

## 4. Setting the Incentives Right for Intergovernmental Relationships

Decentralization can mean a number of things depending on the perspective adopted. It can be understood as the process of dividing functional responsibilities and resources among different levels of government (fiscal approach), as the apportioning of decision-making power among different constituencies (political approach), or as an efficient way of providing services (organizational approach). In fact, decentralization comprises all of the above, making it difficult to conceptualize it in operational terms. According to Burki et al. (1999), a useful way of understanding decentralization is as "...a management reorganization of the public sector, in which the rules of hierarchical bureaucracy are replaced by a much more limited set of constraints on the behavior of subnational political actors." This notion focuses attention on the changes in rules that are required to promote a movement from a centralized to a decentralized system of allocating resources and deciding on its use to provide services to the population. That is to say, moving away from a system where policy is set at the top and executed by decreasing levels of a hierarchy ruled by administrative procedures and executed by agents motivated by the desire of internal advancement within the hierarchy. The movement is toward a system where local decisionmakers are motivated by their relationship with the constituencies whose opinion determines whether or not they hold on to power.

From this perspective, two sets of rules are of importance: (a) the rules defining the assignment of responsibilities and resources among the different tiers of governments, and (b) those that regulate elections, the exercise of power by elected representatives and public involvement in making decisions. This chapter discusses the former, while the next chapter will discuss the latter.

Five questions must be answered when discussing intergovernmental relationships among different tiers of government:

1. Who does what? The question of expenditure assignment.
2. Who levies which taxes? The question of revenue assignment.
3. How is the (virtually inevitable) resulting imbalance between the revenues and expenditures of subnational governments resolved? The question of vertical imbalance.
4. To what extent should fiscal institutions attempt to adjust for the differences in needs and capacities between different governmental units at the same level of government? The question of horizontal imbalance, or equalization.
5. Can subnational governments borrow, and under what conditions? The question of subnational borrowing autonomy.

Ideally, these questions should be approached in the specific circumstances of each country, taking into account both the political constraints (such as the strength of different regions and groups in political decisions) and economic constraints (such as the development of financial markets) facing policymakers.

The resolution of these issues hinges on the design of the system of intergovernmental relationships for which, in turn, certain general rules can be established. The actual solution should provide the actors with the incentives to make full use of local financing capacity, attain the greatest possible level of efficiency in providing services and achieve a balanced set of local and national objectives.

## WHO DOES WHAT? THE ASSIGNMENT OF EXPENDITURES

How government functions should be divided among levels of government is a complicated matter, to which each country has its own unique solution. The main point that needs to be stressed is that, from an economic perspective, the most important question about expenditures is not *who* does what but rather *what* is done and *how* well it is done. The details of expenditure assignment are less important than the clarity of that assignment, how it is determined and implemented, and how expenditures are managed at all levels of government.

The basic rule of efficient expenditure assignment is often taken to be to assign each function to the lowest level of government consistent with its efficient performance (the subsidiarity principle). As long as there are local variations in tastes and costs, the argument goes, there are efficiency gains from carrying out public sector activities in as decentralized a fashion as possible. From this perspective, services should only be provided centrally if: i) there are no differences in demands for the service in different localities; ii) there are substantial "spillovers" between jurisdictions that cannot be handled in some other way; or iii) the additional costs of local administration are sufficiently high to outweigh its advantages.

Under this approach, apart from the important issue of distribution, almost all public services (other than national defense, foreign policy, and surprisingly few others) should, in principle, be delivered at the local level. Thus, what services are provided, to whom, and in what quantity and quality is decided at the local level and local taxpayers foot the bill. The problem with this approach to expenditure assignment is that there are no guarantees that the services assigned to any particular level of government will be matched by adequate revenue instruments assigned to that same level. To the contrary, a fundamental imbalance in the vertical assignment of expenditures and revenues (and hence an apparent need for intergovernmental fiscal transfers to close the budgetary gap) exists in virtually every country.

The essential economic role of local government is to provide to local residents those public services for which they are willing to pay. Local governments are (or at least should be) accountable to local residents to the extent that those residents finance local government activities. Such accountability is the public sector equivalent of the bottom line in the private sector. Three conditions need to be satisfied to achieve accountability in subnational finance:

1. Subnational governments should, whenever possible, charge for the services they provide.
2. Where charging is impracticable, subnational governments should finance services from taxes borne by local residents (except to the extent that the services are associated with national priorities and the central government is willing to pay for them).
3. Where the central government does pay via transfers, subnational governments should be accountable to the central government at least to some extent.

To apply these rules, an essential first step is to establish clearly the lines of responsibility and accountability. But *clarity* of assignment, in terms of specifying exactly what services each governmental agency is responsible for delivering, is only part of the story. Clarity must be matched by *accountability* (in terms of political democracy and transparency of operation) as well as by *authority* (in terms of the ability to manage expenditures and to determine revenues, within limits).

It is important to understand that clarity as to whom is responsible for what does not preclude the involvement of several public sector actors in the provision of any particular service. In many spheres of public sector activity (for example in education), a broad range of territorially differentiated jurisdictions may have critical roles to play. Much of the relevant policy and regulatory framework regarding education, as well as much of the financing, may come from higher levels of government, while the actual service delivery may take place below the

level of the local government. Three or more levels of government may thus all appropriately play important roles in delivering educational services. In these circumstances, it may not be very meaningful to consider education to be "assigned" to the local level. What matters is not so much that each expenditure function is clearly assigned to one level of government or another, but that it is clear to all who exactly is responsible for doing precisely what.

The joint provision of public services by several layers of government calls attention to the problem of coordination. Although lack of coordination may be a problem (as it often implies wasted resources and inefficient service provision), it should be recalled that the coordinated, centralized solution sometimes does not deliver the goods. Or at least, it does not deliver the right goods in the right quantities to the right people. "Letting 1000 flowers bloom" in the form of relatively uncoordinated decentralized public sector suppliers striving to meet clearly specified and publicly accountable mandates may provide a more promising laboratory for the development of new and better public sector services than any conceivable centralized alternative (Oates, 1998). The answer, thus, is not abandoning decentralization, but rather designing intergovernmental fiscal relations in such a way that real coordination problems are minimized. Another part of the answer is, of course, to continue working at the difficult task of establishing better coordinating institutions. Significant progress toward resolving coordination problems can be made by establishing hard budget constraints for all relevant decisionmakers (which is not trivial), and making the operation of the system as transparent as possible.

## **WHO LEVIES WHICH TAXES? THE ASSIGNMENT OF REVENUE**

### **Principles of Local Financing**

The "correct" revenue assignment in a multi-level government structure is by no means clear in principle. There are two fundamental problems. First, the central government can inherently collect most taxes more efficiently

than subnational governments. Second, the potential tax bases that can be reached by the latter vary widely from jurisdiction to jurisdiction. The first of these problems gives rise to vertical imbalance; the second produces horizontal imbalance. While vertical imbalance could potentially be solved by allowing variable surcharges on central taxes (a solution that, with few exceptions, has not been taken advantage of in Latin America), the second problem—horizontal imbalance—would be accentuated by more decentralized revenues. This problem increases the importance of good transfer design, at least in countries in which such disparities are of policy concern.

The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. The only "good" local taxes are said to be those that are easy to administer locally, are imposed solely (or mainly) on local residents, and do not raise problems of "harmonization" or "competition" between subnational governments or between subnational and national governments.<sup>3</sup> The only major revenue sources usually seen as passing these stringent tests are property taxes and taxes on vehicles, but not much else other than user fees. Since this conclusion fits in well with the reluctance of most central governments to provide subnational governments access to more lucrative sales or income taxes, it is not surprising that it has become conventional wisdom. Subnational governments almost everywhere are thus urged to make more use of these revenue sources, and criticized when they do not exploit them adequately.

Although there is much to be said for a better use of these revenue sources, heavy reliance on property taxes at the local level may lead to some problems. First, property taxes are in fact costly and difficult to administer well, and these problems are greatly exacerbated as the tax burden increases. In addition, the high visibility of this tax, which makes it appealing, as it fosters

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<sup>3</sup> The classic tax assignment arguments are set out in Musgrave (1983). Recent restatements may be found in Oates (1998) and McLure (1999a). For a review of this literature, see Bird (1999a).

accountability, also creates political resistance to increases, limiting its revenue potential. Due to these political constraints, property tax increases often end up affecting primarily those nonresidential properties that most lend themselves to tax exporting. This undercuts one of the principal arguments for local use of this tax base.

Second, and perhaps more important, even a well-administered local property tax cannot finance major social expenditures (education, health, social assistance) except perhaps in the richest communities. As far as it is desirable for governments to finance from their own revenues the services they provide, local governments financed by property taxes are either confined to providing local services (street cleaning, refuse removal, etc.), or are heavily dependent on transfers from higher levels of government.

Third, the problem of the insufficiency of conventional subnational revenue sources becomes more severe in the case of larger countries with important intermediate levels of government, which generally play a major role in financing social expenditures. Even if *local* governments can finance local services through property taxes and user fees on residents, *regional* governments as a rule cannot. Given the move toward decentralization in Latin America, and the fact that subnational governments are becoming increasingly responsible for social services, the appropriate revenue structure for subnational governments should be reexamined.

The characteristics of an ideal subnational tax may include the following:

1. The tax base should be relatively immobile, to allow local authorities some leeway in varying rates without losing most of their tax base.
2. The tax yield should be adequate to meet local needs and sufficiently buoyant over time (that is, it should expand at least as fast as expenditures).
3. The tax yield should be relatively stable and predictable over time.
4. It should not be possible to export much, if any, of the tax burden to nonresidents.

5. The tax base should be visible, to ensure accountability.

In addition, taxpayers should perceive that the tax is reasonably fair. Finally, it should be relatively easy to administer efficiently and effectively.<sup>4</sup>

International experience suggests that subnational governments carrying out important expenditure functions are more likely to do so responsibly the more they are responsible for raising the revenues they spend. While there will always remain an important role for intergovernmental transfers, especially in countries with wide regional economic disparities, there seems to be no reason, in principle, why wealthier regions (including metropolitan areas) should not be able to raise and spend most of their budgets themselves.

It is very important that subnational governments have some significant degree of freedom to alter the level and composition of their revenues. Without this freedom, local autonomy and local accountability are not meaningful concepts. In particular, subnational governments should be able to set tax *rates* (albeit perhaps within limits). However, this condition is seldom satisfied in developing countries. In Latin America in particular, such rate flexibility is essential if local governments are to be adequately responsive to local needs and decisions, while remaining politically accountable to their citizens (see IDB, 1997a).

A potential danger in permitting local governments even limited freedom to tax is that they will not utilize fully all the revenue sources open to them, thus allowing the level and quality of public services to deteriorate. If intergovernmental fiscal structures are properly designed, this should not be a real problem. If the service in question is one of national importance or one

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<sup>4</sup> Obviously, not every level of government will agree that all these objectives are equally desirable. For example, while central governments should be concerned about limiting the scope for tax exporting, and fostering visibility of the tax to ensure accountability, such attributes are unlikely to be appealing for local governments.

in which there is a strong national interest in maintaining standards, it should presumably be funded (and the extent to which it is achieved, monitored) by the central government. If it is not a matter of national interest, why should the central government be concerned? Of course, this argument assumes that the central government has both adequate information and a pre-determined transfer system, as discussed below.

If local electors do not like what their local government does, or does not do, they can try to change the elected officials at the next election. The freedom to make mistakes, and to bear the consequences of one's mistakes, is an important component of local autonomy in any country. Indeed, unless local governments are given some degree of freedom with respect to local revenues, including the freedom to make mistakes (for which they are accountable to their citizens), the development of responsible and responsive local government is likely to remain an unattainable mirage. Of course, if the conditions of effective democracy and adequate information are not satisfied, or if those who fail to collect local taxes or to spend revenues efficiently are bailed out by discretionary transfers, the elected officials may not be changed but rather be re-elected for their success in obtaining a larger share of other people's money. Countries that, for whatever reason, fail to set up an appropriate intergovernmental fiscal structure are likely to have more problems in managing decentralization and less satisfactory policy outcomes.

A more potent danger may be that local governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. Although limited local taxation of business may be warranted on "benefit" grounds, it may be desirable to limit local government access to taxes that, in many instances, fall mainly on nonresidents. This includes most natural resource levies, pre-retail stage sales taxes and, to some extent, nonresidential real property taxes. One way to deal with this problem may be to establish a uniform set of tax bases for local governments (perhaps different for different categories such as big cities, small

towns and rural areas), with a limited amount of rate flexibility permitted to provide room for local effort while restraining unproductive competition and unwarranted exploitation.

In sum, the approach taken here to subnational taxation is based on three simple principles. First, more attention should be paid to matching expenditure and revenue needs at different levels of government. Second, more effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. Third, subnational taxes should not unduly distort the allocation of resources.

Attention can be now turned to two distinct and important problems in subnational taxation. The first is how to finance regional governments, a problem of significance in larger and especially federal countries, but by no means confined to those countries. The second problem, found everywhere, is how to finance "local services" more narrowly understood.

### **Financing Regional Governments**

The most immediately important subnational revenue issue facing larger countries in Latin America is probably to develop a satisfactory revenue base for regional governments, that is, one for which those governments are politically responsible. While in most countries more can be done in the form of regional excise taxes (especially on vehicles and fuels), if regional governments have significant expenditure responsibilities, there are really only two financing possibilities: through a surcharge on the Personal Income Tax (PIT) or a surcharge on the Value Added Tax (VAT). If a country wants its local governments to be both large spenders and less dependent on grants, experience suggests that it must provide them with access to national tax bases. Piggybacking through surcharges seems to be the only viable way to do this while retaining an important element of political accountability (Bird, 1999).

The possibility of local income tax surcharges now seems to be broadly accepted. Unfortu-

nately, as Shome (1999) has recently emphasized, few Latin American countries have sufficiently robust central income taxes to offer much hope that subnational governments will soon be able to derive much revenue from this source. A potentially more promising alternative for subnational revenues may thus turn out to be a surcharge on the VAT. Such a tax already exists and works well in Canada. Its implementation now seems feasible even in countries with less well-developed tax administrations. At least in the larger Latin American countries with federal features, such as Brazil, Argentina, or Mexico, this path seems to be open and it should be explored further.

Turning to local taxes, apart from user charges there seem to be only two major possibilities, a revised, and revived property tax and an improved form of local business taxation.

*User Charges.* Since many services provided by local government clearly benefit identifiable persons (or businesses, or properties) the failure to levy user charges where they are applicable not only results in government spending that is higher than it should be, but also in a mix of government spending that does not reflect the real needs of society as determined by citizens, rather than bureaucrats. At least three types of local user charges, broadly defined, exist almost everywhere: service fees, public prices, and specific benefit charges.

*Service fees* include such items as license fees (marriage, business, dog, vehicle) and various small charges levied by local governments for performing specific services (registering this or providing a copy of that) for identifiable individuals (or businesses). In effect, such fees constitute cost reimbursement from the private to the public sector. Charging people for something they are required by law to do may not always be sensible (for example, if the benefit of, say, registration is general and the cost is specific) but on the whole there is seldom much harm, or much revenue, in recovering the cost of providing the service in question.

In contrast, *public prices* refer to the revenues received by local governments from the sale of

private goods and services such as water (other than the cost-reimbursement just described). All sales of locally provided services to identifiable private agents (from public utility charges to admission charges to recreation facilities) fall under this general heading. In principle, such prices should be set at the competitive private level, with no tax or subsidy element included unless doing so is the most efficient way of achieving public policy goals (and even then it is best if the tax-subsidy element is accounted for separately).

A third category of charge revenue may be called *specific benefit taxes*. Such revenues are distinct from service fees and public prices because they do not arise from the provision or sale of a specific good or service to an identifiable private agent. Unlike prices that are voluntarily paid, taxes represent compulsory contributions to local revenues. Nonetheless, specific benefit taxes are (at least in theory) related in some way to benefits received by the taxpayer (in contrast to such general benefit taxes as fuel taxes levied on road users as a class or local general business or property taxes viewed as a price paid for local collective goods). Examples abound in local finance: special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary property taxes related to the provision of sewers or street lighting, development exactions and charges, delineation levies, and so on. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property (its area, its frontage, its location).

Unfortunately, it is not easy to “get the prices right” and charge correctly. Most of the fees and charges that now exist in most countries are clearly defective. Water rates, for example, are frequently applied as fixed charges independent of the volume of water consumed. Consequently, the marginal cost of consumption is zero, leading to over-consumption of water and over-investment in water capacity. Even when water consumption is metered but declining block rates are used, prices are less than marginal cost for large water consumers, thus favoring those with large lawns and backyard swimming pools. The fact that sewer charges are usually prorated on the amount

of the water bill only compounds this pricing error (see Bird, 1999b; Bird and Miller, 1989; Bird and Tsiopoulos, 1997).

Distance from the source of supply, for example, should matter in setting an appropriate user fee, as should the time of year when there are seasonal peaks in demand. The uniform pricing approach almost never makes economic sense (although it may sometimes be warranted when administration and enforcement costs are taken into account). Generally, user fees should correspond to the marginal costs of providing service to each consumer. A connection (or admission) fee should be charged to cover capital or fixed costs. Such a two-part pricing policy is a more efficient pricing instrument than a user fee set at the level of average total cost. On the whole, municipal governments should be encouraged to adopt an appropriate fee for services approach to program delivery wherever possible. Many municipal waste management facilities and parking lots, for example, are seriously underpriced in most countries.

Quite apart from the failure to set the “right” prices, the main failure in most countries is that prices are far too low, and indeed often zero. One reason less use is made of such charges than seems warranted in most countries is that they are often thought to produce adverse distributional effects. User charges are perceived to hurt low-income people when a service that was previously provided free of charge to everyone now costs everyone who uses it the same amount. Nonetheless, those concerned about helping the poor are generally mistaken in opposing pricing: providing the wrong public services inefficiently is no way to improve income distribution. Moreover, it is often far from clear who benefits from a “zero-price” policy. Upper-income households frequently benefit disproportionately from the consumption of free, or low-cost, public services.<sup>5</sup>

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<sup>5</sup> Flat-rate water charges, for example, favor households with large lawns, swimming pools, and multiple vehicles to wash and not the poor (Bird and Miller, 1989).

Although distributional concerns may often be exaggerated, they are nonetheless real and must be explicitly considered in developing a user charge policy. Moreover, it is by no means always easy in reality either to be precise as to when, and to what extent, charges are appropriate on efficiency grounds. Or, if they are appropriate, it is not easy to establish how such prices should be set. Subnational governments should impose user charges whenever feasible. But no one should think that to do so is either technically or politically a trivial problem.

*The Property Tax.* Almost without exception, much can and should be done to strengthen the deficient property taxes now in place in most Latin American countries. The tax should be simplified and applied uniformly. Cadastral maps should be updated and valuations made more consistent and current. Improved use should be made of flows of information from property registries, local building license authorities, public utilities, etc. In addition, from a revenue perspective, more attention should generally be paid to improving collection and enforcement rather than to the technically more costly (and less immediately productive in terms of revenue) mapping and surveying.

While the property tax is a useful and necessary source of local revenue, it is important to stress that, in most countries, it cannot easily provide sufficient resources to finance a significant expansion of local public services. In the most advanced countries, local property taxes can seldom yield enough to finance local services. In developing countries, despite substantial efforts and considerable foreign assistance, property taxes seldom account for more than 20 percent of local current revenues (Bird and Slack, 1991). The problems stem from the high visibility of the tax, which makes it politically unattractive, and from difficulties associated with tax administration, especially in countries with endemic inflation.

Regarding the visibility problem, the property tax generally has to be paid directly by taxpayers in periodic lump sum payments. This makes taxpayers more aware of the size of their tax bill, which adds to the accountability and responsi-

bility of governments, but it also greatly increases the sensitivity of taxpayers to even nominal increases in taxes. In addition, since the base of this tax does not, as a rule, increase automatically over time, the need to maintain real revenues when price levels rise requires increased tax rates. These periodic rate increases exacerbate the resistance of taxpayers to the property tax, making it politically unattractive.

Other problems result from property tax administration. As a rule, property is supposed to be assessed on the basis of its market value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Even in countries with well-developed property tax systems, discrepancies arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons (Bird and Slack, 1993). Since taxpayers can easily compare their property taxes with those of similar properties in their neighborhood, such discrepancies lead both to specific assessment appeals and to general pressure for tax relief.

The temptation to indulge in politically painless but economically inefficient "tax exporting" suggests that some constraints should be placed on local taxation of nonresidential property. As discussed below, some local business taxes may be justified on benefit (efficiency) grounds, but in principle they should always be strictly constrained in order to preclude localities from attempting to shift the costs of services to outsiders.

Other policy reforms are also needed to turn the property tax into a responsive instrument of local fiscal policy. First and most importantly local governments must be allowed to set their own tax rates. Few countries currently give local governments much freedom in this respect. Secondly, the tax base must be maintained adequately. In countries with much inflation, some form of index adjustment may be advisable. Sometimes, national assessing agencies must be provided direct financial incentives to keep the tax base up to date. Finally, procedural reforms are often needed to improve collection effi-

ciency, valuation accuracy, and the coverage of the potential tax base. None of these steps is easy, but countries that want to have local governments that are both responsive and responsible must follow this hard road. There are no short cuts to successful local property taxation.

*Local Business Taxes.* Another critical problem in many countries is to replace all or some of the various subnational taxes on business with less distortionary taxation. While the ability to distort markets through taxes must be restrained (for example, by establishing a uniform national base for local business taxation, with a minimum and maximum rate<sup>6</sup>) there is an economic (benefit) case for some regional and local taxation of business. Indeed, in many countries, given the political resistance to residential property taxes, local business taxes have sometimes been the only way in which local governments have been able to expand revenues in response to perceived local needs.

Unfortunately, most forms of local and regional business taxes in developing countries (corporate income taxes, trade taxes, business taxes, differentially heavy nonresidential property taxes, and even so-called 'retail' sales taxes) may introduce serious economic distortions in a variety of ways. One way to reduce such problems is through a so-called "Business Value Tax" (BVT) in essence, a relatively low rate flat tax levied on an income-type value-added base. In contrast to the regional VAT surcharge, the BVT is aimed primarily at improving the allocative efficiency of subnational revenue systems. This line of action may offer a potentially promising alternative to the proliferation of increasing, and increasingly distorting, subnational business taxes.

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<sup>6</sup> A minimum rate is needed to prevent distorting "tax competition" (with richer jurisdictions -- those with larger tax bases -- lowering rates to attract still more tax base). A maximum rate is needed to prevent equally distorting "tax exporting" (as when jurisdictions in which breweries or gas distribution pipelines are located impose especially heavy taxes on such facilities in the expectation that the taxes will ultimately be paid by persons not resident in the jurisdiction).

## CLOSING THE GAP: DEALING WITH VERTICAL AND HORIZONTAL IMBALANCES

Regardless of the revenue sources made available to local governments, transfers from central to local governments will undoubtedly remain an important feature of the public finances of many countries. Transfers are necessary if services must be provided by local governments that do not have the fiscal capacity to finance them at levels considered adequate. They are also needed if there are externalities associated with the services in question, or if it is important to address differences in needs among regions. Thus, a well-designed system of intergovernmental transfers is an essential component of any decentralization strategy, which together with a properly designed subnational tax base provide incentives for "fiscal responsibility" at the local level. Unless made accountable, public sector decisionmakers are unlikely to make effective and efficient resource allocation decisions.

The previous section stressed the fact that subnational governments carrying out important expenditure functions are more likely to do so responsibly when they are also responsible for raising the necessary revenues. When spending "other people's money," local governments (and their constituents) are unlikely to face local pressure to spend this money efficiently. As important as limiting vertical fiscal imbalance may be, however, it is even more important to impose accountability *at the margin*. Even if, due to differences across jurisdictions, some local governments are 90% dependent on central transfers, it is in principle still possible for them to be fully accountable, as long as the amount of the transfer is predetermined, that is, cannot be altered as a result of action by the recipient. A well-designed formula-based transfer along these lines will ensure that at the margin, local actions to raise or lower local revenues or expenditures will directly affect outcomes, which is what is needed to ensure political accountability.

## Basic Principles in the Design of Intergovernmental Fiscal Transfers

Experience suggests that no simple, uniform pattern of transfers will be suitable for all circumstances. Among other things, transfers reflect closely the nature of a country's political system. As a result, their inherently political nature must be taken into account. What is most critical about intergovernmental transfers, however, is not who gives them, or who gets them, or their design details, but rather their effects on policy objectives. As with user charges, the idea is to "get the prices right" in the public sector—or, to put it another way, to impose a hard budget constraint on all actors involved. Three aspects of intergovernmental fiscal transfers need attention: the size of the "distributable pool," the basis for distributing transfers, and conditionality.

*Determining the Distributable Pool.* There are three ways of distributing funds through intergovernmental fiscal transfers, variants of which can be found throughout the world. Funds can be distributed as a fixed share of central government revenues or on some other "macro" basis, for example, as a percentage of GDP. They can be distributed on an ad hoc basis, that is, in the same way as any other budgetary expenditure. And finally, they can be distributed on a "formula-driven" basis, that is, as a proportion of specific local expenditures to be reimbursed by the central government or in relation to some general characteristics of the recipient jurisdictions.

Defining the total distributable pool in an ad hoc fashion creates a number of problems. First, recipient governments need transfers to be stable and predictable, in order to be able to budget properly. Ad hoc transfers are neither stable nor predictable. Second, this system is not conducive to hard budget constraints. Central governments will be constantly subject to political pressures from powerful regional lobbies in order to increase the size of the transfers. This problem becomes even more serious when the distributive formula is discretionary as well.<sup>7</sup>

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<sup>7</sup> This last concern may be misplaced in countries where the central government is very powerful vis-à-

Systems that establish transfers as a fixed percentage of central taxes (or current revenues) provide some degree of stability for local governments as well as flexibility for the central government. Sharing specific national taxes is less desirable than sharing all national taxes because it leads central governments over time to tend to increase more those taxes that they do not have to share. This option, however, has some problems as well. First, it makes it more difficult for the central government to make adjustments during periods when this is necessary, in particular in countries where transfers are a significant share of revenues. For example, if a fiscal deficit prompts the central government to increase taxes, part of the increased revenues go to subnational governments, who then can increase expenditures. Second, this approach may provide insufficient stability for subnational income when national taxes are very sensitive to external shocks (such as a fall in export prices) or to the business cycle. As a result, subnational financing of such vital human capital development services as education and health may suffer. It may therefore be desirable either to base the total amount transferred on a more stable macro measure, such as a GDP moving average, or finance such services separately through a system of capitation grants.

*The Distributive Formula.* Discretionary or negotiated transfers are clearly undesirable. Sound transfer systems should distribute funds among recipient jurisdictions on the basis of a formula. These transfers provide the central government a lot of flexibility to direct resources to the jurisdictions with the greatest needs. But, for the same reason, unless the central government is very strong vis-à-vis the subnational governments, these transfers are more likely to result in soft budget constraints for the subnational governments, and thus do not provide adequate incentives for fiscal responsibility. This view is based on the belief that, under discretion, transfers will tend to be allocated to those jurisdic-

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vis the subnational governments. An example of this is Peru, a country where transfers are almost completely discretionary. However, the problems for the recipient governments in terms of lack of stability and predictability obviously remain.

tions that are facing financial difficulties or are running a deficit. This can very easily give rise to a moral hazard whereby subnational governments spend beyond their means because they know that they will receive supplementary transfers from the central government. Alternatively, transfers could be allocated for political reasons, which would not be efficient either. In addition discretion regarding the allocation of transfers will result in transfers that are very unstable and unpredictable for the subnational governments

The essential ingredients of most formulas for general transfer programs (as opposed to "matching grants" which are intended to finance narrowly defined projects and activities) are needs and capacity. Needs may be sometimes roughly but adequately proxied by some combination of population and the type or category of municipality. A more difficult, but conceptually critical, problem is to include some measure of the capacity of local governments to raise resources, given the revenue authority at their disposal. One way to structure a good transfer system, for example, might be to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a (centrally) predetermined level of services. Because capacity-based transfers are, in principle, based on measures of potential revenue-raising capacity (not on actual revenues), this approach does not create disincentives to fiscal effort. Differentials in needs and in the cost of providing services (for example in rural or less densely populated areas) may be taken into account, but caution is necessary in this respect. It is easy to turn a simple, transparent formula into one that is obscure and easily manipulated by introducing too many refinements into its definition.

*Conditionality.* Once the total amount to be distributed has been decided and the basic distribution formula determined, the key remaining question is whether the transfer should be made conditional on the provision of certain services at specified levels. Two quite different approaches may be taken. On one hand, to the extent that the primary objective of transfers is to ensure that all regions have adequate resources to provide such services at acceptable minimum standards, simple lump-sum transfers, with no

conditionality other than the usual requirements for financial auditing, are called for (Shah, 1994). In this "federalist" approach, it is assumed that the fact that the funds flow to locally-responsible political bodies will ensure sufficient accountability and that it is neither necessary nor desirable for the central government to attempt to interfere with, or influence, local expenditure choices.

On the other hand, if the central government is using local governments as agents in executing national policies (for instance to provide primary education at a specified level throughout the country), then it is sensible to make the transfer conditional upon the funds being spent for the desired purposes (Bird, 1993). Since money is fungible, even transfers based solely on need do nothing to ensure that the recipient governments will in fact use the funds as the central government might wish unless receipt is conditioned on performance and compliance is monitored in some way. Thus, in these cases, monitoring of performance is a key element of design. As a general rule, in the circumstances of most developing countries some conditionality seems desirable, particularly when local governments provide important national services such as education and health.

### **Fiscal Capacity and Fiscal Effort**

Some measure of fiscal capacity is an essential element in the design of intergovernmental transfers. Different jurisdictions have different revenue-raising abilities and will vary resource needs from the central government in order to provide similar levels of public services. Transfers based on measures of potential revenue raising capacity (not on actual revenue) they do not create disincentives to fiscal effort. Unfortunately, measures of fiscal capacity are not easy to construct. A rough approximation may be attempted using estimates of regional GDP per capita or some other macroeconomic index, although these indices tend to be very imperfect measures of fiscal capacity.

However, it may not be advisable to include measures of fiscal effort in the distributive formula. Fiscal effort can be understood conceptually as the ratio of actual taxes collected to "po-

tential" taxes estimated on the basis of some standard measure of fiscal capacity and some standard (e.g., national average) tax rate. Though it may seem appealing to reward fiscal effort, in particular given the "fiscal laziness" sometimes observed at the subnational government level, doing so entails some problems. First, the measurement of fiscal effort is more complex than usually assumed. If, for instance, tax bases are sensitive to tax rates, then the usual measures overestimate capacity in low tax rate areas (and hence underestimate the effort needed to increase tax rates) because the base will decline if the rate is increased. Moreover, given the limited flexibility most local governments in developing countries have to alter their revenues through their own actions, it is far from clear to what extent it is meaningful to interpret the behavior of revenues as reflecting their "effort." In addition, including actual tax rates in the formula may undesirably open it to manipulation by recipient governments if actual rates set by a particular jurisdiction can affect the size of the transfer it receives.

### **Transfers and Poverty**

In many countries, transfers are designed to redistribute resources among jurisdictions. In Argentina, for example, poorer provinces tend to receive more support from the central government, though it is not the very poorest that gain the most. Per capita transfers to the poorest provinces of Argentina (Chaco, Formosa and Santiago del Estero) are only slightly higher than the average, while other relatively wealthier provinces (such as Catamarca) received almost double the average per capita transfer (Porto and Sanguinetti, 1993). But even if transfers were effectively directed to the poorest jurisdictions, there is no guarantee that they would reach the poorest individuals in those jurisdictions. In addition, many poor families live in the richer regions. For example, in Chile, more than half of the persons whose incomes fall below the poverty line live in the wealthiest regions (the Metropolitan Region of Santiago, Valparaiso and Libertador Bernardo O'Higgins). Regional transfers are inherently inefficient in reaching these poor families. In principle, the greater the weight that the central government places upon the eq-

uitable delivery of essential services to specific groups of poor citizens, the less the weight that can be given to the autonomy of local governments in the sense of leaving them free to spend as they see fit. If a principal aim of central policy is to deliver "basic needs" to the poor, either the central government should do it itself, or it will have to develop an elaborate and detailed (and probably not very effective) monitoring system to ensure that local governments perform their role as agents of central policy efficiently and equitably. Decentralization, properly carried out, may have many virtues, but doing exactly what the central government wants in terms of income redistribution is not likely to be one of them. This point may be especially relevant to those concerned with alleviating the poverty of groups not favored by local power structures.

International experience suggests that those who would decentralize successfully, while at the same time focusing on poverty-alleviating policies, should be wary of unnecessarily complicating intergovernmental finance (Bird and Rodriguez, 1999). In all countries, fiscal relations between governments are inevitably complex and usually unsatisfactory in some respects to all parties concerned. If the central government wants to accomplish a specific goal (such as delivering specific services to specific (poor) households), it should do so without further complicating intergovernmental finance. Many of the complications, and complaints, characterizing intergovernmental fiscal issues in most countries result from overloading the system with tasks for which it is ill-equipped, such as targeted poverty alleviation. Whenever feasible, direct transfers to the poor (e.g. through some variant of vouchers) are better than indirect transfers to localities (even poor localities) that are intended primarily to help poor households.

If, for some reason, such key poverty-related services as education and health must be provided through decentralized governments, very careful attention has to be paid to three key issues. First, getting the prices facing service providers right (e.g. via a well-designed system of grants). Second, setting up an information and inspection system sufficient to ensure that the desired services are delivered to the target

groups. Third, devising some system (e.g. a national "fail-safe" provision) for dealing with those who are not in compliance without punishing those who comply. None of these tasks is easy.

### **MACROECONOMIC IMPACTS: TRANSFERS, BORROWING AND DEFICITS**

An interesting aspect of the recent move to decentralize public sector activities in many countries has been the revival of an old worry, that decentralization might have a negative impact on macroeconomic performance. In part, these concerns are based on fears that, left to their own devices, subnational governments would act in a fiscally irresponsible way. Of particular policy concern in many countries has been the alleged need to develop new and more stringent controls over subnational borrowing. There are several channels through which decentralization could potentially result in macroeconomic problems, such as increased spending or deficits: i) whenever transfers of resources to subnational governments are increased without transferring equivalent expenditure responsibilities; ii) when revenue sources are transferred to subnational governments and they fail to exert adequate effort at mobilizing resources (similarly, when transfers are increased and subnational governments reduce the efforts on the revenue sources they already control); iii) in countries with a high degree of decentralization, central governments responsible for macroeconomic management may not have enough room to maneuver if resources and responsibilities are concentrated at the subnational level; iv) when the central government fails to impose hard budget constraints on the subnational governments.

#### **Transfers**

When a national government transfers revenues to subnational governments, it should also as a rule transfer expenditure responsibilities that are roughly equivalent. If this is the case and in the absence of behavioral reactions, subnational expenditures should increase by exactly the same amount as subnational revenues. Revenues available for expenditure at the national level

decline and those available at the subnational level rise by the same amount, as do subnational expenditures. However, in several recent moves toward decentralization in Latin America, revenues have been transferred without the corresponding responsibilities. Sometimes, increases in transfers have been mandated by a new constitution. While it is possible that these increased transfers could reflect the fact that resources available to subnational governments were insufficient to carry out their tasks, in several cases the increase in resources has led to increased general government spending and central government deficits.

Transferring expenditure responsibilities together with additional resources does not eliminate the potential for macroeconomic impacts, however. These will depend on two things: the behavior of central government spending in response to the transfers, and the effect on subnational government "own" revenues. Regarding the first issue, on occasions central governments have been very slow to let go of the transferred responsibilities, and have not reduced their own expenditures proportionately. This obviously results in a duplication of activities, lack of clarity and accountability regarding who is responsible for what, and increased expenditures and deficits. Recent experience in Colombia illustrates this behavior by the central government. This problem, however, is more likely to be temporary (until the central government adjusts to the new situation) than permanent.

Subnational revenues may decline as a result of increased transfers (a phenomenon known as "fiscal laziness," "decrease in fiscal effort," or "substitution effect" of transfers), they may remain the same as in the absence of transfers ("flypaper effect"), or they may actually increase local own revenues ("stimulative effect" of grants). On the whole, the evidence suggesting a decrease in local effort is far from overwhelming (Burki, et. al. 1999). This suggests that most macroeconomic problems arising as a result of increased transfers are either due to the spending behavior of the central government, or to improper design of intergovernmental relations (such as transferring resources without corresponding responsibilities), rather than to irre-

sponsible behavior by the subnational governments.

In any event, even the most irresponsible local politicians can cause macroeconomic problems only when their actions are in some way validated by either the central bank (monetizing subnational deficits) or the central government (bailing out subnational governments). Decentralization may certainly complicate macroeconomic management, but it does not shift responsibility for it out of the hands of the central government.

Since macroeconomic stabilization is, for the most part, a national government task, it is important that the national government have full control over all the instruments of policy it needs to carry out this task properly.<sup>8</sup> In a few very decentralized countries in Latin America, such as Argentina and Brazil, subnational governments are responsible for almost half of total expenditures and, once transfers are taken into account, command a substantial portion of government revenues as well. This raises valid concerns that, when fiscal adjustment is necessary, it will be more difficult for the central government to control expenditures. At the same time, increases in taxes may not be as productive a form of adjustment since, given the importance of tax sharing arrangements, part of the increased revenues have to be transferred to the subnational governments, which in turn may increase their expenditures as a result of the windfall.

But perhaps the main concerns with decentralization, from a macroeconomic perspective, relate to subnational government borrowing.

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<sup>8</sup> There is some scope, however, for subnational governments to carry out some stabilization responsibilities. They can, for example, smooth out the cycle by using stabilization funds. Most of the US states have "rainy day" funds precisely for this purpose, and some subnational governments in Argentina have recently adopted this type of funds, in the context of loan programs financed by the IDB.

## Subnational Borrowing

The rules regarding borrowing by subnational governments in Latin America vary considerably from country to country. While some countries, such as Chile or Venezuela, restrict subnational government borrowing almost completely, others, such as Argentina and Brazil, allow a high degree of subnational borrowing autonomy.<sup>9</sup> These last two countries have also experienced notable substantial subnational deficits and debt (Dillinger and Webb, 1999). The association between autonomy and bad performance is not coincidental; under certain circumstances, borrowing autonomy can lead to soft budget constraints for the subnational governments. At the heart of the issue is a problem of commitment. It is often very difficult for central governments to commit not to bail out state and local governments when they are in financial trouble. Absent the ability of central governments to commit, borrowing autonomy may well result in irresponsible fiscal behavior on the part of the subnational governments. This behavior is nothing more than an optimal response to incentives when the perception of a bailout exists.

There are several reasons why the central government may find it hard to commit to a no bailout rule. First, if a jurisdiction is in financial trouble, the central government may resort to a bailout to ensure the welfare of the affected population or avoid negative externalities on other jurisdictions in the absence. This last factor has been crucial in the rescue of state banks in the larger Brazilian states. Failure to do so could have resulted in widespread bank runs.

This discussion helps to identify some of the characteristics of intergovernmental relations that may exacerbate the difficulties central governments face when trying to impose hard budget constraints. First, it will be more difficult for the subnational governments to get themselves out of financial trouble if they have no

control over their revenues. Limited flexibility to increase their own resources (either because of high vertical imbalance or because they cannot affect the tax base and tax rates) will make necessary adjustments more painful in the absence of bailouts, and thus will make a bailout more likely. Similar considerations apply to the expenditure side. If the subnational government does not have flexibility to cut expenditures (perhaps because they receive a large proportion of revenues via conditional transfers), undertaking adjustments on their own will be more difficult, if not impossible.

Discretionary transfers are another potential source of bailouts, since they provide an easy way for central governments to extend bailouts and an easy way for subnational governments to request them. The less transparent the transfer system, the more damaging discretionary transfers can be. The degree of borrowing autonomy of subnational governments also plays an obvious role in determining bailouts. Lack of autonomy to borrow does not eliminate bailouts, but reduces the scope to situations such as accumulation of debts to suppliers and workers. Preliminary results from a seven-country study on the determinants of subnational government bailouts in Latin America, conducted by the IDB, are consistent with this conclusion.<sup>10</sup>

A clear case can be made for extending at least some capacity to borrow to state and local governments. As public finance textbooks note, in terms of both allocative efficiency and intergenerational equity it often makes sense to finance long-lived investment projects, especially those that will increase productive capacity, by borrowing rather than relying solely upon either current public savings or transfers. For this reason, restricting subnational borrowing, at least for investment purposes, entails important costs. Other reasons for borrowing are less defensible. In some cases, for example, local officials have reaped the political benefits of expenditure financed by borrowing, while leaving the political pain of debt service to their successors.

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<sup>9</sup> See IADB, 1997, for a country-by-country index of subnational borrowing autonomy. Brazil has moved toward more restrictive conditions as part of the debt renegotiations between the states and the central government.

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<sup>10</sup>The study includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay.

Such practices entail an externality and raise a major issue of accountability.

Borrowing with the expectation of a central government bailout involves an externality as well. State and local governments will borrow beyond what is socially optimal if they think they can shift part of the cost of repayment onto others outside the jurisdiction. Moreover, when the risk of bailouts exists, markets are clearly not an adequate disciplining device. If lenders expect the central government to bailout local governments, they will accommodate the borrowers more readily than would otherwise have been the case. In these cases, constraints on subnational government borrowing may be the right policy.<sup>11</sup>

Imposing strict borrowing limits may pose some difficulties, however. First, it may not be easy to do in the case of federal countries, where the central government's ability to impose intergovernmental fiscal relations is more limited, at least in some countries. Second, central limits to subnational borrowing may have a perverse effect. If loans that fall within subnational borrowing limits are perceived by lenders as having the central government's seal of approval, they in effect carry an implicit guarantee of central government backing. As a result, lenders may not scrutinize the fiscal situation of potential borrowers as closely as they might otherwise. The same concern exists when transfers are used as guarantees, affecting the lender's assessment of risk, undermining the impact that such assessment has on the fiscal discipline of subnational governments.

As the previous paragraphs make clear, when it comes to subnational government borrowing, there is "good" borrowing as well as "bad." In principle, it is as important to facilitate the former as to block the latter. Indeed, facilitating the access of subnational governments to borrowing can, under the right conditions, help over time in

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<sup>11</sup> See Ter-Minassian (1995) for a description of different types of arrangements regarding subnational government borrowing and their effectiveness.

developing some degree of market discipline. On these grounds allowing subnational access to capital markets, if done right, should in the long run strengthen rather than weaken fiscal discipline. Of course, the central government's refusal to engage in further bailouts of subnational governments must be credible.

While emergency central support may sometimes be unavoidable to resolve debt problems, it should carry the obligation to introduce and make effective any necessary reforms under the supervision of a review board. The loss of political autonomy in the event of a bailout may reduce moral hazard behavior on the part of subnational government politicians. Given that formal bankruptcy proceedings are impossible in the public sector, reducing this moral hazard depends at least upon the institution of a credible review/control system for resolving debt. More generally, to ensure accountability, all subnational borrowing should be reported immediately and in a transparent fashion both so that no governments can shift hidden debts onto the next administration and so that both local voters and the central government can understand clearly what is going on. Inappropriate borrowing by subnational governments should be viewed not so much as a "problem" of decentralization but as a symptom of more basic underlying inadequacies with the intergovernmental fiscal system in general. Once that system is cleaned up (by such measures as reassignment of revenues and perhaps expenditures; a revised transfer system; the introduction of transparent, timely, and reliable reporting systems; and the establishment of a stable, accepted periodic review process), the institutional problems that may give rise to unsustainable subnational borrowing may largely be solved.

However, some ex-ante limits on subnational borrowing may be warranted. Borrowing should be permitted only for investment purposes (which may be difficult to enforce in the absence of strictly segregated capital budgets), since the only good case for local borrowing is to finance capital investment.<sup>12</sup> A case could also be made

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<sup>12</sup> Of course, some arrangements may have to be made to permit "in-period" borrowing to smooth out

for requiring prior approval from the central government for foreign borrowing. Finally, given the extreme dependence of some subnational governments on central transfers and the expectation of central government bailouts, there

may be a case for ex-ante administrative controls on borrowing, such as requiring prior central approval or limiting debt service to a certain proportion of current revenues.

## 5. Local Democracy at Work

### CHAPTER SUMMARY

The sources of the relevant incentives for good subnational government performance are wide-ranging. The structure of inter-governmental fiscal relations and the rules establishing the division of functional responsibilities present a pivotal set of incentives, which to some degree circumscribe the rest. Underneath this broader umbrella, but not less significant, are the incentives that stem from the more specific regulatory frameworks and standards established by the central or regional governments to govern the delivery of services. However, decentralization not only implies changes in the rules defining the assignment of resources and responsibilities among different levels of government, but also a change in the rules governing the relationship between elected officials and their constituencies. For the benefits of decentralization to be fully realized a profound democratization of local government must take place.

This chapter focuses on democratic institutions and practices that shape the incentives on subnational public officials to govern responsibly, effectively and in accordance with the preferences of their constituents. The subsequent chapter focuses on the problem of how to build the organizational and managerial capacity of subnational governments to respond to the challenges presented by the new responsibilities and increased citizen demands for better quality services.

### LOCAL DEMOCRACY AT WORK

#### **Strengthening Incentives for Improved Government Performance and Increased Responsiveness**

In theory local democracy is expected to enhance the degree to which the mix of goods and services provided by governments matches that preferred by citizens. But, “bringing the government closer to the people” does not necessar-

ily mean that the government will be more responsive to “the people” or that “the people” will manifest themselves in a more visible form before governmental officials and make their preferences and demands clearly known. Given the hard realities that it is costly for citizens to participate in politics and acquire political knowledge and that, as a consequence, day-to-day politics tends to be the work of professional full-time politicians, it is equally possible that local governments may be run by, and in the interests of, a narrow group of wealthy, politically connected, and/or well-educated elite. Or, it may be that political parties, centralized in the hands of national or regional political patrons (or bosses) dominate local governments, with little sensitivity to the needs and preferences of the majority of the citizens.

The potential problem of representation and accountability at the local level is reflected in and aggravated by the disenchantment with democratic politics evident in many countries. Opinion polls point to the low esteem in which politicians and political parties are held. They are blamed for corruption, abuse of authority, and the failure to respond adequately to public needs.

Whether decentralization leads to more democracy and better government depends critically on the structure of local political institutions. These institutions generate the incentives that shape the extent to which elected and non-elected government decisionmakers carry out their duties transparently, responsibly, and in a manner that responds to citizen needs and preferences. Important institution-related incentives fall under five main categories that are discussed below.

The first is the extent to which elections serve to communicate citizens’ preferences over local policy issues and their approval or disapproval of public officials’ performance in office. The second incentive relates to the extent to which subnational councils or legislative bodies have

the capacity to assimilate and aggregate the full range of citizen and group preferences and to act as a counter-weight to the executive (mayoral) branch to ensure that it does not abuse its authority or does not ignore citizen concerns. In the third place is the extent to which formal institutions exist in which citizens and nongovernmental organizations (NGOs) have real opportunities to air their complaints, articulate their preferences (for instances in respect to capital investment projects), and receive and provide information and advice. Fourth is the degree to which the government is required, because of central government regulatory regimes or national and local laws, to regularly provide reliable information about such matters as legislation enacted, the level and functional distribution of expenditures and revenue collection, and comparative unit costs for public services and other performance-related evaluations. The last institution-related incentive is the extent to which a fair and independent media and a relatively rich network of civic organizations exist.<sup>13</sup>

### **Electoral Systems and Representative Institutions**

The rules governing the election and removal of local officials provide the basis for making them accountable to their constituencies. As such, they are an important part of the system of incentives that promote efficient behavior in local governments. Within their sphere of influence, electoral systems play as important a role as the rules assigning tax revenues and authority to borrow, to induce elected officials to manage public accounts responsibly and to supervise the effectiveness of local bureaucracies. Election rules that are set up correctly can go a long way toward making possible the fulfillment of the two theoretical benefits of decentralization;

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<sup>13</sup> As Putnam (1993) and others have argued, the propensity of citizens to participate in politics and to associate together in civic organizations is affected by culture and other historical factors. At the same time, however, it is likely that this propensity is affected by the perceived efficacy and costs of civic engagement, which are influenced by more malleable factors, including the nature of political institutions (Hirschman, 1970; Cohen and Rogers, 1992).

namely, enhanced citizen involvement in governmental affairs and an improved match between the goods and services delivered and those desired by citizens. But, while it may be true that a closer connection with government activity can mobilize citizen interest, it is also certain that a faulty political system (for instance, one that does not provide opportunities for real citizen influence or that restricts electoral choice) can quickly generate cynicism and disengagement.

When do elections work as a mechanism to communicate citizen preferences? When do they allow citizens to effectively register their approval or disapproval of local government conduct? Given the complexity of most policy issues; lack of citizen interest, knowledge or time; the absence of complete or objective information; and their relative infrequency, elections cannot be expected to perform these functions perfectly. As a result, there must be additional avenues through which citizens can express their preferences and involve themselves in the political process. Despite their inherent limitations, however, elections are obviously a vital element of democracy. The characteristics of the electoral system and other aspects of the formal structure of subnational government shape their effectiveness.

*Direct Election of Mayors.* As reflected in its widespread adoption across Latin America, *the direct election of mayors* and governors appears to be an indispensable step in enhancing democratic accountability at the subnational level. Table 3.1 shows that after the electoral reforms of the 1980s and 1990s most countries elect mayors directly. The only exceptions are Costa Rica, Honduras, and Peru. In Peru the candidate heading the winning party list for council membership is automatically selected mayor. In the other two cases the mayor is indirectly elected by the councilors from among themselves. In Chile the council candidate with the most votes becomes the mayor unless the winning candidate fails to obtain more than 35% of the vote. If that happens, the newly elected city council members select the mayor from among themselves.

*Length of the Mayor's Term and Reelection.* Another set of electoral rules affecting accountability at the local level is the length of the mayor's term of office and whether he/she can be reelected. If terms are three years or less, municipal governments are less likely to be able to establish a track record of performance for which they can claim exclusive responsibility. Further, they are less likely to assume the risks of reforms that entail short-term costs but have the potential to bring significant future benefits. In addition, under these circumstances a significant share of the mayor's term of office is first spent learning on the job and then, in the third year, becoming involved in the election campaign of their successors (Nickson, 1995).

At the same time, the possibility of reelection gives mayors clout to carry out their programs, encourages them to be responsive to citizen concerns, provides a greater incentive to risk some political capital for the sake of bringing about improvements, and permits greater continuity in municipal policy programs and administrative staffing. Short terms of office and the impossibility of reelection tend to create a "revolving door" for staff and devalues training and technical expertise.

This is a common problem. In five countries (Colombia, Guatemala, Mexico, Peru, and Venezuela) mayoral terms are relatively short and in seven countries no immediate reelection is permitted.

*Election of Council Members.* Electoral accountability at the local level is also affected by the manner in which city council members are elected. One issue is whether council members are elected from narrower geographical districts (wards or neighborhoods) or at-large districts taking in the entire municipality. Other things being equal, election from at-large districts restricts territorial representation at the municipal level and limits the ability of citizens to hold council members individually accountable. Ward or neighborhood-based participation could be expected to encourage higher levels of citizen participation since involvement is more likely to bring tangible results and also to open politics to more people by making it less costly to run for

office. Throughout most of Latin America, however, council members are elected from at-large districts. The only exceptions are Panama (where the "first past the post" or "plurality system" based on sub-municipal electoral wards is practiced) and some English-speaking Caribbean countries.

*Timing of Elections and Ballot Structure.* The utility of elections as a mechanism for signaling local citizen policy preferences and for holding individual council members and mayors accountable for their actions in office is further undermined when local elections are held concurrently with elections at the national level, when electors are unable to split their vote between different governmental offices, and when voters are forced to choose between party lists and cannot express their preference among individual candidates in the same or different parties. Especially when the latter two rules are followed, the coincidence of elections at different levels of government tends to reduce the importance of local issues in contests between parties and/or individuals at the local level. As a consequence, the effectiveness of elections in indicating citizen preferences in respect to local issues and in signaling approval or disapproval of the conduct of local officials in office is diminished. In addition, concurrent elections means that the selection of party candidates for municipal office is often determined by the electoral support they can mobilize for the party's national politicians rather than by the personal capabilities of the candidates and their fitness for local government office (Nickson 1995). Though electoral reforms have separated local from national elections in some countries, they remain concurrent in almost half of the countries of Latin America.

At the same time, the scope for electoral choice and the possibility of holding politicians individually accountable would appear to be undermined when voting is by blocked party lists, where voters must vote a straight party line and cannot divide their votes between candidates of different parties. In many of the cases where such a system is in place, the lists are also closed.

Table 4.1 Elections and Citizen Participation at the Subnational Level

	Executive							Legislative				Local Elections Coincide with National?	Other forms of participation	
	Intermediate			Local				Intermediate		Local			Are there any?	By popular initiative
	Elective position	Direct election	Immediate reelection	Elective position	Direct election?	Immediate reelection?	Mayoral Term Length	Electoral System	Immediate reelection?	Electoral System	Immediate reelection?			
Argentina	yes	no	yes	yes	yes	yes	4	PR	yes	PR	yes	yes	yes	yes
Bahamas				yes	yes	yes				PL	yes	no		
Bolivia	no	n/a	n/a	yes	no	yes	5	Mix	no	PR	yes	no	no	n/a
Brazil	yes	yes	no	yes	yes	no	5	PR	yes	PR	yes	yes (state)	yes	yes
Chile	no	n/a	n/a	yes	yes <sup>1</sup>	yes	4	N/A	N/A	PR	yes	no	yes (local)	yes (local)
Colombia	yes	yes	no	yes	yes	no	3	PR	yes	PR	no	no	yes	yes
Costa Rica				yes <sup>2</sup>	no	yes <sup>2</sup>				PR	yes	yes		
Ecuador	yes	yes	yes	yes	yes	no	4	PR	yes	PR	yes	no	no	n/a
El Salvador				yes	yes	yes				PR	yes	yes		
Guatemala				yes	yes	yes	2 <sup>3</sup>			PR	yes	yes		
Honduras				yes	no	yes	4			PR	yes	yes		
Mexico	yes	yes	no	yes	yes	no	3	Mix	no	PL	no	no	no	n/a
Nicaragua				yes	yes	no				PR	yes	yes		
Panama				yes	yes	no	5	N/A	N/A	PR	yes	yes	no	n/a
Paraguay	yes	yes	no	yes	yes	no		PL	yes	PL	yes	no	no	n/a
Peru	yes	yes	yes	yes	no	yes	3	PR	yes	PR	yes	no	yes	yes
Rep.Dom	no	n/a	n/a	yes	yes	yes		N/A	N/A	PR	yes	no	no	n/a
Uruguay	yes	yes	yes					PR	yes			yes	yes	yes
Venezuela	yes	yes	yes	yes	yes	yes	3	Mix	yes	Mix	yes	no	yes	yes

Shaded areas indicate that the level of government does not exist.

<sup>1</sup>In Chile the city council and mayoral candidate with the most votes becomes mayor unless no candidate receives 35% of the vote or more. In this case the newly elected council members from among themselves select the mayor.

<sup>2</sup> In Costa Rica mayors are elected by municipal council members who in turn are elected by popular vote.

<sup>3</sup> Guatemala City has a four year term of office

That is, voters can choose only between competing party lists, and the party ranks its own candidates, thus determining who will sit on the council at different levels of total voting support. These practices prevent electors from expressing their support for council members who appear to be particularly devoted and responsive and from penalizing those who are lazy or unresponsive. It also encourages politicians to be accountable mainly to the party apparatus rather than to the electorate and limits the potential pool of candidates. As a result, certain groups, such as women and indigenous peoples may be underrepresented. The limits on electoral choice entailed by closed and blocked party lists may be partly responsible for the fact that women occupy only about 4 percent of mayoral offices and about 10 percent of municipal council seats (FLACSO, 1995).<sup>14</sup> Voting by blocked and/or closed party lists also tends to limit the independence of the electoral mandate of councilors and thus undermines the capacity of the councils to oversee and counterbalance the power of the local executive branch (Peterson 1997).

In most Latin American countries councilors are elected by party lists, which are usually closed and blocked. The main exceptions are the English-speaking Caribbean countries, Panama, Brazil, and Chile. In Brazil and Chile voters choose a single candidate instead of a list of candidates from an at-large district. In Panama councilors are elected one by one from sub-municipal wards in a "first past the post system."

*Powers of Municipal Councils.* Though importantly shaped by these attributes of the electoral system, the capacity of municipal councils to have an effect on policy-making, to monitor the mayor's office, and to represent citizens between elections is also influenced by the level of their resources (salaries and expertise of council members, availability of technical advisors, etc), their size, and the formal legislative powers

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<sup>14</sup> Within systems in which parties control which candidates have opportunities to be elected, one way of enforcing a greater proportionality in gender representation in political offices is through quota laws, described below in the text (Htun, 1998).

vested in them by the constitution. In most cases, councils in Latin America tend to be very weak. Though the mayor generally is required to submit key financial decisions to the council for approval, the council lacks the ability or, in some cases, the legal power to compel changes in the details. The council is left with the role of ratifying or refusing to ratify legislation and enacting internal administrative regulations. In some cases, however, the mayor can even override council opposition to executive actions. (Nickson, 1995; Peterson, 1997). Thus, organizational and legal weakness impedes the ability of the councils to be more effective in channeling feedback from the public to elected or appointed decisionmakers, in resolving diverse social preferences into a coherent set of policy and spending programs, and in overseeing the executive.

*Referenda, Citizen Initiatives, and Recall Elections.* A partial remedy for the bluntness of periodic elections as an instrument of political accountability can be found in the introduction of other electoral mechanisms, such as referenda (on such issues as taxation and borrowing, for example), citizen initiatives, and recall elections. Referenda are potentially valuable for local democracy since they give citizens a chance to directly decide matters of great importance to them and lend greater legitimacy to key governmental decisions. Initiatives allow citizens to force action on issues where special interests lobbying or weak grassroots links keep politicians from being fully responsive to majority preferences. Recall elections provide an additional incentive for elected politicians to pay attention to voters between elections, thus providing added incentives for them to act as representatives rather than as delegates of citizens.

#### **COMMUNITY PARTICIPATION AND CIVIL SOCIETY ORGANIZATIONS: ADDITIONAL MECHANISMS FOR ENHANCING DEMOCRATIC ACCOUNTABILITY**

In addition to these more traditional electoral mechanisms of representation and accountability, other forums, rules, and government-citizen partnerships have been utilized in advanced de-

mocracies, and increasingly in Latin American countries, to enhance communication flows between the municipal government and citizens, and to expand opportunities for citizen participation and involvement in government.

While electoral participation is to a great extent an individual activity, more continual forms of citizen involvement usually require a higher degree of organization. There are a host of non-government organizations (NGOs), community based organizations (CBOs) and other civil society organizations (CSOs) like neighborhood associations, trade associations, church groups and sports clubs, whose activities are of great importance for local development. Their involvement covers a wide range of activities. Some are key actors in promoting community involvement in local decision-making and have a significant impact on local governance. Others collaborate with local governments in the provision of services through philanthropic activities targeted to specific population groups. Yet others function as contractors for the execution of local development programs. They vary significantly in size, institutional capacity, and in the scope of their interests and support base. For instance, some are international or national organizations and others have a local character.

The expansion of the scope and capacity of civil society organizations and their role in development can increase the accountability of government to citizens, enhance the degree of citizen ownership in development projects (and, therefore, their viability and effectiveness), and promote greater efficiency in the allocation of public resources.

National and subnational governments can play a role in promoting the development of civil society organizations, by granting them legal status, by providing indirect forms of financial support (such as giving nonprofit organizations tax exempt status), and by incorporating opportunities for the participation and the collaboration of civil society organizations into the design of programs and decision processes. International financial institutions, foreign governments, and external NGOs also can provide important support, both through direct financial

assistance and by promoting their participation and formal partnership in state-sponsored projects.

Forums such as community advisory boards, regulatory commissions, open town meetings, public hearings, citizen complaint centers (offices of citizen assistance), and judicial and legal proceedings provide opportunities for citizens and civil society organizations to articulate their preferences, air their grievances, and influence policy and investment decisions beyond Election Day. Several interesting examples of mechanisms for formalizing community participation in local agenda-setting exercises have begun to emerge in a few countries in the region. Some examples are the local *Mesas de Concertación* in Colombia, solidarity groups at the municipal level in Mexico, *Organizaciones Territoriales de Base y Comités de Vigilancia* formed under the Popular Participation Law in Bolivia, participatory budgeting in Porto Alegre (Brazil), and municipal government partnership with community groups in La Florida (Chile).

Such forums hold great promise but their potential has thus far been underexploited in Latin America. Though in several countries town meetings have been written into national law, their role is limited when citizens and groups draw up project proposals without adequate information about project costs and budgetary constraints (or they are not compelled to consider such information) or when they are not given a formal place in the decision-making process. In the open town hall meetings in countries like El Salvador and Honduras, for example, community groups' impact on decision-making is limited by the fact that, lacking access to cost or budget information, they are unable to truly participate in setting investment priorities (Peterson, 1997). Nevertheless, when citizens' demands are expressed in such a forum it raises the chances that their interests will be taken into account.

Bolivia's Popular Participation Law, the partnership of the municipal government of La Florida (Chile) with community groups, and the "Participatory Budget" in Porto Alegre (Brazil) are each cases in which citizen participation entails

real decision-making power in respect to capital investment planning and public works spending (Peterson 1997). In these cases, community groups must face the realities of resource constraints and compare the costs of alternative project proposals. In addition, given the trade-off between leaving decisions to the executive or to a more automatic mechanism, they have a strong incentive to build consensus behind a common set of objectives. Participatory mechanisms of this kind can significantly increase efficiencies in respect to resource allocation and productivity and can promote the development of neighborhood-based organizations and greater degrees of civic engagement and empowerment. This has further implications in terms of subnational government accountability and efficiency.

Citizen and community participation has also been enhanced in the United States and some Latin American countries by means of requirements regarding meetings of public boards (e.g. school boards), planning and zoning commissions, and/or legislative councils. Specifically, these meetings must be open to public attendance and participation. In addition, provisions have to be made for public comments on major rulings or decisions. Such participation can be quite important in ensuring that public services, investment planning, and government decisions are responsive to citizens and public officials are accountable.

Productive and effective participation requires accurate and comprehensive information not only about the budget but other matters as well. Thus, citizen involvement in matters like investment planning or zoning decisions is enhanced when citizens are guaranteed in law full access to the findings of review panels, to government records, to company data (such as on pollutants emitted, taxes paid, etc.) and to other relevant information.

Aside from knowledge of costs and resource constraints and access to a wide array of information, the broadening and deepening of citizen representation requires that the participation of different socioeconomic and ethnic groups directly in the democratic process or through membership in community groups be propor-

tionate to their presence in the population. In addition, the profile of public office holders should mirror to the greatest extent possible the nation's underlying sociocultural diversity. Unfortunately, evidence suggests that the participation of women and marginalized groups in many cases has not been sufficient for their interests to be adequately represented. For instance, while women appear to be relatively well represented among those who attend local assemblies and meetings, their participation as members or leaders of local organizations and decision-making bodies has remained low.

The broadening of representation can be advanced, on the one hand, through the establishment and/or strengthening of agencies or councils that advocate for the particular minority or under-represented group. Such agencies or councils can advocate for the modification of laws and public policies or collaborate in the design of sector programs aimed at enhancing the group's conditions and opportunities. For instance local institutions or offices that focus on women's issues have been established in Argentina (in 20 of 24 provinces), Chile (in 129 of 341 municipalities), Colombia (in 12 municipalities), Venezuela (100 institutions at different levels of government coordinated by a national Council) and in Paraguay (Htun, 1998).

On the other hand, some steps toward increasing the effective participation of women have also been made through "pool-enlarging" strategies that attempt to increase the number of women who are qualified and able to compete for leadership positions, and quota laws that enforce given thresholds of representation for women in party electoral slates. "Pool-enlarging" strategies have included university scholarships, leadership and professional training programs, and initiatives to increase campaign funds for women candidates. The movement toward quotas, though highly debated, is gaining momentum. To date, laws at the national level requiring that between 20 percent and 40 percent of candidacies be reserved for women have been passed in Argentina, Bolivia, Brazil, Costa Rica, the Dominican Republic, Ecuador, Panama, and Peru (Htun, 1998). Quota laws are also being enacted at the subnational level. For example, 22 of Ar-

gentina's 24 provinces have adopted quota rules for state legislature and municipal councils. Similarly, three Mexican states have also done so (Jones, 1996).

### **Accountability and Intergovernmental Relations**

As has been emphasized throughout, if decentralization is to work properly, those charged with providing local services must be accountable both to those who pay for such services and to those who benefit from them. Local political accountability will not work effectively unless the division of responsibilities between different levels of government is clear (and well-enforced and respected). It also requires that local officials have sufficient authority to perform the roles assigned to them and bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. Otherwise, local citizens will not know who to blame for poor performance and will not face realistic trade-offs between their public spending needs and desires and the associated costs in terms of taxation (Dillinger, 1994).

But, given that many types of local government actions have a consequence not only for local citizens but also for the nation as a whole, to some degree local governments must be held accountable not only "downwards" to their constituents but also "upwards" to the central government. Central regulation of local decisions is clearly warranted in the case of those functions that have consequences for the nation as a whole (such as monetary and fiscal policy). Central regulation is also appropriate with regard to functions that are viewed to have implications for core national values or objectives, such as reducing poverty. In these cases the central government may delegate much of the responsibility for the delivery of the particular service to local governments but maintain some regulatory authority. By contrast, central regulation is difficult to justify when the impact of local government behavior is mostly localized and regulation requires detailed knowledge of local conditions and priorities.

Of course, in many cases the choice between reliance on central regulation and systems of local accountability is not clear-cut and is often a source of conflict between different jurisdictions. Once the important issue of the lines of authority is settled, however, the two forms of accountability can complement each other. For instance, in the context of an on-going process of decentralization, central government oversight may enhance local political accountability by enforcing compliance with certain performance standards and providing needed information. Such information can allow for more efficient client/customer choices (in semi-privatized service delivery systems) and can boost the capacity of citizens to participate effectively and hold local officials accountable. Unless local publics are made aware of what is done, how well it is done, how much it costs, and who paid for it, no local constituency for effective government can be created.

A clear need for central regulation also exists when, in the typical case, the central government absorbs a considerable share of the responsibility for financing the provision of a given public service in the form of transfers. As stressed in Chapter 3, effective decentralization depends on the establishment of an appropriate regulatory framework that clearly delineates the various responsibilities of each jurisdictional level in respect to each type of service. Otherwise the subnational authorities can use the transfers designated to fund a particular service for other purposes, knowing that the central government will come in to fill the gap.

Given the usual need for transfers to fund services that are administered at the subnational level, it is especially necessary for the central government to develop its regulatory capacity. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized or that transferred funds are being spent appropriately and efficiently. Therefore, an essential element of the hard budget constraint needed to promote efficient local decisions is adequate central enforcement capacity in the form of credible information gathering and

evaluation. The "carrot" of central financial support of local efforts must, in the end, be accompanied by the "stick" of some degree of withdrawn support if performance is inadequate. Moreover, a credible stick requires both some standards of adequacy and some way of knowing to what extent performance measures up.

Unfortunately, the lack of an appropriate central government structure to monitor and support local governments is a common problem. Most central authorities do not have a very good understanding of either the existing situation of their local governments or of the likely effects of any proposed changes in local finance. Most need much more regular and detailed financial data on local governments than they usually possess. Key conditions for improving monitoring include:

1. The existence of uniform financial reporting and budgeting systems and an appropriate agency—preferably with a certain degree of political separation from the central government—for collecting and processing data in a timely fashion.
2. Central government support for developing and maintaining an appropriate reporting system, and for training and supporting local government officials.

3. Formal reporting and evaluation systems adapted to the needs of the public to whom subnational governments are accountable.

Regardless of the form that decentralization takes, an important institutional problem remains; namely, how to ensure that the relevant central government agencies have adequate incentives and the ability to monitor and regulate subnational activity, and that subnational governments have sufficient incentives to provide the necessary information. Some incentives for compliance with demands for information may be created by making timely submission of such reports a condition for receiving fiscal transfers. Transparency with regard to government functions is essential to strengthen the effectiveness of intergovernmental accountability mechanisms and to provide citizens a factual basis for evaluating the impact of public policies and the effectiveness of incumbent governments and politicians.

But, organizational and managerial capacity must also be developed at the subnational government level if entities at this level are going to be able to successfully face the challenges presented by their expanded responsibilities and the increased political pressures to carry them out effectively. This important dimension of decentralization is the topic of the next chapter.

## 6. Strengthening the Capacity of Subnational Governmental Organizations to Respond to the New Incentives

### CHAPTER SUMMARY

The lack of adequate institutional capacity at the subnational level is one of the most important obstacles for the effective decentralization of government. Particularly challenging in small rural municipalities, this problem also affects local governments facing the mounting poverty problems concentrated in the metropolitan areas of the region. The high rotation of personnel and the hiring and promotion of staff on political rather than merit grounds compound inadequate organizational and operational structures in weakening institutional capacity in subnational governments of all types. Simultaneous and coordinated changes are required in key management areas, including policy making and strategic planning and evaluation systems to raise institutional performance to levels compatible with the efficient administration of the expanding responsibilities entrusted to subnational governments. Of utmost importance for promoting efficiency in these public agencies is that the diverse management systems must generate incentives that lead individuals to work in harmony and with reasonable competence and effort. These incentives match reforms of the intergovernmental relations and governance systems described in previous chapters in promoting efficient and democratic subnational governments.

#### **CAN LOCAL INSTITUTIONAL PERFORMANCE BE IMPROVED? BUILDING LOCAL CAPACITY**

Local democracy, when working properly, should result in a heightened demand for better quality and more efficiently and equitably targeted governmental services and public investments. But, such “external” incentives, while critical for spurring necessary reforms and improving communications between citizens and subnational governments, will not automatically result in improved governmental performance.

Rather, a second set of “internal” incentives must also be overhauled in order for subnational governments to be able to meet the challenges posed by their new responsibilities and by heightened citizen demands. Efforts to better harmonize and strengthen key public management systems (including those related to the design of policies and strategic planning, budget implementation and revenue collection, personnel, information storage and flow, and control and evaluation) are also necessary to ensure that the potential benefits of decentralization materialize. In fact, if insufficient efforts are devoted to building the institutional capacity of subnational governments, then the resulting imbalance between citizen demands and governmental performance could erode the legitimacy of the decentralization process, further complicate the task of institutional reform, and possibly weaken democracy itself.

Some authors have expressed concern about the possible dangers of decentralization (Prud'homme, 1995), particularly those arising from the poor quality of local administration in most developing countries. Concerns about the supposed incompetence or deficient capacity of local governments have slowed the process of decentralization. Local administrations are viewed as being filled with deficiently qualified and under-motivated staff, to be plagued by excessive turnover of professional staff, and to lack any capacity for strategic planning or effective management. These deficiencies in turn are viewed to result from widespread practices of clientelism in which public employment is treated more as an instrument for doling out political favors than as a valuable resource for carrying out the government's responsibilities. While there is often good reason for such concerns, it should be emphasized that subnational officials respond to the incentives with which they are faced. If those incentives discourage initiative and reward inefficiency and even cor-

ruption, it should not be surprising to find corrupt and inefficient local governments. Experience has shown that with the appropriate democratic as well as “internal” incentives in place it is possible even for local governments in relatively underdeveloped regions to significantly enhance their capacity in a relatively short period of time (Fiszbein, 1997).

Building the capacity of subnational governments to carry out their new and often more complex responsibilities requires a comprehensive approach in which most public management systems are upgraded and integrated in a more harmonious fashion. Deficiencies or misalignments in the capacities of local governments (considered as a whole or in terms of individual organizations or agencies) will undermine their performance and their responsiveness to citizen demands and social needs. Deficiencies may affect many activities including policy design and strategic planning, budget management and revenue collection, human resources and information management, control and performance evaluation, just to name a few. The present chapter outlines proposals for improving institutional capacity in subnational governments. The first three sections focus on the key management systems: personnel, budget, and control and evaluation. The fourth section discusses reform strategies relevant to the different types of services commonly managed by local and regional governments.

### **Human Resource Management for Local Development**

A basic approach to the institutional weaknesses of subnational governments puts the blame on the deficient training and poor motivation of the administration. However, these problems, while in many cases real, are but one component in a mosaic of dysfunctional traits that have a more complex origin related to deficiencies of a broad set of management system.

Nevertheless, the deficient performance of staff is, in most cases, at least partially rooted in personnel rules and practices. In this area there are numerous potential causes, including hiring systems that fail to guarantee that individuals

will be selected on the basis of merit and will have the appropriate training for the position being filled. The widespread practice of clientelism that often substitutes merit and qualification-based hiring in part originates in deficient legislation but also in the absence of judicial and management mechanisms to enforce compliance with existing laws. Conversely, in the lower and middle positions in the local bureaucratic hierarchy there is often excessive security, which creates strong disincentives to good performance (Nickson, 1995). By contrast, there is a high level of discretion and relative insecurity with regard to professional level positions, especially those that are most susceptible to political pressures and corruption. High professional staff mobility, which also results from pay scales which are consistently below those of the private sector (or even other parts of the public sector), is one of the most important deficiencies of local public management that have a negative impact on the continuity of policy. The generally low salaries and low social status of local government employment, along with the politicized nature of appointments and instability at higher ranks, impedes the development of a more talented, appropriately trained, and stable work force.

Incentives for good performance are also limited by the absence of a career system. When mechanisms of internal promotion exist they tend to be applied arbitrarily and usually fail to take into consideration pertinent criteria, such as past performance and skills of the incumbents. Aside from the lack of a merit system, career structure, and adequate pay scale, motivation is also undermined in many cases by the absence of sufficient mechanisms to evaluate performance and the weakness or infrequent application of disciplinary regimes.

Deficiencies in the personnel system are generally compounded by deficiencies in the broader management structure. For instance, the weakness of planning and policy-making makes it difficult to develop personnel policies. Deficiencies in strategic planning often exist side-by-side with weaknesses in personnel management. As a consequence, often the roster of job positions is not rationally connected with the direction in

which the agency is headed, and the skills and functions needed for each position are poorly specified. It is common for clientelist pressures to thrive in this personnel policy and strategic management vacuum, expanding the workforce well beyond the needs or budget capabilities of local governments.

There is a generalized absence of qualified training institutions in the region. When they do exist, training programs are often not geared to the skills required and/or not linked closely with the strategic plan of the organization. Training methodologies also need to be changed, with less emphasis on classroom teaching and more on problem solving, on-the-job, and hands-on approaches. The potential of distance education also needs to be tapped to train local governments staff in isolated areas. The demand-oriented approach to service provision and its financing through the sale of services to municipalities makes Brazil's Institute of Municipal Administration (IBAM) a source of good practices.

## **BUDGET MANAGEMENT FOR LOCAL DEVELOPMENT**

### **Managing Revenue Collection**

The difficulties that subnational governments face in raising own revenues only in part originates in the intergovernmental restrictions discussed in Chapter 3; namely, their lack of discretion in the selection of tax bases and rates. These difficulties are compounded by weaknesses in revenue collection procedures and the deficient capacity of functional units in charge of tax administration (IDB 1998). Progress in revenue assignments, particularly locally administered taxes and user fees, must be accompanied by a significant improvement in local capacity to manage tax rolls and collection systems.

*Legislative Framework.* Municipal tax codes and small-yielding levies, which are difficult to administer, do little to improve tax management. In some cases, municipal tax legislation is not compatible with national or intermediate gov-

ernment legislation for instance, in the definition of certain tax bases.

*Institutional Setup for Revenue Management.* The functional makeup of municipal revenue bureaus and units makes it difficult for these governments to collect taxes efficiently. For one thing, few have compliance monitoring and audit units or plans, and very few do tax inspections and audits and in general exercise their enforcement authority. Likewise, many municipalities have no master tax roll and collection systems, such as current-account systems that can furnish aggregated data on the tax liability of each taxpayer. Further collection of property taxes, the single largest source of local revenue for many local governments, is seriously hampered by out-of-date property rolls and by the fact that property data are often spread among various record offices. For instance, real estate property transactions are registered with different offices than those that track property valuation for tax purposes. In addition, a different level of government often handles registration. The frequent lack of communication among these units makes it difficult for subnational governments to update tax rolls to keep track of the commercial value and current ownership of properties.

It is frequent to find municipalities with no integrated information systems for financial management that would expedite budget management, efficiently track municipal spending and make it compatible with revenues. The financial management modules in place for budgeting, accounting, cash management, and procurement and contracting are not usually integrated. A large number of municipalities, even those in the most advanced countries in the region, have budget systems that are incompatible with systems used by other levels of government. For instance, budget classifications are usually not grounded in technical criteria, making it difficult to compare accounting and financial information across municipalities. A similar problem emerges from the lack of uniformity between municipal and central government public investment systems. The cases in which financial management systems are directly linked with tax administration systems are rare.

*Asymmetry of Institution-Building Needs.* The institutional problems outlined vary in magnitude and frequency from one subnational government to the other. Moreover, although the problems described are common to a vast majority of local fiscal institutions, not every subnational government in every country faces the same problems. Even in the presence of similar institutional constraints, it is important to consider that while problems may be similar, solutions should not necessarily be the same. The objective of creating efficient tax units in every municipality, for example, should not be pursued across the board, without considering at least two factors: environment and size. If the proper legislation and political support exists, it might be equally or more efficient to piggyback certain tax services (such as collection and auditing) on those of larger municipalities or even national tax agencies. Solutions should always be customized in order to avoid the inefficient standardization of approaches.

Fiscal capacity building at the subnational level may proceed as incremental programs addressing one or more specific problem areas for defined groups or as integrated institution building efforts in a target set of subnationals. The choice of one approach or the other is dictated mostly by the situation of the target government, including the quality of the legal and institutional environment. There is the option to attempt massive institutional development programs to assist a whole cohort of subnational governments with solutions implemented in a serial manner. This option entails the development of a menu of products appropriate for a significant number of municipalities, such as information systems comprising standard tax and financial management modules and including the required training programs for their use. It is most suited for situations in which the legal and institutional environment for local government development has been reformed to enable a sufficient degree of autonomy and efficacy.

Capacity building programs for fiscal decentralization in general, and institutional development for efficient fiscal management in particular, usually confront the dilemma of whether to undertake such activities prior to the completion of

policy reforms or to wait until these have been completed. The question of what should go first, policy reform or institution building does not have a final answer. All depends on the circumstances, particularly on the depth of the reforms required. Except in the most trying circumstances, a comprehensive approach involving both policy and institutional strengthening activities is more likely to succeed inasmuch as these activities reinforce each other. As the reform of the legal and institutional framework frees local energies, institutional support activities allow the newly empowered local governments to stand up to the challenge.

*Intergovernmental Support Systems.* For a large cohort of subnational governments, the strengthening of local fiscal bureaus requires long-term support from fiscal agencies at higher levels of government. Areas where this collaboration is productive include:

1. Technical advice for upgrading of managerial and operational systems to make them compatible with national systems;
2. Provision of information to support auditing or supervisory functions;
3. Provision of revenue collection and auditing services, and
4. Training of local officials.

However, it is not always the case that central or state/provincial governments are able to provide such support. A weak national or provincial tax administration not only will lack the required technical resources to assist local governments, but also will likely complicate the work of local offices. Such programs, therefore, should prioritize efforts to strengthen technical capacity at the national or intermediate level of government as a prerequisite for building such capacity at the local level.

A related issue emerges when local government systems and management practices are not fully compatible with those of the central or state/provincial governments. This situation calls for harmonization of critical areas like data reporting (cash versus accrual basis) or budgetary classification.

## Managing Public Expenditures

*Sources of Funds and Autonomy of Decision Making.* No matter where subnational governments get their funds, they are unlikely ever to have enough resources to do all they or their citizens want and expect. A critical element in successful local government is to ensure that scarce public funds are managed efficiently and used effectively. This is an essential component of local capacity building.

Financial honesty and political accountability require properly established and implemented budgeting and financial procedures. They also require comprehensive, comparable, verifiable, and public budgeting, financial reporting, and auditing. It is equally important, however, to ensure that budgeted resources are applied as efficiently and effectively as possible to achieve desired public outcomes. Adequate and appropriate procedural norms are important in any financial system. But substantive outcomes are what really matter and budgeting and financial procedures are, in the end, simply the accounting manifestation of public policy. Proper public expenditure management must adequately control the total level of revenue and expenditure, appropriately allocate public resources among sectors and programs, and ensure that governmental institutions operate as efficiently as possible (World Bank, 1998). It seems particularly critical that subnational governments have sufficient authority to manage their revenues and expenditures.

As discussed in detail in Chapter 3, it is important to ensure that the correct incentives exist on the revenue side. Specifically, subnational governments must have access to some significant revenue sources for which they are economically and politically responsible. On the expenditure side, the earmarking of substantial parts of inter-governmental transfers for local infrastructure investment has characterized much of the recent experience with decentralization in many Latin American countries. For example this feature is found in Argentina, Brazil, Colombia, Chile, Ecuador, Guatemala, and Venezuela. Presumably motivated in part by the desire to prevent local governments from "wasting" transfers on

expanding local payrolls, such earmarking has had the paradoxical effect in some cases of exacerbating local fiscal problems. Although not fully effective,<sup>15</sup> the result has usually been to increase capital spending to some extent, while making the already difficult problem of financing operations and maintenance even more difficult. Such earmarking has relatively little to be said in its favor: it distorts local preferences, exacerbates perverse incentives already found in the local finance system, and often connects revenue sources with expenditures in totally illogical ways. Moreover, excessive earmarking (and the related process of "mandating" subnational governments to spend in accordance with central preferences rather than their own) significantly reduces the scope for subnational governments to allocate expenditures according to the needs and preferences of local citizens and in a cost-effective manner.

*Planning and Budgeting.* As with good fiscal practice anywhere, good subnational budgeting should take place within the framework of a medium-term expenditure framework (MTEF). This is required to ensure the proper financing of investment projects and to reduce the scope for short-term political manipulation of budgets (for example, to expand pre-election public employment in an unsustainable fashion).<sup>16</sup>

An essential first step in this direction is to put sound budgetary and financial procedures into place, especially in the more important subnational governments, such as states and large cities. Subnational budgets must be comprehensive, accurate, periodic, authoritative, timely, and transparent. The budget law must be uniform and clear, and it must be enforced. Moreo-

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<sup>15</sup> Since money is fungible, there is usually some substitution of transfers for own-source revenues.

<sup>16</sup> Of course, unless there is an adequate MTEF at the central level, it may be difficult to require one locally. On the other hand, given the growing importance of local governments in many countries, it is increasingly difficult to have an adequate MTEF at the central level in any case without explicitly incorporating aggregate local revenues and expenditures into the budgeting and planning exercise.

ver, expenditures must be subject to external audit to ensure that the law is followed. All this would seem to require a strong central hand to ensure that the rules are in place, and complied with. For example, the central government should establish a "framework" budget law and require adequate external audit (such as by a private sector firm).<sup>17</sup>

A strong budgeting and financial system along these lines will satisfy two essential requirements of good government. First, it will establish the basis for financial control. Second, it will provide reasonably accurate, uniform, and timely financial information. But, by itself, even the best financial procedures can do nothing to ensure that scarce public resources, even if properly spent and accounted for according to law, have been spent in the best possible way or as efficiently as possible. Nor, as some countries have seen in recent years, does even the best enforced budgetary procedures ensure that aggregate fiscal discipline will be adequately maintained. To attain favorable outcomes in these respects, additional important fiscal institutions need to be put in place.

For example, the MTEF can encourage *fiscal* discipline by providing an essential baseline for measuring and monitoring the budgetary impact of policy changes. Similarly, fiscal discipline requires predetermined intergovernmental transfers that are not subject to political renegotiation during the budgetary year. Moreover, as discussed in Chapter 3, subnational governments must not be able to depend on central government bailouts when they have made unwise financial decisions (such as unsustainable borrowing or expenditure increases).

*Ensuring Efficient Management.* Similar institutional safeguards should be in place to ensure allocative and operational efficiency within affordable fiscal limits. *Allocative efficiency* requires that managers at all levels receive adequate and accurate information on the effective-

ness and social outcomes of the programs for which they are responsible. Such signals can derive from the revenues produced by properly designed user charges and/or through participatory interaction with clients at both the budgetary and implementation stages. Moreover, they must have strong incentives to respond to these signals. For example, by facing a predetermined spending limit, which can be altered only if they can "sell" more services than their client groups are willing to pay for.

*Operational efficiency* may best be achieved in most cases by allowing line managers (like the school managers mentioned earlier) significant discretion, within budgetary cash limits. Such discretion allow managers to reallocate funds among inputs or perhaps even across budgetary periods, subject to the attainment of predefined operational (performance) goals as well as compliance with appropriate internal and external financial control and audit systems. Emphasis is thus shifted from input controls (hiring a given number of persons at a given wage or renting a given amount of office space) to output controls (providing health care of a determined quality to a given number of persons within a specified time period or issuing a given number of marriage licenses).

Shifting the emphasis in public finance from inputs to outputs in this way is an essential step for improving policy outcomes at any level of government. It carries with it some risks and it is by no means fully clear how best this shift can be accomplished in the difficult circumstances faced by most countries of the region.<sup>18</sup> Nonetheless, there is already considerable experience in Latin America with such techniques as client surveys, participatory budgeting (notably in some Brazilian cities), performance budgeting, and user financing (Burki, 1999). The path to success is by no means clearly marked. But at last some clarity exist about the directions in which countries should begin to move in terms

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<sup>17</sup> It should *not*, however, require subnational budgets to be subject to prior approval, or the whole point of decentralization is lost.

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<sup>18</sup> For example, there must still be full accountability by clearly identifiable decisionmakers with respect to all expenditure decisions to reduce the possibility of fraud.

of expenditure management if their leaders are seriously interested in making life better for their populations.

### **Control and Evaluation Management Systems for Local Development**

The strengthening of control and evaluation mechanisms entails granting subnational governments the capacity to monitor their own activities, to learn from past experience, and change direction. Such mechanisms enable the government to supervise and audit the resources that are employed (INPUTS), its degree of compliance with rules, norms and procedures, and results obtained (OUTPUTS), as well as the consequences of these results or their final impact (OUTCOMES). Following are a few potential mechanisms to bring about improvement, given the considerable weakness of control and evaluation systems in most subnational governments.

One approach might be to build "sunset" provisions into transfer programs; that is, make transfers to local institutions subject to renewal in a specified number of years provided they pass some form of independent evaluation of their performance. Another approach might be to use centrally supported access to capital markets for infrastructure finance not only as a screening device to reject obviously flawed projects but also as an evaluation system to build up "ratings" of local capacity and effort. Yet another approach might be to assemble and publicize reliable comparative information on subnational government performance. Finally, most democratic federal countries have developed specialized institutions that serve, on the one hand, to partially integrate the fiscal decisions of governments at different levels and, on the other, to provide the informed public with some useful and trustworthy (nonpartisan) information on what both levels of government are doing, separately and together.

Developing such institutional "infrastructure" is neither a quick nor a cheap undertaking, but it is an essential one if countries want to decentralize important public sector activities without losing touch with what is going on in these parts of the

public sector. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance are adequately performed once they have been decentralized. Much more informed and open discussion of these matters than is common in most countries is needed. Regular publication of relevant data is essential. However, the system cannot rely solely on one of the interested parties (the central government) to carry out all the analysis that is needed for informed public discussion in any country in which intergovernmental financial issues are important. In countries in which the role of local government is important, consideration might therefore be given to establishing a nongovernmental institution focusing on local government problems.

Some central governments are learning through experience to carry out this essential information and monitoring activity more adequately in their own interests (for example, to avoid excessive subnational borrowing and hence potentially undesirable macroeconomic pressure). In no country, however, has any central government yet admitted that full disclosure (transparent accountability) should apply also to its own actions as they affect intergovernmental fiscal relations. Decentralization is a two-way street, and the central governments need to more fervently assume their pivotal role in this complex process. As Breton (1996) has demonstrated, for the potential benefits of increased governmental competition to be realized, governments at all levels must become more transparently comparable and hence accountable for their actions.

The main conclusion one can draw from international experience with specialized "decentralization institutions" is that each country takes its own approach. Nonetheless, experience around the world suggests that several different roles might be envisaged for a body concerned with intergovernmental finance issues. Depending upon what is politically desired and feasible, some of these roles may, or may not, be combined in the same institution.

One possible role might be to serve as a link between the political and executive branches in

the center and the regional (and perhaps local) governments. A special institution does this by:

1. providing a nonpartisan forum within which various relevant actors may get to know one another in a nonconfrontational setting;
2. providing a common informational basis to all parties that will (one may hope) be trusted by all parties; or, finally,
3. training, both formally and informally, a cadre of experts in local service provision, fiscal and financial areas that may, over time, spread over the country, thus improving the trust in (2) and the basis for (1).

Whether the "forum" role (which would appear to require that members largely be selected on political criteria) is really compatible with the other two objectives is not clear, however. In the circumstances of many countries one of the most important needs is for a cadre of fiscal and policy analysts to be trained at all levels of government. They should be trained not only in the mechanics of analysis but in working together, from their different perspectives, towards the common goal of making the complex political and administrative system work.

Other ways in which an intergovernmental agency might, if desired, serve a formal political role are the following:

1. making annual or periodic reports on "the state of the federation"
2. determining, or reporting on, the appropriate basis for grants;
3. providing "federalism impact statements" indicating clearly the impact on subnational governments of central actions; or
4. working with central banks and departments of finance in developing comparable public finance data (for example, on borrowing).

A body whose main formal role was educational rather than political could achieve the substantive content of each of these tasks as well or better. For example, a common accounting framework could be developed and utilized for monitoring the fiscal performance of all levels of subnational government. Such reports, which would be relevant to both the central govern-

ment and to citizens in general, might be more credible if the agency did not have a formal "reporting" role to the central government, and its output was accepted as the work of competent and politically neutral analysts. Similarly, an intergovernmental fiscal body might play a very useful role by monitoring and reporting on the impacts of possibly intrusive central government policies on subnational governments. Again, its work on such matters might be more credible if it were not seen as one of the players in the political game but more as an outside, but very well informed and trustworthy referee.

For any decentralized system to work well in a democratic setting, people need to understand not only what is going on but also the real possibilities and constraints facing governments at all levels. An appropriate intergovernmental agency might serve as a central analytical focus, both supplying trustworthy information to all actors and, importantly, helping to create the informed public that is needed for the political system to cope with the great strains and many challenges facing it in most countries today. How "political" such a body might be, or what its optimal structure might be, is something to be determined in the context of each country.

### **Specific Reform Strategies for the Types of Services Typically Managed by Local and Regional Governments**

A strategy for improving the institutional capacity of regional and local governments should start with a specific diagnosis of institutional performance in those areas that are considered to be critical. From there, attention should be focused on identifying the more specific causes of deficient performance and determining the objectives of the reform effort, in light of the conflicting interests in play and the available resources. Notwithstanding the need for specific diagnosis to support proposals for specific situations, existing knowledge in the fields of organization theory, management science, and public policy analysis, and the accumulated experience of the Bank and other multilateral institutions, makes it possible to suggest some orienting guidelines for the improvement of performance tailored to the particular nature of the govern-

mental function and the public intervention in consideration. These guidelines should be considered as initial hypotheses to be considered in the specific diagnostic analyses of particular cases mentioned above.

The universe of government interventions can be classified into the following basic types:

1. Representation and defense of local interests outside local area
2. Policy-making
3. Establishing norms and regulations
4. Application and enforcement of laws and regulations
5. Provision of public goods and services (in nonmarket conditions)
6. Provision of public goods and services in market or quasi-market conditions

Table 5.1 shows the type of intervention that corresponds to each function or set of local-regional public activities. The details of this table differ from country to country depending on their institutional capacity and the extent to which they can mobilize resources for the provision of goods and services and social welfare. The classification presented here assigns each type of activity to types of intervention that are most pertinent from a management perspective.

In what follows we present guidelines to improve performance in the public interventions that are most important in terms of their weight in the activities carried out by local governments.<sup>19</sup>

### **Provision of Goods and Services under Non-market Conditions**

The provision of public services like education and health are complex public interventions. The nature of the activity requires that careful attention be given to training the professionals in

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<sup>19</sup> To see a discussion of the other types of public interventions and for a more in-depth analysis see Losada and Payne (1999) *Documento de orientaciones para programas y proyectos de reforma del Estado*.

charge of delivering a service that requires that they enjoy substantial freedoms to adequately perform their jobs. The personnel systems, therefore, cannot aim to tightly regulate the behavior of individuals in their execution of the job (i.e. teachers should have a great deal of discretion to teach a given curriculum in the way they think is best).<sup>20</sup> For this type of activity the professional organization model (also called the professional bureaucracy) is particularly valid. In reforming institutional mechanisms for the delivery of these services, emphasis should be placed on personnel policies for the professional providers of the public service (e.g. doctors, teachers, social workers). Particular attention should be given to the processes of hiring, training and retraining, socialization in the values of the profession and of public service, promotion of the professional career (avoiding the flight toward management careers), and in evaluation and payment scales.<sup>21</sup>

To improve efficiency in service delivery, it is important to maintain relatively flat organizations with few levels of management and avoid creating hierarchical and power-oriented cultures. The loss of professional discretion should be avoided and an organization design with broad job classes (with few levels of vertical specialization) should be maintained. Bureaucratization and excessive rule making should be avoided to the greatest extent possible. Investment in training should be targeted at professional employees, rather than at the middle level or at the administrative assistant level, as long as these are critical to sustain good performance.

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<sup>20</sup> Mintzberg, 1979. Cap. 12

<sup>21</sup> For specific thoughts on health care see Moore, 1996. That study makes a distinction between public health and prevention activities, for which a traditional bureaucratic model is most appropriate, and the provision of therapeutic medical services, for which a professional bureaucratic model is most appropriate. See pages 16 to 21.

FORM OF INTERVENTION	Representation and defense of local interests	Policy-making	Making laws and regulations	Application and Enforcement of Laws and Regulations	Provision of public goods and services in non-market conditions	Provision of public services in market or quasi-market conditions
<b>TYPES OF LOCAL GOVT. ACTIVITIES</b>						
<i>Economic Activities</i>						
Local economic development						
City marketing and attraction of foreign investment						
Creation of economic infrastructure (e.g. convention centers, industrial parks)						
Management of markets and distribution facilities						
<i>Urban Planning Activities</i>						
Territory planning, land use						
Territory management: urban plans						
Public works						
Neighborhood recovery						
Environmental programs						
Maintaining public property						
<b>Infrastructure and Urban Service Activities</b>						
Management of water runoff, sewage						
Public transportation						
Management of waste and street cleaning						
Maintaining urban real estate, parks, public lighting, parks						
Management of cemeteries						
<i>Social Activities</i>						
Provision of education services						
Cultural, sporting and other activities						

Provision of social services (families, elderly, youth)						
Public health maintenance and health services						
<b>FORM OF INTERVENTION</b>	<b>Representation and defense of local interests</b>	<b>Policy-making</b>	<b>Making laws and regulations</b>	<b>Application and Enforcement of Laws and Regulations</b>	<b>Provision of public goods and services in non-market conditions</b>	<b>Provision of public services in market or quasi-market conditions</b>
<b>TYPES OF LOCAL GOVT. ACTIVITIES</b>						
<i>Governmental activities</i>						
Collection of taxes, user fees						
Management of basic information						
Management of registries						
Police and security						
Justice admin. and peace justice						
Detention centers, prisons						
<i>Institutional Activities</i>						
External representation and defense of city						
Citizen participation and articulation of conflicting interests						
Creation of a consensual vision of goals/plans/projects of city.						

When the local or regional government decides to guarantee or regulate rather than to directly manage the delivery of a particular good or service, the mixed management model is likely to be most appropriate. This model entails that subnational governments will have to assume the task of elaborating the legal framework and the rules of the game that should govern the delivery of the service and monitor and enforce compliance with these rules and provide the necessary financing.<sup>22</sup>

### **Provision of Public Services in a Market or Quasi-market Environment: The Divisional Model**

Subnational governments are responsible for services such as water, gas, and electricity. Given that these goods and services are in large part excludable and do not show significant externalities, there are no compelling reasons to keep them in the hands of the public sector, at least when a market can be established that ensures competition and adherence to a given set of standards. As a result, they are being privatized. In these cases, the only relevant function that remains in the hands of the government is the regulation of private providers, a function performed sometimes at the national level, others at the subnational level (mostly states and provinces). A different approach to reform is desirable for the services that remain in the public sector.

Different market mechanisms are needed for this type of public intervention. For example, demand and supply changes are required to lower costs and improve quality of service. Supply-side reforms may include the breaking up of monopolies, promoting the entrance of new competitors, promoting public-private competition, and creating markets or quasi markets. Demand-side reforms entail giving consumers or users of public services the power to choose among suppliers, creating co-payments/vouchers schemes, and improving the availability of in-

formation about costs. When market or quasi-market mechanisms are used, the public entities should be managed in a business-like manner. In practice, these activities are commonly carried out through a public stock company or an entity with a high level of autonomy relative to the executive (semi-autonomous organizations, state agencies etc). The challenge for subnational governments is managing the provision of services through autonomous or semi-autonomous units over which they do not have direct control. This public management model is made up of four elements,<sup>23</sup> each of which indicates areas for improving performance.<sup>24</sup>

*Grouping Functions According to the Provision of Goods and Services.* The first area that requires attention is the criteria used to determine the functions and services that should be included in the new unit or division. The agencies or units should assume responsibility for all of the functions necessary for the production of a public good or service or final output. The reach of the agency cannot be limited to one function or one part of the process; it must be able to generate by itself an identifiable and measurable product or service. The idea of a tangible and homogeneous output is key to the grouping of functions and is a prerequisite of the other elements of the agency model (the business as well as the divisional variant).

*Separation of Policy and Management Responsibilities.* The policy responsibility entails establishment of a mission, objectives, performance indicators, and control of results according to objectives and targets for the agency or business.

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<sup>23</sup> Details may vary; however, all four elements are essential to ensure the internal cohesion of the model.

<sup>24</sup> The divisional model is a specific variant of agency theory. The principal-agent relationship in this case is based on the existence of highly specifiable outputs and/or the possibility of introducing competitive mechanisms. These means of control are possible because there is no imbalance between principal and agent in negotiations *ex ante* (e.g. information is available to the principal), and because it is also possible to carry out an *ex post* control based on results without needing to control the process.

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<sup>22</sup> For the specific reform recommendations associated with this model see Losada, Payne (1999, cap. 3).

Management responsibilities should be assigned to professional directors whose earnings are tied to performance. The agency model depends heavily upon the professionalization of the public administrator or director function (otherwise its implementation can be highly counterproductive).

*Management Autonomy.* The third area of attention is the level of autonomy granted to the new division. Agencies should be designed with considerable autonomy. It can be considered a limited decentralization, predicated upon a more effective and efficient fulfillment of its mission. The degree of decentralization and management autonomy will depend upon the outputs. The powers that are subject to transferal include management of the agency's operations (its structures and internal procedures), management of its human and financial resources, and management of support services (purchases, information technology, etc.). Functions that are required for establishing the agency's policies and those that are essential for maintaining the broad integrity of the institution should never be transferred. These functions include the development of strategies and allocation of resources; rule making; the design of accountability systems based on results; decisions concerning strategic investments; the naming and renewal of directors; and the definition of the strategies of information systems.

*Control Based on Results.* The last area of attention is the design of the control system. While bureaucratic structures base control on hierarchical supervision and the uniform imposition of procedural rules, control in the business or agency model is based on a comparison of the results obtained with the targets set previously in management plans. Control entails two areas of action: (a) the supervision of the agency's compliance with the basic rules of the game in the framework within which it exercises its management autonomy and (b) regular checks on results indicators (quantitative and qualitative) which allows the identification of deviations and determines the need for corrective action. For accountability mechanisms to be efficient a central unit specialized in the oversight and control of the operations of the businesses/agencies is required.

## **Summary of the Elements for Improving Local Institutional Performance**

The problems affecting local public administrations in Latin America are significant, however things may not be as bad as they seem. Central governments have not performed well in delivering services. The devolution of authority and the onset of electoral accountability mechanisms for subnational governments have been quite recent in most cases. Therefore, it should not be surprising that the process of building capacity would take some time. The devolution of functional responsibilities has frequently been driven by political expediency and, in many occasions, resulted in the establishment of a broader intergovernmental framework that produces disincentives for improved performance. Thus, the initial slowness of local governments to respond to the new challenges is due to the distorted incentives arising from poorly specified and separated responsibilities, inadequate regulatory frameworks, and/or imbalances between expenditure responsibilities and available resources.

Creating incentives for improved local government performance depends not only on the establishment of a more rational and clearly specified framework of intergovernmental relations and more effective institutions for citizen participation and representation, but also on more effective and finely tuned public management systems. Patronage-based personnel systems need to be transformed into ones that take labor needs, individual merit, and incentives for good performance fully into account. However, to create a capable public administration staffed by adequately trained, well-motivated, and properly directed individuals, requires reforms not only of personnel norms and procedures, but simultaneous and coordinated changes in other public management areas, including policy-making and strategic planning and evaluation systems. In order for public agencies to perform efficiently—that is, to adequately meet the objectives they are designed to achieve—the diverse management systems must generate incentives that lead the individuals within the organization to work in reasonable harmony and with reasonable competence and effort.

The effectiveness of local governments in managing revenues and expenditures is constrained by the limited discretion given them in selecting tax bases, in assigning tax rates, and, in choosing how to spend funds transferred from the central government. However, the problems stemming from the structure of intergovernmental fiscal relations are often exacerbated by the deficient local capacity to maintain and utilize reliable and up-to-date taxpayer data, to enforce fulfillment of tax obligations, to integrate information on the revenue side with that on the expenditure side, and to efficiently and accountably allocate public resources among sectors and programs. Transparency, reliability, and comparability in budgetary information are not only a prerequisite for efficient revenue collection and budget implementation, but also a key factor for promoting the accountability of the government to citizens via electoral and other participatory mechanisms.

Given the diversity of country conditions, the varied causes of deficient performance in specific areas of governmental activity, and diverse governmental priorities, it is not possible to develop a general approach to building institutional capacity at the local level. However, it is clear that the desired managerial systems and the nature of the incentives for promoting good performance vary according to the type of public intervention being addressed.

Given the complex, yet predictable nature of the governmental function of delivering public goods and services not readily amenable to market competition, it must be ensured that appropriate personnel policies are in place in respect to the professional providers of the public service and that a relatively non-hierarchical and non-bureaucratic authority structure exists. For goods and services that are amenable to market competition it is possible for the government to devolve responsibility for direct management to public stock companies or semi-autonomous or autonomous agencies. If the government is to effectively perform this task of indirect management it should ensure: 1) that such agencies assume the responsibility for all of the functions necessary for the production of the public good or service or final output; 2) that while the management responsibilities associated with these core functions are fully devolved, the policy responsibilities are retained by the government; 3) that the degree of autonomy granted the directors of the agencies is tailored to the outputs being produced and the specific conditions for effectiveness and efficiency; and 4) that the government has sufficient capacity to supervise the agency's compliance with the basic rules of the game and to enforce necessary adjustments in the agency's performance.