

1. Introduction and Summary

The paper provides information and analysis in support of the Bank's subnational development strategy (GN-2026). . *Subnational*. . The strategy will guide future Bank operations in support of decentralization to address the complex issues countries are facing in their efforts to promote the socioeconomic development in subnational territories.

Chapter 1 provides an overview of the decentralization process in Latin America and the Caribbean and sets the stage for an analysis of the key issues that need to be addressed by the Bank when supporting the decentralization process in the region.

Chapter 2 discusses the challenges confronted by subnational governments. The development of subnational governments is key to improving well-being, subnational

The strategy recommends that the Bank assist countries to create the conditions necessary to reach these goals. That is, subnational governments capable of taking over expanded responsibilities in the provision of services and infrastructures and becoming active players in the promotion of economic development in their jurisdictions. This approach requires a change in the way the Bank approaches lending for subnational development moving away from merely financing the expansion of capacity and good financial management and focusing attention on the system of incentives built into the different structures that determine subnational government outcomes:

1. The structure of intergovernmental relations.
2. The system of governance.
3. The institutional capacity of subnational governments and
4. The mechanisms for financing subnational entities.

The goal for Bank involvement in decentralization is to establish subnational governments capable of providing for themselves the institutional and financial resources needed to discharge their responsibilities

The following chapters of the Background Document support the objectives and recommendations related to the four areas identified. Chapter 3 focuses on the structure of intergovernmental relations and concludes that a well-designed structure of intergovernmental relationships provides subnational governments with incentives to efficiently allocate resources to the most socially profitable uses. Consequently, recommends the Bank to assist countries to establish subnational governments with:

1. Clearly defined responsibilities.
2. Sufficient resources to discharge their functions.
3. And facing hard budget constraints that force decision makers to fully assume responsibility for the tradeoffs involved in collecting and allocating a limited pool of resources.

It is further recommended that to foster the efficient allocation of resources at the subnational level, the Bank should stress the need for a close correspondence between those who benefit and those who pay for government programs and services to ensure that the different constituencies are aware of the costs of their choices. The use of transfers, co-participation in centrally collected taxes, and other forms of higher tier financing of subnational governments need to be guided by the objective of putting in place incentives for local decision makers to adopt fiscally sound decisions.

Chapter 4 discusses the governance issues involved in decentralization. It recommends the Bank to stress the importance of well-functioning

mechanisms of citizen representation and oversight so that elected subnational officials can be effectively held accountable and the management of local affairs can be made transparent. Attainment of these governance objectives – essential conditions for democratic oversight – is a necessary condition for good fiscal management and accountability at the subnational governmental level. To this end, the Bank will also contribute to the strengthening of the central government functions related to setting performance standards, performing evaluations and ensuring the transparency of subnational governments' operations.

Chapter 5 concentrates on the institutional aspects of decentralization and concludes that the Bank should emphasize the need for subnational governments to have sufficient institutional capacity and resources to discharge their responsibilities at socially acceptable levels of performance. Whenever necessary, the Bank sponsored programs should include reforms and institutional development components to support the development of the organizational structure, administrative systems and human resource policies of subnational governments of different size. Emphasis should be placed on strengthening the civil service career, thereby providing incentives for continuity and the professional development of subnational civil servants.

Chapter 6 discusses the variety of issues related to financing subnational governments and recommends the Bank to stress the paramount impor-

tance of sufficient sources of financing for ensuring good subnational government performance. Own sources of revenue should constitute the principal source of financing for subnational governments, using fee for services rendered where possible. Otherwise, to the extent possible the services should be financed from taxes borne by local residents. When subnational services are associated with national or regional priorities, high tier government transfers are efficient. Transfers should not substitute for own revenues, and should be in forms that do not distort local expenditure preferences. For borrowing to be an efficient source of financing for subnational governments, regulations and capital markets, combined with a sound structure of inter-governmental relations, should impose on them a hard credit discipline. Therefore, the Bank will stress the need for linking subnational development programs to programs aimed at developing capital markets and their regulatory framework.

When appropriate, the Bank will incorporate the necessary conditionality in subnational development loans and will provide the required technical cooperation and policy advice to foster a hard credit discipline for subnational governments. Finally, chapter 7 discusses the implications of these proposals for Bank operations in support of decentralization including a revision of the potential role that the lending and non-lending products offered by the Bank can play in pursuing the objectives identified in the preceding chapters.

2. The Decentralization of Government, A Sustained Trend in Latin America and the Caribbean

WHAT IS IT HAPPENING? DEMOCRATIZATION AND DECENTRALIZATION

Democratic Decentralization

One of the most remarkable features of the recent history of Latin America and the Caribbean has been the decentralization of political and fiscal decisions. The devolution of responsibilities to subnational entities of government has proceeded at a fast pace in the last decades. The process has run in parallel with the democratization of government, dramatically changing the way local affairs are run in the region.

The number of IDB borrowing member states with democratically elected central governments increased from 13 in the mid-1980s to all 26 in the late 1990s. Democratization also has taken place in subnational governments. Elected officials run municipal governments in 23 countries (up from only 6 two decades ago), in most of them (17) mayors are elected by direct vote while in the rest they are nominated by an elected council (IDB 1997a).

Subnational governments not only are becoming more democratic; they are also playing a larger role in the management of local affairs. In less than 15 years the average share of public expenditures managed by subnational governments rose from 8 percent to almost 15 percent. However, there are significant variations among countries in the degree of decentralization. While Argentina, Brazil and Colombia are highly decentralized (with over 40 percent of total government expenditures managed by subnationals) others are still highly centralized. For instance in Costa Rica, Dominican Republic, and Panama subnational governments manage less than 5 percent of total government expenditures. Others have not decentralized at all. In Barbados and The Bahamas the central govern-

ment remains in charge of all expenditures (see Table 1.1). There is still much room for expanding decentralization considering that in industrialized countries 35 percent of government expenditures are in the hands of local authorities (IDB 1997a). In sum, as stated by Bird (2000) decentralization is not only in the air; it is already on the ground and influencing policy outcomes throughout the continent in a major way.

Motivation

The motivations of the decentralization process in Latin America and the Caribbean are many and do not always fully coincide with the propositions that support decentralization as a mechanism to better allocate and use public resources.

The often-quoted advantages of decentralization include allocative efficiency; that is, the potential for attaining a better match between the set of goods and services offered by the government and the preferences of the population. Decentralization is also reputed to foster greater levels of engagement and ownership by the community on local development programs. In functioning democracies, it should also result in greater accountability and better governance as decisions are adopted closer to the community's scrutiny. The expectation is that the great variation of needs and preferences observable in different parts of the countries will be better served by decentralized systems of decision-making than by centralization (IDB 1998). These advantages, significant for the allocation of resources, are not present in the discharge of the governments' stabilization and redistribution functions that are better executed in a centralized manner. Not surprising, they have remained largely centralized.

The downsides of decentralization are also significant and fuel a strong counter current that has tempered the decentralization drive in many

countries. Opponents point to the fact that autonomy of decision does not by itself guarantee improvements in public services. Service provision may even worsen for certain groups if the local political elite captures the decision-making process or if the distribution of resources does not balance the delivery capacity among subnational jurisdictions. Although these outcomes are mostly the result of faulty intergovernmental relationships that do not allow the full benefits of decentralization to bloom, they provide arguments to the centralization lobby usually nested around finance ministries and those concerned with macroeconomic stability and fiscal discipline.

Specific motivations driving decentralization vary among countries. There are cases where the process is driven by the desire of strapped central governments to transfer the responsibility to pay for local services to lower tiers of government in the hope that local governments may be able to mobilize community resources or raise additional revenue. In other instances, decentralization is driven by the need to diffuse political pressure exercised on the central government by communities calling for greater participation in decision-making. These motivations rarely support efficient decentralization processes and often lead to partial transfers of responsibilities (thus generating overlapping jurisdictions) and the allocation of insufficient resources to subnational governments. There are also governments that genuinely try to improve the provision of certain services through decentralization. However, this motivation still may lead to deficient intergovernmental relationships as central governments find it easier to transfer the responsibilities but not the resources decision-making autonomy required to properly perform them. Decentralization often clashes with dated legislation framing intergovernmental relations, further hampering the process.

Level of Decentralization and Type of Government

The influence of the system of government on decentralization is not conclusive to explain the degree of decentralization attained in a country. In principle, federal systems of government

would grant more autonomy to subnational levels of government than unitary systems, the latter leaning toward the exercise of greater degrees of central control. Actual autonomy though, seems to be determined more by the political circumstances and size of the countries involved than by the system of government.

Argentina, Brazil, Mexico and Venezuela are all federal republics. However, the autonomy enjoyed by subnational governments in each of them is very different. At one end of the scale, the large political and fiscal autonomy of the Argentine provinces is noteworthy. They have their own constitutions and legislative bodies that regulate many aspects of local political and economic life (including the responsibilities and resources assigned to municipalities). They receive block transfers from the central government (*coparticipaciones federales*) that they can allocate with autonomy. At the other end are the Venezuelan states that have but nominal responsibilities and manage a small proportion of public resources. Similarly, decentralization also varies significantly in countries with unitary systems of government. For example, decentralization is much greater in Colombia, a unitary state, than in Mexico, which has a federal government system. A decade-long, sustained political commitment to decentralize responsibilities and resources has made Colombia one of the most decentralized countries in Latin America. In Mexico, however, the central government has retained many of the responsibilities and resources that could have been handled by states and municipalities. Measuring decentralization as the percentage of total public expenditures managed by subnational governments, Argentina, Brazil and Colombia are the most decentralized countries of the Region (40 percent or more), followed by Bolivia, Mexico and Venezuela (between 20 and 30 percent) (see Table 1.1). This is a good mix of federal and unitary states. Differences also exist in the focus of decentralization. There are countries that transferred responsibility and resources to intermediate levels of government, while others have done it directly to the municipal level, often to the detriment of the intermediate level. Argentina and Brazil have emphasized devolution to the intermediate level (provinces and states respec-

Table 1.1. Countries and Level of Decentralization

Focus of Decentralization	Level of Decentralization (Subnational Public Expenditures as a percent of total)		
	More than 20%	Between 10 and 20%	Less than 10%
Intermediate Level (states or provinces)	Argentina (49.3) Brazil (45.6) Mexico (25.4) Venezuela (19.6)	Peru (10.5)	
Local Level (municipalities)	Colombia (39.0) Bolivia (26.7)	Uruguay (14.2) Chile (13.6) Honduras (12.3) Guatemala (10.3)	Ecuador (7.5) Trinidad and Tobago (7.2) Paraguay (6.2) El Salvador (6.0) Nicaragua (5.2) Panama (3.2) Dominican Rep. (2.9) Costa Rica (2.3) Barbados (0.0) Bahamas (0.0)

Source: IDB 1997a

tively) and through them, they transfer resources and responsibilities to municipalities. Peru has strengthened the provincial level of government at the expense of the municipal level, while Bolivia and Colombia have done the opposite, transferring resources and responsibilities mostly to municipalities.

The decentralization processes currently taking place in Latin America and the Caribbean seldom addresses explicitly the underlying system of incentives driving the behavior of the different actors in the process: the central government, the various subnational governments, national and local politicians, government officials, the local community and the private sector. It is increasingly evident that these incentives determine the outcome of decentralization and their reform should play a major role in any decentralization process. Failure to address the system of incentives makes the resulting structure of intergovernmental relationships incapable of fully realizing the potential benefits offered by decentralization. This is a major theme of this document that will be discussed in following sections.

WHAT IS IT BEING AFFECTED? LOCAL GOVERNMENTS AND THE ASSIGNMENT OF RESPONSIBILITY

Assignment of Responsibility

A key aspect of decentralization is the assignment of responsibility among different levels of government. History and the system of government have a significant influence on this. Certain functions have belonged to the subnational level of government since colonial times (for example, the control of markets, abattoirs or cemeteries has always been a municipal responsibility). Other functions have been transferred from the central or intermediate levels of government as a result of decentralization programs. The net result of this process is that, to date, the distribution of responsibility among the different levels of government is only partially optimal. While some functions are allocated according to the subsidiarity principle (i.e., decisions should be made at the lowest possible level of government), many are being shared by different levels of government with a logic that can only be ex-

plained by the history of the decentralization process.

The complexity of the issue prevents its full analysis within the scope of this paper.¹ (It involves a variety of factors, including the distribution of responsibility for allocating resources and choosing a delivery structure, as well as responsibility for the execution and supervision of delivery.) A review of one of these aspects (the distribution of responsibility for 24 functions in 18 countries), indicates that the greater the decentralization the larger the number of functions whose execution is shared among levels of government (see Table 1.2). Not surprisingly, in countries in which the subnational level of government is responsible for less than 10 percent of total public expenditure (Table 1.1), the division of functions is fairly clear: the central government is responsible for providing most services. In these cases, municipalities are mainly concerned with traditional functions such as maintaining roads and regulating markets, abattoirs and cemeteries. In countries with greater decentralization of expenditures (between 10 percent and 20 percent controlled by subnational governments), national and subnational governments share responsibility for a number of functions. These are typically centered on social services, including primary and secondary health care and education, and subsidized housing. The involvement of intermediate levels of government in the provision of services is only significant in the most decentralized countries of the region (Brazil, Argentina, Colombia and Mexico). Most often, they share responsibility with the national and municipal levels.

Allocation of Resources

A lesser degree of devolution of responsibility is apparent in the allocation of resources among the different levels of government. Frequently, central governments retain decision-making powers in the allocation of resources for services

but assign their provision to lower levels of government. In many countries, decentralization refers to a delegation of responsibility for service provision that places subnational governments in the role of agents of the central government for the execution of certain functions. Proper decentralization involves devolution. Devolution implies that the authority to decide what services will be provided is transferred to subnational governments together with responsibility for implementation. A disturbing trend is that, in the more decentralized countries, there are a number of services for which decisions about the allocation of resources are shared among the different levels of government (often all three levels). The ambiguities that this situation produces may be a source of inefficiency in the allocation of resources that negates some of the benefits of decentralization.

Sharing execution responsibilities among the various levels of government may be efficient in certain circumstances and a waste of resources in others. When the overlap in responsibilities results from a legitimate need to support weak subnational governments, as is the case in primary and secondary education, sharing responsibilities for providing the service may be efficient. When the overlap results from an incomplete transfer of responsibility and duplicates efforts, it is wasteful and may lead to an under-supply of services. Programs whose aim is to optimize the decentralization process must assess this aspect carefully. The rationale for assigning responsibilities for making decisions and allocating resources, as well as the structure of delivery, execution and supervision, must be evaluated in each particular case in order to enact the appropriate reforms. What matters is not so much that each expenditure function is clearly assigned to one level of government or another, but rather that all those involved understand clearly who is responsible for carrying out which tasks.

¹ The IPES (IDB 1997a) contains data concerning the distribution of responsibility the amount of resources allocated to the function, decisions on the delivery structure, execution and supervision of its delivery for 20 services in 18 countries.

Table 1.2 Assignment of responsibility for the provision of services selected countries

Level	Activity	Country																																				
		ARG		BRA		COL		BOL		MEX		VEN		URY		CHL		HND		PER		GTM		ECU		TTO		PRY		SLV		PAN		DOM		CRI		
		N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	N	I	L	
National	Utilities/regulation	R			R			R			R			R			R			R			R			R			R			R			R			
	Airports/ports/railways	R																																				
	Police		R			R																																
	Welfare services		R																																			
	Regional highways																																					
	Secondary and tertiary health care																																					
	Primary health care																																					
	Tertiary education																																					
	Secondary education																																					
	Primary education																																					
	Public transportation																																					
	Social housing																																					
	Urban planning																																					
	Public hygiene																																					
	Potable water																																					
	Sewerage																																					
	Waste management																																					
	Drainage																																					
	Markets																																					
	Abattoirs																																					
	Cemeteries																																					
	Street maintenance																																					
	Street lighting																																					
	Traffic control																																					
Local	Parks and recreation																																					
	Exclusive function	N																																				
	Shared function	I																																				
		L																																				

Does not include traditional national functions like foreign affairs, defense, national highways. Functions are ordered from those most local at the bottom to those more national at the top. Countries are ordered according to decreasing level of decentralization from left to right on the basis of the data on Table 1.1. Source: IDB 1997 and Nickson 1995

Legend Sole responsibility of the level of government
 Shared responsibility of more than one level of government
Level of government N = National I = Intermediate, State, Province, Regional L = Local

WHERE IS IT HAPPENING? SUBNATIONAL GOVERNMENT, POPULATION AND URBANIZATION

Decentralization and Size

A recent study identified a strong relationship between size and decentralization. Measuring size in terms of population, territory and GNP, it was found that the greater the size, the greater the decentralization (IDB 1997a). The region's largest countries (Brazil, Argentina, Colombia, Mexico), show greater degrees of decentralization than smaller countries in terms of territory, demographics or economic size. Extreme cases of this relationship are the very small countries of the Caribbean where there is no decentralization at all. For instance, all public expenditures in Barbados and The Bahamas are the responsibility of the central government.

One of the basic characteristics of a subnational government is a clearly defined jurisdiction. Therefore, the apportioning of the territory among these entities becomes a significant factor in the analysis. History, geography and the regional economic development determine how territories have been apportioned for internal governance. Territorial jurisdictions established in colonial times have survived the hazards of independence and different economic and political development cycles and define subnational territories to this day. The boundaries of most Brazilian states and Argentine provinces that were established during the colonial era persist to this day (to some degree because of inertia and parochial interests). Only a handful of countries have undertaken methodical revisions of their territorial subdivision that changed subnational boundaries significantly.

Population size has a definitive impact on a country's political subdivisions regardless of whether the government is federal or unitary. Except for a few odd cases (Peru, which has more municipalities than Colombia even though it has a smaller population, or the Dominican Republic with a larger population but fewer municipalities than Honduras and Paraguay) the

larger the country the larger the number of subnational governments (see Table 1.4).

Types of Subnational Governments

The Latin American subnational government landscape is complex. The more than 100 states and provinces (also known as departments or regions) and 14,000 municipalities that exist in the region comprise a vast and varied set. Some states have very large populations (the state of Bahia has over 30 million inhabitants and the province of Buenos Aires has more inhabitants than most Latin American and Caribbean countries). Others are the economic powerhouses of their countries (the state of São Paulo accounts for over 50 percent of the industrial output of Brazil). There are also small and poor states that command fewer resources than a medium-sized municipality.

The great majority of the municipalities listed in Table 1.4 are small and many are very small. As Graph 1 shows, 90 percent of the municipalities have less than 50,000 inhabitants and more than 30 percent have less than 5,000 inhabitants. Still, the average size of municipalities in Latin America and the Caribbean is relatively large compared with the European countries. Table 1.4 shows that, excluding Jamaica and Uruguay, the average population of municipalities is 36,000 compared with 12,000 in the European Union countries (Dexia 1997). In other words, the average Latin American municipality must provide services to three times as many people than their homologous institution in Europe.

In terms of the size of the population served by municipal governments it is worth distinguishing four groups. The first group comprises the very small municipalities (with less than 10,000 inhabitants). These account for 53 percent of the total number of municipalities but serve only a small portion of the population (8 percent), which is mostly rural and lives scattered throughout the territory in small hamlets. Small size (usually accompanied by a lack of human and financial resources and low population density) poses a significant challenge to the efficient provision of services.

Table 1.4. Number of Subnational Governments, Selected Countries

Country	Population (000s)	Federal		Unitary		Average size Mun.
		States	Municip.	Depart*.	Municip.	
Brazil	174,825	26	5,001			35,000
Mexico	102,410	32	2,397			42,700
Colombia	37,822			23	1,026	36,900
Argentina	36,648	23	1,922			19,000
Peru	25,082			12	1,818	14,300
Venezuela	24,170	22	333			72,600
Chile	15,311			13	341	44,900
Ecuador	12,646			21	205	61,700
Guatemala	12,222			22	330	37,000
Bolivia	8,329			9	311	26,800
Dominican Republic	8,495			28	153	55,500
Honduras	6,485			19	291	22,300
Paraguay	5,613			17	213	26,400
Nicaragua	5,169			15	143	36,100
Costa Rica	3,798			7	81	46,900
Panama	2,856			9	68	42,000
Uruguay	3,274				19	172,300
Jamaica	2,543				14	181,642
Guyana	883				6	147,200
Suriname	447				10	44,700
Subtotal		103	9,653	195	5,029	
Total number of municipalities		14,682				

* Departments otherwise known as provinces or regions

The second group includes municipalities in the 10,000 to 100,000 population range. These make up 42 percent of the municipalities and provide services to 40 percent of the population. The local governments in this group face complex institutional problems. A significant portion of the population of these municipalities is scattered in rural areas (although a portion live in urban areas). Except for particular circumstances (for instance, municipalities that receive royalties from the exploitation of natural resources), their capacity to provide services is hampered by lack of institutional and financial resources.

The third group comprises municipalities with populations between 100,000 and 1.5 million. Although relatively few in number (just over 600 in the sample analyzed, or less than 4.5 percent of total), they are very significant, providing services to 40 percent of the population,

which is mostly urban. Most municipalities with more than 100,000 people are in fact medium-sized cities that play significant roles in their regional economies.

Large metropolitan areas make the fourth group and represent a special case in local government. There are four mega cities (cities with more than 10 million inhabitants) in the region: São Paulo (17.8 million), Mexico City (16.4), Buenos Aires (11.4) and Rio de Janeiro (10.2). Three other metropolitan areas are home to more than 5 million inhabitants, they are: Lima (8.4), Bogota (6.3) and Santiago de Chile (5.4). Nine large cities are in the 3 million population range. The later group includes Belo Horizonte (4.4), Pôrto Alegre (3.8), Recife (3.5), Guadalajara (3.4), Salvador de Bahia (3.2), Caracas (3.1), Fortaleza (3.1), Monterrey (3.1), and Santo Domingo (3.0). In most cases, the built-up area of these

Figure 1.1. Number of Municipalities and Population (in percentages)

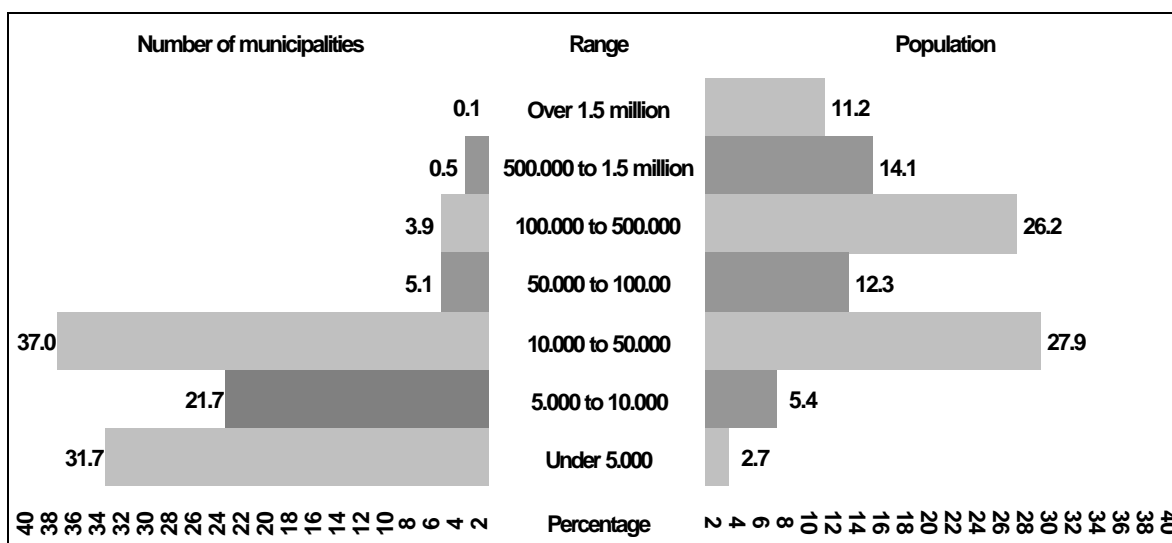


Table 1.5. Number of Subnational Governments, Selected Countries

Country	Population (000s)	Federal		Unitary		Average size Mun.
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Guyana	883				6	147,200
Suriname	447				10	44,700
Sub-total		103	9,653	195	5,029	

cities extends well beyond the administrative boundaries of the core municipalities, encompassing the jurisdiction of several local governments, and their economic and functional influence extends even beyond their territories.

The last group involves the states and provinces of federal countries and makes a varied lot. The just over 100 subnational governments of this type have diverse functions and fiscal and budgetary autonomy. They range from the fairly autonomous Argentinean provinces and Brazilian states to the limited Venezuelan states. Some are larger than many countries; they have sizable resources and generate a large percentage of national output. Others are small, commanding fewer resources than a middle-sized municipality

The differences in size among subnational governments reflect enormous differences in institutional capacity. There are municipalities like São Paulo, Buenos Aires and Mexico City whose institutional capacities are greater than those of many small countries and allow for sophisticated financial management. However, some small municipalities often do not have permanent staff and, least of all, the services of a professional accountant. Their financial capacities also show staggering differences. The per capita revenue of the Government of the City of Buenos Aires is over US\$1,000 per year while many municipalities have to do with less than US\$5 per year in own-source revenue.

URBANIZATION AND THE CONCENTRATION OF POPULATION AND ECONOMIC ACTIVITIES

Over 75 percent of the population of Latin America and the Caribbean live in urban areas, making it one of the most urbanized regions in the world. The great majority of this urban population lives cities with 100,000 residents and over. Therefore, municipalities servicing large and medium-sized cities are a critical component of local government inasmuch as their capacity to provide services affects large populations. This becomes even more important because medium-sized cities are growing faster than any other urban areas in the region.

The Metropolitan Regions pose a particularly complex problem for local governments, which increases with size (see Habitat, 1996). As Table 1.6 shows, this is an issue of growing significance since the number of urban agglomerations with more than 1 million residents grew from 21 in 1975 to 47 in 1999 housing a total population that more than doubled in that period from just under 70 million to more than 150 million. As urban areas expand and begin to extend over several local jurisdictions, authority and responsibilities for the provision of services weaken and overlap.² Often other levels of government complicate matters attempting to solve the problems created by territorial fragmentation. Examples of the problems created by metropolitan growth include the imbalances between the demand for services felt by core municipalities and the resources available to provide them. (These demands often originate from commuters living in outlying communities who do not contribute to the tax base of the core municipality.). The increasing complexity of managing the transportation and environmental problems of these agglomerations is another example. These problems often surpass the capacity of any single municipality, forcing state or central government intervention and the emergence of a plethora of semi-autonomous organizations created to provide services in a unified manner.

Territorial Imbalances

The disparity in the distribution of Latin America's population and the region's urban concentration are rooted in economic trends that favor the concentration of economic activities. Disparities in absolute and per capita output among different regions are significant throughout Latin America. Per capita GDP in Argentina's richer provinces (or the richest states in Mexico or Brazil), for example, can be up to four times higher than in the poorer regions. This serves as

² For example, Authority in the Buenos Aires is split between the city government (which has provincial status) and 19 other municipalities situated in another province. Similarly, 32 independent municipalities have responsibility in Santiago, Chile.

Table 1.6 Urbanization Trends 1950-2000
(Population in thousands)

	1950	1950-1975	1975	1975-2000	2000
Total population	179,050		319,893		523,875
Increase in total population		140,843		203,982	
Urban population	74,484		196,094		401,287
Increase in urban population		121,610		205,193	
Urban population as % of total	41.6%		61.3%		76.6%
Agglomerations of over 1 million					
Population			69,534		153,995
Number			21		47

Source: HABITAT 1996

a population magnet to these areas and their urban centers. Projections of the economically active urban population of Mexico indicate that it will double by 2025 (from 26.8 million in 1995 to 54.3 million in 2005). In contrast, the economically active rural population is only expected to grow by 18% in the same period (from 8.5 million to 10.1 million).

The concentration of economic activity in large metropolitan areas and medium size cities generates agglomeration economies that favor productivity. However, it also creates shortages of infrastructure and environmental damage whose solution requires huge investments. In rural areas, the out migration of the population and the sector concentration of productive activities (which are usually limited to a few extractive or natural resources based activities) make productive diversification difficult and render local economies extremely vulnerable to market fluctuations.

These regional imbalances waste the local potential for economic expansion; create migratory and social tensions among territories, uneven wealth distribution, and the perpetuation of huge disparities among the regions. Further, regional imbalances have strong impacts on subnational governments affecting their resource base and institutional capacity. Subnational governments in rich regions may command more resources to maintain the infrastructure and services required for economic growth and development. In con-

trast, the subnational governments of poor regions may face a vicious cycle where the lack of financial and institutional resources hampers local economic development.

Cultural Diversity

Local cultural differences are another ingredient of the challenges (and often opportunities) of effective decentralization. Ethnicity, history, and geography combine to produce a varied mosaic of cultural differences among communities. Although these differences may pose a challenge to old-fashioned policies that aimed for the unification of the modes and structures of local government, they are a great asset for effective decentralization. Cultural differences are the foundations on which social capital is constructed. They present an opportunity to build diverse local communities whose forms of organization respond to share cultural traits. For instance, taking advantage of cultural traits can increase the effectiveness of the provision of services in communities with a strong tradition of cooperation, or facilitate local democracy in communities with long traditions of community councils. Cultural diversity can also be a destructive force for local cohesion, as is the case where ethnic or cultural clashes remain unresolved. Perfecting local democracy can go a long way in reducing these conflicts and turning cultural diversity into a positive factor for local identity.

WHO IS IN CONTROL? THE MANAGEMENT OF DECENTRALIZATION

The institutional setting within which subnational governments function in most developing countries falls into one of three categories: (i) the overcontrolled local public sector, (ii) the undercontrolled local public sector, and (iii) the perversely regulated local public sector (World Bank, 1995a).

The first of these situations seems most common in developing countries. Central governments sometimes control all the details of local government—who they hire, what they pay, where and when the buses run, etc.—and leave little or no freedom of action for local initiative. In addition, central governments often finance local services directly or earmark the resources they transfer to local governments to such an extent that local finance is as effectively restricted as if they did exercise direct control. These arrangements (microcontrol) generally produce weak and incapable local governments. While less common, the opposite problem (under control) is also apparent in several countries as a result of inappropriate decentralization strategies. Under control resulted in fiscal imbalances (excessive borrowing and inefficient service provision). Finally, all too frequently local governments receive perverse signals from central governments in a number of ways. If, for example, the amount of transfers a government receives depends upon the size of its budget deficit, incentives are clearly perverse. As another example, national funding is often available for infrastructure investment at no cost, but no funds are available for operation and maintenance. This creates a perverse preference for new investment and rewards localities for not maintaining existing facilities (which they would have to do out of their own funds) in order to strengthen their apparent need for new ones (for which the central government will pay).

Even when the incentives facing local government are wrong-headed, local efforts and policies may sometimes make a real difference. In Brazil, for example, some cities are well run and

provide services efficiently, while others, apparently similar in character and resources, are badly run and poorly equipped. In Colombia, some departments provide better health services than others with similar resources. Almost everywhere, some local governments do better than others. The reason may be simply historical circumstance (for one reason or another an area started to do something well some time ago, and it continues to do so) or it may be because of a caring and charismatic local leader or some other chance circumstance. Whatever the cause, such experiences emphasize two important points. First, even in the perverse situation in which many local governments are placed by inappropriate central policies, there is usually some scope for local initiative. Second, such local initiatives may make a real difference in the lives of local residents. Indeed, an important aspect of making decentralization effective and efficient in any country is both to make it easier for such "good examples" to occur by giving subnational governments some room for maneuver, and through facilitating an adequate flow of information, to make it easier to emulate such successes elsewhere.

IDB REACTION: NEW APPROACH TO DOING BUSINESS

Overview of Bank Lending to Subnational Governments

The Bank has been an active supporter of decentralization in Latin America and the Caribbean. Bank loans have traditionally supported investment in most sectors for which subnational governments are responsible. In addition, lending has focused on strengthening subnational governments and supporting national or state municipal development institutions. More recently, through its private sector window, the Bank has expanded the scope of its support to decentralization by providing loans to private companies that have acquired municipal services. In its forty years of operations, the Bank has lent more than US\$17 billion (in 1992 US\$) in more than 240 projects that directly benefit subnational governments. This figure represents 14 percent of the total resources lent by the Bank

during this period and almost 10 percent of all the loans approved.

Bank operations for municipal development, integrated urban development and urban transportation have covered investments in almost all areas of responsibility of subnational governments. These include water supply and sewerage, waste disposal, urban and rural roads, traffic management and public transportation, education and health infrastructure, markets, passenger and cargo terminals, rural and urban electrification, abattoirs, burial grounds, environmental protection and recreational parks. The number of municipal development operations has grown steadily in recent years. Stand-alone operations in the sanitation, infrastructure, environment, education and health sectors also benefited subnational governments, mostly by financing state and provincial investment programs. In terms of number of projects and total loans, the sanitation and infrastructure sectors are important, particularly in Brazil where borrowing by states have been significant.

Phases of Bank Lending

Bank lending in support of subnational development has evolved considerably. Bank operations have adapted their objectives, eligible investments and execution mechanisms in response to the expanded responsibilities and growing autonomy granted to subnational governments. However, the share of Bank municipal lending to finance the expansion of infrastructure and services has remained relatively stable over the years. It still accounts for the largest proportion of project funds. Changes in Bank thinking and investment in support of decentralization parallels shifts in the role of subnational governments in service delivery and socioeconomic development. In the last decade, central governments have decentralized many functions, such as the provision of social services. For subnational governments, these new responsibilities have been added to existing ones since they have not relinquished responsibility for traditional tasks like street lighting, garbage collection and maintenance of open spaces. Consequently, Bank operations expanded the variety of eligible infrastructure and service activities

Table 1.7 Bank Lending for Local Governments 1961-1998
(1992 US\$ million)

Type of Operation	Sector	Amount	No
Urban development operations benefiting local governments	Municipal Development	2,668.5	32
	Integrated Urban Development	1,335.2	14
	Urban Transportation	707.0	6
Sector operations benefiting local governments	Sanitation	8,881.0	160
	Infrastructure	1,952.6	20
	Urban Environment	1,512.1	12
	Education	165.1	2
	Health	155.1	1
Total		17,376.6	247

and adjusted the execution mechanisms to fit the needs of the new subnational responsibilities.

Similar shifts are noticeable in the structure of Bank loans. Early loans were granted to the central government, which acted as borrower, executor and guarantor, even when part or all of the activities may have been executed by public enterprises or agencies of other levels of government. Later, Bank operations allowed for decentralized execution by subnational governments, but the central government continued as borrower and guarantor. Due to legal and constitutional restrictions, there are countries in the region where the central government has been unable or unwilling to guarantee the provision of counterpart funds or subnational government compliance with their contractual performance covenants. In these cases, the Bank has allowed a partial guarantee from the sovereign covering only the repayment of the principal, interest and charges, with the local government assuming other elements of the guarantee.

First Phase: Expanding Capacity. The initial Bank approach to subnational lending focused on expanding the capacity of local governments to provide infrastructures and services to a growing urban population. A key concern of this generation of projects was the efficient allocation of investment resources and the proper operation and maintenance of the infrastructure. Bank loans thus emphasized project preparation and appraisal, devoting the bulk of institutional development resources to improving the execution of project-related activities. Bank conditionally focused on cost recovery to cover operation and maintenance and later, part of the capital investment. The Bank also promoted national intermediary institutions to on-lend resources to subnational governments. With central government guarantees, the Bank supported municipal development banks and state or provincial municipal development funds to on-lend or transfer Bank funds to states or municipalities.

Second Phase: Building Financial Capacity. In response to deepening political and functional decentralization in the region, the Bank provided support to a second generation of municipal de-

velopment programs that promote reforms to the intermediation mechanisms and the structure of intergovernmental relationships in an attempt to improve the fiscal situation of subnational governments. Key objectives for these projects included (i) ensuring reliable sources of revenue for subnational governments to effectively discharge their expanding duties, (ii) sustaining the financial buoyancy of subnational governments, and (iii) strengthening the financial capacity to plan and finance investments and to mount efficient cost recovery mechanisms. Still, the bulk of the resources provided by the Bank were destined to investments to expand capacity. Innovation in financial intermediation was a parallel objective. The Bank supported a variety of institutional arrangements including second-tier financial institutions rediscounting loans by private banks and the refinement of government sponsored municipal funds to prepare them for issuing debt instruments in the local capital markets.

The Future: Restructuring Intergovernmental Relations. In the meantime, the decentralization wave sweeping the region has increased the complexity of the development problem posed by subnational governments. In many countries municipalities are now responsible for providing key services for the low-income population (like health and education), while many others are assuming new regulatory roles for privatized services. Moreover, subnational governments are assuming more active roles in promoting local economic growth and favorable business conditions. . As Table 1.8 shows, the Bank pipeline contains a significant number of projects that benefit state and provincial governments. Based on the recent experiences of loans to the provinces of Buenos Aires and Mendoza in Argentina, these operations focus on the reforms required by these governments to fit in the system of intergovernmental relations. These operations are an addition to traditional municipal development loans, which play a significant role in the pipeline. To assist local government develop, Bank operations will have to give priority to institutional capacity.. This means that the Bank must address topics as varied as reforming the structure of intergovernmental relations, strengthening local fiscal management,

Table 1.8 Bank Pipeline 1999-2001
(in US\$ millions)

Type of Operation	Sector	Amount	No
Operations with subnational governments	Municipal Development	2,059	23
	State and provincial development	1,340	8
Sector operations benefiting local governments	Sanitation	2,737	17
	Infrastructure	1,952.6	20
	Urban Environment	77	2
	Education	150	1
Total		8,315.6	71

and the quality of community involvement in local decision-making. These topics will assume an even more critical role in the Bank effort to assist subnational governments to become efficient and democratic providers of services. Noteworthy is the number of sector operations that directly benefit subnational governments. The strategic approach adopted by the Bank concerning its support to local government has a direct impact on these operations.

The Institutional Component of Bank Projects

A review of the municipal development projects in execution and recently completed (Verdisco 1998) shows that although institutional development concerns are being incorporated into Bank operations, what has been done is still insufficient. Projects executed in the 1980s typically devoted around 2 percent of their resources to institutional development activities and, as noted earlier, they were mostly targeted to the enhancement of the executing agency's capacity to identify, evaluate and execute investment projects. Projects under execution in the 1990s typically devote around 8 percent of their re-

sources to institutional development activities that encompass a wider set of concerns, including fiscal management, budgeting and investment planning in addition to the traditional project oriented institutional support of the past.

Responding to IDB-8 mandates, Bank operations in support of decentralization are now concerned with a wider array of social services and focus on institutional developments to ensure the sustainability of subnational governments in the emerging structure of intergovernmental relations and new responsibilities. In order to respond to and complement on-going changes in the roles of subnational governments, the design and execution mechanisms of Bank operations is more process oriented and flexible than in the past.

However, implementation of the institutional components is frequently far from efficient because the need to strengthen institutions that are simultaneously the target of institutional development and essential for the execution of Bank operations creates certain ambiguities. Only a handful of Bank loans contain institutional conditionality to discriminate among beneficiaries

on the basis of their institutional capacity prior to disbursing Bank investment funds. Institutions are slow to change; reform is not automatic, nor does it occur in a linear fashion. As a result, the scope and reach of the reforms often fall victim to institutional inertia. Despite innovation in delivery mechanisms, service provision may, in practice, still replicate the top-down modes of the *status quo ante* well into the execution of Bank sponsored reforms. Such inertia conflicts with the timetables and disbursement schedules laid out in Bank loans. Delays in implementation, nor surprisingly, thus arise.

Delays in implementation in municipal projects under execution are consistently traced to weakness in institutional capacities. Similarly, projects rated as unsatisfactory in their execution status or as unlikely to achieve their development objectives all appear to have institutional problems. These weaknesses parallel those found in the overall portfolio where almost 90 percent of projects with unsatisfactory performance cite institutional capacities as principal reasons for difficulties in implementation (IDB 1997b).

This problem is only partially solved in Bank operations that rely on “executing units,” (agencies especially created to execute Bank projects), which commonly operate under different rules than the rest of the civil service. These are more of a *Band-Aid* approach to institutional problems than a permanent institutional solution. Institutional strengthening activities required to execute the increasingly complex Bank operations must be address *ex-ante* or in a more comprehensive manner.

Encouraging trends are emerging from recent loans. They give subnational governments a larger role in project implementation than that assigned to them in the past and consequently, provide more attention to their institutional strengthening. Furthermore, they are linking more closely institutional strengthening activities at the local level with the reforms introduced in the fiscal and legal framework of the decentralization process. Most operations approved in the late 1990s complement wider processes of institutional reform launched by the countries.

3. New Responsibilities, New Opportunities

Emerging Challenges to Subnational Institutional Capacity

The transfer of responsibilities to subnational governments is a complex undertaking. It is further complicated by the assignment of new tasks to states and municipalities, in addition to their traditional responsibilities of supplying infrastructure and local services. Some of these new tasks emerge from the need to respond to economic globalization (for example, the promotion of economic development). Others, like the provision of services to the poor, are the result of the reassignment of responsibilities among levels of governments. Yet others emerge from the privatization of the provision of infrastructure and services that force local governments to assume supervisory roles for privatized services. These new responsibilities are taxing the institutional and financial capacities of subnational governments. The proper integration of these new functions into the subnational government structure is perhaps the single most demanding challenge faced by the countries of Latin America and the Caribbean in their decentralization efforts. It requires not only an expansion of capacity to take over the new functions but a profound reshaping of the way subnational governments are financed and managed. This chapter discusses the characteristics of the challenge posed by the new responsibilities as a frame of reference for discussion of the reforms required in intergovernmental relations, governance, institutional capacity and subnational financing.

Local Economic Development

The most important determinant of the well-being of the population is the strength of the local economy and its ability to provide jobs and raise government revenue. International experiences suggest that there are a host of factors under the purview of local governments that play a key role in the development of small and medium enterprises and overall economic development. The proper management of these factors

by subnational governments is becoming a key factor in shaping the competitiveness of the local economies.

The Impact of Globalization

Rapid economic globalization is not only affecting the economy as whole, but is having differential impacts within countries. Local factors, which are strongly affected by territorial constraints, remain imperfect but global markets of goods and services have become highly developed. Global markets of goods and services involve large numbers of suppliers and consumers interacting in increasingly efficient and competitive markets. However, Latin American factor markets (like financial and labor markets) do not exhibit the levels of efficiency that characterize industrialized countries. They are often constrained by the dynamics of the domestic economy, at the national, subnational and local levels, which has a negative impact on the system's overall competitiveness.

This imbalance between global markets and local factor markets has a significant impact on small and medium enterprises. These firms have more problems than large enterprises in reaching productive factors that are mostly supplied in main cities or international markets. Small and medium enterprises in out-of-the-way regions are in a weaker competitive position to access key inputs such as sophisticated financial products or highly qualified labor than larger enterprises that thanks to their scale and resources can reach metropolitan and international markets.

Given present trends, traditional economic growth factors (natural resources endowment, capital, technology, and labor) explain only part of the growth of any given economy. The rest depends on the local factors that determine the competitiveness of the local enterprises. Territo-

rially determined factors like the social capital embedded in local networks of entrepreneurs, the quality of the labor force, and the quality of local infrastructure, affect the costs of production and play a significant role in determining the success and vigor of the local economy.

Local Competitiveness and Growth

Local economic development efforts are geared to attracting new investments in a broad business base (small, medium and large enterprises) capable of generating stable growth in local employment and income. These include investment to expand capacity in local industries or to develop new local industries and attract new investment. To this end, three basic factors need to be considered:

- ? *The use of endogenous capabilities and assets for development.* They depend on the territory's development capacity (location, resource endowment) and the population's entrepreneurial and managerial skills. Their mobilization requires identifying and taking advantage of business opportunities in emerging and external markets for local products and improvements in the quality of the labor force.
- ? *The generation of external economies within the local territory.* The public and private provision of business services that generate or enhance the type of economies of agglomeration that are typical in industrial concentrations but are usually lacking in less industrialized areas.
- ? *The reduction of business transaction costs.* The cost of doing business differs among territories depending on factors such as: local governance, red tape, the rule of law, institutional efficiency, the articulation of civil society institutions, and the level of trust among economic actors. The social capital of a community and its level of productive integration in local clusters also affect the competitiveness and ease with which firms can reach global market

The Role of Subnational Governments

Several of these factors fall under the purview of subnational governments, making this level of government a significant player in promoting local economic development. This means that subnational governments should enact economic development policies, a task that opens up an opportunity to establish productive partnerships with the private sector. Small and medium size enterprises (SMEs) are a natural focus for economic development policies. As the largest source of formal employment in urban areas, they are significant actors in employment generation strategies. Furthermore, they are also important in rural areas, representing the most effective way of promoting local economic diversification.

Local factors influencing local economic development include both tangible (all kinds of infrastructures) and intangibles (efficient local labor markets, financial and nonfinancial services, support for technological innovations, entrepreneurial culture). Some of these factors are sensitive to subnational government policies, while others are more sensitive to the activities of the private sector. This makes private-public partnerships an effective mechanism to promote local economic development. The most dynamic subnational governments in the region are already working in partnership with private sector organizations. Through an equitable distribution of responsibilities (social gains and costs between the public and private partners) they actively promote competitive local factor markets. Success stories are more obvious in the more decentralized countries, reflecting the benefits of decentralizing policies such as labor training, dissemination of technology, business development services, and small and medium size enterprise development. The advantage of subnational governments rests on their greater capacity to identify the needs of local enterprises. However, the transfer of these responsibilities to subnational governments requires a corresponding increase of their technical and managerial capacities and stable sources of financing that allow long-term planning and sustained interventions.

Local Economic Development Strategies

Subnational governments can promote new investments by creating a favorable environment for putting unused or underutilized local resources into full production, or by improving local competitiveness for new direct investment. Subnational governments have long been aware of the importance of good quality local infrastructure to attract and retain economic activities. Reliable and cheap supplies of energy, water and communication services are central to the productivity of firms, as is a good and uncongested road system. Consequently, governments have long endeavored to ensure the provision of good infrastructure in their territories and, more recently, of good residential services. Subnational policies and regulations also determine a wide variety of factors influencing the efficiency of firms. These factors range from labor training to the regulation of natural resources including the operation of real state markets.

New factors, also within the purview of subnational governments, are gaining in importance as determinants of local economic growth. These include fostering the availability of services in the local economy and the cooperation of individual enterprises for acquiring economies of scale in the provision of certain goods and services. Local governments can encourage the diversification of local service providers by facilitating the creation of new enterprises, fostering the entrepreneurial culture and supporting coordination among enterprises in areas such as the promotion of local goods in international markets. Local development agencies can also have an impact on local economic development by promoting increased flexibility in local labor markets. Training labor on the basis of the needs of local producers has long been an area of local concern and action. More recently, local institutions are experimenting with labor pools (*bolsas de trabajo*) to match skilled workers to available jobs. Another effective public/private partnership is that of allowing the local private sector to participate in the provision of public services.

Local/Regional Development Agencies

The institutional setting is critical for the development of effective public-private partnerships to promote local economic development. Subnational governments, the business community and civil society organizations (particularly universities, chambers of commerce and entrepreneurial organizations) come together in this setting to discuss economic development goals, prepare strategic plans, and design and implement programs and projects. The more decentralized the structure of the political and institutional system, the easier it is to create discussion and negotiation forums between subnational governments and local civil society.

An effective approach to establishing a suitable institutional setting is the creation of local/regional development agencies. The international experience, including some cases in Latin America, indicates that there is no unique model for a regional/local development agency. Differences reflect different responsibilities and intervention approaches. Some operate as think tanks, specializing in the research and analysis of the local economy's growth potential. Others work as forums for the discussion of the long-term role of the local economy. Yet other agencies focus on designing strategic development plans that establish an outline for achieving local economic and human development goals in their area of influence. Still others are more concerned with operational planning and the design and implementation of development programs in specific fields such as infrastructure, tourism, technology, the creation of SME clusters, financing innovative projects, international marketing of local products and enterprises, attracting foreign investors and the like.

Financing for these jointly owned (public/private) agencies depends on the kind of activity that they perform and their beneficiaries. Partial public financing would make sense if the agency's activities generate direct returns (paid for by the beneficiaries), increase the subnational government's tax revenues or have measurable beneficial impact on the local economy. For example, a unit that specializes in reducing red tape (single window or one-stop-shop), can

cover its expenses by charging processing fees (although it will also generate indirect benefits to the local government through the simplification of bureaucratic procedures). In any event, success cases indicate that the regional/local development agencies should be managed under private sector criteria and follow demand driven programs.

The source of public funding for local economic development should be consistent with sound fiscal discipline. Investment promotion must not require tax exemptions or other types of fiscal concessions (a traditional resort of local politicians). The objective is not subsidized economic development but the growth of dynamic, competitive and self-sustaining enterprises. New enterprises must be tax contributors, not consumers of local resources. It is important to support the efforts of small businesses in this endeavor. Their entry into the formal economy, as well as their growth and consolidation are the basis of their contribution to the creation of new jobs and wealth. As they grow and prosper, these small businesses can become taxpayers assisting local government to continue with the process. Local governments need to be cautious of not imposing an excessive tax burden on micro, small and medium enterprises to avoid driving them underground.

The diversity of institutional models and responsibilities of local/regional agencies is also a function of the areas in which they operate, their political and administrative structure and the priorities established by stakeholders. The term "local" can refer to various geographic areas. It can be used to represent a regional area (state, province or department) or a municipal jurisdiction. Further, differences exist at the municipal (urban) level between large metropolitan cities, middle-size cities and their immediate area of influence; and small rural cities. Each one of these jurisdictions plays a different and variable role in national economic development.

Subnational Involvement in Local Economic Development

The states and provinces of large decentralized countries such as Argentina and Brazil already

have a considerable tradition of promoting economic development through long established ministries of development, industry, economy or promotion. This is a more recent development in Mexico, where the states of Jalisco, Chihuahua and Baja California are involved in promoting local development. Local governments in other countries, such as Venezuela, Chile or Colombia are less involved in promoting local development.

The availability of a good communication infrastructure, attractive living conditions (access to cultural activities, entertainment and educational institutions), and the variety and quality of the specialized services available from the local diversified economy attracts the command and control activities of the large enterprises to large metropolitan areas (Sassen 1998). Two prime examples are São Paulo and Buenos Aires, whose combined GDP exceeds that of four Andean countries (World Bank 1999). These cities attract all types of enterprises and are engines of economic growth for the nation as a whole. Yet, appropriate management of local factors like congestion, pollution, and the quality of housing are essential to maintaining their economic dynamism. The size and complexity of these problems is a mayor challenge that only recently has started to be addressed.

The impact of local factors in boosting economic development is evident in the increasing economic importance of medium size cities. Their population is growing at a faster rate than any other component of the urban structure in most Latin American and Caribbean countries. Moreover, their economies are playing a growing role in national economic development. To a great extent, this reflects the fact that these cities offer most of the advantages of larger cities (good infrastructure, diversified services, and a well-trained labor force) without the problems normally associated with metropolitan areas (congestion, poor environmental quality, high cost of land).

Local factors not only affect the development of medium size cities but also that of all types of settlements. For example, rural growth and productivity are influenced by local factors that fall

under the control of local governments. These include the availability of feeder roads as well as the efficient management of water resources and local environmental impacts. Rural areas are excellent niche markets where SMEs can start-up and grow thanks to the availability of idle local resources. In exchange, SMEs benefit local economies through their impact on economic diversification and vigor.

PROVISION OF SERVICES TO THE POOR

The Rationale for Subnational Participation

Differing community preferences and resources lead to spatially differentiated patterns of consumption of public goods and services. Subnational governments can increase the general well being by better adjusting the use of public resources to local preferences and capacities. They are in a better position to understand the varying needs and preferences of the local population and thus have advantages in the provision of goods and services that generate spatially defined benefits whose delivery can be tailored to the preferences of different communities. Accordingly, traditional local functions have always included responsibility for items such as local infrastructure (including parks, community centers and sports facilities), transportation and land use planning, and the delivery of public services like garbage collection, street cleaning, public lighting.

By taking advantage of their capacity to tailor services to community needs and preferences, subnational governments are also in a good position to take responsibility for public services whose centralized national provision presents intrinsic diseconomies of scale, lack of flexibility and administrative inefficiency. This is the case of social services, such as social assistance, which are very specific and must be targeted. The same is often also true of those whose provision involves the management of a multiplicity of small units, like education and health. (Marcel 1993). Note must be made of the fact that decentralization of services delivery does not necessarily mean that the subnational level of government is the most efficient provider. There are

cases where efficient delivery calls for the transfer of resources and decision-making powers to even more decentralized structures like school boards or individual hospitals.

Areas of Subnational Government Action

Social Service Provision. Second generation reforms affecting health and education are taking advantage of the potential benefits of decentralization and enhancing the role of subnational governments and other local organizations in the allocation of resources and the provision of services. A similar trend is apparent in the execution of emergency programs such as social investment funds.

Access to Land. In the absence of sustainable mechanisms to allow low-income households access to housing through the formal sector, progressive housing construction is the strategy of choice for these households. The viability of this strategy rests on the access to suitable land. More often than not, subdivision and land use regulations hamper access to land by the poor, requiring infrastructure standards and lot sizes that put the land out of their reach. Management of land development is a traditional activity of local governments that has significant impacts on the housing status of the poor. Subnational governments can facilitate access to land by low-income families by amending regulations governing the subdivision of land.

Settlement Upgrading. Traditionally, subnational governments provide urban infrastructures that are critical for the health and well being of the population. These include water supply, sewerage or wastewater control and treatment, drainage and garbage collection. Making these services available to the poor is one of the most powerful tools to improve the living conditions of disadvantaged members

of the community. Municipalities (often with central government encouragement and help) have embarked in settlement upgrading programs that provide services that weak public utilities have been unable to provide. These programs target substandard settlements that originated from land invasions or illegal subdivisions

and provide, in addition to sanitation, secure land tenure and community infrastructure.

Transportation Services. The management of urban public transportation also offers local governments an opportunity to assist the poor. By regulation or incentives, local governments can direct transportation services to low-income neighborhoods, thus improving the poor's access to jobs and urban services.

Challenges of Service Provision

Health and education services provide for the basic needs of the population and supply an essential service to the economy, a healthy and educated labor force. The latter offers the best hope the poor have to escape poverty. However, the provision of these services is plagued with difficulties and has yielded less than satisfactory results given the resources expended. The most critical difficulties facing delivery systems are monitoring performance, ensuring equity and addressing distortions in the allocation of resources (IDB 1996a).

Most problems can be traced to the government's inability to run centralized and standardized delivery systems in an efficient way. In most countries, centralized and hierarchical structures give operational decision-making power to officials that are distant from service providers and who lack the necessary information and direct contact with beneficiaries to improve delivery. Standardization prevents providers from adjusting services to local circumstances and needs. Most services systems are trapped in a vicious circle in which low pay is used as an excuse for absenteeism and low efficiency while poor performance is used as an excuse to limit discretion and autonomy for providers. These systems are considered to be unresponsive to changes in demand, incapable of achieving an efficient input mix, slow to innovate and ineffective at motivating improved performance. This leads to weak performance and the discrediting of the system.

Experience indicates that services can be better supplied locally by fostering competition. Most countries could be better served through central

funding of services to address externalities and inequities. By the same token, multiple services providers can lead to reduced costs, improved quality and a better response to changing needs and innovations. Service providers can include subnational entities or autonomous enterprises in addition to the private for-profit and nonprofit organizations. The critical feature is giving clients the option to choose among providers and make the public resources follow them to their chosen providers.

The way in which social services are financed affects the structure of incentives. It is important to ensure that financing for services responds closely to the demand for services. For example, schools can be funded on the basis of the number of students attending, and health services financing can be made a function of the number of people kept healthy rather than the number of employees. In other words, public delivery systems should be budgeted on the basis of output, not inputs. Capitation grants, discussed in Chapter 3, are one mechanism that can serve this purpose well. In systems undergoing this transition, attention must be given to complementary actions to assure that outcomes are properly measured and rewarded.

Subnational Impact

Decentralization of the delivery of social services to subnational entities will not improve the provision of services, in and of itself. Such improvements require the assignment of responsibilities to different levels of government and providers in ways that creates incentives for making efficient decisions. Proposals must also be justified on the basis of economies of scale and scope, efficiency gains from coordination and the breaking of delivery units among relatively homogeneous client groups. In other words, in order to improve services, some functions must be decentralized while others are centralized.

The education sector provides a good example. The central government may, for example, appropriately set national standards for graduates and teachers, and may also establish the basic curriculum. It can promote research on

pedagogical techniques and learning; reward innovations in teacher training and disseminate findings and teaching tools. In turn, regional governments may develop their own policy goals (for instance, with respect to school facilities) and deploy appropriate regulatory instruments in an attempt to achieve them. Local governments or independent school boards may be responsible for actually paying teachers and maintaining facilities. And, of course, local schools deliver educational services which as, experience suggests, produce better outcomes if they have a substantial degree of budgetary autonomy and managerial authority to respond to teachers, parents, the local community and information regarding performance and cost.

As governments face institutional difficulties in the delivery of services, nongovernmental organizations (NGOs) and, to a lesser extent community based organizations (CBOs), have stepped in to provide services to low-income households. These initiatives have encompassed a large variety of mostly isolated projects that profess to rely on popular participation. Although sometimes successful in alleviating poverty at the community level, these initiatives are not immune to the institutional limitations in which local governments operate. For instances, they rarely are able to undertake long-term planning and development activities to effectively benefit the target population, nor are they capable of generating programs of sufficient scale to tackle the problem effectively. NGOs and CBOs can play a significant role in strategies to alleviate and eliminate poverty provided that their activities are framed in an integrated long-term plan whose formulation and financing is best carried out by the subnational government.

Regulating Privately Provided Infrastructures and Services

Local governments are important providers of services to firms and households. These services are intrinsic in their management of key economic infrastructures and services that are essential to ensure the quality of life and protect the environment. They include, for example, water and sanitation, wastewater and solid waste

management and the regulation of protected areas. To increase efficiency and promote cost recovery, local governments are increasingly transferring responsibility for the provision of a wide variety of services to private providers under many different modalities. Examples range from the small town council giving private entrepreneurs the concession to manage the local market, to the large metropolitan municipality privatizing the municipal water and sewerage company. The privatization drive also encompasses outsourcing the provision of services, like the operation of the land cadastre. Although widely different in the amount of resources involved, once completed, the types of transactions described face local governments with a similar problem, that of regulating service provision.

The Challenge of Decentralization

The development of an adequate regulatory framework for the private provision of services is a new area of concern where subnational governments need to develop capacity. To fully tap the potential of privatization, subnational governments need to develop privatization strategies. These strategies will indicate the most efficient privatization schemes under the local circumstances. Further, local governments need to develop institutional capacity to outsource services, sell or lease assets, award concessions and supervise contracts or build infrastructures under innovative financial and operational arrangements. The efficient provision of the services that cannot be privatized also requires institutional developments to ensure the appropriate separation of functions and finances between services and to run efficient cost recovery schemes. Local governments must also be equipped to solve equity issues arising from the privatization of services by means of clearly defined and well-funded social programs that do not jeopardize the financial foundations of service provision.

The complexity of the problem varies significantly among different types of local governments. What in a small rural community entails establishing and operating a cooperative to run the potable water service, in a large metropolitan

area may involve a complex international transaction to award a concession for the delivery of water and sewerage services. The complexity of the problem is also large when the city turns to the private sector to expand service capacity through innovative finance schemes like build, operate and transfer (BOT). States and provinces face similar complex problems, for instance when dealing with the concession of the regional road network.

There is ample opportunity for local governments to engage civil society organizations (OCS). Private nonprofit corporations, cooperatives and professional associations are already playing a role in providing health, education and social services with private and public funding. They can be contractors to local governments in providing these services, a role that can be particularly significant in small rural municipalities where for-profit providers may find it difficult to operate. Taking advantage of this opportunity means that local governments must develop the capacity to contract and supervise the services of this varied group of social actors. Furthermore, local governments must develop a strict payment discipline since these organizations rarely have the financial capacity to deal with delays (a common means by which local governments obtain credit from suppliers).

Traditional Responsibilities, Renewed Challenges

Traditionally, subnational governments, particularly municipalities, have taken responsibility for the provision of important community services. This includes, for instance, environmental functions such as land use regulation, building codes and drainage works. Municipalities often take responsibility for a variety of functions that range from fire and hazardous materials safety and control, to safeguarding public health, ensuring the safety of public events and regulating commerce and the professions. Local jurisdictions are also responsible for the administration of justice in areas such as neighborhood relations and maintaining archives and registries (property, marriage, birth, and death). Although great variation exists among different types of municipalities, some of these

activities are still performed according to their original intent and objectives (such as, for example, responsibility for operating traffic courts and adjudicating neighbor disputes). Other activities are a form of control and regulation on behalf of the common good that is rarely exercised, but for which municipalities still collect revenue. These include the issuance of licenses to carry out commercial activities or practice professions.. Others are carried out in a perfunctory manner, like the maintenance of archives and records and the control of land use and building regulations.

Most large and medium sized municipalities should have sufficient institutional capacity to properly discharge these functions. In these cases, shortcomings in service provision relate more to organizational and operational deficiencies than to structural problems. Institutional strengthening programs should be able to take care of these problems provided that sufficient priority is given to them. Unfortunately, most of the attention of institutional development usually goes to financial and budgetary management to the detriment of these activities. However, their importance can be easily understood. A few examples illustrate the point.

The regulation of commerce to safeguard public health involves the licensing and supervision of establishments selling food and drugs, and requires periodic site visits by specialized personnel. With the exception of the better organized municipalities, most municipalities find this a difficult task and their failure to properly carry out their duties can give rise to potential threats to the community. Lacking the knowledge and information to protect themselves, consumers are unable to mitigate their exposure to these risks. The same is true of land use regulations and building codes supervision. Compliance with land use regulations is important to avoid construction on dangerous sites such as flood plains or landslide prone areas). Building codes ensure the structural safety of buildings (a critical issue in earthquake and hurricane prone areas) and their installations (electricity and natural gas). As with public health, this involves the licensing and inspection of buildings by specialized personnel, a task that is beyond the fi-

nancial and administrative capacity of many municipalities. Consumers do not have the knowledge and access to the required information to protect themselves. The cost of not performing these duties (or doing so inadequately) is the heavy casualties sustained when natural disasters occur. These casualties are, to a great extent, avoidable.

The hidden costs of not performing functions that are less conspicuous but nonetheless important are obvious in the case of municipal archives. Municipalities inherited the functions of the *cabildos* or *ayuntamientos*, which were the backbone of local administration in colonial times. These local authorities had responsibility for civil and criminal justice as well as the administration of their jurisdictions. They maintained these functions after independence and most still perform them. Documents from colonial and republican administrations are valuable records of the history and culture of the communities. However, they are poorly stored and kept in municipal (or provincial) archives and are being lost at alarming rates. Some of these archives, like those of Santa Marta (Colombia), Lima (Peru), La Paz (Bolivia), Buenos Aires (Argentina) are invaluable and need to be preserved (Colon de Carvajal, 1998). The loss of these documents may have no obvious significance for the day-to-day concerns of local administration, but it does affect the preservation of the community's historic and cultural heritage. On a more practical vein, municipal archives often provide essential information for updating land cadastres or settling commercial disputes.

WHAT IS REQUIRED? CHALLENGES FACING DECENTRALIZATION

The decentralization process in Latin America and the Caribbean will not result in more effective government unless deficiencies in the legislation and practices that govern intergovernmental relationships are addressed and resolved. The solution to these challenges depends greatly on the particular circumstances of each local jurisdiction, from small and scattered populations to the region's mega cities. This section

outlines these challenges and provides a framework for organizing the discussion that follows.

It appears useful, therefore, to separate subnational governments according to size and institutional capacity because each group faces unique challenges and requires different solutions. In addition, states and provinces under federal systems of government often face unique fiscal and governance problems that are necessarily reflected in the problems faced by the municipalities under their jurisdiction. The grouping of subnational governments in functional associations often creates economies of scale for service provision or to access capital markets. In other cases, associations are needed to cope with problems that cut across the administrative boundaries, for instance, the association of municipalities within a metropolitan area.

Intergovernmental Relationships

Most legal frameworks that define the responsibilities and resources of local governments fail to properly match the devolution of responsibility with the allocation of resources and to provide appropriate incentives to foster efficient and fiscally responsible responses from local governments. The mismatch takes the form of poorly defined responsibilities, improperly designed fiscal policies or lack of clarity in intergovernmental transfer systems. The regulatory environment in which local governments discharge their responsibilities requires development to allow higher levels of government to efficiently regulate local borrowing, resource allocation and the provision of services.

Governance

There are more than 15,000 local governments in Latin America and the Caribbean. Although reforms are necessary to improve institutional capacity in all local governments, implementation mechanisms may vary significantly depending on the circumstances. The rules governing democracy in subnational government affect the accountability of elected officials and their inclination to respond to the demands of their constituencies. Community involvement in decision-making is another central factor deter-

mining the capacity of oversight that can be exercised by the constituencies and their capacity to get their views taken into consideration in day-to-day decision-making. Governments have a critical role in establishing legal and institutional mechanisms to ensure transparency in local government administration, an essential condition for democratic oversight and capital markets involvement in local financing.

Lending to Subnational Governments

There are compelling reasons for subnational governments borrowing to finance investments in infrastructure and in other areas of capacity building. The IDB's principal contribution to decentralization is lending to subnational governments.

However, borrowing creates opportunities for wasteful and inefficient resource allocation if not carefully regulated. Unfortunately, most of the time intergovernmental relations do not provide sufficient oversight and create opportunities for subnational governments to shift financial responsibility to other government entities. There are still few sources of capital for subnational governments and their capacity to acquire debt varies widely. Tapping the full potential of this source of financing requires significant improvements in subnational financial and institutional capacity and the development of long-term debt instruments in the local capital markets.