

## 7. Lending to Subnational Governments: Developing a Hard Credit Discipline

### CHAPTER SUMMARY

From the system of financing subnational activities emanates a significant part of the structure of incentives under which local decision-makers operate. As discussed in Chapter 3, established practices need thorough reforms to create the right set of incentives. Own sources of revenue need to be developed in synchrony with intergovernmental transfers so that the latter do not displace the former. The transfer mechanisms used establish another layer of incentives inasmuch as tied transfers may encourage the overprovision of certain services to the detriment of other community priorities. General budget transfers provide more room for the expression of local preferences and are preferable although they reduce the capacity of higher tiers of government to attain specific sector objectives. Borrowing by subnational governments is a powerful tool of financing, but poses potential problems when used where: (a) subnational governments are not subject to hard budget constraints, (b) capital markets fail to impose a hard credit discipline, and (c) officials are not fully accountable to their constituencies. Developing an efficient and equitable system of financing for subnational governments should be a priority for design and implementation of decentralization programs.

### Support for a Hard Credit Discipline

Responding to the expanded functions entrusted to subnational governments, the largest and strongest states and municipalities are increasingly financing their investment programs with borrowing, mostly from national banks and financial institutions and lately in the capital markets. This trend creates an opportunity for private investment in local infrastructure, a major step in financing decentralization. However, this option is limited to creditworthy subnational governments that are able to borrow.

A preliminary survey of the financial condition of subnational governments shows that few have the degree of creditworthiness needed to access domestic capital markets. In fact, the great majority of the municipalities lack the capacity to borrow. Their local economies do not support a large enough tax base or the wherewithal to recover cost from beneficiaries. Further, they do not have the institutional capacity to undertake the level of project planning, implementation and operation usually required by financial institutions. As a result, they are now and are likely to remain unable to borrow. They will rely mostly on transfers to finance capacity expansion plans. A number of poor and institutionally weak states and provinces face similar problems.

For subnational governments that have the ability to borrow, putting in place conditions that promote a hard credit discipline will effectively complement reformed intergovernmental relations and democratic governance in establishing the appropriate incentives. As the discussion in previous sections shows, even for these subnational governments, general financial management restructuring is needed before considering a major municipal capital markets access initiative. There are a handful of municipalities and states that can today access local or international capital markets. The limited experiences of Buenos Aires, Bogota, Rio de Janeiro or Sao Paulo indicates that these governments have obtained funds on good terms but also points to the narrow conditions under which private lenders were willing to lend. Events of the past year, including the defaults of several states, suggests that true market readiness might be even less attainable than originally thought.

There is an opportunity for expanding the role of private lenders in financing subnational infrastructure investments. Seizing this opportunity requires a concerted effort to prepare these borrowers to satisfy the creditworthiness conditions

of lenders. This section proposes a framework to promote lending to subnational governments based on a gradual strategy. Under this approach, a technical assistance program to develop the different aspects that support creditworthiness from the perspective of private lenders would guide sub-sovereign governments. After achieving a reasonable degree of creditworthiness, subnational access to capital markets would then be assisted by a credit enhancement facility, which could take many forms. The analysis favors national level mechanisms jointly capitalized with national governments but involving a strong element of private sector management and decision-making. Guarantees for the facility would be tailored to each market, but should be partial in nature and focus on credit support and maturity extension. The program, whose characteristics will vary from country to country, must also focus on building sustainable local markets; that is, ensuring that there are a healthy number of issuers consistently accessing the market. Finally, because local finance often has direct political ramifications, the program must be coordinated with national governments, national development banks, and other multilateral development institutions operating in the country.

### **The Foundations of a Hard Credit Discipline**

The Bank faces a significant challenge in aligning its lending operations to subnational governments with the general approach advanced in this paper that centers on generating the right incentives for subnational governments to behave in an economically efficient, fiscally responsible and transparent manner. The solution to this challenge lies in promoting a hard credit discipline on the actors involved, including local financial intermediaries, subnational governments and multilateral development banks. The proposal rests on the proposition that instilling creditworthy values and practices in the system will break the barriers that constrain financial opportunities for subnational governments.

The factors that give rise to a “hard credit culture” are those systemic elements that help to mitigate risk and generally encourage the repayment of debt on time and in full, and dis-

courage delinquencies and defaults. As figure 6.1 demonstrates, these factors can be grouped into the following pillars that sustain a hard credit culture.

*Improved intergovernmental relationships* (as discussed in Chapter 3) generate the favorable environment for strengthening the financial capacity of subnational governments. Some of the key elements include the legal and policy framework that facilitates local borrowing, debt servicing, and revenue sourcing. Attention should be given to the development of a stable and predictable intergovernmental fiscal system that provides shared revenue and/or the capacity to raise own-source revenues that reasonably match the needs and responsibilities of local authorities. Unambiguous legislation and legal provisions regarding the authorization, treatment and use of subsovereign debt is a critical element in facilitating the development of a subsovereign financial market. Of particular importance is clear legal authorization for subnational governments to incur debt and pledge collateral to secure that debt. In addition, investors must be comfortable with the legal process that governs the enforcement of security claims. Furthermore, the legal ability to incur debt must be accompanied by a regulatory framework that encourages responsible use of debt. This might include regulatory limitations and enforcement measures on all forms of indebtedness for subnational governments, and possibly negative consequences for local borrowers in the event of nonpayment.

Local authorities must have the *institutional capacity* to fully execute the responsibilities that they are being assigned. As discussed in Chapter 5, consistent accounting, auditing, budgeting, tax administration, reporting mechanisms and internal controls for municipalities and municipal enterprises must be established, along with appropriate disclosure standards.

*Increased private sector involvement* in the financing and provision of subsovereign services can create the incentives for these entities to build their financial capacity to source low-cost funds with adequate tenor in the private financial market. This is a significant challenge for local

authorities that do not have the credit history and credit culture needed to secure the levels of funding necessary.

*The development of local financial markets*, particularly capital markets, including the supporting legal and regulatory infrastructure (such as rating agencies, underwriters, bond insurers) is the fourth pillar of a hard credit culture. Shallow local capital markets are a major obstacle to encouraging private financing of local entities to provide infrastructure. Mechanisms that enhance the creditworthiness of local entities should address both perspectives of the problem: limited financial capacity on the demand side and constrained market interest from financiers on the supply side. Capital markets often begin to develop in economies faced with increasing demand for local and regional infrastructure.

The overall hard credit culture framework described above sets the parameters for an efficient subsovereign financial system. In addition to these systemic factors, which can be used as a basis for assessing subsovereign risk, there are also transaction-specific factors that must be considered.

#### **TRANSACTION-SPECIFIC RISK ASSESSMENT: EVALUATING CREDIT- WORTHINESS**

Lenders and guarantors will need to focus on the identification of a set of borrower-specific credit risk evaluation factors. As shown in figure 6.2, in underwriting credit transactions, particularly for subsovereign projects, close and often complex interactions occur among the concepts of willingness to pay, ability to pay, and essentiality. Together, these three factors are used to guide the assessment of subsovereign risk.

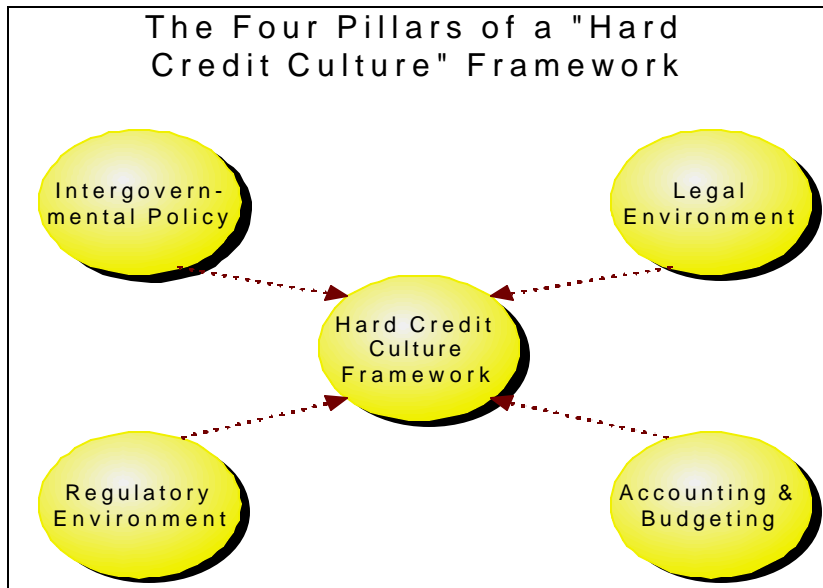
*Willingness to Pay*. This concept refers to the political will of borrowing entities to repay debt, including the ability to charge appropriately and receive payment for services provided. Among the measures of credit quality included in this concept are:

1. The strength of the overall legal and regulatory environment;
2. The strength of specific legal obligations to repay debt;
3. Expressions of political commitment by citizens and/or their legal representatives;
4. Demonstrations by decisionmakers of their political capacity to raise taxes or rates; and
5. The financial performance of the debtor during prior periods of political or economic stress.

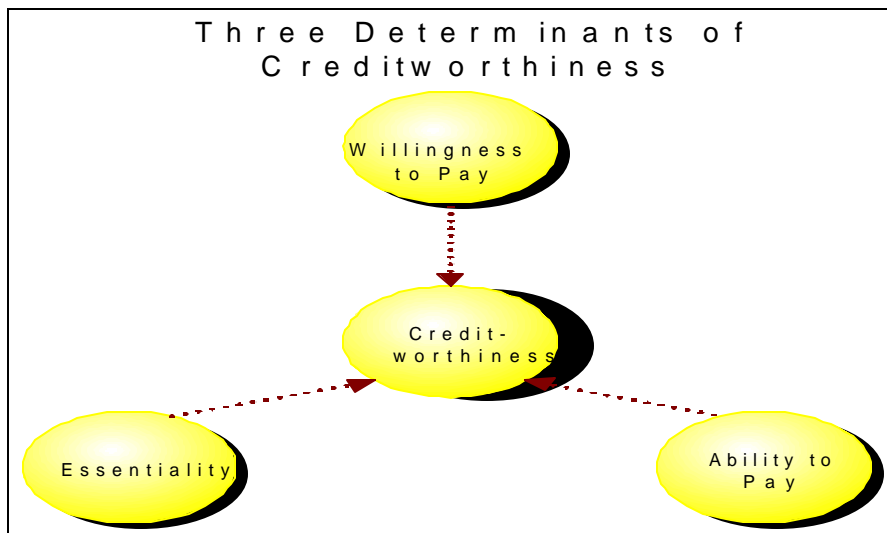
*Ability to Pay*. Ability to pay assesses a borrower's actual capacity to repay debt. This concept summarizes a second cluster of basic credit quality indicators, including:

1. Measures of the social and economic base of borrowing jurisdictions;
2. The ability to levy and collect taxes and/or other revenues;
3. The financial and procedural ability to apply collected revenues to the payment of debt service now and in the future, as measured by the analysis of the structural flow of funds;
4. Assessments of management and governance;
5. Measures of the anticipated financial performance of borrowing jurisdictions; and
6. Reasonable projected demand and revenue estimates.

**Figure 6.1 The Hard Credit Culture Framework**



**Figure 6.2 Determinants of Creditworthiness**



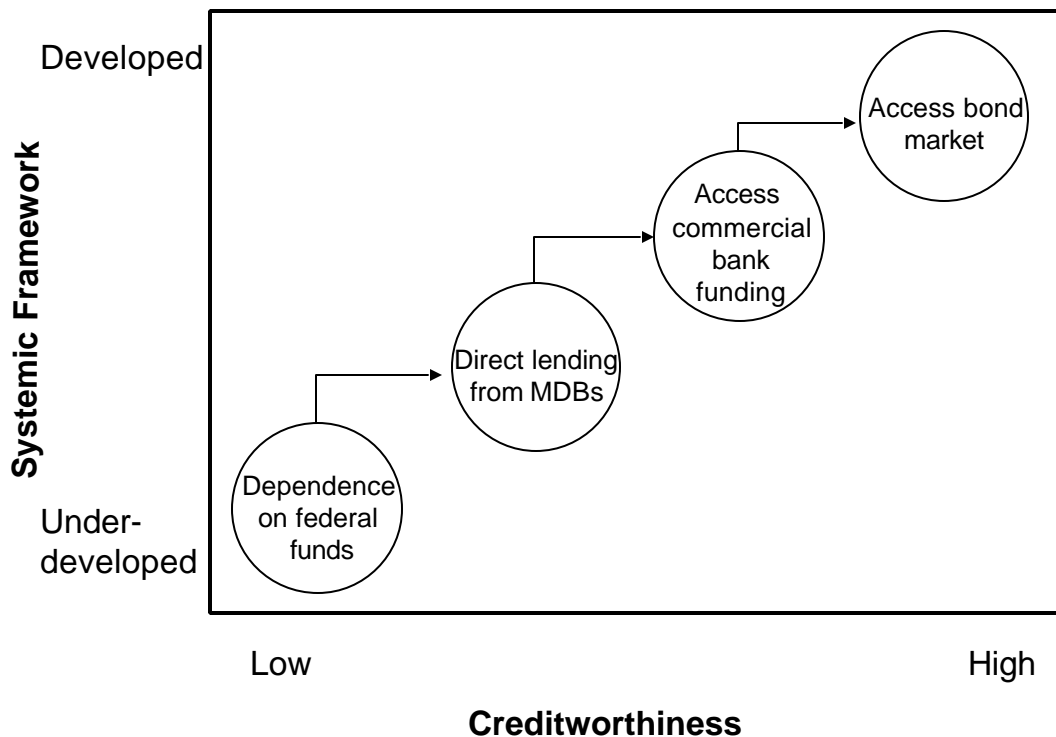
*Essentiality*. The concept of essentiality captures a third set of indicators concerning the priority that decisionmakers can be expected to place on specific public facilities or other assets. Indicators of essentiality include:

1. Close association with public health, as with basic water and sanitation facilities;
2. Basic educational or training value, as with elementary, secondary and other fundamental educational institutions or equipment;
3. Close association with public safety and the rule of law, as with police, fire, judicial and similar facilities and/or equipment; and/or,
4. Provision of utilities deemed fundamental by most citizens, a definition that in developed countries like the United States will include electricity, gas, solid waste, water, sanitation and even telecommunications, but which may vary somewhat in other countries.

### Impact on Potential Sources of Funds

The assessment of subnational governments based on the framework described above determines the potential funding sources available to these entities. As figure 6.3 indicates, this depends on the relationship between the level of development and the degree of creditworthiness. The result is a stepped course that begins with complete dependence on central government funding and culminates with direct subnational access to bond markets. As national systemic frameworks become more developed and subnational governments become more and more creditworthy, they will enjoy access to a greater pool of credit. Borrowers will move from relatively limited and inflexible sources of credit to larger and more diverse funding sources. This will be maximized when subnational governments have the ability to consistently access private financing through commercial banks and bond issues in local capital markets.

**Figure 6.3. Potential Sources of Financing for Subnational Governments**



Credit enhancement can play an instrumental role in the development of subnational financial markets. In figure 6.3, credit enhancement can be employed to boost sub-sovereigns along the steps to cheaper, more efficient, and larger pools of funding. For issuers, credit enhancement has the potential to facilitate access to capital markets, broaden investor participation, and lower the cost of funds. For investors, credit enhancement serves to decrease the risk profile of the transaction by allocating risks (commercial, political, financial, etc.) to the party best suited to manage it.

In Latin America credit enhancement can be instrumental in introducing the more creditworthy subnational governments to the markets. It can form the basis of nascent domestic financial markets, while at the same time demonstrating the value of creditworthiness to other subnational governments. Examples of credit enhancement mechanisms that might be applicable to Latin American subnational governments include revenue intercept mechanisms; over-collateralization; guarantees; letters of credit; debt service reserve accounts; pooled-risk mechanisms; and bond insurance.

Not all of these credit enhancement mechanisms are consistent with providing decisionmakers with incentives to adopt fiscally responsible decisions. Transfer intercepts have been used as a short cut to provide security for subnational loans; however, this practice has serious drawbacks in the long term. Fundamentally, it reduces the incentives for private lenders to fully assess the risk posed by individual subnationals, thus weakening the borrowing discipline that the market can exercise. Committed to promote a hard credit discipline for subnational governments, the Bank does not advocate the use of the intercept when its use discourages lenders from assessing the full risk presented by subnational governments. For the intercept to bring to bear its potential benefits, it should be capped on the basis of a small proportion of own revenues and used only when subnational indebtedness is fully disclosed. There are other options that may achieve the same results without using the intercept, for instance the establishment of irrevoca-

ble trust funds by subnational governments to guarantee repayment of loans.

### **An Agenda to Support a Hard Credit Culture**

The previous section of this chapter has outlined the prerequisites for development of a hard credit culture. This section provides four principles that make up a finance program that could be implemented in almost every Latin American country and is consistent with the Bank's larger development agenda

*Focus on Creditworthiness and Self-Sustainability.* At the core of a development agenda should be the emphasis on self-sustainability. In subnational finance this refers to an agenda to promote creditworthiness. This does not mean that all revenues must come from the locality, or that expenditures have to be drastically cut to meet an arbitrary budget. Rather, it implies that an operating budget should be rationally balanced between intergovernmental revenues and local taxes; that tax administration should be effective and efficient; that an investment budget should be financed with a reasonable issuance of debt, and also that user fees should be charged at appropriate levels.

*Employ a Graduation Strategy.* A vision for subnational finance should be that states and municipalities eventually graduate to self-sufficiency. The basic map is a path that leads from dependence on central government transfers to capital market access, with all progress based on creditworthiness. For the larger and financially more capable subnational governments, the Bank should steadily move from its current lending to government-owned financial intermediaries, to a second step focused on credit enhancement mechanisms to bridge the gap between subnational governments' existing debt issuance capacity and local capital markets. Initially, only a handful of states and local governments in each country would qualify for the credit enhancement vehicle, while most would be best served by direct lending coupled with technical assistance. Inevitably, some of the poorest subnational governments would remain

financially dependent on the national government for the foreseeable future.

*Develop Private Sector Intermediaries.* In addition to assisting localities with creditworthiness issues, the Bank program also needs to support the formation of private sector intermediaries that act as brokers, developers, feasibility consultants, and trustees. This does not mean that the Bank will fund these private sector agents, but rather that lending and credit enhancement mechanisms should not pre-empt and, in fact, should encourage these private sector participants.<sup>25</sup> A successful graduation strategy requires a system of private sector intermediaries with expertise in commercial banking, debt markets, or both.

*Coordinate with Other Multilateral Financial Institutions and National Development Banks.* Several multilateral financial institutions are pursuing a subsovereign finance agenda. Coordination between the institutions is important to avoid duplication of effort and/or contravening initiatives (see Chapter 7). In addition, current programs should be wary of activities that distort the market and do not promote creditworthiness. The current Bank approach to avoid subsidized lending and focus on market rate loans coupled with grants, point in the right direction. This creates a competitive environment where private sector banks can provide the loan and creates marketable loans for future securitization.

Close coordination with the various national development banks is also important. As the MFIs may be implementing a lending program with national development banks, they must be sensitive to the challenge of operating a subsovereign program outside of their customary

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<sup>25</sup> Two examples are useful to consider. In Guatemala, INFOM does much of the feasibility analysis and also holds all of the credit information on cities. Consequently, no brokers exist to develop municipal transactions, and few feasibility consultants exist to allow commercial banks and institutional investors to assess the value of particular projects for which cities want to issue debt. In Mexico, no municipal debt bankers exist because BANOBRAS is a direct lender to states and cities. Consequently, almost no commercial lending exists for municipalities.

channel of distribution.<sup>26</sup> If possible, technical assistance initiatives should be designed and implemented in close concert with the development banks. Direct lending should operate as independently as possible.

### **A Three-Pronged Agenda**

- ? In light of these four reform principles, a three-pronged subsovereign program consisting of technical assistance, direct lending and credit enhancement is advisable.

### **The Technical Assistance Program**

A core part of any financial reform program for subnational governments must be a comprehensive technical assistance program. Technical assistance programs and delivery mechanisms will have to be custom tailored for each country, but should be guided by a general framework.

*Comprehensive Support to Budget and Finance Activities for Self-Sustainability.* For states and municipalities with a history of lack of control over the major components of their budgets and finances, the first step is to implement a program to develop responsibility and accountability in all key parts of the planning, revenue and spending components of the local government administration. The goal should be a comprehensive reform that incorporates meeting benchmarks on an agreed upon continuum toward self-sufficiency. While it is likely that governments will take different approaches to implementation of technical assistance programs, the core areas for reform targeted by these programs should be consistent across all countries. The programs should consist of four main areas: revenues, expenditures, investments, liability management and political risk.

*Revenues.* In some countries, especially those where taxing authority is being devolved in tandem with expenditure responsibility, the most

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<sup>26</sup> If the national development bank perceives these initiatives as threatening, the response may be to undercut the MFI direct lending or credit enhancement program with heavily subsidized funds and looser credit criteria, resulting in a defunct MFI program.

important area requiring technical assistance will be tax administration. Local independent authorities, such as water authorities, also need assistance in establishing efficient fee collection mechanisms to reduce under-investment. Efficiency improvements will lead to increased revenues without requiring new or higher user fees.

*Expenditures.* In a decentralizing system, the management of an increasing array of expenditures can be a fundamentally new activity for states and municipalities. The implementation of budgeting and control systems will be a major activity in these places.

*Investment.* The capital expenditure process will involve creating a medium-term plan based on a needs assessment for the state or city. Many of the current planning systems in place have only a vague relationship to the actual capital expenditure process. New systems will have to be implemented.

*Liability Management.* The main new local activity will be the management of the liability side of a government balance sheet and the development of a sustainable financial strategy.

*Political Risk.* It will be necessary to develop safeguards and institutional arrangements against interference for lenders rights due to political instability and constraints

*Focus on Systemic Factors.* The Bank will focus its assistance on strengthening the areas that make up the foundation of a hard credit discipline. In addition, the Bank will support the reforms required by the financial and management mechanisms to enhance subnational borrowing from capital markets. Some of the specific considerations include improved intergovernmental relationships, institutional capacity, increased private sector involvement and the development of local financial capacity.

*Improved intergovernmental relationships* will generate a favorable environment for strengthening of the financial capacity of subnational governments (see Chapter 3). Local authorities must have the necessary *institutional* capacity to

fully execute the responsibilities that they are being assigned (see Chapters 4 and 5). *Increased private sector involvement* in the financing and provision of local services can create incentives for subnational governments to strengthen their financial capacity to source low-cost funds with adequate terms in the private financial market. This is a significant challenge for local jurisdictions that do not have the credit history and credit culture needed to secure the levels of funding necessary. The foundations for accessing private funding are laid out by comprehensive support to budget and finance activities for self-sustainability already described. *The development of local financial markets*, particularly capital markets, is especially important. This includes the legal and regulatory infrastructure such as rating agencies, underwriters, and bond insurers. In this area, the recommendations of the Bank's *Capital Market and Financial Market Strategies* should be followed. Shallow local capital markets are a major obstacle to enhancing private financing for subnational government activity in infrastructure provision. Mechanisms that enhance the local entities' creditworthiness should address both perspectives of the problem: limited financial capacity on the demand side and constrained market interest from financiers on the supply side.

In addition to these systemic factors, which can be used as a basis for assessing subnational risk, there are also transaction-specific factors that must be considered. It is essential to create the conditions under which lenders and guarantors of subnational debt focus on borrower-specific credit risk evaluation factors (including willingness to pay, ability to pay, and the priority placed by the community on the investments to be financed) and undertake their own due diligence.

### **The Direct Lending Program**

The direct lending program would take different forms in different countries in recognition of the varying levels of development. However, there are key elements that should form the core of the program, regardless of country of implementation.

*Focus on Essential Infrastructure.* Apart from being almost the only area of subnational financing for which borrowing is efficient, lending focused on essential infrastructure allows for relatively simple prioritization among projects by the community, and simple testing of the criteria of willingness to pay and ability to pay.

*Conditionality Leading to Graduation.* Conditionality should concentrate on graduating borrowers away from national municipal banks and multilateral support. Loan conditionality should include a commitment to adopt reform programs that will lead to self-sufficiency within several years and to graduation from development bank lending to the capital markets or bank loan market.

*Bank Lending.* The traditional lending program will aim at strengthening the financial autonomy of subnational governments as well as their capacity to access capital markets. It will be directed at fostering private sector participation in financing infrastructure and the expansion of services provided by subnational governments. Bank lending should also be used to strengthen institutional capacity to enhance the delivery of these services.

*Lending with Sovereign Guarantee.* All Bank loans to states, provinces and large municipalities have been provided with full guarantee from the sovereign. The Bank will continue this practice and no loans will be provided to subnational governments without the central government guarantee. There are no advantages to Bank lending without this guarantee. All of the Bank objectives concerning subnational development can be accomplished through operations with sovereign guarantee. Furthermore, under the faulty inter-governmental relationship structure that exists in the countries of the region, lending to subnationals without the guarantee may lead to moral hazard. The externalities involved in cases of subnational default on a loan with the Bank will lead a central government to provide a bail-out in order to prevent a default from affecting future access to Bank loans by other subnational governments. This amounts to an implicit guarantee on the part of the sovereign. Explicit, negotiated and well-priced guarantees are preferable and the Bank

will continue its current practice of requiring these guarantees.

*The Role of Government-owned Financial Intermediaries.* The Bank will consider financing municipal development funds and other government-owned and or managed financial intermediaries only as a temporary step to target market failure. This approach will be pursued when private markets are unwilling or unable to provide a particular service and these activities would not distort market functioning. These activities will also be justified when local capital markets are shallow and lack the institutions capable of lending to subnational governments. Bank operations will follow the *Financial Markets Strategy* that states that Bank operations with publicly owned and managed financial intermediaries must be based on an understanding of the incentives facing public banks and the comparative advantages they may hold vis-à-vis private banks. Their inherent corporate governance problems, including conflicts of interest, moral hazard and adverse selection, need to be addressed directly. Bank operations should work to eliminate these distortions supporting either their privatization or conversion into second tier banks for the period in which they are needed to facilitate the flow of long-term external funds to the private sector at market conditions. Bank operations in support of these institutions will include measures to prepare them for privatization at the earliest possible date.

### **The Credit Enhancement Program**

Credit enhancement mechanisms are required whenever the undeveloped nature of local financial markets makes private investors unwilling and unable to accurately underwrite subnational credit risk. To address this market failure, governments may institute credit enhancement mechanisms to attract private investment and improve creditworthiness. Options include direct guarantees and structured finance techniques like reserve funds and over-collateralization. To avoid moral hazard the credit enhancement strategy needs to rest on credit criteria based on commercial terms, which involves identifying risks in advance, and ensuring that they are rea-

sonably priced and that the structure of all agreements is negotiated in great detail.

#### *Why Credit Enhancement?*

One of the most powerful tools that a multilateral institution can use is its ability to bring to bear various types of credit enhancements to attract private investment into subsovereign finance and to induce governments to adopt policies that increase creditworthiness. The Bank could develop a credit enhancement product to meet the needs of countries that have developed systemic frameworks and have achieved a basic level of creditworthiness. The objective of the credit enhancement product should be to facilitate subnational government access to the local capital or commercial bank markets. Credit enhancement is the application of some form of credit support to a loan or bond to improve its rating, lower its interest rate or extend its maturity. There are many mechanisms through which credit enhancement can be delivered: direct guarantees, structured finance techniques such as reserve funds, or over-collateralization. However, developing an overall credit enhancement strategy is probably more important than the specific mechanisms used to achieve it.

The starting point for discussing credit enhancement is to argue that it is not needed because the market should price the real risk of a debt issue. However, due to the undeveloped nature of local financial markets, private investors have been both unwilling and unable to accurately underwrite subsovereign credit risk. As a result, a number of national lending institutions have been created to address this market failure. However, most attempts on the part of governments or development agencies subsidize the credit risk and further distort the allocation of capital, creating various forms of disincentives for improved credit management on the part of the state or municipality. Although the foundation for any effective credit enhancement mechanism should be to effectively price the risk it is absorbing, the dominant situation in most Latin American countries is that in the near future there will be a gap between the level of creditworthiness of even the best localities and the investment grade requirements by institu-

tional investors. The new mandatory pension funds are the natural source of long-term funding for municipal capital investment needs and are probably the only source large enough to meet existing investment need. Therefore, credit enhancement that would stimulate private sector availability to discriminate among a wide range of potential borrowers is a logical transitional tool to link pension funds to municipalities.

#### *The Moral Hazard Problem.*

The central problem of credit enhancement is moral hazard. Essentially, if investors rely on a guarantee, whether full or partial, lenders will adjust the quality of their due diligence to match the expected loss under the guarantee structure. This reduces the pressure faced by investors, and it shifts the responsibility for creditworthiness to the credit enhancer. If the credit enhancer is a government agency or wields strong political influence, it will be difficult for it to maintain commercially viable standards in the long run. A likely outcome is that the credit enhancer ends up lowering its standards, allowing localities to incur too much debt, and ends up having to be bailed out itself. The key to a successful credit enhancement strategy is to maintain the credit criteria on commercial terms. To identify risks in advance, it must ensure that they are reasonably priced and the structure of all agreements is negotiated in great detail.

#### *Potential Forms of Credit Enhancement.*

The definition of this product line is one part of implementing a credit enhancement or capital markets graduation strategy. There are eight important parameters for a credit enhancement facility that are defined below.

*Direct Individual Guarantees vs. Funding Facility.* The Bank can issue direct guarantees with a national government counterguarantee or it can capitalize a national or regional guarantee facility. Operating on a project-by-project basis, the assumption would have to be that only a few large projects could be completed each year, which negates a comprehensive market development strategy. Funding a facility is analogous to wholesaling a guarantee, which would require

the approval of a uniform retail guarantee product. This approach would facilitate greater volume and deeper private sector involvement.

*Individual Issues or Bond Bank.* Credit enhancement could apply to each individual issue as it is sold into the market or could be operated through a conduit, such as an accumulation or bond bank that creates both greater diversity and volume.

*Full Guarantees.* The simplest form of credit enhancement is a full guarantee of timely payment of principal and interest. This is the easiest way to get an AAA-rated debt instrument using a financial guarantee. However, full guarantees works against the main objective of the development exercise that is to have investors make the market self-sustaining by enforcing on-going financial accountability on the part of localities. Given this policy goal, full guarantees are probably best left to those markets with the strongest basic debt markets, where commercial insurance vendors can offer a product that always has an uninsured alternative. In these markets, full guarantees can offer the issuer or the investor a higher degree of liquidity at a price that is more likely to result in sustainable risk management.

*Partial Guarantees.* Development banks have generally preferred to use partial guarantees, one for risk and one for credit. Adopted by the World Bank and the IDB in 1993, the implementation of the partial guarantee program has been problematic for a number of reasons. One is that it was intended for projects that would otherwise be unable to obtain financing on commercial terms. Another was that they require a government counterguarantee. Nevertheless, a product line of partial risk could play a catalytic role because it allows for the disaggregation and discrete identification of particular risk components of transactions as well as for appropriate risk allocation.

*By Type of Risk (Partial Risk).* Investors typically desire coverage of regulatory, political, and performance risks. Partial risk guarantees ensure payment in the case of default resulting from the nonperformance of contractual obligations un-

dertaken by governments or their agencies in private sector projects. For example, the investor may be concerned about several specific risks in a municipal project. A water district may have only just implemented a tariff reform and the investor may have concerns about a tariff roll back if political pressure on the district is strong. An investor may want assurances from the national government that the current levels of intergovernmental revenue will not change dramatically over the term of loan. Debt service payment may be dependent on a project completion, and the investor may want to be insulated from this risk.

*By Maturity of Risk (Partial Credit).* Partial credit guarantees cover all events of nonpayment for a designated part of a financing. These guarantees encourage extension of maturity by covering part of a financing typically the latter maturities. Partial credit guarantees extend the term and thus better match the liability with the economic life of the asset, thereby mitigating refinancing risk. A put to the credit enhancement facility is a useful product in this situation.

*Hybrids – The EGAT Structure.* Neither of the two products mentioned above gets at the fundamental level of credit risk of the municipality. To have partial risk coverage that affects the overall credit rating requires some form of hybrid coverage. An example is the recently completed structure used by the IBRD and the Government of Thailand for EGAT (the Energy Generating Authority of Thailand). In this transaction the IBRD insured the principal and the next interest payment due. If the government defaults on the interest payment, the IBRD pays the investor, and the government then has 60 days to cure the default in order to preserve the guarantee for the next interest payment. These types of guarantees can be extremely useful in raising the investor interest in municipal debt, while preserving the need to analyze fundamental credit risk.

*Currency Hedge Products.* Much discussion by states and large municipalities over the last few years has concerned international bond issues, in which case some sort of currency risk insurance would have great value. This may make sense in

certain project finance transactions that earn foreign currency, but for local governments, whose revenues are generated in local currency, international bond issues present a high degree of risk. Whether the Bank should offer a hedging product as part of the local credit enhancement package is a topic best considered after a local currency credit enhancement product has been implemented.

Credit enhancement may take many forms; however, certain forms are better suited to attain the development objectives described. For instance, guarantee facilities are to be preferred to direct individual guarantees that serve specific projects as the latter greatly increases transaction costs with limited benefits for development.

Wholesaling of guarantees through uniform products facilitate greater volume and deeper private sector involvement. Bond banks can accumulate issues having greater impact through diversity and volume thus being more effective than individual issues.

Partial guarantees, one for risk and one for credit, are the form of choice of development banks and will be used whenever suitable, clearly indicating the specific events covered to avoid the Bank from assuming *de facto* risks for which it is not fit to handle. The clear identification of the specific events and risk covered also serves to correctly price the credit enhancement offered by the Bank.

## 8. Assisting Subnational Governments to Develop Instruments for Bank Support

### **KEY AREAS FOR BANK SUPPORT FOCUSING ON THE UNDERLYING INCENTIVE STRUCTURE**

Decentralization in Latin American and the Caribbean is a well-established trend as many governments have demonstrated a strong resolution to devolve responsibilities and resources to subnational governments. The region's sustained democratization process is percolating from the national to the subnational level of government and provides the underpinning for the decentralization efforts. Many countries are perfecting the mechanisms that support local democracy providing communities with greater involvement in decision-making and oversight capacity.

Bank activity in support of subnational development should center on assisting countries to create the conditions under which subnational governments can take over expanded responsibilities in the promotion of economic development in their jurisdictions and in the provision of services and infrastructures to the population and economic activities. This requires a change in the way the Bank approaches lending for subnational development. Attention should shift from the current focus on financing the expansion of capacity and good financial management at the local level to address the system of incentives built into the different structures that determine subnational government outcomes in an integrated fashion. These are the structure of inter-governmental relations, the system of governance, the institutional capacity of subnational governments and the mechanisms for financing subnational entities.

The goal for Bank involvement is to contribute to the consolidation of subnational governments capable of obtaining the institutional and financial resources needed to discharge their responsibilities. This is a vast and complex undertaking that requires coordinated long-term developments in the political, fiscal, institutional and

financial arenas. Some of the required changes must take place simultaneously, thereby adding further complexity to the process. In facing this challenge the Bank can draw on its vast experience in municipal lending, and on knowledge and experience from a variety of other sources. The Bank can support governments in putting in place the required reforms through technical studies, policy advice and best practices, and will require, whenever necessary, that implementation of the reforms be made part of the conditionality of loans.

Pursuing the strategic focus proposed requires a shift in the emphasis in Bank lending for subnational development. The Bank should no longer lend just to expand municipal infrastructure but should also support solutions to the problems that distort the resource allocation process, or prompt fiscally irresponsible behaviors on the part of subnational governments. These issues lie at the core of the incapacity of subnational governments to provide services and maintain and operate infrastructures. Thus, current Bank practices in subnational lending will need to be expanded to address the core elements of the institutional framework resulting in unsatisfactory outcomes. Access to Bank programs is to be made conditional on firm commitments on the part of governments to undertake necessary reforms. Given the complexity of the issues involved and the encompassing nature of the reforms required, progress will take time. Bank support for subnational development should be structured accordingly, as a phased sequential program involving the coordinated use of the full array of Bank instruments

### **Conditions for Efficient Subnational Governance**

The discussion in previous chapters indicates that the structure of incentives and the accountability of elected officials are critical to the

functioning of subnational governments and for attaining the objectives of decentralization. The development and regulation of capital markets also play important roles in establishing the hard credit discipline required to make borrowing by subnational governments an efficient and equitable source of investment financing. These conclusions can be summarized as a set of conditions that must be met for decentralization to work.

1. Local democracies must work well and hold elected officials accountable for their decisions.
2. Transparency in transacting government business is essential for democratic oversight.
3. These conditions are the foundations of good fiscal management and accountability.
4. Subnational governments must have clearly defined responsibilities.
5. There must be a close correspondence between those who benefit and those who pay for government programs.
6. Subnational governments should face hard budget constraints.
7. Subnational governments must have the institutional capacity and resources to discharge their responsibilities at socially acceptable levels of performance.
8. Regulations and capital markets should impose a hard credit discipline on subnational government borrowing.

Helping the countries of Latin America and the Caribbean attain these conditions poses an ambitious development agenda for the Bank from which it cannot shy away. The mandates of the VIII Capital Replenishment see decentralization as an important step in improving social programs (IDB 1994, paragraph 2.12b). Further, the Report of the Working Group on the Institutional Strategy (IDB 1999, paragraph 3.51) identify decentralization as one of the important components of the modernization of the state and an area where the Bank has a comparative advantage in providing support to borrowing countries. These priorities are reflected in the significant number of projects in the Bank pipeline that address issues of municipal develop-

ment and reform of the state with a significant subnational focus.

### **Implications for Bank Support to Subnational Development**

Supporting decentralization in Latin America and the Caribbean is a vast and complex undertaking. For the process to succeed, a complex set of developments in the fiscal, political and financial fronts need to take place. Some of the required changes must take place simultaneously, a condition that further complicates matters. In facing this challenge the Bank can draw on its vast experience in municipal lending, on the conclusions and recommendations of recent evaluations (IDB 1998), and on the knowledge and experience of a variety of international sources. However, even within its vast store of resources the Bank faces limitations. The limited set of instruments at its disposal and the small volume of lending relative to needs, force the Bank to select the areas of the decentralization process where the development impact of Bank intervention can be the largest.

Given the very large investment needs of subnational governments, the supply of funds to finance investments in infrastructures and services is clearly not an area where the Bank can have the greatest impact. Even using its full lending capacity to support decentralization for the years to come, the Bank would be able to supply only a small portion of the resources required to develop subnational institutions, provide services and expand social and economic infrastructure. To be effective, the Bank must focus attention where its resources can have a meaningful impact. This is where the proposed key areas for Bank involvement come into play. Focusing on creating the conditions for the countries to provide for themselves, in an efficient and equitable manner, the resources required by subnational governments to provide services and effectively manage local affairs involves an emphasis on the system of incentives that determines the performance of subnational governments. The practical implications of the proposed strategic focus for Bank activities in support of subnational development are many.

## **Shifts in the Emphasis of Bank Lending**

Pursuing the strategic focus proposed implies changes in the way the Bank engages in lending for subnational development. First, access to Bank programs would need to be made conditional to firm commitments on the part of governments to undertake the necessary reforms. These may be wide ranging, involving the structure of intergovernmental relations, subnational governance and its institutional setup as well as the regulatory and operational conditions for local capital markets to impose a hard credit discipline on subnational borrowing.

Second, given the interdependence that exists between the issues affecting subnational development, the Bank should avoid engaging in discrete projects that focus only on one aspect of the problem. The Bank should no longer lend only to expand municipal infrastructure and services leaving untouched the institutional issues that distort the resource allocation process or prompt fiscally irresponsible behavior on the part of elected officials. These issues lie at the core of the incapacity of subnational governments to provide services and maintain and operate infrastructures financed with Bank resources.

Third, Bank operations must engage all relevant central, state, and municipal entities that have an impact on the effectiveness of subnational governments. The institution building effort must also consider nongovernmental and civil society organizations that play a role in improving subnational governance.

## **Broadening the Themes to Addressed by Bank Operations**

The proposed strategic focus has implications for the scope of themes to be discussed with borrowing member countries while addressing subnational development issues. First, it leads the Bank to venture into the less traveled roads (at least for multilateral development banks) of promoting reforms to the underlying incentive structure that determines the behavior of subnational governments. This requires the Bank to discuss with borrowing countries the system of

intergovernmental relationships that determine whether or not the subnational governments face tight budget constraints or are face incentives that lead them to behave in a fiscally irresponsible manner. It also implies that the Bank should worry about the political system that determines the accountability of elected officials and the incentives they have to respond to their constituencies and behave in a fiscal and administrative responsible manner. Another area of concern is the legal and budgetary rules governing subnational government borrowing and the response of the local capital markets, factors determining whether or not governments and markets are imposing a hard credit discipline on subnational governments.

Second, the proposed approach places great emphasis on institutional development issues. The capacity of subnational governments to manage human and financial resources to respond to the needs and priorities of their communities becomes a central focus of development assistance. Few proven approaches exist to successfully venture into this complex field of work. Further complicating the matter is the fact that successful institutional development depends on changing human behavior, an endeavor that often requires long-term efforts. This may represent quite a challenge because countries often do not commit themselves to objectives or goals whose attainment calls for actions that go beyond the term of the administration in office. Further, traditional Bank lending instruments make fairly ineffective tools for supporting sustained long-term institutional development efforts. Loan appraisal and disbursement procedures work better in the case of discrete investments with clearly identified beneficiaries and benefits that accrue in the short term. For its part, institutional reform requires investing on a wide range of interrelated fronts with diffused constituencies and benefits accruing in the long term. Progress in an area that requires short-term sacrifices in search of long-term gains also requires strong and sustained political commitment, usually in short supply in elected officials with short periods in office.

Third, the strategic focus recommended in this document modifies the development role played

by the investment resources provided by the Bank. From a simple vehicle to finance the expansion of infrastructure and services, investment resources become levers to induce the required institutional changes. This involves approaching lending with a different perspective. Investment money becomes a tool for promoting the structural reforms required to attain the regulatory and institutional environment leading to a self-standing process of subnational government development. The challenge is how to best use the leverage provided by this limited set of tools to induce the required changes in the system of intergovernmental relationships, the rules governing the activities of elected officials and the signals sent by capital markets to borrowing subnational governments. Under this perspective, the disbursement of Bank loans makes a secondary goal. Progress in project execution needs to be measured as a function of the institutional change accomplished rather than of the amount of resources lent.

Finally, the diversity of subnational governments that exist in the region poses an additional complexity to the attainment of the proposed strategic objective. Although the reforms to the system of incentives is a national responsibility, concrete measures and policies still need to be tailored to the circumstances of the different subnational governments. To the necessary diversification of rules, different approaches to institutional development must be added. While the institutional development of a large and resourceful state must be approached as a singular case, reaching the vast number of small municipalities will require national intermediation.

### **New Areas of Bank Development Assistance**

Borrowing member countries require policy advice and best practice support to confront the complex challenge posed by subnational development. Country sector studies and subregional studies can be sponsored by the Bank to provide necessary inputs for policy dialogue and the design of country specific reform programs. The Bank's project design and implementation will also benefit from a better knowledge of good practices in subnational development. The Bank is in a privileged position to identify and dis-

seminate good practices in the fields relevant for the development of subnational governments.

### **Tailoring the Support Mechanisms**

The complexity of the development agenda described is augmented by the diversity of subnational governments existing in the region and the variety of challenges they face in becoming efficient and equitable service providers. As discussed in Chapter 1, subnational government is a term that covers a wide range of institutions each with particular development needs. For the purposes of the present paper, five general types of subnational governments are worth considering.

*States and provinces of federal countries* sit at one extreme of the range of subnational authorities. There is a great variety in this second tier of government. Some states and provinces are larger than many Latin American countries while others are small and command fewer resources and institutional capacity than large municipalities.

*Large cities and metropolitan areas* vary greatly in size. Some are home to more than 10 million people, others have populations in the 4 to 6 million range and many have populations between 1.5 and 4 million. They are often managed by several subnational governments adding an additional layer of administrative complexity to the of managing infrastructures and services for such vast urban agglomerations.

*Medium-size cities*, with populations between 100,000 and 1.5 million, are numerous, play a significant role in the economy, and provide services to more than one third of the population of the region.

*Medium-size municipalities* with populations ranging between 10,000 and 100,000 inhabitants represent the largest single group of subnational governments, which also provide services to more than one third of the total population. Their territories often contain a small city, several villages and significant rural populations.

*Small municipalities* with total populations of less than 10,000 are the largest subnational government group, yet they provide services to a very small percentage of the population.

This variety in type of subnational governments is compounded by the fact that some are rich while others are poor. Some have a strong local community spirit and some have none. Well-intentioned and trained people run many subnational governments, but incompetent and corrupt officials also do exist. Although the general rule is that the smaller the subnational government the weaker it is in institutional terms; there are well-run and efficient small municipalities and poorly managed large cities. This diversity in type of subnational government is seldom matched by an equally diverse set of management rules and policies to promote their development. One-size-fit-all legislation and policies abound, often impairing local development. Even though some subnational governments may manage to break out of the mold into which they have been put, most will not. Successful decentralization must recognize the diversity and heterogeneity of the universe of subnational governments allowing for an equally diverse and heterogeneous set of responses. At its best, such an approach can focus pragmatically on what may work, rather than on trying to force everyone into the same centrally determined box. Bank operations need to support the diversification of policies to match the variety of situations that exist in a given country. The diversification is also needed in the financial mechanisms used to lend Bank resources and to facilitate subnational access to local capital markets.

## **INSTRUMENTS FOR SUPPORTING SUBNATIONAL DEVELOPMENT**

### **The Bank's Toolkit**

The strategic focus proposed for supporting subnational development requires an integrated response by the Bank. The effectiveness of Bank interventions in promoting subnational development will depend on its capacity to promote, in a coordinated fashion, the reforms required in a variety of fronts. These include, to name a few:

the assignment of responsibility and resources among different tiers of government, rules governing transparency and accountability in subnational governments, developments in capital markets to expand lending to subnational governments, and comparable institutional development of the variety of entities that comprise the structure of subnational government in a country.

The above objective requires an integrated response by the Bank involving the coordinated use of all its available instruments: technical studies, policy advice, best practice research and dissemination, loans, and technical cooperation. Such level of coordination of actions is uncommon in the Bank. Further to fruitfully deploy a coordinated set of Bank instruments in support of subnational development, a broad agreement needs to be reached with the borrowing country that defines the objectives, instruments and sequencing of interventions and the Bank's role in supporting them. Only after such an agreement is reached will it be possible to identify the lending and nonlending products that the Bank can put at the disposal of the borrowing country to assist its subnational development efforts.

The coordination of Bank instruments in support of long-term country objectives in subnational development is taxing on Bank management. It involves guiding instruments as diverse as Bank sector studies and policy advice, loans to the government and subnational entities, loans to the private sector, technical cooperation and operations of the Multilateral Investment Fund so that they all work toward a common objective. Attainment of the above conditions has implications for most Bank activities, from programming to evaluation.

### **Programming**

*Policy Dialogue.* The need for an integrated response on the part of the Bank places a significant toll on the programming of Bank activities in a given country. To incorporate the many dimensions of subnational development, programming exercises will have to be extended beyond the current sector-based and operation-focused approach of the country papers. The

programming process should become a vehicle for an integrated discussion of the issues confronting subnational development in the country. In those countries placing a priority on Bank support to decentralization, programming exercises should lead to agreements on a long-term subnational development program. Inasmuch as this program guides national decision-making concerning decentralization, it constitutes a non-financial product of the Bank in support of the country. A second outcome of this exercise is a definition of the scope of the support (national, subnational levels), the topics to be addressed (intergovernmental relationships, governance, provision of services, and local economic development) and the sequencing of the Bank intervention.

Given the long-term nature of the interventions required to foster subnational development, the Bank's operational program will require a corresponding long-term perspective. This contrasts with the current three-year timeframe of programming exercises. When dealing with subnational development, Bank-country agreements will have to adopt a longer timeframe, even though the operational programs may be reviewed in three- to four-year intervals. One option is for the country and the Bank to agree on a multi-phased program engaging the key issues of subnational development with a sequence of interventions designed to accomplish well-defined objectives. This option is particularly taxing on the programming process and requires long-term commitments on the part of governments that are affected by frequent policy swings. The major advantage of this approach for the country is that it contributes to the stability of decentralization policies. For the Bank this approach allows individual operations to fit into a well-designed policy framework. This greatly facilitates the coordination of different Bank products benefiting the different sectors with an impact on decentralization. It also facilitates loan preparation, appraisal, negotiation and start up. The absence of a long-term view for the Bank's support to decentralization may reduce effectiveness and make the loan design and negotiation process less certain.

*Sector Work.* A solid understanding of the issues confronted by decentralization is needed to support the proposed policy dialogue. In countries committed to decentralization and requiring Bank support, sector studies need to be completed in advance in order to support the policy dialogue. Useful country sector work includes technical studies, seminars and meetings with government officials to identify and promote policy reforms that foster the attainment of the government's decentralization objectives. Many topics need to be addressed. Reforms to revenue sharing mechanisms, to relevant local and national taxation, to the rules governing borrowing by subnational governments, powers, responsibilities and the legal framework for the management of local affairs, are but a short list of the themes that can be discussed and agreed at this stage. The sector work also helps to coordinate reforms promoted in subnational development programs with those planned or under execution in related sectors (like capital market promotion, tax reform and reform of the state) supported either by the Bank or other agencies.

### **Investment Lending**

Lending with sovereign guarantees is the principal instrument available to the Bank to support reforms in subnational development policies. Traditional Bank operations finance the expansion of local services and infrastructure, and provide resources for institutional development activities. The strategic focus for Bank support to decentralization proposed in this document, calls for the diversification of Bank products offering to borrowing countries the whole array of instruments at the Bank's disposal. These include, sector reform loans for public utilities under the purview of subnational governments, reform of the state operations benefiting institutions central and subnational government institutions, institutional development and investment loans (multiphased or multiple works) to the nation, and states or provinces in federal states, reimbursable and nonreimbursable technical cooperation. MIF operations can support aspects of the reforms needed, in particular the development of local capital markets and the enhancement of the regulatory framework for the privatization of municipal services.

The effective use of the instruments available to the Bank needs the agreed policy framework and multi-year program discussed previously. The defined objectives and goals implied in a clear policy framework allow the country and the Bank to select the most suitable combination and sequencing of Bank instruments for attaining the policy objectives.

### *The Scope and Content of Lending Operations*

The scope and content of lending operations may vary significantly as a result of the differences in the issues faced and the capacity of the different types of subnational governments.

*Large and resourceful states, provinces and municipalities* may benefit from specific Bank loans guaranteed by the sovereign as it is currently done. Combining reforms, institutional development activities and investment financing, these loans are a suitable instrument to promote the development of subnational governments. However, loan preparation and assessment must address the intergovernmental relations and governance mechanisms framing the functioning of the subnational institutions. In a faulty framework, even the best-designed loan-supported program may end up just improving a grossly distorted and suboptimal system of subnational government.

*Small and Weak Subnational Governments.* At the other extreme, support to small, weak and mostly rural subnational governments may be best provided through centralized institutional support mechanisms and financed with well designed transfers. In this case, sector work and policy dialogue with the government should address the issues arising from the current subdivision of the territory, the size and buoyancy of subnational budgets, the assignment of responsibility among the different tiers of government and the capacity of the subnational governments to discharge these responsibilities. It is not enough to focus institution-building activities on the improvement of specific aspects of subnational governance like accounting and tariff collection procedures. It needs to focus on the whole gamut of issues surrounding the delivery

of critical services through dispersed and weak institutions.

*Mid-sized Subnational Governments.* These are the subnational governments that have benefited the most from municipal development loans executed through national intermediaries. The traditional municipal loans extended by the Bank that finance the expansion of services and infrastructure through multiple works programs are well suited to middle-sized subnational governments with sufficient institutional capacity. However, evaluations of dealings with less able subnational governments show disappointing results for the institutional development components. The reason for this lies in the fact that these operations have only occasionally addressed the system of incentives emerging from faulty intergovernmental relations and governance. This range of municipalities and states will benefit the most from greater decision-making autonomy and stability of resources, the expected outcomes of the reforms to the framework of intergovernmental relations and governance promoted in this document.

*Large cities and metropolitan areas* under the control of several subnational governments face complex coordination problems in the financing and delivery of services. The provision of sanitation, drainage and waste management services, public transportation, and pollution abatement, are but a handful of problems that can be resolved if the Bank promotes the appropriate institutional and financial mechanisms. These operations place emphasis on the governance structure. The establishment of efficient and democratic coordination mechanisms for the provision of services and the management of common affairs are the main development outcomes of these operations inasmuch as the volume of investment resources they require far exceed the lending capacity of the Bank.

### *Types of Lending Operations.*

In the array of Bank products, two types of operations stand out as particularly suited for promoting subnational development; namely, *policy-driven investment loans* and *multi-phase program loans*. The former place policy reforms

at the center of its objectives, and the latter allow incorporating gradual policy reforms and institutional development to loan conditionality. Both mechanisms increase the capacity of the Bank to leverage investment resources to promote sector reforms and institutional development. In contrast, *time-slice* operations are less suited to the purposes at hand because they rely on well-structured institutional frameworks for the management of investment resources and delegate to the executing agency most operational decisions. Traditional *multiple-works* municipal loans lose much of their appeal when directed to the pursuit of the strategic focus proposed in this paper. Focusing on investment financing, this traditional Bank lending vehicle for expanding local services has a limited capacity to promote institutional development and none at all to act as a catalyst for policy reforms. Multiple works loans make effective instruments when the major objectives of the reforms are attained and the institutional setting for subnational development is on a strong footing.

The flexibility of *technical cooperation loans* and *reform of the state loans* makes them particularly well suited to support policy reforms and institutional development. *Learning and innovation loans* can also play a similar role at the early stages of implementation of a multi-phased program. They can be designed to finance the cost of administrative reforms and institutional re-engineering in addition to the technical studies and capacity building activities. Because they focus on institutional issues, these operations can play a critical role in the early stages of implementation of a multi-year Bank program and can be instrumental in preparing the groundwork for operations focusing on expanding local service capacity.

#### *Development of an Window to Promote Innovation*

Subnational governments are a source of innovations in service provision and institutional organization. This is a trend that can be supported by Bank operations provided that adjustments are made to the standard loan design and procurement procedures to suit the search and experimentation needs of innovation promotion.

Municipal loans may include a new component to promote innovations, an “innovation-promotion window” to finance new approaches to service delivery. The window is useful because innovations cannot easily be accommodated in the investment expenditure category of municipal loans. Neither are they easily financed through the institutional development components that do not normally allow the financing of the capital investments often required to test innovations. The component could provide funds for institutional development and the initial capital investment required by projects that propose innovative approaches to service delivery at the local level. The resources of the window could be allocated through transparent and competitive procedures similar to those used to allocate research funds in science and technology programs. Funding may be partially nonrefundable because of the risks involved and the element of public good that innovations have when properly disseminated. Potential for replicating the innovations should rank high in the selection criteria and funds should be available to finance the dissemination process. Once tested, innovations can be mainstreamed and subject to standard procurement procedures.

#### *Private Sector Lending*

The Bank is using the private sector window to expand the volume of financing available to private investors in many areas of local responsibility that have been privatized. Examples include water treatment plants under private concession and urban toll roads. Justified on the principle of additionality (Bank involvement acts as a catalyst for private investment) the volume of resources that may be contributed by this line of lending is limited. In addition to supporting the privatization of local services, the most significant development impact of private sector lending in subnational development is to assist in creating the conditions for capital markets to take over subnational development financing. These characteristics make this lending window of limited significance for the implementation of the proposed strategy. Further, the institutional developments pursued by the subnational development strategy proposed are preconditions for the effective use of this line of

financing. Thus, if support for reform is required from the Bank, it will have to come from other instruments.

### **The Multilateral Investment Fund**

The MIF has supported two areas of concern for the subnational development strategy. One is the development of the institutional framework for the privatization of municipal infrastructure and services. The other is the establishment of institutional mechanisms for the promotion of subnational economic development. There is ample room for expanding these activities. Institutionally strong municipalities and states can benefit from the support provided by the MIF inasmuch as these activities are highly demanding on institutional resources. The support provided by the MIF to the development of national regulatory bodies concerned with privatized public utilities has a significant, albeit indirect, impact on subnational development. Similarly, the MIF provides support to the development of local capital markets.

### **Program Development Products**

The Bank can also support the decentralization process, and the consequent development of subnational governments, with policy advice and good practice research and dissemination. The critical exchange of information, and the comparative analysis of experiences, can play a catalytic role in promoting more efficient decentralization efforts and perfecting ongoing experiences.

#### *Products Generated in the Programming Process*

The approach proposed to programming leads to two program development products. The technical studies completed as part of the recommended sector work and the program of interventions resulting from the policy dialogue. These are non-lending products that can promote decentralization and subnational development policies in borrowing countries. They will improve the understanding of the problems and help sharpen the policies and reforms pursued by the governments. The operational program re-

sulting from this process allows governments to coordinate activities and phase interventions, whether or not the Bank finances them.

#### *Other Program Development Products*

The Bank is in a privileged position to undertake studies covering a wide range of topics relevant for policy formulation and implementation. Studies on issues of regional interest (like the impact of central government bailouts on the fiscal discipline of subnational governments) or comparative studies of interest to specific groups of countries (like fiscal effort in federal countries) can make a significant contribution to the quality of policies and projects. Additionally, the Bank is also well positioned to identify and disseminate good practices in subnational development. These studies open the scope of solutions considered in subnational development programs and shorten the time required by innovations to take root.

### **THE INTEGRATED USE OF BANK INSTRUMENTS. EXAMPLES OF SUPPORT FOR EMERGING SUBNATIONAL CONCERNS**

The coordinated use of the complex array of Bank instruments increases the advantage of providing assistance to subnational development efforts. Two examples illustrate the opportunities available through the proper coordination of instruments and also unveil the potential difficulties in achieving such coordination. However, since coordination affects the efficacy of Bank interventions in support of subnational development, the strategy advocates the coordinated use of Bank instruments whenever possible.

### **Local Economic Development**

The Bank Group has several instruments at its disposal to assist subnational governments in fostering the economic development in their territories. These include *municipal development loans* that can finance improvements in infrastructure and local public services that are essential to the competitiveness of local firms. Also pertinent are *reform of the state* programs to improve the efficiency of government and

support the privatization and outsourcing of services. MIF-financed programs can support the strategic planning required to define a long-term program of joint private-public promotion of local economic development. Labor training programs can be designed to fit the partnership approach to training advocated by experts and adopted by the Bank.

The approach to be followed varies significantly depending on the context in which local economic development is attempted. Large metropolitan areas, by virtue of their complexity and size, will be interested mostly in expanding their competitive position as the location for high order command and control activities and the highly productive services supporting them. Their focus will be mostly on identifying a set of objectives shared by all stakeholders that provides political support to the investments required to improve the competitive position of the agglomeration. Strategic planning is thus a central initial activity followed by an investment program agreed with the private sector so that public investments are closely coordinated with private investments in new plant and services. Intermediate size cities offer the greatest potential for a productive partnership between the private sector and the subnational government to promote economic development. Such partnerships can be instrumental in promoting economic activities that reduce the cost of production to individual firms by allowing the outsourcing of services and production processes. Further, labor training programs can be set up in partnership with industry, improving their relevance for the local economy and ensuring the graduates are hired by local enterprises. More rural districts can also promote economic development by focusing on activities with high components of public good that cannot efficiently be undertaken individually by small and medium size production units. Examples of this type of activities are the acquisition and dissemination of new technology and the certification of the quality of local produce.

## **Regulating Privately Provided Infrastructures and Services**

The Bank has gained much experience through municipal development loans in the traditional forms of infrastructure financing, including planning and evaluation of investments. More recently, it has acquired sizable experience advising and financing sector reforms in key areas of infrastructure provision (electricity, roads, energy, water and sanitation). The Bank assists not only in the consolidation of a new sector structure and regulatory framework, but also in preparing state-owned enterprises for privatization. Through its direct operations with the private sector it is enlarging its experience in innovative financing supporting a variety projects designed under different finance and construction structures (built-own-transfer, built-operate-transfer, etc.).

Considering this experience, the Bank is in a privileged position to expand its support for the privatization of local services and infrastructures. This can be stand-alone programs or a component of municipal development loans. The activities to be financed are those currently contemplated in sector reform programs assisting subnational governments to develop the institutional capabilities to take full advantage from privatization. This includes institutional strengthening for planning and executing privatization programs, expanding capacity to manage privatization contracts, funding for preparing government-owned enterprises for privatization, and infrastructure improvement and expansion to meet privatization criteria set by the national government.

## **Loan Execution Mechanisms and Government Sponsored Intermediaries**

Traditionally, the Bank has turned to government-supported intermediaries to on-lend Bank resources to municipalities and provinces in multiple works investment loans. Municipal banks, first and second tier financial institutions and government agencies have been used to on-lend or transfer Bank resources to municipalities, states and provinces. These institutions face severe agency problems because they lack real

incentives to ensure the quality of the projects they finance. Bank loans often have allowed for the use of less than efficient mechanism for managing resources. Examples include the intercept of government transfers to secure repayment of loans and the use of interest rates that are out of line with those prevailing in local capital markets. This execution mechanism is justified on the absence of private institutions interested in or capable of working with subnational governments. The objective of operations that support decentralization must be to develop the hard credit discipline required for the resource allocation process to generate efficient outcomes. For this purposes, the central government plays a role in the prudent regulation of subnational debt issues and in ensuring that capital markets impose a hard credit discipline on subnational governments. However, government sponsored institutions will be needed in many countries as long as local capital markets lack the interest and capacity to lend to subnational governments.

The Bank will consider financing Municipal Development Funds and other government-owned and/or managed financial intermediaries only as a temporary step to target market failure. This approach will be pursued when private markets are unwilling or unable to provide a service and it can be proven that the activities would not distort market functioning. These activities will also be justified when local capital markets are shallow and lack the institutions capable of lending to subnational governments. Bank operations will follow the *Financial Markets Strategy* that states that Bank operations with publicly-owned and managed financial intermediaries must be based on an understanding of the incentives facing public banks and the comparative advantages they may hold vis-à-vis private banks. Their inherent corporate governance problems, including conflicts of interest, moral hazard and adverse selection, need to be addressed directly. Bank operations should work to eliminate these distortions supporting either their privatization or conversion into second tier banks for the period in which they are needed to facilitate the flow of long-term external funds to the private sector at market conditions. Bank operations in support of these institutions will

include measures to prepare them for privatization at the earliest possible date.

### **Execution of Institutional Development Components**

Project financing and institutional development activities have few elements in common that justify execution by the same agency, yet many Bank-financed operations entrust execution of both components to the same institution, usually a government sponsored financial intermediary. This approach has worked to the detriment of institutional development. Financial intermediaries do not have the necessary ability or the structure to efficiently discharge institutional development functions like supporting project selection and preparation, and contracting training and institutional strengthening services. A clear separation of lending and institutional support functions is required in Bank operations that support of subnational development. Lenders should not be charged with the responsibility to ensure that the investment decisions made by subnational governments are realistic, a function better discharged by planning departments and elected officials. Furthermore, government effort to support institutional development at the local level can be better organized around institutions that allow the participation of subnational governments in their management and financing.

The national associations of subnational governments that have emerged and are acquiring increasing representation and institutional capacity are potential executors of Bank-financed institutional development activities. Variations exist among countries and this option may not be feasible everywhere. National associations of municipalities are members of international associations such as the International Union of Local Authorities (IULA) or the International Association of Capital Cities, benefiting from joint action. One example is the SERCADEL Program that promotes training and institutional development in several countries of the region.

Transparency and accountability in subnational government require information and analysis of subnational finances and institutional capabilities. This function can be better performed by

independent institutions that are financed jointly by the government and users. The design and start-up of these institutions' operations can be part of the execution mechanisms of Bank loans and their creation promoted whenever they make a suitable solution to the information problem. Bank operations also need to focus on the standardization of reporting procedures, a task that involves the national government and financial regulators. When necessary, these institutions must be incorporated into the execution mechanism of subnational development loans.

### **COORDINATION WITH OTHER DEVELOPMENT INSTITUTIONS**

Other development institutions support the development of subnational governments in Latin America and the Caribbean. The Subnational Development Strategy seeks to coordinate activities with these institutions to avoid the duplication of efforts and take full advantage of the synergy created.

#### **Multilateral Institutions**

The World Bank is active in support of decentralization in Latin America and the Caribbean and has co-financed municipal and provincial development loans with the IDB in several countries. The most recent policy paper on the subject (World Bank 1999) acknowledges the growing importance of urban development and subnational government issues for attaining the socioeconomic development objectives of its borrowing countries and calls for a renewed assistance strategy. The aim of the renewed strategy is to promote sustainable cities and towns that improve the lives of the poor and promoting equity while contributing to the progress of the country as a whole. Based on the good performance shown by the urban development portfolio of the World Bank, the strategy aims at greater impact in supporting countries to tackle the urban transition process by focusing on cities. The objective is to promote the livability, competitiveness, good governance and bankability of cities. The building blocks of the strategy are support the formulation of national urban strategies and city development strategies as the

framework for planned intervention. Lending will focus on scaling-up services to the poor. Capacity building will focus on supporting intermediary networks for wholesaling the exchange of knowledge and expertise among subnational governments and other agencies involved in urban management and services delivery. These proposals are essentially compatible with the strategic focus proposed in this document since they recognize the need for longer-term commitments to sustain municipal policy and institutional reform. The World Bank works with specific cities in long-term partnerships to implement the strategy proposed.

The United Nations Center for Human Settlements (HABITAT) is active in municipal development in the region, concentrating on supporting efficient urban management. Apart from technical cooperation programs benefiting specific cities (La Paz/El Alto, Rio de Janeiro, Guayaquil) and national programs (resettlement in Guatemala, municipal support program of INURBE in Colombia) HABITAT has subregional and regional activities. These include the support to the Central American Center for Sustainable Development of Human Settlements, the Latin American and Caribbean Urban Management Program, the Urban Indicators Program and the Forum of Good Practices in urban management. All these activities are consistent with and complementary to the strategic approach proposed for the Bank in this paper.

The European Commission's URB-AL program aims to establish partnerships between cities of Europe and Latin America and the Caribbean to foster the exchange of experiences and develop themes of common interest in emerging urban issues such as drugs, conservation of historic areas, management and control of urbanization, urban mobility and the like. The URB-AL program is focused on specific cities and does not contradict the strategic focus proposed for the Bank, in specific instances it may reinforce it.

#### **Bilateral Institutions**

Several bilateral cooperation agencies are active in areas related to subnational development in the region; many have substantial programs.

USAID's Making Cities Work Program promotes effective city management by stimulating local economic growth, cost effective provision of urban services and environmental protection. The program supports projects in specific cities and, consistent with the proposed strategic focus for the Bank, emphasizes management issues for the sustainable provision of services, especially to the poor.

Germany's GTZ also actively supports municipal development in Latin America and the Caribbean. Based on a bottom-up approach, the focus of GTZ assistance is to facilitate community involvement in local affairs with a particular emphasis on the problems of the low-income households. The technical assistance provided by GTZ is complementary to financing provided by the KWA, focusing on the development of sustainable mechanisms for improving the living conditions of the poor.

The Swedish International Development Agency (SIDA) is active in low-income Latin American and Caribbean countries, mostly working with poor municipalities to improve the living conditions of the low-income population. The Canadian International Development Agency (CIDA) has provided assistance to municipalities in several countries with a particular emphasis on the English-speaking Caribbean.

### **Donor Coordination Forum**

Responding to a proposal by USAID, the Bank hosted the creation of a Donor Coordination Forum with the involvement of the international cooperation agencies. The forum provides an opportunity to share information on technical approaches, policies and programs to avoid the duplication of activities or conflicting policies. The main instrument of the forum is a web site for the dissemination of information that is managed by a technical secretariat housed at the International City Management Association (ICMA). The forum expects to expand the topics covered in the web site to include information on best practices in technical cooperation for subnational development.

### **Corporate Impacts**

Addressing the needs of subnational governments is a significant challenge for the Bank. The new focus for lending proposed in this paper will be more demanding of Bank resources than present activities because it emphasizes reforms to the framework of intergovernmental relations and governance, and the coordinated use of lending and program development instruments to attain country specific objectives.. A possibly larger challenge will be the proper coordination of Bank instruments to support decentralization in the countries where the Bank embarks on a subnational development program. Municipal development loans that finance the expansion of services and infrastructure and contain only limited sector objectives will no longer be sufficient. Loan operations framed under the proposed strategic approach will need to be coordinated with technical cooperation, and MIF and private sector operations to address, in addition to current concerns, the systemic issues surrounding intergovernmental relations and governance.

Execution of the proposed approach to subnational lending will expand the scope of counterpart agencies involved in loan preparation and negotiation, making the loan execution processes more complex and time consuming. Further, the Country Offices will have to assume more complex responsibilities in the supervision of policy driven and multiphased loans inasmuch as these operations require closer technical supervision.

### **Additional Transaction Costs**

*The Cost of Sector Work.* To support the policy dialogue that should precede the adoption of a Country Sector Strategy, the Bank and the country will have to finance the required sector studies and consultation exercises. This will increase the burden on local specialists and policymakers as well as on the work program and budget of the Regional Operations Departments. Coordination of operations within the Bank Group is required if integrated interventions are sought. This poses programming problems, particularly if the coordinated use of OC and FSO

loans and TCs, PRI loans and guarantees, and MIF and IIC equity operations is desirable to accomplish the objectives agreed with a country. This is a difficult task in the best of circumstances.

*Subregional Strategies.* In certain instances, the Regional Operations Departments may find it useful to adopt subregional strategic approaches to better support decentralization. This is the case of Regional Operations Department II, which adopted an Operational Strategy on Subnational Finance and Development to guide policy dialogue with the countries (Henry et al., 1997).

*Coordination of Bank Expertise.* Given the many dimensions of decentralization, greater coordination among Operations Divisions will be required to properly conduct sector work. Bank expertise on decentralization is distributed among many divisions. The Regional Operations Departments will have to pool the expertise of specialists on municipal development from the Social Programs Divisions with that of specialists on capital markets and infrastructure economics from the Finance and Basic Infrastructure Divisions, and sanitation specialists from the Environment and Natural Resources Divisions. Expertise available in the Central Departments will also be necessary, particularly that of the Fiscal Division (INT/FIS) and the Research Department. The technical divisions of the Sustainable Development Department contribute strategic and policy advice and best practices research that play a significant role in identifying suitable solutions to sector problems.

In sum, to properly conduct sector work in a given country, a major collaborative effort is required among the operational units of the Bank. This has been a rare occurrence in the past; it thus requires a major Management commitment in the future. The importance of this collaborative managerial approach is underscored by the fact that the importance of the Bank for the borrowing countries in the future will increasingly rest on the knowledge it can contribute to the solution to development problems. With respect to subnational development problem, Bank knowledge is spread among

many operational units and needs to be coordinated.

*Loan Processing.* With sovereign guarantee, large municipalities, states and provinces can approach the Bank for direct operations and the volume of lending they require usually justifies Bank involvement. Taken to its limits, direct lending to this group of subnational governments greatly expands the number of potential clients and thus the administrative effort the Bank must engage in to respond to this demand. There is a natural limit to the number of operations that the Bank can process in a given year given existing budget and human resources constraints, thus limiting its capacity to deal directly with a large number of subnational governments. Furthermore, operations aimed at addressing the different issues involved in subnational development will require a significant expansion of or modifications to existing Bank operations. Loan preparation and assessment will have to be wider in scope and the negotiation of loan conditionality will be more complex. This will increase loan-processing times, long a source of friction with countries.

*Loan Execution.* The resulting operations are most likely going to be complex and, as a result, more difficult to execute and supervise. The operations that may emerge from the proposed focus for the Subnational Development Strategy most likely will involve policy-related tranching of investments. The correct evaluation of compliance with the conditionality of the tranches is a complex technical problem requiring vast sector knowledge and experience. Project Teams working on new operations will have to rely heavily on the reduced staff of specialists available in Headquarters, this will limit the support they will be able to provide the Country Offices during project execution.

### **Financing of Program Development Products**

Focusing on the institutional development aspects of subnational governments will require the Bank Group to expand the range of program development products to support the soft aspects of the reforms. Financing sources will have to be identified to provide funding for activities like

technical cooperation for institutional development, policy dialogue, and good practice research and dissemination. Advances in program development products consume significant amounts of staff time and other resources. In addition to the shortage of qualified personnel, the Bank's lending approach will have to be modified to promote the development of program development products.

## **Evaluation**

*Program Evaluation.* Evaluating the performance of Bank operations in support of subnational development under the strategic focus proposed in this document requires moving away from ex-post valuation methodologies to continuous feedback on the effectiveness of the operations. In project design, the Bank will utilize clear benchmarks and define specific expected results and will develop supervision and evaluation methodologies to assess the effectiveness of operations during execution to identify corrective action. The methodologies will include the use of, among other elements, quantitative indicators, questionnaires, public opinion surveys, and periodic evaluation meetings. The observance of these elements will improve the quality of collected evaluation data, facilitate the participation of beneficiaries in evaluation, and promote executors' self-evaluation, in addition to providing transparency to the evaluation process.

*Evaluating the Implementation of the Proposed Approach to Bank Lending.* The forces propelling

subnational development in the region are many and their interrelations very complex. The Bank is but one of many actors in the process. This prevents measuring the implementation of the approach proposed in this document on the basis of its impact on the development of subnational territories in any particular country, let alone the region as a whole. The best available option is to measure the impact of the strategy on the scope and nature of Bank operations in support of subnational development. To this end, the Bank may undertake a baseline study to assess the extent to which its projects in the last four years have included the key themes addressed in the strategy. The same study may be conducted after five years of implementation to assess whether the new crop of operations incorporated the themes and orientations provided for by the strategy. This methodology allows a measure of the influence of the strategy on Bank operations, a significant dimension of impact.

## **Policy Implications**

Most of the interventions that may emerge from the strategy (multiple works loans, policy-based investment loans, technical cooperation, loans to the private sector, MIF supported investments) may be executed by the Bank Group within the framework of existing Operational Policies. Therefore, no new policies will have to be developed to execute the proposed strategic approach. It is also consistent with the existing strategies framing Bank activities in related areas; notably, the Public Utilities Policy and the Strategy for the Delivery of Social Services.

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