

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**DECENTRALIZATION AND SUBNATIONAL GOVERNMENTS
SECTOR FRAMEWORK DOCUMENT
FISCAL AND MUNICIPAL MANAGEMENT DIVISION**

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ABBREVIATIONS

CCLIP	Conditional Credit Line for Investment Projects
CoPLAC-MfDR	Latin American and Caribbean Community of Practice on MfDR
CPE	Country Program Evaluation
DEM	Development Effectiveness Matrix
DNP	National Planning Department
ECLAC	Economic Commission for Latin America and the Caribbean
ESCI	Emerging and Sustainable Cities Initiative
GDP	Gross domestic product
ICMS	Tax on the consumption of goods and services
MfDR	Managing for development results
OECD	Organization for Economic Cooperation and Development
OVE	Office of Evaluation and Oversight
PCR	Project Completion Report
PFM	Public financial management
PIP	Public investment project
PNAFM	National Program to Support the Administrative and Fiscal Management of Brazilian Municipalities
PPP	Public-private partnership
PROCONFIS	Fiscal Stability Consolidation Program for Development
PROFISCO	Program to Support the Management and Integration of Finance Administrations in Brazil
SAT	Tax Administration Service
SFD	Sector Framework Document
SIAF	Integrated financial management system
VAT	Value-added tax

I. THE DECENTRALIZATION AND SUBNATIONAL GOVERNMENTS SECTOR IN THE CONTEXT OF THE BANK'S SECTOR STRATEGIES

A. The Decentralization and Subnational Governments Sector Framework Document as part of existing regulations

- 1.1 This Sector Framework Document (SFD) has been prepared in accordance with document GN-2670-1, "Strategies, Policies, Sector Frameworks and Guidelines at the IDB." It aims to set out the Bank's goals in the decentralization and subnational governments sector (hereinafter, the "Sector") and guide its operational, dialogue, and knowledge generation activities with the countries, their governments, and private borrowers. This SFD covers the seven elements that sector frameworks must contain. Once it has been approved, the Subnational Development Strategy (document GN-2125-2) will cease to be in effect, as indicated in document GN-2670-1. The current SFD incorporates those sections of the strategy that are considered relevant.
- 1.2 This is a flexible SFD that will allow the Bank to address the changing contexts and challenges faced by its 26 borrowing member countries, while guiding Bank financing for sovereign-guaranteed and non-sovereign guaranteed operations in the Sector. In addition, this SFD can be tailored to the individual circumstances and preferences of each country in terms of both the design and implementation of Sector projects. The Bank will prepare an updated SFD three years after the approval of this document.

B. The Decentralization and Subnational Governments Sector Framework Document as part of the Sector Strategy on Institutions for Growth and Social Welfare

- 1.3 The Decentralization and Subnational Governments SFD falls within the framework of the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) in the area of improving the provision and utilization of resources for growth and social welfare. In particular, as this SFD indicates, many of the significant social services are provided on a decentralized basis. Therefore, adjusting the institutional capacity of subnational governments¹ to reflect their growing responsibilities and scope of authority constitutes a great challenge within the overall task of improving social welfare. To confront this challenge, the Bank will continue to support subnational governments in improving public sector management, resource mobilization, and service delivery.
- 1.4 This SFD is also associated with the IDB Infrastructure Strategy: Sustainable Infrastructure for Competitiveness and Inclusive Growth (document GN-2710-5), which conceives of infrastructure as both a pillar and a precondition for the success of the decentralization processes. This SFD is also related to the Strategy on Social Policy for Equity and Productivity (document GN-2588-4), which points out that service delivery can be critically affected by institutional arrangements such as decentralization and subnational authorities. This SFD also relates to the IDB Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy (document GN-2609-1), which identifies the

¹ Subnational governments encompass not only intermediate-level governments (states, provinces, departments, etc.) but also local governments (municipios), including entities under their responsibility, such as subnational public enterprises.

- need to establish strong institutions at the subnational level, capable of developing climate change strategies and implementing well-funded operational action plans. Lastly, the Sector is assigned priority under the program “From Billions to Trillions—Transforming Development Finance, Post-2015 Financing for Development: Multilateral Development Finance,” which seeks to increase the amount of official development assistance through the main multilateral organizations (including the IDB).²
- 1.5 The Decentralization and Subnational Governments SFD recognizes the multisector nature of the decentralization process, manifested in part by the various responsibilities and tasks entrusted to the different subnational governments. Consequently, this SFD does not include a specific discussion of each public policy dimension affected by this process. From the Bank’s perspective, these issues are addressed in the SFDs for each sector, including urban development and housing; fiscal management; citizen security and justice; health and nutrition; education and early childhood development; gender and diversity; transportation; tourism; agriculture and natural resource management; water and sanitation; integration and trade; and environment and biodiversity.
 - 1.6 Instead, this SFD focuses on the crosscutting aspects that operate as a precondition for subnational governments to efficiently and effectively perform their specific functions, recognizing that decentralization is not an end in itself. In particular, this SFD will emphasize two interdependent aspects: (i) the incentive structure that characterizes intergovernmental relations; and (ii) the development of institutional capacities at the subnational level. In the context of this sector framework, the Bank will seek to tailor interventions to the specific needs and demands of each country as well as to the individual circumstances of each client, taking into account the heterogeneous nature of the region. In this respect, this SFD is of a strategic and indicative (rather than restrictive) nature. Specific interventions will be based on sector notes and country strategies, consistent with the demands of each country.
 - 1.7 Under this Decentralization and Subnational Governments SFD, the Bank’s actions will be aimed at fostering the development of institutional capacities and a suitable incentive structure with a view to achieving more effective and efficient subnational management in Latin America and the Caribbean, thereby helping to improve the quality of life of all citizens. To this end, this SFD pursues two major objectives: (i) to support interventions and institutional changes in the Bank’s 26 borrowing member countries in order to address: (a) weaknesses in intergovernmental arrangements; (b) deficient expenditure management and service delivery by subnational governments; (c) insufficient generation of own revenue and poor access to financing by subnational governments; and (d) limited transparency and accountability by subnational governments; and (ii) to consolidate and expand the Sector’s knowledge agenda.
 - 1.8 This document consists of five sections. This section describes the relationship between the Sector’s SFD and the current regulatory framework. Section II presents a sample of the international empirical evidence available regarding

² For more information on this program, see: <http://www.iadb.org/en/news/announcements/2015-04-16/joint-statement-by-mdbs-on-financing-for-development,11140.html>.

programs in the Sector. Section III identifies the major challenges facing the Sector in Latin America and the Caribbean. Section IV summarizes the lessons learned from the Bank's experience in the Sector. Lastly, Section V sets out the goal, principles, dimensions of success, lines of action, and specific activities that the Bank proposes to prioritize in its Decentralization and Subnational Governments Sector work.

II. INTERNATIONAL EVIDENCE REGARDING THE EFFECTIVENESS OF POLICIES AND PROGRAMS IN THE DECENTRALIZATION AND SUBNATIONAL GOVERNMENTS SECTOR, AND IMPLICATIONS FOR THE IDB'S WORK

A. Context and evidence

- 2.1 Decentralization is an institutional reform process consisting of a set of policies designed to transfer responsibilities, resources, and/or authority from the central government to the subnational governments. Depending on the type of decentralization involved, the process usually takes one of two forms: *Political decentralization* includes reforms aimed at opening up or activating spaces for authorities to be represented and elected at the subnational level. *Fiscal decentralization* refers to the transfer of responsibilities for public expenditures to the subnational levels of government, along with sources of financing, which include own revenue, transfers, and debt.³ In addition, the scope of decentralization varies based on the level of autonomy of the subnational governments. In its most limited version, decentralization takes the form of deconcentration, involving a transfer of responsibilities to administrative units of the same central government that are simply geographically closer to the population receiving the service. At the other extreme, the most ambitious version of decentralization provides for the devolution of responsibilities and functions to politically autonomous subnational governments (Baskaran, 2009; Cheema and Rondinelli, 1983).
- 2.2 During the past thirty years, decentralization has usually been supported in developing countries as a mechanism that, by bringing government closer to the people, facilitates a more efficient allocation of public resources and promotes enhanced accountability (World Bank, 2004). Decentralization has also been encouraged as a laboratory for development and experimentation with new forms of public policy (Oates, 2008). However, governments become motivated to decentralize by multiple factors, including changes in the political regime, the need to prevent and/or reduce internal conflicts, or political incentives for those involved in the decentralization (Eaton, Kaiser, and Smoke, 2010).
- 2.3 This implies that there is no single way of decentralizing, and that the design, sequence, and implementation of the process will be subject to the prevailing conditions in the relevant country, including economic factors. Nevertheless, international experience points to a series of principles that are the focus of this SFD, which when followed by the country help to reach the objectives of

³ The classical literature also speaks of *administrative decentralization*, which occurs when the central government transfers the responsibility for managing public services to the subnational governments. For purposes of this document, this type of decentralization is included in the category of *fiscal decentralization* (for more details, see Dickovick, 2014).

decentralization and mitigate its risks. These principles include a clear definition of spending responsibilities by level of government (Bahl and Martínez-Vázquez, 2006); allocation of sources of own revenue to subnational governments (Bird, 2011); coordination of transfer systems that cover the cost of providing the allocated services and compensate less developed subnational governments (Shah, 2007); effective implementation of a subnational fiscal responsibility framework (Rodden, 2006); development of management capacities at subnational governments in keeping with their responsibilities (IDB, 2010b); and implementation of mechanisms that facilitate transparency and accountability at the subnational level (Faguet, 2012).

- 2.4 Evidence of the causal impact of decentralization is limited. On one hand, the process itself has a general effect on the entire territory, making it difficult to identify appropriate comparison groups at the subnational level for building a counterfactual. On the other, decentralization is usually part of a broad program of reforms, including democratization processes and/or market reforms.⁴ Despite these restrictions, an emerging literature aimed at evaluating the decentralization processes and their impacts at the subnational level indicates mixed results both in Organization for Economic Cooperation and Development countries (OECD, Ahmad, Brosio, and Tanzi, 2008) and in developing countries (Mansuri and Rao, 2013; Smoke, 2013; Channa and Faguet, 2012; Ahmad and Brosio, 2009). Below is a brief summary of this literature. While not claiming to be exhaustive, this review illustrates the main findings regarding the effects of decentralization processes on the delivery of public goods and services both inside the region and beyond.⁵
- 2.5 First, the decentralization process is in some countries associated with an allocation of public spending more in line with local needs, a geographic reorientation of expenditures toward relatively poor municipios, and a shift in the composition of public investment toward greater investment in human capital (health and education). For example, before the decentralization process in Bolivia, the three largest and richest districts received more than 85% of the shared revenue (coparticipation), while more than 300 of the remaining municipios received less than 15%. After the decentralization, these figures changed to 27% and 73%, respectively (Faguet, 2012). Moreover, as a result of the decentralization, investment in education became higher in regions with lower initial literacy rates, while spending on water and sanitation grew more rapidly in municipios with greater infrastructure shortfalls.⁶ In other countries, however, decentralization had a limited effect on the degree to which public services reflected the demands of the local population (Skoufias, Narayan, Dasgupta, and Kaiser, 2011; Akin, Hutchinson, and Strumpf, 2005).
- 2.6 Second, the evidence indicates that decentralization can improve policy results through the capacity of local communities and subnational governments to leverage their information advantages with respect to other, higher levels of

⁴ In addition, as described below, the ambiguity in many countries as to which level of government is in charge of providing certain services makes it impossible to clearly assign this responsibility.

⁵ For an exhaustive review, see Smoke (2013); Faguet (2012); and Treisman (2007).

⁶ In the case of Colombia, the decentralization process is associated with higher school coverage rates and access to public healthcare services by the poor (Faguet and Sánchez, 2014).

government (Mansuri and Rao, 2013). One area where these advantages have become manifest is in the selection of strategies or mechanisms to improve the targeting and distributive impact of certain social programs, particularly when identifying eligible households is a challenge and where decentralized strategies allow for better use of information regarding the local context (Alatas, Banerjee, Chandrasekhar, Hanna, and Olken, 2013; Galasso and Ravallion, 2005; Alderman, 2002). Nonetheless, the benefit of better information can dissipate if there is a captive decision-making process at the local level (Bardhan and Mookherjee, 2000, 2005, 2006), if the delegated authority is used opportunistically (Camacho and Conoyer, 2011), or if capacity at the local level is limited. In terms of capture, evaluations of social investment funds in Latin America and the Caribbean and elsewhere that provide for community participation in the selection processes show that inequality at the local level adversely affects the likelihood that pro-poor investment projects will be selected (Bardhan, Mookherjee, and Torrado, 2010; Araujo, Ferreira, Lanjouw, and Ozler, 2008). These evaluations also show that the selection process is sometimes dominated by better educated individuals with broader contact networks, tending to diminish the distributive impact of these instruments (Rao and Ibáñez, 2005).⁷

- 2.7 Third, decentralization has allowed several countries to experiment and create good practices through various healthcare services delivery models. For example, the pioneering experience of Costa Rica (Rosero-Bixby, 1990) and Jamaica (Riley, 2005) in the use of community agents as a nexus between the population and the healthcare services illustrates the important role of education in modifying behavior and in encouraging the use of healthcare services that have helped to increase average life expectancy. In addition, the evaluations of a decentralized program executed at the local government level in Brazil (Programa Saúde da Família [Family Health Program] (PSF)) show positive impacts on changes in behavior and outcomes (Macinko, Guanais, and Marinho de Souza, 2006; Rocha and Soares, 2010): the municípios that were exposed to the PSF for a period of three years lowered their infant mortality rate by 1.5 infants (per 1,000 live births) in comparison with municípios that did not adopt the program, and the drop was most pronounced in the more undeveloped regions (North and Northeast).
- 2.8 Fourth, even though the evidence on school decentralization shows positive effects on coverage levels and some impact on retention and graduation rates, the evidence on improvements in quality of education (measured by the learning results) and equity is limited. For example, while test results in mathematics and Spanish rose by 3.5% and 5.4% respectively after five years of decentralized management in Argentina, these improvements occurred in schools belonging to non-poor municipalities (Galiani, Gertler, and Shargrotsky, 2008). This prompts consideration of the distributive consequences of decentralization⁸ and the need to develop complementary policies that strengthen the ability of these communities to benefit from this process. In that regard, the evaluation of a school decentralization

⁷ Evaluations of social investment funds have been conducted in several countries in the region: Bolivia (Newman et al., 2002), Ecuador (Araujo et al., 2008), Guatemala (Ibarrarán, Sarzosa, and Soares, 2008), Peru (Paxson and Shady, 2002; Shady, 2000), Nicaragua (Pradhan and Rawlings, 2002), and Jamaica (Rao and Ibáñez, 2005), etc.

⁸ On the relationship between inequality and decentralization, see Goerling and Seiferling (2014).

- program in marginalized communities in Mexico (Apoyo a la Gestión Escolar [Support for School Management]) shows evidence of a 4% to 5% decline in the proportion of failing and repeating students following a strengthening of parent associations (Gertler, Patrinos, and Rubio-Codina, 2012).⁹ However, similar experiments conducted in other contexts find mixed impacts in terms of learning (Duflo, Dupas, and Kremer, 2014; Glewee and Maiga, 2011).
- 2.9 Lastly, there is less evidence on decentralization of the provision of infrastructure and basic services. Nonetheless, in the transportation area in Peru, a gradual approach to the transfer of rural road service management to the municipios, starting with the preinvestment studies and continuing with the actual execution of projects as the capacities of the responsible subnational institutions became consolidated, helped to make this decentralization process more effective and sustainable (IDB, 2014a). Regarding the effects of decentralizing the provision of water and sanitation services at the municipal level, this has in some cases led to excessive fragmentation, giving rise to problems of scale for service providers in terms of recovering costs and providing quality services. In this regard, clustering or consolidating small and medium-sized providers can help to create economies of scale, with potential cost savings and improvements in service quality (IDB, 2014b; ECLAC, 2011a).
- 2.10 In short, recent international evidence indicates that the results of decentralization vary from country to country as well as within countries. This suggests the need to pay attention to the implementation details and institutional design considerations in order to identify the conditions that can allow the process to help reach the objective of better spending allocation and greater accountability on the part of subnational authorities.
- 2.11 Of course, these results are affected by contextual variables such as poverty levels, inequality, and education of the population, along with political economy restrictions associated with the various motivations of the stakeholders in the decentralization process (subnational governments and their associations, central government, Congress, civil society, and others) (Tommasi, 2014). Taking these variables and restrictions into account, this SFD focuses on those elements, associated with the incentive system for key Sector stakeholders and the development of institutional capacities, that can help improve the performance of subnational governments. Such elements include the structure of intergovernmental relations, the management capacities of subnational governments, and the mechanisms to foster transparency and accountability at the subnational level.
- B. The structure of intergovernmental relations**
- 2.12 Both the theory and practice of fiscal decentralization point to the advisability of observing certain general principles in order to maximize benefits and minimize costs. First, international experience indicates that the spending responsibilities of the various levels of government should be clearly defined (Fedelino and

⁹ The region's experiences with school decentralization (school-based management) that have been evaluated include Chile (Vegas, 2002), El Salvador (Sawada and Ragatz, 2005), Nicaragua (King and Ozler, 2005), Mexico (Skoufias and Shapiro, 2006), and others. For a general review, see Gunnarsson, Orazem, Sanchez, and Verdisco (2009).

- Ter-Minassian, 2010).¹⁰ A determination as to who does what should be based on best international practices, seeking to apply the principle of subsidiarity, which holds that countries ought to assign responsibility for spending to the most decentralized level of government capable of fulfilling it. The potential existence of economies of scale and interjurisdictional externalities making centralized provision preferable should also be taken into account (Oates, 1999; Bahl and Martínez-Vázquez, 2006).
- 2.13 In practice, however, how responsibilities are distributed among the various levels of government is often determined by considerations other than an optimal allocation of functions. As a result, many of the spending functions are concurrent, allowing for some degree of overlap among the various levels of government (Bahl and Martínez-Vázquez, 2006). When this overlap is excessive, it is unclear which level of government regulates, finances, and implements each function. This overlap is accompanied by efforts to limit the degree of authority over the spending responsibilities of the subnational governments, giving rise to a perverse dynamic, known as partial decentralization,¹¹ which carries potential negative implications for the efficient delivery of services and accountability (Devarajan, Khemani, and Shah, 2009; Khemani, 2010). Specifically, it may lead to situations in which citizens are unsure from whom to demand service improvements, and public officials operate without a clear notion of the scope of their responsibilities.
- 2.14 A second principle is that subnational governments should have a sufficient own revenue base (Bird, 2011). There is evidence as to the benefits of granting more autonomy to subnational governments in determining the levels and makeup of their revenue. These benefits include budgetary predictability and greater accountability due to the high correlation between financing and subnational provision of public goods and services (Faguet and Sánchez, 2014; Weingast and Poeschl, 2013). In fact, when citizens bear the burden of financing their subnational governments, they have greater incentives to demand that their taxes be well invested (Paler, 2013). The historical experience of developed countries with fiscal decentralization shows that own financing and the provision of subnational services are highly aligned, since powers of taxation are delegated to the subnational governments (Gadenne and Singhal, 2014; Glaeser, 2013).
- 2.15 However, the allocation of taxation powers to the various levels of government is a complex process, particularly in developing countries, where the tax potential is limited and regional inequalities are high. Thus, the main taxes available to countries, such as the value-added tax (VAT) and income tax, which have a broad and elastic base, tend to be assigned to the national government. The reasons for this are the administrative economies of scale and the high revenue involved, which entail a strong redistributive and macroeconomic stabilization potential. Consequently, the taxes left to the subnational governments, although significant, have lower revenue raising capacity: the property tax is the local tax par

¹⁰ Specifically, this requires defining three aspects: which level of government formulates the spending plan; who finances it; and who ultimately implements it (Ahmad, Hewitt, and Ruggiero, 1997).

¹¹ Partial decentralization is defined as decentralization reforms that do not enable citizens to demand that their subnational authorities be held accountable for their budgetary decisions and the results of those decisions (Devarajan et al., 2009).

excellence, since it has a fixed and highly visible base and a stable performance.¹² Taxes on benefits, such as tariffs and user charges, have clearly local attributes but typically cover only the cost of providing the service in question. The recovery of increases in property value due to public works is another potential source of funds, although as suggested by the term itself, its objective is to recover the investment.

- 2.16 Nevertheless, international experience indicates that, even in developing countries, there is room for assigning taxes to the subnational levels of government, particularly the intermediate level, with a view to aligning own financing with the delivery of subnational services (Bahl and Bird, 2008). Taxes such as those on final sales and on the consumption of specific goods are suitable candidates for decentralization, since administration is relatively easy. With respect to the VAT and the personal income tax, countries such as Canada apply subnational surcharges to national taxes in order to resolve the administrative and coordination difficulties stemming from the applicability of different rates.¹³ This simplifies tax administration, which can continue to be handled by the central government, while providing subnational governments with significant revenue of their own (Fedelino and Ter-Minassian, 2010; Fenochietto and Pessino, 2000).
- 2.17 A third principle is intergovernmental transfer systems that are well designed; correct vertical imbalances (difference between subnational government expenditures and own revenues) and horizontal imbalances (difference in fiscal capacity and spending needs among subnational governments);¹⁴ provide incentives for efficient delivery of services; minimize discretionary transfers; and are able to adapt to changing circumstances (Shah, 2007; Bird and Smart, 2002). In view of the disparate fiscal capacities of subnational governments, several countries have introduced equalization transfers, seeking to compensate less developed entities to ensure that all subnational governments have the opportunity to provide similar public goods and services. At present, several of the more decentralized OECD countries have transfer systems in place specifically designed to reduce regional fiscal disparities: the evidence shows that these disparities are substantially reduced and, in some cases, are practically eliminated (OECD, 2014).¹⁵ At the level of European Union countries, it was found that structural funds, that is, transfers aimed at reducing the differences in development between regions and member States, help to accelerate the growth rates of the regions that lag furthest behind, thus facilitating economic convergence (Becker, Egger, and

¹² Regarding OECD good practices on the property tax, see Slack and Bird (2014).

¹³ As examined in the next section, this problem affects Brazilian states, which set different rates for the tax on the consumption of goods and services (ICMS) depending on the origin and destination of the purchased good or service. This encourages tax evasion and tax wars.

¹⁴ The fiscal capacity of subnational governments is their potential, associated with their social and economic development, to raise their own revenue. The spending needs of subnational governments are determined by the costs of providing services, which in turn depend on geographic, demographic, and socioeconomic (as well as other) characteristics (see OECD, 2014).

¹⁵ Worth mentioning is the experience of Canada, where the central government performs equalization transfers in favor of provinces with below-average fiscal capacity, and Australia, where in addition to compensating for insufficient fiscal capacity, the equalization formula incorporates the spending needs of the states based on their respective socioeconomic profile and the differential costs of providing public goods and services (Boex and Martínez-Vázquez, 2007).

- von Ehrlich, 2010). The coordination that makes this type of transfers possible can be harnessed to consolidate institutions responsible for defining and updating the resource allocation formulas.¹⁶ Aside from the key role that these institutions perform in managing the transfer system, they help to achieve improvements in the various dimensions of the intergovernmental arrangements (Srinivasan and Wallack, 2006; Watts, 1999).
- 2.18 In this regard, international evidence points out the various incentive-related problems created by certain transfer systems or revenue coparticipation mechanisms commonly used in developing countries. The design of these systems is frequently not in line with best practices, which dictate that the financing should follow the function. As a result, transfers are decided upon without properly considering the spending needs of the subnational governments. Thus, in certain cases, the transferred spending responsibilities end up unfunded, creating pressure on the central government to cover the resulting deficit (Bahl and Martínez-Vázquez, 2006). Conversely, many countries, particularly in Latin America and the Caribbean, initiate their decentralization reforms by increasing transfers without clearly defining which spending functions are being assigned these additional resources. Furthermore, the increased dependence on transfers can erode accountability and the quality of expenditures (Weingast, 2009).
- 2.19 In addition, it is well known that discretionary transfers create distortions, since the transfer amount and allocation are not usually determined on the basis of efficiency and/or equity criteria (Brollo and Nannicini, 2012; Arulampalam, Dasgupta, Dhillon, and Dutta, 2009; Ansolabehere and Snyder Jr., 2006). Transfers of this type have been used in certain countries to cover subnational fiscal deficits, affecting macroeconomic stability. They also encourage rent-seeking by subnational governments, thus reducing these governments' incentives to generate their own revenues. In addition, such transfers are unstable and unpredictable, which hinders subnational planning (IDB, 2000).
- 2.20 Lastly, to promote fiscal sustainability, subnational governments should be subject to effective budgetary restrictions. In other words, there should be a credible commitment that fiscally irresponsible subnational governments will not be bailed out by higher tiers of government (IMF, 2009; Rodden, Eskeland, and Litvack, 2003). This principle has received considerable attention in recent decades in the wake of fiscal crises in certain countries, particularly in Latin America and the Caribbean, that were precipitated in part by subnational fiscal irresponsibility (Dickovick, 2014). These crises led to conceptual developments that illustrate the risk that the decentralization incentive structure will encourage key stakeholders to behave in ways that can affect macroeconomic stability.¹⁷
- 2.21 A fundamental feature of this incentive structure is the high dependence on transfers. In fact, when subnational governments are primarily financed through

¹⁶ The experience of Australia and its Commonwealth Grants Commission, which is responsible for the management of the country's equalization transfers, is noteworthy. In terms of developing countries, the experiences of India and South Africa are worth mentioning.

¹⁷ This branch of conceptual developments is known as second-generation fiscal federalism, as opposed to first-generation fiscal federalism, which emphasizes the potential welfare gains from decentralization stemming from a more efficient allocation of resources due to the government's proximity to the citizenry (see Oates, 2008).

taxes paid by the rest of the country, they have fewer incentives to internalize the cost of their fiscal decisions. This can lead these governments to increase their spending beyond budgetary limits, with the expectation of receiving additional resources from the common pool. In international experience, this high dependence on transfers can contribute to creating subnational fiscal deficits and/or increasing the size of the public sector when combined with debt autonomy for subnational governments, low central government monitoring, limited transparency, lack of clarity as to spending responsibilities, existence of discretionary transfers, and a history of financial bailouts of subnational governments by the central government (Vigneault, 2005; Rodden, 2002 and 2003; Bordignon, 2000; IDB, 2000; Stein, 1998; World Bank, 1999).

- 2.22 Various instruments and design features can help to mitigate this risk, provided there is complementarity in their implementation and they are consistent with the more general incentive structure. They include reducing the high dependence on transfers, enhancing subnational fiscal transparency, clearly defining spending functions by level of government, minimizing discretionary transfers, avoiding financial bailouts, and controlling subnational debt through subnational fiscal rules,¹⁸ combined with credible mechanisms for compliance (Aldasoro and Seiferling, 2014; Grembi, Nannicini, and Troiano, 2014; Rodden, 2006).

C. The management capacities of subnational governments

- 2.23 In order for the decentralization process to achieve its goals, it is important to have subnational governments capable of properly performing their assigned responsibilities (IDB, 2010b). This management capacity affects the dimensions of their responsibilities in the areas of revenue, service delivery and public spending, and debt.
- 2.24 With regard to revenue management, the evidence points to the importance of ensuring that subnational governments are responsible at the margin for financing any additional expenditures with their own resources. For example, the evaluation of a local tax administration strengthening program in Brazil shows that the resulting rise in revenue collection has a positive effect on the quantity and quality of investments in educational infrastructure (Gadenne, 2013). Along the same lines, local taxation efforts in Colombia are associated with coverage and quality improvements in various sectors, such as education and water and sanitation (Sánchez and Pachón, 2012; Faguet and Sánchez, 2008). There are no impacts of similar magnitude in either country from alternative sources of financing, such as transfer revenues, including from the development of nonrenewable resources. In fact, the evidence points to the negative impacts of an exogenous increase in the latter on various outcomes, including the integrity of subnational authorities (Brollo, Nannicini, Perotti, and Tabellini, 2013), the quality of institutions (Gervasoni, 2010), the provision of local public goods (Caselli and Micheals, 2013), and the technical efficiency of public expenditures (Ardanaz, 2014; Ardanaz and Tolsa Caballero, 2015; DNP, 2012).
- 2.25 The factors discouraging fiscal effort by subnational governments notably include in certain countries the discretionary nature of transfer distribution, which makes it

¹⁸ Preferably with explicit quantitative targets or restrictions, such as debt limits as a percentage of own resources, operating deficit limits, etc.

simpler for subnational authorities to obtain resources from the central government than to increase the tax burden on local taxpayers (Artana and Templado, 2012; Pineda, 2014). There are experiences by semiautonomous tax administration agencies at the subnational level that illustrate how to reduce political influence on the revenue collection effort and contribute to a more client-focused management approach. Thus, in Peru, the tax administration services (SAT) implemented in nine of the country's municipios have shown better revenue collection results than similar municipios without SAT (IDB, 2013a; von Haldenwang, 2010). In Honduras, the Office of the Mayor of the Central District (Tegucigalpa) opted for outsourcing the tax collection process and reported a doubling of revenue collection between 2007 and 2012 (Pérez Rincón, 2014).¹⁹ With regard to property taxes, key factors affecting collection include the prevalence of tax exemptions and incentives as well as the quality of the property records and the appraisal update system (Slack and Bird, 2014). Lastly, affecting taxpayer perceptions can help to improve local revenue collection efforts: experimental evaluations in municipios of Argentina and Peru show that the inclusion of messages in the main municipal tax forms is an effective tool for influencing taxpayer behavior and improving tax compliance (Castro and Scartascini, 2013; Del Carpio, 2013).²⁰

- 2.26 With regard to expenditure management, the implementation of public financial management (PFM) systems can improve the operating efficiency and transparency of subnational governments (Fedelino and Smoke, 2013).²¹ For example, in the case of public procurement, implementation of an electronic procurement exchange in the state of São Paulo, Brazil has made it possible to centralize information on government providers and procurement prices. In 2013, this contributed to a 26% reduction in the negotiated value of procurement contracts with respect to the originally projected figures (Alves Ferreira, 2013). Other Brazilian states (including Amazonas, Rio Grande do Sul, Bahia, and Pernambuco) are using the reference prices arising from transactions recorded for purposes of the tax on consumption of goods and services (ICMS)²² as a source of information for public procurement. With regard to integrated financial management systems (SIAF), their implementation in all municipios in Peru since 2007 has helped to correct irregular practices in recording public debt, making it possible to check each municipio's itemized budget execution in real time (Llempén, Morón, and Seminario, 2010).

¹⁹ Experiences such as implementing tax administration services or outsourcing tax collection require an exhaustive assessment in each case to ensure the autonomy, effectiveness, and sustainability of tax administration.

²⁰ In Argentina, the most effective message was the one that listed the applicable penalties and the potential administrative and legal steps available to the municipality in the event of noncompliance. This message succeeded in raising the tax compliance rate (calculated as the ratio between the payments made by taxpayers and the billed amount) by 7% (Castro and Scartascini, 2013). In Peru, tax compliance increased by 20% with the disclosure of information on previous compliance levels (Del Carpio, 2013).

²¹ PFM refers to budget management in its various phases (formulation, approval, execution), with a focus on the processes and procedures that span all aspects of public expenditure management (Cangiano, Curristine, and Lazare, 2013). It includes, without limitation, government accounting, single treasury accounts, budgetary processes and procedures, integrated financial management systems, open and electronic procurement systems, and asset management, payroll, and public investment systems.

²² The ICMS is the Brazilian state VAT.

- 2.27 In addition to PFM systems, developing the pillars of management for development results (MfDR) can serve as a mechanism for generating better subnational government performance (IDB, 2011a).²³ In Brazil, the state of Minas Gerais has moved forward in implementing MfDR, using goal-setting instruments with the institutions responsible for programs and projects. This has been done with formal monitoring and governance procedures for the resolution of management problems. These instruments are helping to make the state's management performance more effective and efficient (Lobato, 2014). In the state of Ceará, the implementation of transfers to municípios based on their performance in delivering health and education services has helped to improve the results in those sectors (Holanda, 2014). In the state of Pernambuco, the implementation of strategic management through a center of government has made it possible to integrate the key government functions, setting sector priorities and establishing intensive monitoring routines and mechanisms for problem resolution. This has helped to achieve results such as improvements in basic education, reduction in crime, and decrease in infant mortality (Alessandro, Lafuente, and Santiso, 2014).
- 2.28 Subnational governments can help to create conditions conducive to economic development by improving economic governance (Jin, Qian, and Weingast, 2005; Zhuravskaya, 2000; Weingast, 1995 and 2009). This concept encompasses an array of interactions between the public and private sectors relating to the protection of property rights, fulfillment of contracts, and taking of collective action to provide suitable physical and organizational infrastructure (Carcach, 2012; Dixit, 2009). In addition, economic development makes it possible to increase the fiscal resources available for improving the delivery of public services, creating a virtuous circle of public-private interaction. One area in which subnational governments can facilitate business development is administrative simplification (World Bank, 2015a). In this regard, the launching of a Rapid Business Start-up System (SARE) in several Mexican municípios shortened the average business registration time from 30.1 days to 1.4 days. In turn, this increased the number of newly registered businesses by 5% and the percentage of salaried employees in eligible industries by 2% (Bruhn, 2011).
- 2.29 With regard to debt management, many subnational governments in OECD countries can obtain low-cost, long-term financing for investment projects by issuing domestic bonds. This access is largely made possible by a decentralization framework that reflects the principles described in the preceding section: macrofiscal stability, developed capital markets, and external credit ratings that classify the subnational governments as financially sound (Darche and Gallo, 2012). In developing countries, however, the World Bank has estimated that of the 500 largest cities, barely 4% are creditworthy in international markets and 20% in domestic markets.²⁴ To elevate these percentages and allow more subnational governments to have access to low-cost, long-term financing, the World Bank highlights the importance of establishing effective budgetary restrictions and helping subnational governments to improve the aspects cited as weak in the external credit reports and allow them to be rated as creditworthy. Such measures,

²³ These pillars include strategic and operational planning, financial management, results-based budgeting, management of programs and projects, and monitoring and evaluation systems.

²⁴ <http://www.worldbank.org/en/news/feature/2013/10/24/financing-sustainable-cities-africa-creditworthy>.

which in certain cases include, for example, mitigating the risk of foreign exchange exposure arising from foreign-currency debt accumulation, also contributes to a comprehensive strengthening of the subnational government's finances.

- 2.30 Lastly, human resource management systems that foster merit and transparency, and improvements in the technical capacities of public officials, are important contributing factors for subnational management. In particular, the approach taken by the technical training and assistance programs influences the outcomes. For example, in an intervention in Russian municipalities aimed at enhancing efficiency in the delivery of local services, an extended, intensive, and resident technical assistance approach helped raise user satisfaction levels more than short-term informative training. These improvements took place in municipalities that had a longer track record of providing services on a decentralized basis and were more accountable to the population (Beuermann and Amelina, 2014).

D. Mechanisms to foster transparency and accountability

- 2.31 An institutional framework that promotes transparency and accountability at all levels of government is a prerequisite for obtaining better decentralization outcomes. To the extent that citizens obtain more information regarding the subnational government's performance and politicians have incentives to become informed about local preferences and act accordingly, voters become better able to reward and punish their representatives. In the context of decentralization in developing countries, the provision of information has proved useful for identifying problems related to the opportunistic handling of various types of intergovernmental transfers. For example, a study found that only 13% of capital transfers in education actually reached the schools; the remainder was captured by local authorities (Reinikka and Svensson, 2004). In other cases, at least 20% of transfers in kind failed to reach the beneficiary households due to local capture problems (Olken, 2006) and almost 60% of subsidies for certain inputs (fertilizers) were similarly appropriated by local authorities (Pan and Christiansen, 2012). In these examples, the vulnerable population groups are those most affected by the lack of transparency and accountability, underscoring the importance of providing information to ensure a more efficient use of public resources.
- 2.32 The evidence shows that mechanisms aimed at providing more information to the citizenry, and thereby making public action more visible, can foster accountability at the local level.²⁵ Specifically, there are two types of instruments: top down and bottom up. Worth mentioning among the former is the audit program in Brazil, through which the federal government (via the Office of the Comptroller General and the Federal Court of Accounts) monitors the use of transfers at the subnational level. This program reduced the likelihood of reelection by more than 20% for mayors whose administrations were found to have committed irregularities in the use of federal funds (Ferraz and Finan, 2008; 2011).²⁶ By the same token, an increased likelihood of being audited is associated with a lower ex post level of

²⁵ Even if informed, citizens may have limited ability to mobilize in favor of their collective interests due to factors such as distance, poverty levels, and the presence of crime and violence. For a discussion of the organizational arrangements that facilitate or impede collective action, see Keefer (2013).

²⁶ In Mexico, where immediate reelection is not allowed, an evaluation of the effects of disseminating information on irregular expenditures found a significant decline in electoral participation (Chong et al., 2014).

irregularities (Lichstig and Zamboni, 2013). Similar experimental evidence is found in other decentralized countries (Olken, 2007).²⁷

- 2.33 On the other hand, the literature on transparency and community empowerment (bottom up) shows mixed results. For example, an evaluation of a citizen communications campaign regarding the amount of transfers in education found a reduction in the opportunistic handling of funds by local authorities, with positive results in terms of coverage (and to a lesser extent, quality) of education (Reinikka and Svensson, 2005; 2011). In the area of health, an intervention that distributed bulletins with quantitative information on the performance of service providers and encouraged participation in an action plan to address local problems led to greater use of preventive services and long-term declines in infant mortality (Bjorkman and Svensson, 2009; Bjorkman et al., 2014). However, the results in other contexts and sectors indicate that community involvement had a limited impact on the intended outcome (Banerjee, Banerji, Duflo, Glennerster, and Khemani, 2010; Casey et al., 2012), pointing to the need to generate more evidence regarding mechanisms aimed at fostering accountability to the public by the authorities.

III. MAIN CHALLENGES FOR THE REGION

A. Evolution of the decentralization process in Latin America and the Caribbean

- 3.1 Since the 1980s, the decentralization process in Latin American and Caribbean countries has picked up momentum. As a result, subnational governments have become increasingly important in the provision of public goods and services that are critical for economic and social development. In fact, the subnational governments' share of consolidated public expenditures in the region's countries almost doubled between 1985 and 2010, from 13% to 25% (see [Figure 1](#) in the Annex). This measure is approaching the average of 32% for OECD countries (2010), which remained stable over the previous decade (OECD, 2014). At the same time, political decentralization has followed a similar path: since 1997, municipal mayors in all Latin American and Caribbean countries are placed in office through popular elections, while in 1980 this was the case in only six countries.²⁸ For intermediate levels of government, the number of countries with popularly elected authorities rose from just one in 1980 to nine since 2005 (Daughters and Harper, 2007).²⁹
- 3.2 Thus, almost all countries in Latin America and the Caribbean have in the past three decades made efforts to bring government closer to the citizens through greater decentralization toward subnational governments and/or territorial deconcentration by the central government. The motives behind fiscal decentralization have been diverse and in certain cases concurrent. They include democratization, which created demands for greater political and fiscal autonomy

²⁷ Comptrollers play a growing role in auditing results-based performance at both the national and subnational levels. See Lonsdale, Wilkins, and Ling (2011).

²⁸ In Barbados and Suriname there are no municipal mayors because this level of government does not exist.

²⁹ There are eight other countries in Latin America and the Caribbean with intermediate levels of government whose authorities are appointed by the central government.

at the subnational level (Arzaghi and Henderson, 2005); the economic crisis of the 1980s, which led certain countries to transfer spending functions to the subnational governments within a context of structural adjustment (Rezende and Veloso, 2012); and second-generation institutional reforms, particularly since the mid-1990s, which transferred responsibilities to the subnational governments in an effort to make the public sector more efficient (Lora, 2007). An important contributing factor in the growth of subnational expenditures during the first decade of our century was the boom in the extractive industries, primarily mining and hydrocarbons, which boosted transfers of tax revenue from these industries to subnational governments, particularly in Andean countries (ECLAC, 2012). This factor carries a fiscal sustainability risk at the subnational level, since the price volatility of natural resources impacts the volume of transfers to the subnational governments.

- 3.3 Average spending by subnational governments in Latin America and the Caribbean conceals pronounced differences among countries, based on variables such as history and size of the economy, population, and territory. While more than 40% of consolidated expenditures in Brazil, Argentina, and Mexico were executed at the subnational level in 2010, the equivalent figure in Panama, Jamaica, and Honduras was lower than 5% (see [Figure 2](#) in the Annex). The region offers a variety of experiences, including: insular decentralization in The Bahamas; territorial deconcentration by the central government in Suriname; the recent creation of a municipal government level in Uruguay; and innovations in results-based transfers to municipios of certain states in Brazil.³⁰ In general, the countries in the region can be classified into three large groups: federal, such as Argentina, Brazil, and Mexico; unitary with a high level of decentralization, such as Bolivia, Colombia, Ecuador, and Peru; and unitary with a lower level of decentralization, such as Chile, Paraguay, Uruguay, and the Central American and Caribbean nations.³¹
- 3.4 The region has more than 18,000 subnational governments offering a variety of public management experiences.³² Of this total figure, a mere 2% fall into the intermediate level of government, the rest being municipios (see [Table 1](#) in the Annex).³³ In this regard the Sector is highly diverse, with differences not only among but also within countries. This is particularly pronounced at the municipal level. As described in the Urban Development and Housing SFD (IDB, 2013b), Latin America and the Caribbean is an increasingly urban region, with eight out of every ten inhabitants residing in cities. However, a mere 11% of the municipios in the region, all of them urban, account for more than two thirds of the entire

³⁰ See Holanda (2014) for the case of the state of Ceará.

³¹ Under a federal system, the constitution guarantees the permanence and independence of the subnational governments and grants them their own legislative, executive, and judicial powers. Under a unitary system, subnational governments usually lack constitutional sovereignty, and the central government determines which decision-making powers are devolved to them. Both concepts are ideals in a continuum within which countries are classified on the basis of the constitutional sovereignty granted to the subnational governments (Britannica, 2014).

³² Women's representation in these subnational entities has gradually increased but remains low, as it does at the national level (see Gender and Diversity SFD, IDB, 2015). For example, the percentage of women mayors doubled between 1998 and 2012, and now stands at 11% (UNDP, 2013).

³³ In six countries in the region there are two levels of local government, and in Haiti there are three.

population, while roughly 50% of the local governments have less than 10,000 inhabitants each (Eguino, Porto, Pineda, Garriga, and Rosales, 2010). This reality poses challenges both for urban municipios, which manage services involving coordination with other subnational entities, and for rural areas, where most of the region's municipios are concentrated, with a small population and limited administrative capacity (Martínez-Vázquez, 2010).

- 3.5 Subnational governments in the region are becoming increasingly important in the provision of public goods and services that are critical for economic and social development. The majority of municipios are responsible for services that include garbage collection, street sweeping and cleaning; local transportation; maintenance of parks and gardens; public lighting; and issuance of construction and operating licenses (Eguino et al., 2010). In addition, both municipios and intermediate-level governments (if any) carry out public investment projects (PIPs) in sectors such as roads and transportation, water and sanitation, productive infrastructure, tourism, health, and education, and are subsequently responsible for the operation and maintenance of these PIPs.³⁴ In fact, the share of subnational governments in the execution of public investment has grown over the past decade in several countries in the region, and now exceeds 50% of consolidated public investment in some Andean nations (IDB, 2012a and 2014e).
- 3.6 Health and education services significantly affect the size of the subnational public sector, accounting on average for more than 40% of total expenditures (ECLAC, 2011b). In Argentina and Peru, these services are for the most part provided by the intermediate levels of government; in Colombia, primary responsibility falls to the local governments; in Brazil, Mexico, and Venezuela, different levels of government have parallel responsibilities (Martínez-Vázquez, 2010). Subnational government autonomy in managing these services tends to be related to the governments' capacity to generate their own revenue. However, this is not the case in all countries: the provinces of Argentina, which have significant own revenues, have greater control over management than the regional governments in Peru, which are funded almost entirely through transfers; yet in Mexico, states have traditionally been largely autonomous in the management of education services despite being highly dependent on transfers.³⁵

B. Recent advances and challenges

- 3.7 The decentralization process in the region has made advances in the past decade, while it has also faced traditional challenges that have intensified (see [Table 2](#) in the Annex).³⁶ On one hand, there has been significant progress in the fiscal sustainability of subnational governments, particularly in Argentina, Brazil, and Colombia, where the subnational debt contributed to bouts of macrofiscal instability

³⁴ In several of the region's largest countries, the subnational governments also have responsibilities in the area of citizen security. See Citizen Security and Justice SFD (IDB, 2014c).

³⁵ By implementing the Fondo de Aportaciones para la Nómina Educativa y Gasto Operativo [Conditional Transfer Fund for Education Payroll and Operational Expenses] (FONE), the central government is taking on greater control over the teacher payroll it finances (see IDB, 2014d).

³⁶ The information in Table 2 is a specific contribution of this SFD in view of the limited transparency of subnational finances in the region. It is the result of a questionnaire completed by IFD/FMM specialists who work with the vast majority of countries in the region and/or reside in these countries, and has made it possible to describe and analyze recent decentralization trends in those countries.

- in the late 1990s/early 2000s. In particular, the implementation of fiscal rules for subnational governments in Brazil and Colombia served as a model for the development of subnational fiscal responsibility frameworks in other countries of the region. Yet despite these advances, fiscal risks continue to exist, for example in Mexico, due to the high indebtedness of certain subnational governments (Pineda, 2014; Rasteletti, 2014); in the Andean countries, due to the high growth of volatile transfers associated with natural resources (Radics, 2012; ECLAC, 2012); and even in Brazil, due to the growth of pension liabilities (Moody's, 2014a).
- 3.8 On the other hand, the Sector has traditionally been challenged by the financing structure of subnational governments, which is highly dependent on transfers (ECLAC, 2011c). This challenge has intensified over the last decade as a result of the growth in transfers linked to natural resources. Indeed, between 2000 and 2010, average expenditures by subnational governments as a percentage of GDP rose by more than one percentage point (see [Table 2](#) in the Annex). However, this rise was primarily due to higher transfers related to an increase in tax revenues from natural resource development, particularly in Bolivia, Ecuador, and Peru. For their part, own resources of subnational governments have remained relatively stagnant during this period. From a comparative viewpoint, the financing structure of subnational governments in Latin America and the Caribbean observably stands in contrast with its counterparts not only in OECD countries but also in other regions with a relatively similar development level, such as Eastern Europe and emerging Asia (see [Figure 3](#) in the Annex).
- 3.9 As set out in the following paragraphs, this high dependence on transfers reduces the incentives available to subnational governments for efficient management and accountability. It also highlights weaknesses in the relations between the different levels of government. In addition, the performance of the subnational governments is also adversely affected by a context of low institutional capacities, limited transparency, and insufficient capacity to monitor subnational management. In view of this, the primary challenge facing the decentralization and subnational governments sector is to foster the development of institutional capacities and provide a suitable incentive structure so as to make subnational management in Latin America and the Caribbean more efficient and effective, thus helping to improve the quality of life of all citizens. This requires supporting interventions and changes that systematically address the institutional weaknesses in the Sector as manifested in the following four major problems: (i) weak intergovernmental arrangements; (ii) subnational governments with deficient expenditure management and service delivery; (iii) subnational governments with low generation of own revenue and poor access to financing; and (iv) subnational governments with limited management transparency and accountability.
- 3.10 **Weak intergovernmental arrangements.** First, there is deficient coordination among the different levels of government. In certain cases, the spending functions of each level of government are not clearly defined, giving rise to parallel expenditures in key sectors such as education and resulting in a lack of transparency and a duplication of expenditures (Martínez-Vázquez, 2010). In addition, the defined spending functions by level of government and the concomitant financing are not properly matched: in some cases, the central governments have transferred spending functions to the subnational governments without providing sufficient resources to carry them out. Conversely, in several

countries, significant resources have been transferred to the subnational governments without a clear definition as to how to apply them (World Bank, 1999; ECLAC, 2001). As a result of these circumstances, voters lack the basic information as to which level of government does what, and political responsibility is often diluted. For example, in a survey on subnational public spending in Mexico, fewer than half of those interviewed were able correctly to identify that mayors are responsible for the sewage systems, water supply, and lighting (Chong, De La O, Karlan, and Wantchekon, 2014). In the area of citizen security, there are problems due to a lack of coordination between national and local violence prevention policies (IDB, 2014c). In large cities, service delivery and regulation are fragmented into several jurisdictions and there is often no entity responsible for organizing them (IDB, 2013b); in some cases, this limits the ability to leverage economies of scale that could result in cost savings and improved service quality.³⁷ This fragmentation is also apparent in the capacity to coordinate regional development planning strategies with subnational governments.³⁸

- 3.11 Second, with the exception of Argentina and Brazil, whose provinces and states (respectively) have broad tax bases, the assignment of taxation powers to the subnational governments, particularly to the intermediate levels of government, is barely incipient, exacerbating the dependence on transfers.³⁹ Even in Argentina and Brazil, the main taxes for which the intermediate-level governments are responsible, namely the gross receipts tax (Argentina) and ICMS (Brazil), create distortions stemming from the design of the tax.⁴⁰ The assignment of tax bases at the national level is complex and requires exhaustive cost-benefit analysis. Nevertheless, there is an opportunity to evaluate reform options, particularly for some intermediate-level governments highly capable of raising their own revenues (IDB, 2013a).
- 3.12 Third, there is room for improvement in the design of intergovernmental transfer systems, especially in terms of addressing the horizontal imbalances that are characteristic of the region. Latin America and the Caribbean have high territorial inequality: the average ratio of gross geographic product per capita between the

³⁷ See World Bank (2009a) for an analysis of the problems involved in the provision and regulation of transportation services in the Buenos Aires metropolitan area and other major cities in Argentina.

³⁸ Problem identified when implementing the Emerging and Sustainable Cities Initiative (ESCI) with regard to development of the north corridor in Haiti (IDB, 2013c). It also comes into play with other issues that require coordination among subnational governments, such as watershed management. In the case of Peru, territorial fragmentation has been addressed through attempts to leverage economies of scale by creating commonwealths (for local governments) and macroregions (for intermediate-level governments). These attempts have had limited success, primarily restricted to the joint management of certain projects by the different subnational governments.

³⁹ The assignment of taxation powers to the subnational governments is usually provided in national legislation and, in certain cases, in the constitution (for example, in Brazil) (see Martínez-Vázquez, 2010).

⁴⁰ The gross receipts tax levied by the Argentine provinces is applicable to all stages of all sales activities, thus generating multiple taxation and encouraging vertical integration (Artana and Templado, 2012). For its part, the Brazilian ICMS provides different rates depending on the origin and destination of the purchase, thereby encouraging tax evasion and tax wars, which carry high administrative costs for taxpayers, requiring coordination with the central government (Ter-Minassian, 2012). Lastly, the payroll tax imposed by Mexican states has lower revenue-raising potential and also leads to distortions in the formal labor market, encouraging an expansion of the informal labor market and adversely affecting productivity and economic development (Díaz-Cayeros and McLure Jr., 2000).

richest and poorest areas in Latin American and Caribbean countries is twice as high as in OECD countries ([Figure 4](#) in the Annex). However, transfers offset the disparities among subnational governments, albeit to a limited extent (Beramendi, 2012). While many of the transfer systems incorporate redistributive criteria related to population, rurality, and/or poverty, these criteria are insufficient to close the regional gaps. Specifically, no country in the region has adopted a system of equalization transfers that compensates subnational governments for their insufficient taxation capacity and addresses their spending needs so as to give each subnational entity an equal opportunity to provide basic public goods and services in fulfillment of its functions (Martínez-Vázquez and Sepúlveda, 2012). In fact, transfers of a certain common type, namely those resulting from the development of nonrenewable natural resources,⁴¹ tend to exacerbate territorial inequalities (Loayza, Mier y Teran, and Rigolini, 2013; Sanguinetti, 2010).⁴²

- 3.13 Faced with the political difficulty of modifying their transfer regimes, such as by updating the distribution criteria, countries often create new mechanisms and thereby add to the system's complexity. As part of this trend, discretionary transfers have also increased in recent years. These transfers are characterized by high volatility and uncertainty, and are known to discourage own revenue raising efforts. In view of this, creating spaces for discussion and periodic updating of the distribution criteria for transfers, based on simple systems with clear operating rules, is an important step toward improving intergovernmental coordination institutions. Along more general lines, it is worth noting that despite the maturity of the decentralization process in several countries in the region, there are no established institutional procedures or mechanisms for coordinating the various dimensions of the process. In view of this, the introduction of equalization transfer systems would not only address territorial gaps but would also establish a venue for determining and periodically updating resource allocation formulas in the territory, thereby helping to consolidate institutions coordinating decentralization. Worth noting in this regard is the progress made in Brazil, where the thematic networks of subnational governments have improved coordination with the central government on strategic issues such as financial management and tax administration.⁴³
- 3.14 Lastly, an important aspect of intergovernmental coordination is the development of a subnational fiscal responsibility framework. Such a framework is aimed at establishing effective budgetary restrictions to ensure the fiscal sustainability of the subnational governments. Setting subnational fiscal rules that provide limits on debt levels and spending growth contributes to this objective. The recent experience of Brazil and Colombia in this area, which relies to a large extent on lessons learned from the overindebtedness of many of their subnational governments in the late 1990s/early 2000s, shows that the success of subnational fiscal rules depends on effective compliance. To this end, the rules should be

⁴¹ Since the allocation is characterized by mainly benefiting the entities in which the extractive activities take place.

⁴² In the case of certain specific transfers, such as those aimed at supporting the innovation and competitiveness systems in Mexican states, more federal resources are allocated to entities that have greater institutional capacities, thereby deepening the existing regional inequalities (Stezano and Padilla-Pérez, 2013).

⁴³ The Bank has helped to create and develop these thematic networks in Brazil.

simple, transparent, and in line with the compliance capacities of the subnational governments and should strengthen these capacities. In addition, there should be exhaustive and continuous monitoring by the central government, with credible and timely corrective action (Nunes, 2010; Urrea, 2010). This monitoring should include contingent liabilities (arising, for example, from subnational public enterprises and public-private partnerships (PPPs)) and projected expenditures such as public pension liabilities (Moody's, 2014a and Moody's, 2014b), with particular emphasis on subnational governments that have received high and volatile transfers linked to natural resources.

- 3.15 **Deficient expenditure management and service delivery by subnational governments.** The citizenry in Latin America and the Caribbean has a negative perception of the quality of subnational management. In a survey conducted in 25 Latin American and Caribbean countries, more than two thirds of those surveyed in 16 of those countries indicated that municipal services are fair to very poor. Only in one country did more than half of those surveyed indicate that the quality of such services is either good or very good (LAPOP, 2012). In a survey conducted in 17 cities in the region, asked whether local taxes are used to improve welfare through better public services, the majority in 12 cities answered in the negative (CAF, 2010).
- 3.16 Many subnational governments in the region are deficient in managing expenditures and providing services. This is partly the result of very disparate initial conditions.⁴⁴ For example, municipios that have higher populations, more average years of schooling, and therefore a trained staff, typically show higher levels of public investment execution (Loayza, Rigolini, and Calvo-González, 2011) and better indicators of public expenditure efficiency (Herrera and Franke, 2007). Similarly, in municipios with lower literacy levels and higher levels of poverty and inequality, the productivity of public spending on education is relatively lower (Tavares and de Cavalcanti, 2014, and Machado, 2013). In Colombia, among municipios that in 2013 presented complete information for a comprehensive performance evaluation, average performance improved in local governments with more robust development environments. In addition, the vast majority performs below the satisfactory level in terms of efficiency (DNP, 2014).⁴⁵ In the states of Brazil there is a weak correlation between the relative efficiency of spending on education and both state spending per capita on education and state GDP per capita. This suggests that simply having more funds does not guarantee better outcomes, unless those funds are accompanied by improvements in the management of service quality (Boueri, Mac Dowell, Pineda, and Bastos, 2014).
- 3.17 Management of the subnational public investment cycle (planning, formulation, execution, and ex post evaluation) is deficient. This is an expenditure item of growing importance for subnational governments in Latin America and the Caribbean, with great potential for helping to reduce the territorial gaps in

⁴⁴ In this regard, shortcomings tend to exist to a greater extent in less developed countries, including many of the Bank's Group C and D borrowing member countries.

⁴⁵ Colombia has the distinction of having been consolidating an annual evaluation of the municipal comprehensive performance index for more than 10 years under the direction of the National Planning Department (DNP). This index is built by measuring and weighting municipal performance components, including effectiveness, efficiency, management, and legal compliance.

- socioeconomic development. In Peru, more than 80% of the public investment projects (PIPs) prepared by the subnational governments in 2007 failed to properly apply the formulation criteria of the National Public Investment System (SNIP) (IDB, 2012a). These shortcomings are also evident in the execution stage, resulting in delays and cost overruns. In Bolivia, 42% of the PIPs prepared by subnational governments between 2005 and 2013 required reformulation (IDB, 2014f). In addition, the subnational scope of the SNIP is limited. In Nicaragua, for example, very few municipios are covered by the system despite the fact that, between 2007 and 2013, subnational public investment increased from 1.6% of GDP to 2.4% of GDP (Bartels and Muñoz, 2014).
- 3.18 Furthermore, the ability of subnational governments to attract investments is subject to constraints, limiting opportunities for economic development, including export promotion. For example, little use is made of electronic government to facilitate the delivery of services to individuals and enterprises, in part due to the limited development of broadband infrastructure.⁴⁶ There is also a need to expand initiatives for simplified procedures and physical integration of face-to-face services through the use of one-stop shops.⁴⁷ For example, on average, setting up a business in Central America or the Dominican Republic requires twice the number of procedures and takes three times longer than in high-income OECD countries, raising the costs to the private sector (World Bank, 2015b). In 2013 in El Salvador, a competitiveness index was used to assess the business climate in 41% of the country's municipios. The index found below-average values in subindexes such as quality of municipal services and proactiveness in developing initiatives to attract investment (USAID, 2013).⁴⁸ In addition, with the exceptions of Brazil and Mexico, the development of PPPs at the subnational government level in Latin America and the Caribbean is incipient (Infrascope, 2013). In all these respects, central government support is critical, particularly for subnational governments with limited capacity and high poverty and inequality rates.
- 3.19 Significant constraints on improving the quality of subnational expenditures include the limited development of MfDR and PFM pillars and insufficient implementation of management models to strengthen centers of government, which fosters coordination of government priorities by directly supporting subnational government authorities. In many subnational entities there are also weaknesses in the administrative processes, which are usually not supported by basic management tools.⁴⁹ In particular, despite advances in the region over the past two decades in modernizing national PFM systems, the development of these systems at the subnational level lags behind. In terms of coverage, worth noting are the cases of Peru, where the SIAF has been implemented by all subnational governments (IDB, 2010a), and Brazil, where the SIAF is in operation in all

⁴⁶ Ninety-six percent of Latin American and Caribbean municipios have a broadband penetration rate of less than 50% (Digilac, 2014).

⁴⁷ In this regard, it is worth noting the experience of the Bogotá Mayor's Office with the CADE network of centers that deliver integrated services to individuals and enterprises (IDB, 2012b).

⁴⁸ The index was measured through individual surveys of business owners and managers, mayors, and municipal officials. Eight business climate features derived from the concept of economic governance were measured in each municipality: transparency, municipal services, proactiveness, unlawful payments, public safety, time to comply with regulations, assessments and taxes, and entry costs.

⁴⁹ See IDB, 2012a with regard to regional governments in Peru.

states,⁵⁰ having been recently modernized in half of them (Pimenta, 2015).⁵¹ This limited development has also reached other PFM systems, such as electronic public procurement (in an effort to simplify procedures and improve subnational capacities), payroll, and asset management (including real estate).⁵² In addition, only a few countries require and supervise effective implementation by subnational governments of medium-term budgetary frameworks and their linkage to MfDR. There is also the challenge of ensuring that the PFM systems are used by the subnational authorities as a management tool rather than primarily as a central government control mechanism.

- 3.20 There is limited development of a professionalized civil service, including competitive staff compensation policies that can better attract, retain, and motivate skilled employees in the context of a fiscally sustainable payroll. This problem tends to be more pronounced in recently decentralized countries. For example, in a representative sample of municipios in the Dominican Republic, a diagnostic assessment found that there were no personnel policies in place and that transfers were being used to a considerable extent to keep a large and generally poorly compensated staff (World Bank, 2009b). In Belize, it was found that the roles and responsibilities of municipal employees were poorly defined and that there were no procedural manuals describing the local management processes (World Bank, 2010a).
- 3.21 The development of a civil service should be accompanied by a sustainable improvement in the technical capacities of public officials, which in many Latin American and Caribbean countries are limited as regards both the government teams that manage the decentralization process at the central level and the officials at the subnational governments. In this respect, in Peru, a resident technical assistance approach in the subnational governments, including capacity evaluations as well as skills and knowledge transfer in the daily work with subnational officials, turned out to be more effective in the area of public investment management than short-term informative training courses. This effort has been accompanied by a deconcentration of central government technical officials in the territory, helping to make the improvement in subnational capacities more sustainable (IDB, 2012a).
- 3.22 **Limited generation of own revenue and poor access to financing by subnational governments.** To become less dependent on transfers, subnational

⁵⁰ In particular, the state of São Paulo has a cost management system that makes it possible to obtain unit costs of priority services. Developments such as this require other modern PFM systems that few subnational governments in Latin America and the Caribbean have at their disposal, such as asset accounting and alignment with international standards, as well as modern and integrated budgetary and financial management (Chan, Holanda, and Pessoa, 2012; Pimenta, 2015).

⁵¹ Bolivia also has high coverage, reaching 96% of municipios for the various systems currently in operation (Lora, 2014). In Nicaragua, as in other examples, the municipal integrated financial management subsystem covers 65% of the municipalities (Bartels and Muñoz, 2014); in Chile, the municipal financial information subsystem covers 35% of the entities (Uña, 2013); and in Honduras, the integrated municipal management system reaches 20% of the municipios (Pérez Rincón, 2014).

⁵² As indicated in the preceding section, implementing the SIAF at the subnational level while at the same time bringing public accounting practices into compliance with international standards, including an accounting of assets and liabilities, can help enhance transparency and accountability. With regard to public procurement, cost overruns due to inefficient management of health, education, and security procurement exceeded 8% of the budget for these functions in one state in Brazil (IDB, 2013d).

governments must improve their capacity to generate their own revenues. This hinges on the allocation of tax bases and tax rates at the subnational level (part of the intergovernmental arrangements) and on the subnational governments' efforts to maximize their tax base, service provision charges, and other sources of funds. In this regard, own revenue collection by subnational governments in Latin America and the Caribbean is not in line with its potential. This is evidenced by the limited development of instruments aimed at capturing increases in property value due to public investments, low recovery of service costs, and weak management of subnational government assets and real property for sale and lease.⁵³ Also worth noting is the undercollection of the real estate property tax, whose average revenue barely amounted to 0.3% of GDP during the 2000s. This is close to half of what is collected in other developing regions and merely one fourth of the figure for the OECD (see [Figure 3](#) in the Annex, Sepúlveda and Martínez-Vázquez, 2012; Bonet, Muñoz, and Pineda, 2014).

- 3.23 This problem has been brought about by factors specific to subnational management as well as by central government restrictions. The former include outdated assessed values and taxpayer records;⁵⁴ lack of systems to automate the revenue collection functions; limited capacity to calculate tax and municipal levy amounts; and insufficient oversight efforts. With regard to the last of these factors, the political cycle influences local fiscal efforts in several countries, particularly in election years. Consequently, there is a need to reinforce tax administration autonomy at the subnational level. In addition, there is scant central government support for subnational governments in their management of own revenue, partly because in many countries this function is not sufficiently prioritized. As a result, with regard to property taxes, the periodic appraisals designed to bring real estate values closer to market value are outdated. Similarly, the public records are not integrated with the municipal property records (IDB, 2013a). Furthermore, subnational governments receive limited technical assistance, which is focused on urban entities with greater revenue collection potential and low management capacity, and possibly also rural subnational governments with high per-capita income (Sepúlveda and Martínez-Vázquez, 2012). In view of the gap in revenue collection between Latin American and Caribbean and OECD countries, especially with regard to property taxes, there is a need to strengthen the payment culture and undertake the investments required to bring subnational revenue collection closer to its potential.
- 3.24 An additional challenge facing subnational governments is their limited access to financing, which restricts their ability to quickly roll out the social benefits of public investment and expand their opportunities for development. Indeed, there are subnational governments that, while having access to debt financing in a context of fiscal responsibility, are constrained by a lack of capacities, an absence of

⁵³ As an example of the potential inherent in real estate management, the sale of an old bus station and an administrative site in Istanbul, Turkey, generated US\$1.500 billion in revenue, which was equivalent to 1.5 times total municipal investment spending for 2005 (Peterson, 2009).

⁵⁴ As indicated in the Urban Development and Housing SFD (IDB, 2013b), cadastral updates not only help to improve revenue collection but also enhance city planning through land-use management. In addition, modernizing the cadaster and registration systems is equally important from the standpoint of agricultural development and natural resources management, as underscored in the SFD on Agriculture and Natural Resources Management (IDB, 2013e).

mechanisms, and institutional limitations.⁵⁵ Weaknesses in PFM, including budgetary planning and management capacities, have an impact on this challenge (as does the limited generation of own revenues). In some cases, the subnational governments accumulate old debts to other public entities (for example, social security) which, not having been satisfied, prevent them from having access to the market (Llempén et al., 2010); in others, low generation of own revenue and an absence of mechanisms for repayment through the use of transfers limit the amount they can borrow. In addition, many subnational governments are too small to be considered eligible for credit, despite the existence of instruments that make it possible to pool the resources of multiple entities into a single transaction.⁵⁶

- 3.25 Moreover, in certain countries, central government support is insufficient to provide the subnational governments with the technical assistance they require to be restored to financial health and subsequently access the market.⁵⁷ This is largely due to a lack of information and monitoring capacity at the Ministries of Finance, limiting the ability to classify subnational governments according to their creditworthiness. In this regard, one of the benefits of the effective implementation of fiscal responsibility frameworks in Brazil and Colombia is the central government's increased ability to know the state of subnational public finances, particularly the financial condition of the larger subnational governments, making it possible to approve debt transactions with a low risk of default.
- 3.26 **Limited transparency and accountability by subnational governments.** First, there is limited management transparency in subnational governments. Only in two countries, Brazil and Peru, is information on subnational finances whose quality can be considered solid made available for consultation. In the majority of countries, the availability of information is either incipient or restricted (see [Table 3](#) in the Annex).⁵⁸ In Colombia, where the quality of subnational information is higher than the regional average, half of the municipios report incomplete information or fail to report any data on their overall performance (DNP, 2014). In Argentina, only four provinces (of a total of 24) meet all minimum transparency standards, such as presenting an annual budget, expenditure execution, and debt stock in their official websites within the time frames required under the regulations (CIPPEC, 2015). In Mexico, based on an index that aggregates the quality and quantity of the information contained in the state budgets, findings show that fiscal transparency worsened in the majority of states between 2011 and 2012 (IMCO, 2014). In

⁵⁵ The next section describes how this challenge has caused Bank loans to subnational governments to be concentrated almost exclusively in Brazil.

⁵⁶ Mexico has implemented mechanisms that make it possible to use transfers and pool small municipios into a single transaction (Gama, 2014). It is important that these mechanisms be closely supervised by the central government, including an analysis of the subnational governments' fiscal sustainability. In addition, the securitization of federal transfers requires a solid regulatory framework for secured transactions to ensure the effectiveness of the established guarantees. The Bank supports these efforts by the Government of Mexico through development banks, specifically Banobras, with a view to facilitating credit to small municipios in the form of rediscount arrangements based on the resources of the Fondo de Aportaciones para la Infraestructura Social [Conditional Transfer Fund for Social Infrastructure] (FAIS), using the line of credit ME-X1002.

⁵⁷ In this regard, the credit evaluations of the subnational governments can help to identify and address areas of their institutional capacity that need improvement.

⁵⁸ This information is derived from the subnational fiscal information platform being developed by IFD/FMM (RG-K1363).

- addition, findings from a sample of Mexican states indicate that the quality of responses to citizen demands for access to information is low (UNDP, 2011).
- 3.27 The problem of opacity at the subnational level is well recognized by the citizenry and carries a considerable cost. For example, a survey of megacities (IDB, 2014e) reveals that those interviewed in four of the five cities surveyed consistently cite the lack of municipal government transparency as one of their most serious problems (together with a lack of citizen security). In terms of costs, based on information contained in audit reports in Brazil, it is estimated that irregularities in the use of local funds affected between 2% and 8% of all transfers audited over the last decade (Ferraz and Finan, 2011; Brollo et al., 2013). In particular, in municipios where education transfers were improperly used, basic school supplies are scarce, the quality of education (as measured by standardized tests) is lower, and students are more likely to drop out (Ferraz, Finan, and Moreira, 2012). More generally, there is evidence to suggest that when audit results reveal irregularities, collection of property taxes declines, this effect being more pronounced in local governments with lower initial revenue collection levels (Timmons and Garfias, 2015).
- 3.28 These outcomes show not only the costs of a lack of transparency at the local level but also the importance of accountability tools for the timely correction of problems related to a lack of transparency and improper government actions. Yet despite the growing decentralization in the region, programs that promote accountability in the use of intergovernmental transfers are still uncommon. Such instruments are particularly necessary in view of the increase in transfers linked to nonrenewable natural resources, where the evidence points to greater irregularity problems in the municipios that benefit most from these resources (Caselli and Michaels, 2013; Ferraz and Monteiro, 2010; Maldonado, 2011).⁵⁹
- 3.29 There is insufficient monitoring and evaluation of subnational management.⁶⁰ Implementation of the PRODEV (Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness) Evaluation System's management-for-results survey in nine capital cities in the region shows that, of the four pillars, monitoring and evaluation is the one that obtained the worst score (García López, 2014). The survey also underscores the challenge of improving the contribution of the Supreme Audit Institutions (SAI) responsible for external control in terms of enhancing subnational results-based management, transparency, and accountability. This includes expanding the territorial coverage of the SAIs in tandem with the growing importance of subnational governments in the execution of consolidated public expenditures. For example, in Peru, financial audits by the Comptroller's General Office barely cover 2.4% of the municipios (IDB, 2013f). In El Salvador, despite the fact that all municipios are required to undergo external financial audits, only one out of a representative sample of 10 municipios fulfilled this requirement (World Bank, 2010b).

⁵⁹ For the 2009-2011 period in Colombia, more than 5,000 irregularities were identified in the handling of royalty resources at the subnational level, accounting for 20% of the total value of royalties transferred during that period (DNP, 2012). In this regard, it is worth noting the recent development, with Bank support, of the Mapa Regalías [Royalty Map] system, which makes it possible to monitor subnational government PIPs financed with royalty resources: <http://maparegalias.sgr.gov.co/>.

⁶⁰ This challenge includes coordinating and monitoring compliance with tools such as subnational development plans.

IV. LESSONS LEARNED FROM THE BANK'S EXPERIENCE IN THE SECTOR

A. Reports issued by the Office of Evaluation and Oversight (OVE)

- 4.1 OVE's analysis consists in a 2006 evaluation, which includes the Sector in the context of Bank interventions in the fiscal area, along with a 2001 study on the relationship between decentralization and effective citizen participation, based on six case studies. It also includes the analysis undertaken in the most recent Country Program Evaluations (CPEs), in countries where these documents indicate the Sector's relevance in the country strategy evaluated. The most relevant conclusions and recommendations made by those studies are as follows:⁶¹
- a. According to the IDB (2006), between 1990 and 2004, the Bank's programs in the Sector have had a high level of coverage and have been highly representative of the region's countries, particularly after 1997 and in investment loans. The study found for the period that the evaluability of interventions in the Sector was relatively low. Compared to the World Bank, the IDB covered more countries and had more interventions per country with investment loans, while the World Bank had more coverage through policy-based loans, with a larger average amount per project and addressed more policy conditions.
 - b. With respect to the analysis by country, the most recent CPE for Brazil (IDB, 2011b) notes the growing significance of direct support to subnational governments as part of the change in the business model with the country. It also analyzes the transactional costs that this entails: In the specific case of the Program to Support the Management and Integration of Finance Administrations in Brazil (PROFISCO), it highlights the short periods for preparation of operations, thanks to the standardization achieved with this instrument, although execution costs are relatively high compared to the Bank's average. Compared to the World Bank, the IDB's coverage and support through investment loans to subnational governments was much higher, while the World Bank had a significant number of policy-based loans and a sector-wide approach in its investments.
 - c. The CPE for Mexico (IDB, 2013g) emphasizes that although the Bank managed to implement two operations for US\$610 million in the period evaluated, using Banobras as an intermediary, it was unable to develop an effective, efficient mechanism to directly support the subnational governments.⁶² The CPE for Colombia (IDB, 2011c) considers the value added by the Bank in crosscutting areas of decentralization: It recognizes that the Bank sought to improve the management of subnational governments and investments to improve public service delivery, although there were evaluability issues with the interventions. The CPE for Argentina (IDB, 2009)

⁶¹ The included OVE recommendations have been extracted from: IDB (2001), Decentralization and Effective Citizen Participation: Six Cautionary Tales; IDB (2006), Evaluation of the IDB's Role in the Fiscal Sector; and the CPEs for Argentina (2003-2008), Brazil (2007-2010), Colombia (2007-2010), and Mexico (2007-2011).

⁶² In this regard, it is important to note that the Mexican Constitution prohibits external financing of subnational governments.

indicates that it was not possible to meet the Sector's challenges with the emphasis envisaged in the country strategy.

- d. Lastly, the IDB's analysis (2001) relating to the link between decentralization and citizen participation notes that decentralization is not an indispensable condition for improving citizen participation, since there are other contextual factors that may be even more important, such as political competition, freedom of organization, education, and poverty reduction. Decentralization does contribute, however, to increasing the number of political players and expanding the playing field so citizens can gain experience. As a recommendation, more than promoting decentralization, the Bank should help create environmental conditions conducive to effective participation, such as political competition, education, training on civic partnerships, while monitoring the political economy of the process and the interests of the actors involved.

B. Results of the Development Effectiveness Matrix (DEM)

- 4.2 The DEM classification for Sector projects has improved significantly since 2009. Moreover, since 2011, all Sector projects have been classified as evaluable or highly evaluable. The average DEM score for 2014 (8.5) was close to the Bank's average (8.8).

Table 1. Summary of DEM results for the Sector

Year	Number of operations	Section				Annual DEM average
		Program logic	Monitoring and evaluation	Economic analysis	Risk management	
2009	7	7.5	5.5	1.4	7.5	6.2
2010	10	6.2	4.9	5.6	7.3	5.8
2011	4	6.7	5.6	6.6	8.8	6.9
2012	11	6.8	4.1	8.6	9.5	7.9
2013	16	7.7	6.9	9.4		8.0
2014	10	8.8	7.0	9.6		8.5

Source: Authors' calculations based on OPS, IDB data.

- 4.3 Within the dimensions of the DEM, all categories have improved in the period considered, with the most significant improvement in the economic analysis dimension, where the Sector score in 2014 was above the Bank's average.

C. Lessons learned from experience with Bank operations⁶³

- 4.4 **The importance of uninterrupted dialogue, technical support, and the role of networks.** The Bank's programmatic vision regarding the processes of

⁶³ The lessons are based on the detailed analysis of 18 sovereign guaranteed operations from the sector portfolio in eight countries, including a document review (loan proposal and contract, results matrix, risk matrix, midterm and final evaluation reports and/or project completion reports (PCR), and project monitoring reports (PMR)) and structured interviews with the projects' team leaders and IFD/FMM specialists. The loans are: 2448/BL-BO; 2593/BL-BO; BR-X1005; 2232/OC-BR; 2248/OC-BR; 2841/OC-BR; 3139/OC-BR; 2341/OC-CO; 2744/OC-CO; 1383/OC-ME; 1744/OC-ME; 1679/SF-NI; 1437/OC-PE; 2703/OC-PE; 1343/OC-SU; 2087/OC-SU; and 1489/OC-UR.

decentralization in the region, together with the presence of specialists on the ground, have been the right formula for addressing needs by means of fluid, continuous interaction with the governments.⁶⁴ It is worth noting the case of Brazil, where the specialists' understanding of the country context, coupled with more than 15 years of support, have positioned the Bank as one of the leading partners in the process of decentralization and modernization of fiscal management instruments, successfully executing multiple operations at the federal, state, and municipal levels. Specifically, the Bank has led an important sector dialogue with the Brazilian authorities, helping to develop knowledge networks in the framework of the programs executed, enabling the development, harmonization, and dissemination of fiscal management policies, as well as serving as a space to build consensus on effective technical solutions.

- 4.5 **Complementarity in the use of the Bank's instruments.** Considering that decentralization processes are long and complex, the Bank has supplemented its loans with technical cooperation operations and nonfinancial products to maximize its capacity to respond to the countries' unanticipated or changing needs. In Mexico, the use of technical cooperation resources proved strategic for improving institutional capacities through the PRODEV program (the case of the State of Yucatán) for the subsequent preparation of investment loans. In Peru, the combination of loans in execution and technical cooperation operations was fundamental for maintaining the dialogue with the counterparts, developing more effective capacity-building modalities, and preventing operations from becoming obsolete or irrelevant. In Colombia, the technical cooperation resources were used to hire international experts to prepare studies that were crucial for the decentralization process, as well as to support the exchange of international experiences on monitoring the use of transfers and subnational fiscal sustainability. In Brazil, the Bank used a technical cooperation operation to support the process of approving the fiscal reform, by financing diagnostic studies, seminars, and workshops.⁶⁵
- 4.6 **Considerations regarding monitoring, information sources, and evaluation of interventions.** Problems of transparency and a lack of indicators at the subnational level hinder the measurement of the impact of the Bank's interventions, as well as the development of innovations supporting improvement in decentralization processes. With the Bank's support, some of the operations analyzed have implemented systems that have improved reporting at the subnational level, in addition to developing portals to promote communication and transparency vis-à-vis citizens. However, these actions have not overcome the region's limitations in terms of the quality and relevance of subnational fiscal indicators, which complicates monitoring and decision-making by the various entities requiring information; this includes the Bank, which is impacted in its intervention evaluation activities. Thus, the development and implementation of evaluation alternatives to improve the measurement of interventions' impact remain a pending task.

⁶⁴ This lesson arises from the review of the experiences of Bolivia, Brazil, Colombia, Mexico, Nicaragua, Peru, and Uruguay.

⁶⁵ Support for comprehensive fiscal reform in Brazil (ATN/FI-12544-BR).

- 4.7 **Incentive-based transfer programs.** The Bank's support for incentive-based transfer programs has helped subnational governments improve the quality of their management. This type of program is characterized by promoting competition between subnational governments and contributing to transparency and accountability. In Nicaragua, the competitive funding mechanism for municipios contributed to the transparency and targeting of resources for investments in the country's most vulnerable subnational governments, by promoting participation by beneficiaries, which facilitated a greater sense of ownership and willingness to maintain the works built. In the case of Mexico, through the Program to Strengthen States and Municipios (FORTEM), the Bank supported subnational governments in improving their credit rating, aimed at enhancing access to capital markets, by strengthening their ability to generate their own revenues, budget management, investment planning system, and debt management, while providing financing for their investment plans as an incentive to improve their management. These actions helped generate sound financial performance by the beneficiaries, as well as better public management, and have resulted in an improved credit rating for the states and municipios served. In Peru, the Bank supported the creation of an incentive fund, which transfers resources for the development of public investment projects in regional governments with high levels of poverty, based on improvements in these entities' management of public investments.
- 4.8 **Subnational governments' revenue-generating capacity.** Regional experience shows the need to continue working on increasing subnational revenue generation in order to be able to cover the growing spending responsibilities. Economics and country context are major variables that can explain the low mobilization of own resources by subnational governments, which often lack the necessary incentives to increase revenues. There are also weaknesses in local tax administrations' abilities to tax, collect, and recover debts. The actions taken in the operations analyzed that may be considered in other interventions include the modernization of registries and the development of inventories of subnational taxes in arrears, in order to build the capacity of the subnational government tax administration.
- D. The Bank's comparative advantages in the Decentralization and Subnational Governments Sector**
- 4.9 The Bank has secured a privileged position in supporting the Sector in the region, particularly by deepening the processes of decentralization in the countries over the last three decades. The continuous support and fluid dialogue with national and subnational authorities, the broad coverage of countries, the track record of good practices and innovation, and the high technical capacity in the Sector are all part of this achievement.
- 4.10 During the 25 years between 1990 and 2014, the Bank has financed 151 loans in the Sector for approximately US\$18.7 billion, in 23 of the 26 borrowing member countries, with representation of the region's different country groups.⁶⁶ Through these operations, the Bank has supported the main reforms in the processes of decentralization and improvement of the management of the region's subnational governments. The evolution of the Bank's work in the Sector shows substantial

⁶⁶ Source: IDB (2006) for the period 1990-2005 and OPS for 2006-2014. The only three countries in which the Bank has not had loan operations in the sector are Belize, The Bahamas, and Barbados.

growth in the amount and number of operations from the end of the 1990s, covering not only large countries, but also many small unitary nations (see [Table 4](#) in the Annex). More recently, between 2006 and 2014, sector support was maintained with greater concentration in Brazil, which represented 54% of the projects and 43% of the amounts approved in the Sector.

- 4.11 The Bank's projects have contributed to reforming intergovernmental arrangements, including recent support for Bolivia, Colombia, Guatemala, and Suriname. However, the majority of the operations have been aimed at improving the management of subnational governments. With the exception of Brazil, in almost all countries, the loans have channeled resources to subnational entities through the lead agencies in the central government, rather than directly financing the subnational governments. This is due to economic policy restrictions, in which the central government does not guarantee the subnational borrowing or chooses to act as an intermediary. Or also to legal restrictions: for example, in Mexico, the Constitution prohibits external financing of subnational governments.⁶⁷ Lastly, there are restrictions of scale: Many subnational governments lack sufficient revenues to secure large loans, and, as described in the preceding chapter, financing instruments for this type of entity are underdeveloped. In this regard, the Bank's non-sovereign guaranteed operations provide an alternative source of financing and have the capacity to finance public and semi-public enterprises that provide services and financing.⁶⁸ The lines of actions of Sector interventions have addressed administrative improvement, improved management of subnational services and expenditure, management of own revenues, and to a lesser extent, debt management, transparency, and accountability. In many of the region's countries, the Bank has deployed programmatic support, with successive interventions that incorporate lessons learned and expand the geographic and thematic scope.⁶⁹
- 4.12 In the specific case of Brazil, the Bank has worked directly with the states in coordination with the central government. Since 2008, the conditional credit line for investment projects (CCLIP), PROFISCO, has helped promote the integration and modernization of fiscal, administrative, and service management in Brazilian states, with interventions in all 26 states and the Federal District for more than US\$600 million. Although most projects are still in execution, the midterm evaluation of the PROFISCO CCLIP shows that the group of nine Brazilian states whose execution has progressed the furthest present, on average, better rates of fiscal transparency and greater tax revenue growth than the rest of the states (IDB, 2014g). For its part, since 2008, the Bank has approved seven Fiscal Stability

⁶⁷ This type of restriction partially explains why in certain countries the Bank channels loan proceeds to subnational governments through local development banks. Noteworthy examples include the cases of FINDETER in Colombia and BANOBRAS in Mexico.

⁶⁸ Examples include the partnership loans with Banco de Desenvolvimento de Minas Gerais for the financing of infrastructure and municipal services (3184/OC-BR and 3184/CH-BR); corporate loan for Companhia de Saneamento Básico do Estado de São Paulo (SABESP) (1983/OC-BR); and the Social Financing Program Empresas Públicas de Medellín S.A. E.S.P (EPM-UNE) (2217/OC-CO). Bank instruments like *Aquarating* help evaluate the creditworthiness of subnational water and sanitation enterprises.

⁶⁹ Recent examples of this type of programmatic support include Brazil, Bolivia, Colombia, Mexico, Peru, Suriname, and Uruguay.

Consolidation Programs for Development (PROCONFIS) in five states for US\$2.043 billion, consisting in policy-based loans that support reforms aimed at improving the effectiveness and efficiency of fiscal management, quality of expenditure and public services, and investment management. From the federal government, through the Finance Ministry, two phases of the National Program to Support the Administrative and Fiscal Management of Brazilian Municipalities (PNAFM) have been executed for US\$450 million, contributing to the integration of tax administrations and the modernization of administrative, fiscal, financial, and capital management by Brazilian municipalities. In addition, through the Ministry of Planning, Budget, and Management, phase I of the National Program to Support the Modernization of Public Administration and Planning in the States and Federal District (PNAGE) has been executed, for US\$155 million, helping to improve the effectiveness and institutional transparency of state governments. In Brazil, the Bank has developed innovative projects supporting subnational external control; subnational legislatures; subnational transparency and internal control; and complementarity between private sector development and the improvement of municipal management.⁷⁰ It should be noted that the second stage of PROFISCO is currently in the formulation phase, the third phase of PNAFM was approved, and continued support for the states through PROCONFIS is planned, thus deepening the support for improved management of subnational governments in Brazil.

- 4.13 Together with the IDB, the World Bank has played an important role in supporting the region in the Sector.⁷¹ Between 1990 and 2014 the World Bank approved 95 loans for approximately US\$20.4 billion, which, compared to the IDB, represents about 40% fewer operations for an amount that is 10% higher. The Bank's interventions have been characterized by a higher proportion of investment projects than policy-based loans (80% of the total vs. 50% at the World Bank), with broader country coverage: the IDB has worked in the Sector with 23 countries, in 19 of which, the interventions' development objective was focused on supporting the Sector, while for the World Bank, this ratio was between 15 and 8 countries, respectively. In turn, the World Bank has focused its projects on large countries in the region, particularly in Brazil, where between 2006 and 2014, it allocated 83% of the amount of its operation in the Sector, compared to 43% for the Bank.
- 4.14 **Technical cooperation operations.** Technical cooperation operations are an important support instrument in the Sector, whose volume grew substantially since 2009 in the wake of two special Bank programs: the subnational account of the Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness (subnational PRODEV), and since 2011, the Emerging and Sustainable Cities Initiative (ESCI). On the basis of these two programs, the annual average of nonreimbursable Bank resources in the Sector increased from US\$1.7 million between 1996 and 2008 to US\$13.2 million between 2009 and 2014. Subnational PRODEV contributed 42 technical cooperation operations for more than US\$24 million through 2013, benefiting intermediate and municipal

⁷⁰ Loans for a Multiphase Program Supporting Electronic Legislative Development in Brazil (1864/OC-BR); Program to Strengthen Measures to Prevent and Combat Corruption in Brazil's Public Administration (2919/OC-BR); Urban Development and Municipal Public Investment: Paraná Urbano III (3412/OC-BR); and Klabin – Project PUMA (3308A/OC-BR).

⁷¹ The analysis of World Bank operations in the Sector is based on IDB (2006) for the period 1990-2005 and information from the World Bank website for the period 2006-2014: <http://www.worldbank.org/projects>.

governments in 13 countries in the region, seeking to make public sector management more effective and efficient through better design, execution, monitoring, and evaluation of policies, strategies, programs, and projects. These technical cooperation operations' achievements include the development of budget transparency systems in Antioquia, Colombia; implementation of a multiyear budget in Heredia, Costa Rica, with monitoring of specific programs' output and outcome indicators; the development of a medium-term fiscal and development plan, with a tax, budget, and public investment management modernization program in Yucatán, Mexico; and the formulation of results-based budgeting programs in priority sectors in Lima, Peru.⁷² The Special Program for Institutional Development (SPID) is supporting the managing for results agenda in the region through the efforts of subnational governments to strengthen their institutions and make them more effective, efficient, open, and citizen-centric.

- 4.15 For its part, between 2011 and 2014, the ESCI supported 40 intermediate cities in the region with more than US\$36 million, with one of its three pillars being improved local fiscal management and governance. Since its creation, the ESCI has been contributing to the development of action plans that enable intermediate cities to prepare a prioritized and defined public investment program that helps improve relations with the national government in terms of financial support, and the attraction of private investment. It should be noted that there have been joint Subnational PRODEV and ESCI initiatives in a number of cities, strengthening both instruments. Lastly, since 2006, the Bank has approved another 52 technical cooperation operations in the Sector for US\$12.6 million, aimed at financing regional exchanges of good practices; supporting the formulation of operations;⁷³ financing the development of subnational PPPs (the case of Mexico with the MIF); improving capacities and transparency in fiscal resource management for extractive industries;⁷⁴ and supporting the Bank's strategic knowledge and dissemination initiatives (see following paragraphs).
- 4.16 **The Sector's knowledge products.** The Bank stands out with a broad range of knowledge products in the Sector. Some of the publications include: (i) with respect to the Sector's issues and their connection with economic development, *La Alternativa Local* [The local alternative] (De la Cruz, R., C. Pineda, and C. Poschl, editors, 2010; IDB, 2010b); (ii) regarding the revenue sources of subnational governments, the report *Development in the Americas 2013, More than Revenue* (Corbacho, A., V. Fretes Cibils, and E. Lora, editors, 2013; IDB, 2013a), which contains a chapter on subnational taxation; the book: *El potencial oculto: factores determinantes y oportunidades del impuesto a la propiedad inmobiliaria en América Latina* [The hidden potential: determining factors and opportunities for the

⁷² The technical cooperation operations considered are ATN/OC-11709-CO, ATN/OC-12140-CR, ATN/CO-11851-ME, and ATN/OC-11682-PE.

⁷³ In Chile, for example, the technical cooperation operation Support for the Presidential Committee on Decentralization (ATN/FI-14517-CH), financed by the Institutional Capacity Strengthening Fund (ICSF), is conducting studies and holding seminars that help prepare Bank loans to support decentralization reform.

⁷⁴ Technical cooperation operation, Strengthening Governance in the Extractive Industries in Latin America and the Caribbean (ATN/CF-13115-RG), financed by the Transparency Fund, included support for the design of a royalties map system in Colombia, making it possible to monitor subnational PIPs financed with royalties: <http://maparegalias.sgr.gov.co/>.

real estate tax in Latin America] (Bonet, J., A. Muñoz, and C. Pineda, editors, 2014); the article *Expanding local revenues for promoting local development* (Bonet, J. and V. Fretes Cibils, 2013); and the book *Decentralizing revenues in Latin America—Why and how* (Fretes Cibils, V. and T. Ter-Minassian, editors, 2015); (iii) the book *Descentralización y sostenibilidad fiscal: los casos de Colombia y Perú* [Decentralization and fiscal sustainability: the cases of Colombia and Peru] (del Valle, M. and A. Galindo, editors, IDB, 2010c), which develops a methodological proposal to establish and evaluate subnational fiscal performance and applies it to the cases of Colombia and Peru; (iv) the books *Open Government and Targeted Transparency: Trends and Challenges for Latin America and the Caribbean* (Dassen, N. and J. C. Vieyra, editors, IDB, 2012c) and *Transparent Governance in an Age of Abundance* (Vieyra, J. C. and M. Masson, editors, IDB, 2014h) with experiences of transparency and accountability at the subnational level, in the latter case with a focus on the extractive industries; (v) the book *Governing to Deliver: Reinventing the Center of Government in Latin America and the Caribbean* (Alessandro, M., M. Lafuente, and C. Santiso, 2014) includes an analysis of the Center of Government in the State of Pernambuco, Brazil; (vi) various working documents on the Sector, including: a study on the structural characteristics of the municipal sector in the region, studies of fiscal effort in Mexico and Guatemala, and analyses of the determinants of expenditure efficiency and citizen participation; many of these documents have been financed with knowledge product resources (ESW); and (vii) in the context of executing technical cooperation operations and preparing country strategies, the Bank's specialists and contracted experts have prepared diagnostic assessments, surveys of information, and proposals aimed at addressing the Sector's challenges in the region's countries; examples include ATN/FI-12544-BR (2010), which contributed with studies aimed at improving the comprehensive design of Brazil's fiscal federalism; ATN/OC-11987-BR (2009) and ATN/FG-12612-BR (2010), which helped generate management indicators for state public services and a shared governance agenda between Brazil's federal government and the states; ATN/FI-14572-ME (2014), which assists with analysis of the civil service capacities in Mexican states; ATN/KR-14069-RG (2013), which is an initiative to establish a subnational public finance platform;⁷⁵ and the methodology for evaluating subnational fiscal sustainability and quantifying medium-term fiscal frameworks.

- 4.17 **The Sector's dissemination work.** The Bank has also worked intensively to promote the exchange of Sector knowledge between countries and generate learning opportunities in the preparation and execution of its programs through: (i) regional workshops; (ii) field visits; and (iii) the organization of and participation in international seminars. Noteworthy achievements include the organization of two meetings of the Decentralization and Local Development Network promoted by the Bank, with the participation of national and subnational officials linked to fiscal decentralization management in the region's countries; the organization of seven meetings of the managing for development results network in subnational governments, which at last count included 130 officials from 15 countries,

⁷⁵ The technical cooperation operation financed by the Korea Public Capacity Building Fund (KPC), Subnational Fiscal and Local Development Information Platform. This effort aims to supplement the Bank's progress with the MIF Nexso program, particularly with respect to the geographic visualization tool for socioeconomic information, SmartMap.

representing 54 of the region's subnational governments;⁷⁶ the coordination of three cycles of the award for innovation in public administration for subnational governments, *Gobernarte: the Art of Good Government*, with financing from the Institutional Capacity Strengthening Fund (ICSF);⁷⁷ and two international seminars to exchange experiences in fiscal decentralization between Latin America and the Caribbean and Asia, in the Republic of Korea and Mexico. Similarly, in collaboration with the ESCI, training workshops have been held for subnational government officials on topics related to the dimension of fiscal sustainability and governance, which are part of the initiative.

- 4.18 In short, the Bank shows the following comparative advantages in the Sector:
- a. **Corps of quality specialists, with broad coverage on the ground.** This is a key factor that has contributed to making the Bank the preferred multilateral institution in the Sector in most countries in the region, having provided almost all of them with sustained support over time. In the case of Brazil, this advantage was decisive for the implementation of the PROFISCO program, which has implemented investment loans in every state in the country, with the high demand for support that this implies.
 - b. **Diversity of instruments.** Both the availability of technical cooperation resources and the PRODEV and ESCI programs, together with resources for knowledge products, improve the flexibility, timeliness, and relevance of the Bank's response to the countries' demands, helping to identify needs that have been translated into innovative projects.⁷⁸
 - c. **Adaptation to the heterogeneity among and within the countries.** The Bank has succeeded in tailoring its intervention modalities in the Sector to the region's heterogeneity. For example, while Brazil developed a broad program of direct work with the states (PROFISCO and PROCONFIS) and support for municipalities (PNAFM), Colombia recently approved a CCLIP for US\$600 million, whose first loan will be channeled through the central government to Barranquilla. In countries like Suriname, the Bank has been supporting the deconcentration of the national government since 2001, helping to create the conditions for effective decentralization.⁷⁹ In turn, technical assistance to small municipios has been addressed in countries like Peru through their clustering under intermediate governments.
- 4.19 Given the foregoing, the Bank will continue to devote priority to its work on enhancing the Sector's institutional capacities, both at the level of the incentives generated by intergovernmental arrangements and the subnational governments' own management capacity. With respect to the classification of subnational

⁷⁶ This is one of the networks of the Latin American and Caribbean Community of Practice on Managing for Development Results (CoPLAC-MfDR), made up of officials from the region's countries, which receives funding from the Bank.

⁷⁷ Technical cooperation operation Promoting Cooperation Among Subnational Governments in Latin America and the Caribbean (ATN/FI-13790-RG).

⁷⁸ In this regard, the experiences of Colombia and Mexico are noteworthy.

⁷⁹ In Bolivia, the Bank also supported the deconcentration of the Ministry of Transparency and the Fight against Corruption, establishing satellite ministry offices in those departments where there were none (2216/BL-BO).

entities, priority will be given to work with the intermediate level of government and with municipios in intermediate and principal urban areas. In the context of the decentralization and subnational governments sector, this implies relegating to a second tier areas in which the Bank has fewer comparative advantages, such as direct work with small municipios and decentralization policy framework reform.⁸⁰

V. GOAL, PRINCIPLES, DIMENSIONS OF SUCCESS, AND LINES OF ACTION GUIDING THE BANK'S OPERATIONAL AND RESEARCH ACTIVITIES IN THE SECTOR

A. Goal and principles underlying work in the Decentralization and Subnational Governments Sector

- 5.1 The Bank's main goal in the Sector is to foster the development of institutional capacities and the proper incentive structure for more effective and efficient subnational management in Latin America and the Caribbean, to help improve all citizens' quality of life. To achieve this goal, the proposed lines of action and operational activities respond to the diagnostic assessment in Section III, and to the Bank's comparative advantages identified in Section IV. The SFD also presents knowledge and dissemination activities, which are the foundation for the generation of future innovations in the Sector. The design of interventions will include measurable objectives with respect to a baseline, specifying the appropriate methodology for evaluating their expected impact, in accordance with the Development Effectiveness Matrix for Sovereign Guaranteed and Non-sovereign Guaranteed Operations (document GN-2489), while promoting access to information on Sector interventions. Lastly, the Bank will design interventions on the basis of the specific conditions prevailing in each country, in accordance with the principles for work in the Sector. These principles, arising from the analysis of international evidence (Section II) and from the lessons learned (Section IV), include:
- a. **Institutional capacity-building.** Emphasis in the Sector is on institutional capacity-building, both in the structure of intergovernmental relations (including coordination of the decentralization process) and in the management of subnational governments, while recognizing the importance of the specificity of each sector in the delivery of services at the subnational level.
 - b. **Consideration of incentives for stakeholders.** The various motivations and interests of stakeholders in decentralization (subnational governments and their associations, central government, Congress, civil society, etc.), and more generally, the political economy restrictions, must be taken into account in the design and execution of the interventions in order to achieve legitimate, lasting results.
 - c. **Recognition of the interdependence of the Sector's challenges.** The Sector's challenges are interdependent and must be evaluated as a whole in

⁸⁰ In the case of small municipios, the Bank will continue working with them through the central government and/or under territorial clustering arrangements. In reference to the decentralization policy framework, despite its not being a target of reform in Bank operations, it is a key input for understanding the country's political economy.

the context of the interventions' design and execution. For example, changes in intergovernmental transfers systems have implications on the incentives for key stakeholders, impacting the management of subnational governments.

- d. **Adaptation to the heterogeneity of and within the countries.** Different intervention modalities will be adopted based on the countries' degree of decentralization and the various characteristics of the subnational governments.

B. Dimensions of success, lines of action, and activities⁸¹

5.2 **Dimension 1. Intergovernmental arrangements contribute to improving the management of subnational governments.** Sector interventions will seek to correct weaknesses in intergovernmental arrangements by creating incentives for improved management in subnational governments. For this, support will be provided for the proper definition of competencies and functions among the levels of government and the consolidation of institutional spaces for the coordination thereof. An important focus of attention is the high dependence on transfers by subnational governments for their financing. To achieve these objectives, the following lines of action are proposed:

5.3 **Lines of action:** (i) strengthen the institutional framework for coordination of intergovernmental arrangements; and (ii) support improvements in the definition of competencies and functions among the different levels of government along with the transfer systems, promoting principles of equity, efficiency, and sustainability, while taking the political economy of each country into account. To fulfill these two lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:

- a. **Operational activities:** (i) support programs to establish and/or consolidate the lead agencies in decentralization, responsible for the coordination, monitoring, and adjustment of intergovernmental arrangements, including the institutional framework for the monitoring of subnational fiscal sustainability; (ii) promote reforms aimed at improving the definition and coordination of expenditure functions between the different levels of government, including cooperation arrangements in the delivery and regulation of services, for metropolitan areas in coordination with the comprehensive urban planning activities included in the Urban Development and Housing SFD; (iii) support the generation and diversification of own revenue sources for subnational governments, seeking to increase their fiscal autonomy; and (iv) improve intergovernmental transfer systems, seeking to cover the fiscal needs of the subnational governments, based on criteria of efficiency, simplicity, and contribution to balanced territorial development.
- b. **Knowledge and dissemination activities:** (i) generate knowledge about the impact of intergovernmental transfer systems on the efficiency of subnational public expenditure, regional fiscal disparities, and fiscal sustainability, with particular attention devoted to transfers by extractive industries; and (ii) develop the Latin American and Caribbean fiscal decentralization network,

⁸¹ The lines of action and activities to be financed by the Bank will follow the guidelines of this SFD and others applicable to specific interventions.

made up of central and subnational government officials and their organizations, responsible for managing the intergovernmental arrangements in their respective countries.

5.4 **Dimension 2. Subnational governments improve the efficiency and quality of expenditure and service delivery.** Sector interventions will seek to increase subnational governments' capacity to manage spending and deliver services with efficiency and quality, addressing the population's needs and demands, and contributing to territorial development. Considering the broad range of services provided at the subnational level, this dimension is focused on sustainably enhancing institutional capacities for the delivery of these services, via linkages with the different sectors (urban development, education, health, transportation, water and sanitation, citizen security, tourism, etc.) for the applicable specific topic. To achieve these objectives, the following lines of action are proposed:

5.5 **Lines of action:** (i) strengthen the public expenditure management capacity and increase its efficiency, while seeking to improve the quality of the public services provided at the subnational level; (ii) strengthen the core functions of the governments to promote the effectiveness of public policies, facilitate private sector development, and enhance the public and/or private delivery of citizen services; (iii) improve the management of public investment; and (iv) promote strategic public and/or private investments that contribute to territorial development. To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:

- a. **Operational activities:** (i) support improvements in the organization and processes of subnational management, including human resources management at the subnational level, promoting merit, transparency, and incentives to attract and retain qualified personnel in the subnational governments, in the context of strengthening civil service capacity; the technical capacities of officials at the central and subnational government levels, and the sustainability of such improvements; the pillars of MfDR, the strengthening of centers of government and the leveraging of information and communication technologies, with a focus on facilitating private investment and increasing efficiency and quality in the delivery of citizen services; (ii) promote the modernization and integration at the subnational level of PFM systems linked to the budget, treasury, accounting, public procurement, cost management, and asset and property management, etc., in coordination with the activities envisaged at the subnational level in the Strategy for Strengthening and Use of Country Systems (document GN-2538-14); (iii) strengthen the management of the public investment cycle at the subnational level, orienting it to address the population's needs and demands; and (iv) improve the institutional conditions for attracting strategic public-private investments.
- b. **Knowledge and dissemination activities:** (i) generate knowledge about the effectiveness of different interventions to improve expenditure management and service delivery by subnational governments in a sustainable manner; (ii) contribute to the strengthening of the CoPLAC networks including those for public investment and subnational governments; (iii) support competitions in good practices for subnational governance, such as Gobernarte, by

expanding the issues covered by the annual contests; and (iv) generate diagnostics and action plans to improve the service delivery and operational efficiency of subnational public enterprises, their financial sustainability, and their impact on local markets.

5.6 **Dimension 3. Subnational governments improve own revenue collection and access to financing.** Sector interventions will support the capacities of subnational governments to generate their own revenues, while seeking to strengthen the correlation between service delivery and the cost thereof for local taxpayers. They will also support access to financing for subnational governments in a framework of fiscal responsibility, with the goal of increasing their capacity for sustainable, efficient public investment. To achieve these objectives, the following lines of action are proposed:

5.7 **Lines of action:** (i) support improved revenue collection performance by subnational governments, bringing it closer to its potential; and (ii) help subnational governments access financing, in coordination with lead agencies, and in a framework of fiscal responsibility. To fulfill these two lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:

a. **Operational activities:** (i) support improvements in the generation of own revenues by subnational governments through technical assistance, exchanges, system modernization, and strengthening of the institutions that regulate and administer subnational taxation; (ii) promote the fiscal sustainability of subnational governments, their management of debt and contingent liabilities, and their capacity to access financing in a framework of fiscal responsibility; and (iii) support the generation of financing mechanisms for subnational governments, in coordination with the central government and while maintaining fiscal responsibility.

b. **Knowledge and dissemination activities:** (i) generate knowledge about the impact of programs to improve subnational own revenue management. The book on mobilizing subnational revenues (Fretes Cibils and Ter-Minassian, 2015) analyzes the determinants of subnational revenue collection with case studies on countries representing the Bank's various subregions and includes recommendations for improvement tailored to the characteristics of each case. The book will be disseminated through regional seminars; (ii) with respect to subnational financing, strengthen the Bank's capacities in the analysis of subnational fiscal sustainability, to support operations with subnational governments, and include the issue in meetings of networks of subnational governments (CoPLAC) and of public debt managers of the region's countries; and (iii) topics for future research include the evaluation of transfer arrangements with incentives based on improved subnational revenue collection, and innovative practices in subnational government financing, including clustering arrangements for small municipios.

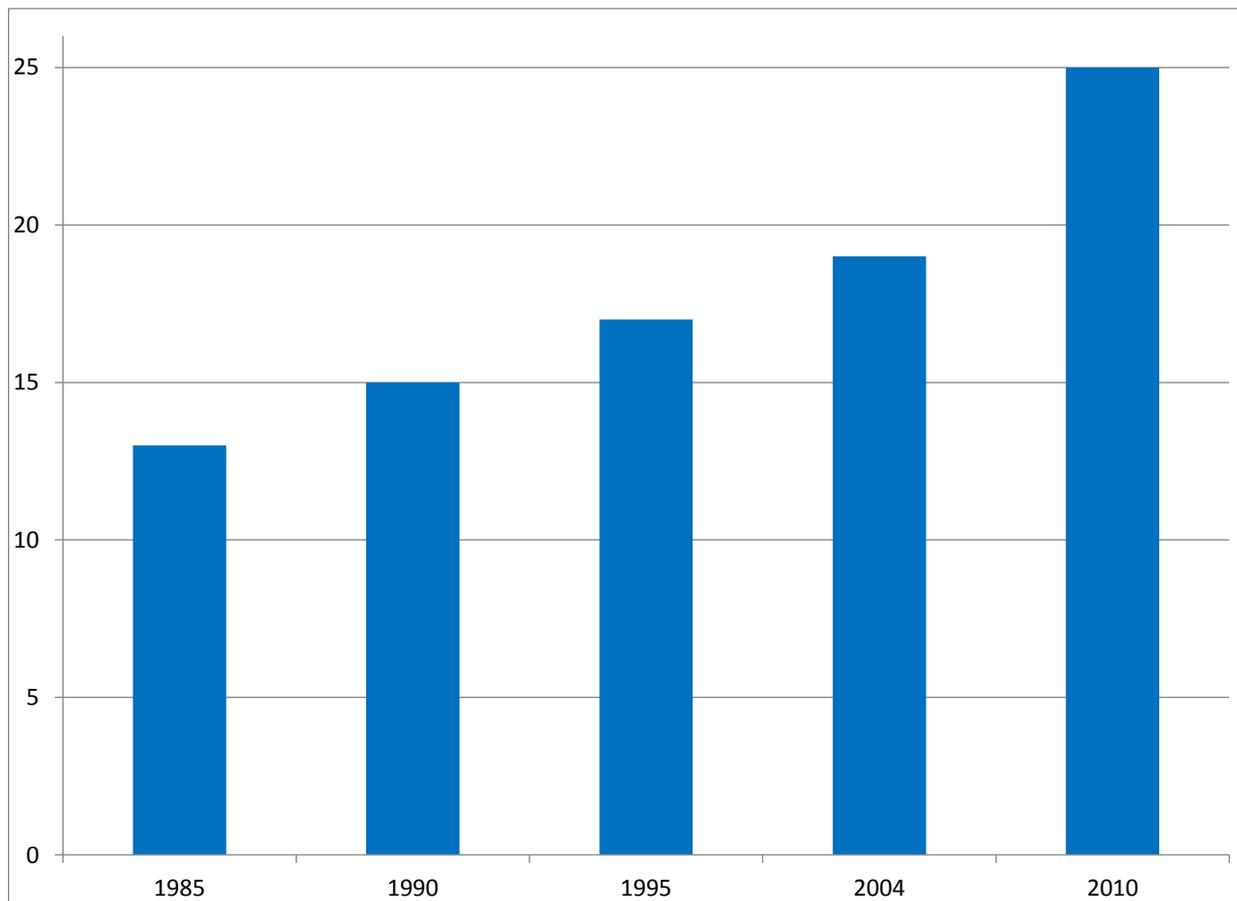
5.8 **Dimension 4. Subnational governments work with greater transparency and accountability.** The interventions will seek to improve the transparency and accountability of subnational governments, as well as the monitoring and control by citizens and other government bodies that finance, regulate, and monitor

subnational management. To achieve these objectives, the following lines of action are proposed:

- 5.9 **Lines of action:** (i) strengthen the transparency and accountability of subnational government management of budgets and service delivery; (ii) enhance the capacity for results-based monitoring and evaluation of subnational management; and (iii) strengthen the subnational government public resources control mechanisms and citizen participation, including issues of gender and diversity. To fulfill these lines of action, it is proposed that financing be provided for the following operational and knowledge and dissemination activities:
- a. **Operational activities:** (i) support transparency and accountability mechanisms and systems, by providing available, quality, understandable information so citizens and lead decentralization agencies can participate and have an impact on improving the management of the subnational budget and public services; this includes institutional capacity assessments for the units executing Bank projects at the decentralized level; (ii) strengthen instruments and institutions responsible for the monitoring and evaluation of subnational management with a results-based approach; and (iii) support improvements in the management of institutions regulating and controlling the proper use of subnational public resources, including legislatures and comptroller's offices.
 - b. **Knowledge and dissemination activities:** (i) generate knowledge about the effectiveness of interventions aimed at increasing subnational transparency and accountability, including the contribution to control systems. The fiscal and governance component of the ESCI will deepen the diagnostic assessment and dissemination of the work on fiscal topics, as well as on transparency and modern, participatory governance. The Bank will also support research on transparency in the management of municipios receiving transfers from extractive industries; and (ii) deepen work on external control with specialized international organizations to promote the agenda of exchange of experiences, innovation, and incorporation of new topics aimed at improving and modernizing the capacities of supreme audit institutions, with respect to their functions of oversight of the use of public resources by subnational governments, including accountability and a results-based approach.
- 5.10 The four dimensions of success that will guide the Sector's operational and analytical activities will enable the Bank to respond to the demands of both public and private sector stakeholders in its 26 borrowing member countries. Under the working principles for the Sector presented in this SFD, the Bank will coordinate the lines of action through the countries strategies, and will orient them toward the specific needs of each country and subnational government to which it provides support. The sum of the policies, programs, and studies presented herein has the primary aim of moving toward a region in which subnational management contributes to improving the quality of life of all citizens.

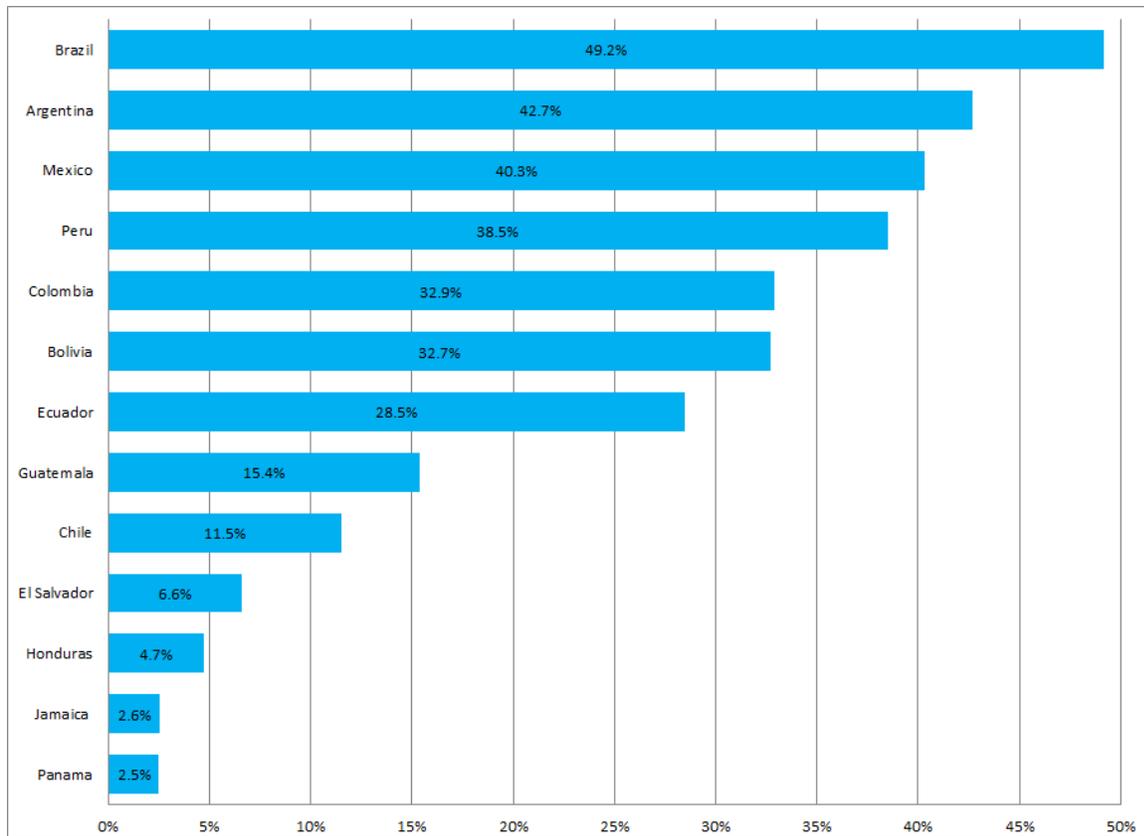
FIGURES AND TABLES

Figure 1. Public expenditure, subnational government as a percentage of total government



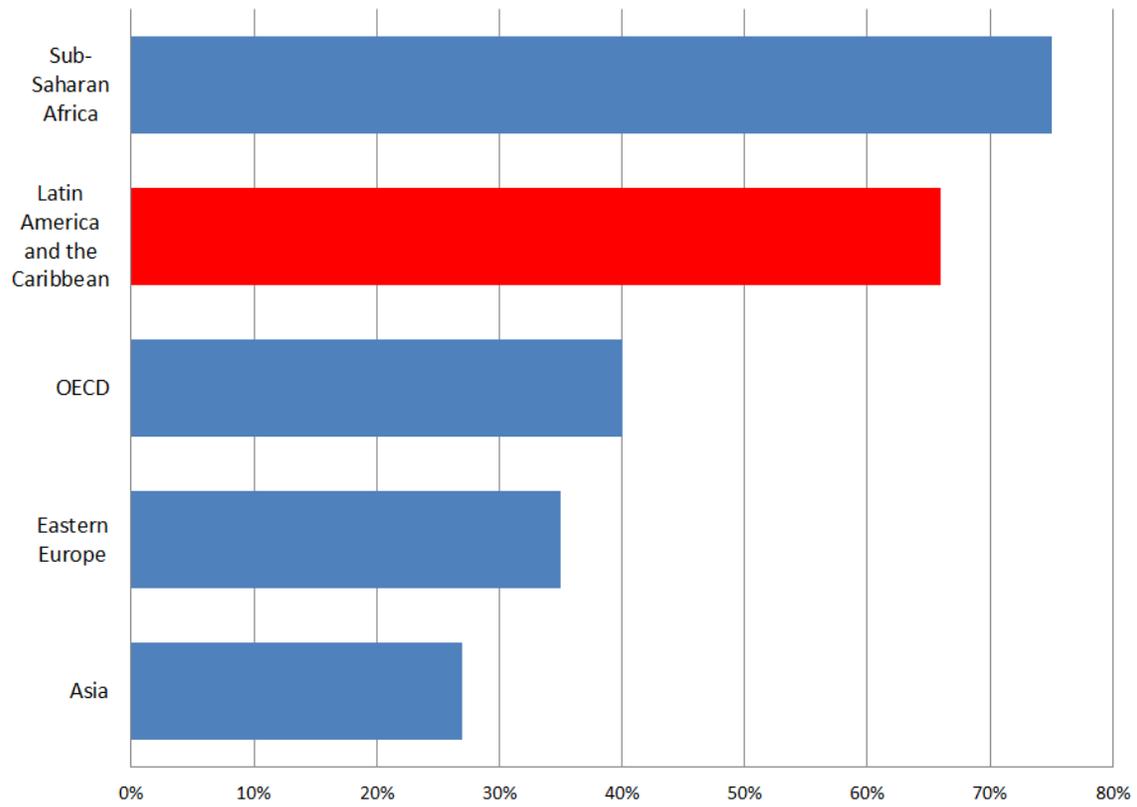
Source: prepared by the authors based on IDB (1997), Daughters and Harper (2007), and the IDB's subnational government fiscal information platform.

Figure 2. Public expenditure: subnational government as a percentage of total government in selected countries in Latin America and the Caribbean (2010)



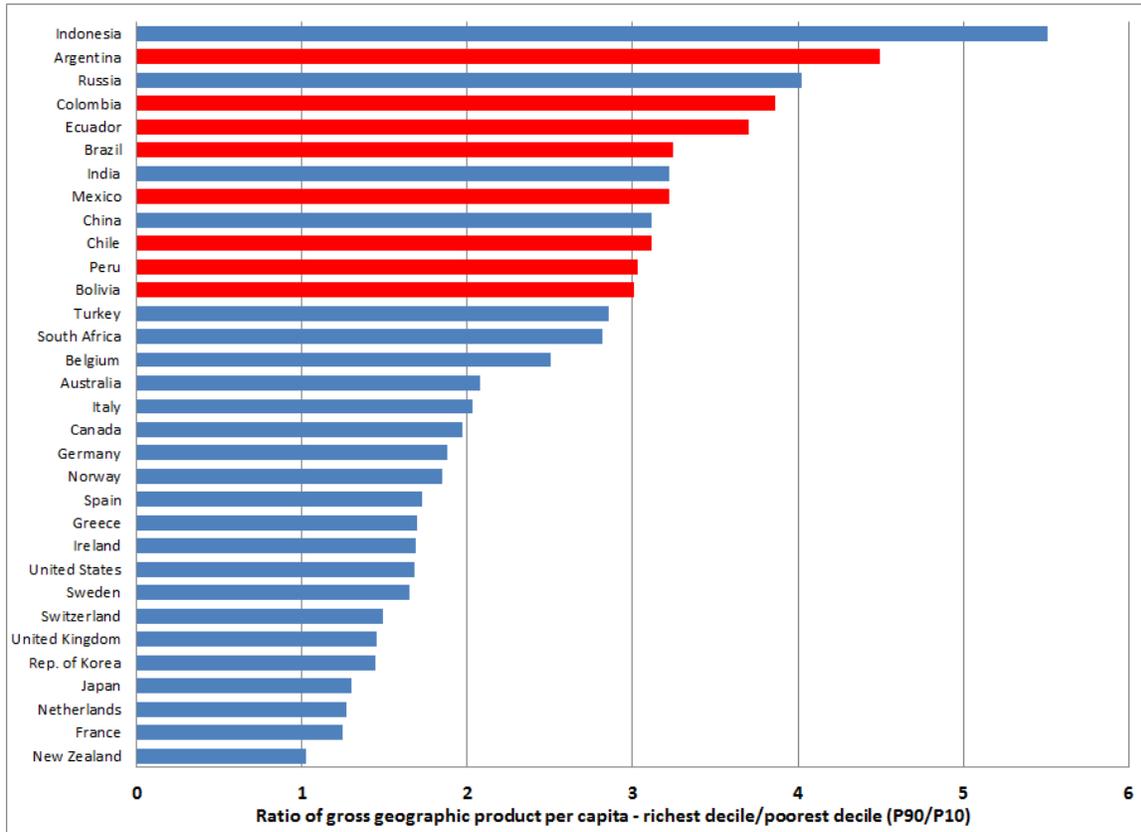
Source: the IDB's subnational government fiscal information platform. For Jamaica, a questionnaire completed by Bank specialists (2011).

Figure 3. Subnational government transfers as a percentage of financing of subnational expenditure in the regions of the world



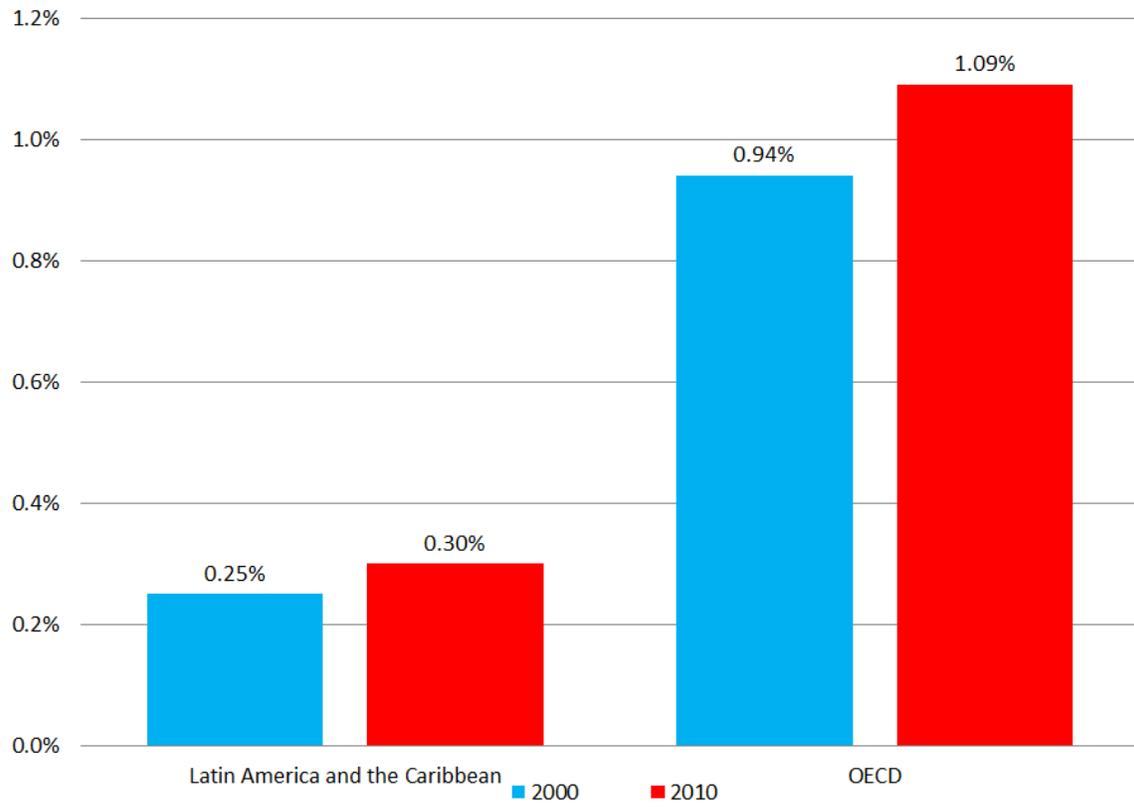
Source: IMF-GFS 2014: <http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=170809>.

Figure 4. Interregional inequality of intermediate governments in selected countries*



* Latin American and Caribbean countries in red.
National sources and OECD (2014).

**Figure 5. Property tax collection, 2000 and 2010, Latin America and the Caribbean vs. OECD
(as a % of GDP)**



Source: Bonet, Muñoz, and Pineda (2014).

Table 1. Number of subnational governments per level of government and by country in Latin America and the Caribbean

	Number of intermediate governments	Number of local governments	Number of subnational governments	Number of local levels
Argentina	24	2,196	2,220	1
Bahamas		32	32	1
Barbados				
Belize		203	203	1
Bolivia	9	339	348	2
Brazil	27	5,565	5,592	1
Chile	15	399	414	2
Colombia	33	1,101	1,134	1
Costa Rica	7	551	558	2
Ecuador*	24	221	245	2
El Salvador	14	262	276	1
Guatemala	22	334	356	1
Guyana	10	146	156	1
Haiti*	10	182	192	3
Honduras	18	304	322	2
Jamaica		14	14	1
Mexico	32	2,473	2,505	2
Nicaragua	17	153	170	1
Panama	12	75	87	1
Paraguay	17	245	262	1
Peru	26	1,838	1,864	2
Dominican Republic	32	387	419	2
Suriname		10	10	1
Trinidad and Tobago		15	15	1
Uruguay	17	264	281	1
Venezuela	23	337	360	1
Total	389	17,646	18,035	
% of Total	2%	98%		

* Local governments do not include rural parishes in Ecuador, or communal sections in Haiti.

Source: prepared by the authors based on country information and a questionnaire completed by Bank specialists in the region.

Table 2. Size and financing of subnational expenditure in Latin American and Caribbean countries, 2000 vs. 2010¹ (as a % of GDP)

Country/ Variable	Expenditure		Own revenue		Vertical imbalance ⁴		Subnational debt ¹	
Argentina ²	15.4	17.1	3.6	5.6	11.8	11.5	21.9	6.8
Bolivia	5.8	9.7	2.5	2.7	3.3	7.0	4.6	1.7
Brazil	19.8	21.5	12.7	13.1	7.1	8.4	18.1	10.5
Chile ³	2.3	2.2	1.6	1.3	0.7	0.9	n/a	n/a
Colombia	9.1	8.7	3.0	3.7	6.1	5.0	3.0	1.4
Ecuador	2.1	5.2	0.8	1.1	1.3	4.1	n/a	2.6
El Salvador	1.3	1.8	1.1	1.5	0.2	0.3	0.8	1.3
Honduras	2.3	2.8	1.3	1.5	0.9	1.3	0.1	1.0
Mexico	7.6	10.6	1.1	2.0	6.5	8.6	1.8	3.0
Nicaragua	3.0	4.0	3.1	3.7	-0.1	0.3	n/a	n/a
Panama	0.8	0.6	0.7	0.4	0.1	0.2	n/a	n/a
Peru	4.2	8.4	1.0	1.0	3.2	7.4	1.3	1.4
Uruguay	3.5	3.0	2.3	2.0	1.2	1.0	n/a	n/a
Simple average	5.9	7.4	2.7	3.0	3.3	4.3	6.4	3.3

¹ Closest available year to 2000 and 2010.

² Does not include municipios.

³ Subnational governments in Chile cannot issue debt.

⁴ Vertical imbalance: difference between expenditure and own revenue.

Source: questionnaire completed by Bank specialists in the region.

Table 3. Countries that make subnational public financial information available for external consultation*

Country / Criterion	Internet availability	Disaggregated information	Subnational government SIAF validation	Harmonization with Government Financial Statistics (IMF)	Rating**
Brazil	X	X	X	-	Strong
Peru	X	X	X	-	Strong
Colombia	X	X	-	-	Basic
Chile	X	X	-	-	Basic
Guatemala	X	-	X	-	Basic
Mexico	X	X	-	-	Basic
Argentina	X	-	-	-	Incipient
Panama	-	X	-	-	Incipient
Uruguay	-	X	-	-	Incipient

* Countries not included, such as El Salvador, Venezuela, Bolivia, and Ecuador, are considered limited access due to limitations in the presentation and availability of detailed data.

** The proposed ratings are: (i) Consolidated: a unified, evaluated, and harmonized information system, open to the public; (ii) Strong: an available, validated system with few restrictions to access, lacking harmonization; (iii) Basic: an available system with different levels of disaggregation, insufficient validation, and lacking harmonization; and (iv) Incipient: information that is dispersed and/or with partially restricted access.

Source: prepared by the authors based on official data – the Bank's subnational fiscal information platform.

**Table 4. Evolution of the Bank's work in the Sector, 1990 - 2014.
Number of projects by country and amounts (in US\$ millions)**

Country	1990-1997		1998-2005		2006-2014		1990-2014	
	Number of projects	Total amount						
Argentina	6	1,578	6	2,992	4	650	16	5,220
Bolivia	1	7	6	146	4	149	11	301
Brazil	1	461	8	651	43	3607	52	4,719
Chile	0	0	1	298	1	50	2	348
Colombia	4	75	2	950	7	918	13	1,943
Costa Rica	0	0	1	65	0	0	1	65
Ecuador	0	0	1	5	2	394	3	398
El Salvador	1	34	1	70	0	0	2	104
Guatemala	0	0	1	20	1	86	2	105
Guyana	1	38	1	20	0	0	2	58
Haiti	0	0	1	65	0	0	1	65
Honduras	0	0	3	88	1	29	4	116
Jamaica	0	0	1	16	0	0	1	16
Mexico	1	340	3	1,100	5	1,850	9	3,290
Nicaragua	0	0	4	113	0	0	4	113
Panama	0	0	1	8	3	105	4	113
Paraguay	1	15	1	9	0	0	2	24
Peru	0	0	5	733	6	395	11	1,128
Dominican Republic	0	0	0	0	1	23	1	23
Suriname	0	0	1	5	1	15	2	20
Trinidad and Tobago	1	23	0	0	0	0	1	23
Uruguay	2	79	2	63	1	85	5	227
Venezuela	1	75	1	200	0	0	2	275
Total	20	2,725	51	7,614	80	8,355	151	18,693

Note: Includes all projects with components and conditions on at least one of the topics identified as challenges for the region.

Source: IDB (2006) and authors' analysis based on the OPS database.

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