisions about the provision of a service, they should be granted “*authority*” to manage resources to this effect, and accept both the reward and the risk of their performance. Risk and reward are key to appropriate incentive alignment.

In *Beyond the Center* we show how this is essential for efficient service provision. And that is why, of course, decentralization has to reach the levels of the schools and the hospitals, as other panelists said, because the key decisions in health and education are made in the hospitals and in the schools. And that is why the power and autonomy in the matter of the decision and control over resources—that is, *authority*—has to get there.

But there also has to be a mechanism of responsibility *to* somebody (that is, *accountability*). In the case of the schools, it should be primarily to parents and communities, either through “*voice*”—the capacity to supervise, take, or influence school decisions through participation in effective school boards—or through “*exit*” mechanisms—the capacity to choose alternative schools through, for example, school vouchers. Secondly, this accountability is to the local authorities and the ministries. (In the case of health, it should be primarily to the patients, who must have the power to choose, and secondarily to the higher authorities.)

The same logic applies to the contribution of decentralization to macroeconomic stability. What we have seen is that it is necessary that the subnational entities have *authority*—that is, that they have the power to impose taxes and to cut costs to achieve desired fiscal objectives. But we have seen it is also necessary that the incentives lean toward having hard budget constraints, so that the incentives are

clear. And that has to do primarily with preventing the central government from rescuing bankrupt subnational governments, prohibiting non-transparent discretionary transfers based on side negotiations, or leaving doors open to continual renegotiation. Well-designed ex-ante controls on indebtedness may be useful, but reputation is more effective; and reputation is built by letting a bankrupt subnational government have to deal on its own with creditors on an adjustment and restructuring package. The control of unfunded or contingent fiscal liabilities (from pension obligations, guarantees to private investment, property of public banks) must also be considered in the design of the institutional structure.

In addition to these central topics in our report, a few additional critical ones have been discussed in this conference. One, which was clear from the presentations of Richard Bird and José Antonio Ocampo, is that there is no way to align incentives well if significant taxing power is not transferred to the subnational entities. And, as Richard Bird said, we cannot continue speaking only about the traditional taxes assigned to subnationals (property and land taxes, vehicles, excises, business taxes). We have to begin to look seriously for an efficient way for the states, departments, and provinces, at least in the large countries, to participate—by piggy-backing or otherwise—in the taxing authority of major taxes such as the value-added tax or the personal income tax, as is now occurring in certain parts of the world. And then, another necessity is good design for a system of transfers that balances the different incentives with regional equity concerns and that combines clarity and detail with flexibility for adjustment as the need arises.

There are two fundamental points that have been always in the discussion of decentralization, but that have come to

the fore through this conference as particularly significant. One refers to the importance of information transparency, “disclosure,” and the need to evaluate and monitor. Richard Bird said that decentralization and evaluation, on the part of the higher authorities, are complementary. They are not substitutes. Information plays an essential role in accountability. And the other is the need for “coordinating” institutions—that there be some entities, as Mariano Tomassi proposed, that are federal in character, to be in charge of the discussion, the direction, the production of statistics, the processing and analyzing, and the political negotiations that must exist in a decentralization process. This need came out very clearly in the papers of Fernando Rojas and of Mariano Tomassi.

To finalize, one of the most interesting things about decentralization, as always happens when power is fragmented, is that there is creativity. Within the same country, very positive outcomes arise in some subnational entities, and bad outcomes in others; but there is always innovation. And it is very important to have mechanisms to quickly disseminate and replicate cases of good practice.

Before inviting the minister to deliver his closing speech, I would like to give, on behalf of the World Bank, our great thanks to the government of Chile for its hospitality, for the efficiency and warmth with which this meeting was organized. Special thanks go to Francisca Castro, who was the key organizer. Also, let me thank the World Bank Institute and the government of Spain for their support and recognize the contributions of World Bank staff—in particular, Steven Webb, Mila Freire, Victor Vergara, Florence Eid, and L. K. Aurora—without whose work it would not have been possible to have this conference.

R A U L T R O N C O S O C A S T I L L O

Minister of National Services of Chile, Mr. Secretary of Treasury of the Republic, Director of Budget, Chief Economist and Director of the World Bank, Guillermo Perry, Secretary of Public Expenditure of Mexico, ladies and gentlemen, mayors, regional councilmen, foreign heads, ladies and gentlemen, I want to, in the first place, reiterate what

the Director of Budget of Chile pointed out, in regard to thanking, on behalf of the government of Chile, the World Bank for making this seminar possible. I think that this seminar has dealt with a matter that to us all is vital to the future development of our countries. I would like to also say thank you for the invitation that you have given me to

close this conference. I must give thanks to the authorities, and with their support, we have brought forward programs that are so relevant, on the part of the World Bank, like educational reform and the improvement of municipal management. Likewise, I thank the Minister of Finance of Chile for his work in bringing this annual meeting to one of the most beautiful cities of our country.

To think about and discuss the financial and fiscal components of the decentralization process, not looking only at the short term, but identifying medium- and long-term perspectives, allows us to see the possible new tools and means of obtaining, deciding on, and distributing the financial resources of the public sector. It allows us also to analyze how to strengthen the responsibility of citizens and their organizations in the financing of economic and social development in our lands. In Chile we have tried to advance to the maximum in these matters. The decentralization of the state began with particular emphasis in 1992, with legal and constitutional reforms whose components gave life, for the first time, to the regional governments. We are happy to say that the reforms have borne fruit in terms of planning agreements and sectoral and regional investments formulated and implemented at the level of regional governments, their councils, and their administrative departments. The reinforcement of the intermediate level of government in Chile has entailed an increase in operational expenditures of the regional governments by almost 10 times. This is a change worthy of note if we recall that in our old Constitution, only the provincial assemblies existed, and even those were not operational. The creation and promotion of regional government reflects the political will of the government, to stimulate decentralization.

Second, there has been a substantial increase in investment resources designated for, and administered through, the regional governments, amounting to approximately 50 billion pesos in 1990 to 388 billion in 1998—that is, a 7.76-times increase in this period. And in relative terms, in 1999, regional investment reached 37 percent of total public investment in the country. By the end of the year 2000, the government of Chile has committed to increase regional investments to 42 percent of total public investment. These constitute the National Fund of Regional Development and its provisions, the planning agreements and sector investments, and regional investments with local allocation. This was a commitment made by the

President of the Republic on a voluntary basis and well beyond what was established by the government's program, and we are reaching that goal as we had planned it. This decision is a new trial of the political will of the government of Chile, especially of the President himself, to deepen decentralization and to endow the regions with real power to negotiate and coordinate the investments with the ministers.

Third, this process of transfer of competition and resources from the central authorities to the regional governments has been undertaken without trauma or major conflicts, and without the public sector's having to stop providing its citizens with the services to which they are entitled. The regional governments, for their part, have strengthened their management. They have a high level of budget implementation, reaching over 95 percent annually, on average, and they invest in the principal sectors for national and social development. Complying with what was promised in the government's program, the electoral system was modified; mayors are now elected directly, reinforcing their legitimacy and representative nature. Election Day was changed from winter to spring in order to facilitate participation in the rural regions in the country. In addition, we proceeded with a constitutional reform, by which municipalities can now selectively choose new responsibilities and are given more flexibility to choose their internal organization, as well as the management of their personnel department.

Also, the Constitutional Law of the Municipalities has been changed with regard to management, strengthening the mayor as the head of that government, and clarifying the council's fiscal and standard role. Local participation was increased in small and poor municipalities, by way of new incentives to promote the association among citizens, internal control, provision, and transparency for citizen control and the question of public accountability. In terms of resources, municipal budgets have been more than doubled between 1990 and 1998, and those now represent 3 percent of the Gross Domestic Product; in 1997, they reached 4 percent of GDP, equal to a real increase of 700 billion pesos, which reflects the growth of municipal resources, which is even greater than the growth of the national economy. In total, considering their own income and transfers, the municipalities, in 1997, managed resources in the amount of 1.4 billion, or 80 percent more than in 1992. Municipalities in our country, and this is

very interesting to point out, were previously bureaucratic organizations, without any professional talent, that developed slowly without much dynamism. In contrast to that old reality and as a result of the plans that were set in motion, we see today how the municipalities emerge each day with a dynamic organization, with initiative, with life and with strength, with projects that permit the channeling of the local energy and neighborhood creativity, with plans and programs for improvement, and with increasingly important results on the ground.

We know that there are still measures to take, however, and actions to develop in order to reinforce the successes attained. It is important also to point out that the process of increasing resources of the regional and municipal governments have not been at the cost of throwing out of balance our fiscal accounts, nor has it threatened the macroeconomic stability of our country. In the area of private investment (even though that is more a result of economic policy and international integration of the country, which was promoted very strongly in recent years) it is outstanding that of the 23 private investment projects foreseen for the 1996-2004 period, 20 are regional; only three are in the metropolitan area, two of which are from the Chilean Telephone Company and the Telecommunications Company, which are nationwide projects. Those reveal that the export model favors the installation of the industries near the raw materials and manufacturing equipment and near the roads of the ports and airports instead of the substitution of imports destined to the domestic market. However, because of the extensive use of mechanization and automation in the productive processes and because of the permanence of the corporate headquarters in the cities, its impact

remains low in terms of both local tax revenue and the labor market.

Our country continues to be highly concentrated. That occurs with personal income, where the wealthiest 10 percent of the population receives 45 percent of the national income, while the poorest 20 percent has only 5 percent. (Because the Gross Domestic Product has doubled between 1989 and today, that 5 percent, in absolute terms, has doubled from 10 years ago.) Such concentration also occurs within the regions and within the municipalities. Forty-seven percent of the Gross Domestic Product remains in the metropolitan region, where you will find 70 percent of the large firms, 50 percent of the managerial power of the country, 75 percent of banking investments, 40 percent of the population, about 55 percent of the income, and approximately 30 percent of total public investment. In the case of the municipalities, without applying the redistribution of resources via the Municipal Common Fund, in 1997, the wealthiest 10 percent captured 69 percent of the system's revenues, while the poorest 10 percent only attained 0.3 percent of those resources. Such concentration is explained by the political and economic history of the nation.

Today we conceive of the relationship between sovereignty and development differently. We share the same project, the same country, more equitable for its people and its lands, with greater economic and cultural aspirations, where improved development is possible, with greater ease for participating in the decisions that affect our destiny and the destiny of our citizens. In summary, we are a unique country, with stronger regions, stronger and more active builders of their own development. Thank you very much.



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