

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**DECENTRALIZATION AND SUBNATIONAL GOVERNMENTS
SECTOR FRAMEWORK DOCUMENT**

FISCAL MANAGEMENT DIVISION

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ABBREVIATIONS

CAF	Andean Development Corporation
CCLIP	Conditional Credit Line for Investment Projects
CPE	Country Program Evaluation
DNP	Dirección Nacional de Planificación [National Planning Department]
ECLAC	Economic Commission for Latin America and the Caribbean
ESCI	Emerging and Sustainable Cities Initiative
ICMS	Imposto sobre Circulação de Mercadorias e Serviços [goods and services circulation tax]
ICTs	Information and communication technologies
IFMS	Integrated Financial Management System
LAC	Latin America and the Caribbean
MfDR	Management for Development Results
n/a	Not available
OECD	Organization for Economic Cooperation and Development
OVE	Office of Evaluation and Oversight
PFM	Public Financial Management
SAI	Supreme Audit Institution
SAT	Servicio de Administración Tributaria [Tax Administration Service]
SIAF	Sistema Integrado de Administración Financiera [Integrated Financial Management System]
SNIP	Sistema Nacional de Inversión Pública [National Public Investment System]
VAT	Value-added tax

EXECUTIVE SUMMARY

This updated version of the Decentralization and Subnational Governments Sector Framework Document fulfills the mandate in document GN-2670-1 (paragraph 1.20), which stipulates that sector framework documents (SFDs) are to be updated every three years. As a result, it reflects new topics and perspectives drawn from research and from the practice of formulating and executing development projects in the sector, replacing the SFD approved in June 2015 (document GN-2813-3).

This SFD highlights advances in decentralization and in the responsibilities of subnational governments in Latin American and Caribbean countries. The average share of consolidated public spending by subnational governments has doubled over the last three decades, reaching 25% in 2015. This figure conceals pronounced differences among countries, based on variables such as history and size of the economy, population, and territory. The motivations for decentralization include democratization, economic crises, and the search for public sector efficiency. The region has approximately 17,500 subnational governments, of which 400 represent intermediate levels of government. The rest are municipios. These subnational governments are increasingly important for the delivery of goods, services, and infrastructure that are crucial for economic and social development. Subnational governments in the region's largest countries are responsible for providing education and health services, with substantial consequences for the size of the subnational public sector.

In recognition of the multisector nature of the decentralization process—as partly manifest in the responsibilities and functions of subnational governments—this SFD does not include any specific discussion of the individual sector policy dimensions affected by the process. (These are addressed in the corresponding SFDs for the different sectors.) Instead, it focuses on the crosscutting factors that are a necessary condition for subnational governments to effectively and efficiently perform the specific functions for which they are responsible: (i) the structure of incentives that characterizes intergovernmental relations; and (ii) institutional capacity development at the subnational level.

This document is split into five sections. Section I sets out the scope and subject matter of this SFD, as well as its alignment with the Bank's main policies. Section II defines decentralization as an institutional reform process consisting of a set of policies that transfers responsibilities, resources, and/or powers from the central government to subnational governments. In bringing government closer to citizens, decentralization seeks to foster more efficient resource allocation and improved accountability. It also encourages subnational governments to experiment with new and innovative forms of public management, including in recent years the increasing use of information and communication technologies (ICTs) and the adoption of new digital tools. The section provides a synopsis of the available evidence regarding the impact of decentralization. It recognizes that the design, sequencing, and implementation of the process are subject to historical circumstances and political economy factors; nonetheless, it documents a series of principles that, when followed by the countries, help to achieve the objectives of decentralization and mitigate its risks. These include: (i) clear definition of expenditure and service delivery responsibilities by level of government; (ii) the assignment of own sources of revenue to subnational governments; (iii) the coordination of transfer systems that cover the cost of providing the assigned services and compensate less developed subnational governments; (iv) effective implementation of a subnational fiscal responsibility framework; (v) the development of management capacities and the adoption of new technologies that

allow subnational governments to fulfill their responsibilities; and (vi) the creation of mechanisms that facilitate transparency and accountability at the subnational level.

Section III presents the main sector challenges in the region, according to the same factors as those analyzed in Section II. Regarding progress over the last three years, the SFD describes the deepening of decentralization in Chile and Panama. It highlights the end of the boom in transfers to subnational governments linked to extractive industries (particularly in the Andean countries), as well as progress in the area of subnational fiscal sustainability in both Mexico and Argentina. From a historical perspective, the SFD highlights the improved fiscal sustainability of subnational governments, particularly in Argentina, Brazil, Colombia, and Mexico. A traditional challenge in the sector is the subnational governments' high dependence on transfers within the financing structure, which contrasts with other regions in the world. This high dependence on transfers reduces the subnational governments' incentives for accountability and efficient management, and it reflects weaknesses in the relationship between the different levels of government. At the same time, the performance of subnational governments is also affected by the context of low institutional capacity, limited transparency, and weak capacities for monitoring subnational management. Accordingly, the main challenge for the decentralization and subnational governments sector is to facilitate conditions that promote institutional capacities and to structure incentives for more efficient and effective subnational management, which should help improve the quality of life for all citizens. To this end, support should be provided for interventions and changes that systematically address institutional weaknesses in the sector, as manifested in the following four major problems: (i) weak intergovernmental arrangements; (ii) subnational governments with deficient expenditure management and service delivery; (iii) subnational governments with low generation of own revenue and poor access to financing; and (iv) subnational governments with limited management transparency and accountability.

Section IV presents the Bank's experience in the sector based on a historical analysis from 1990, with a focus on the progress made over the last three years. It describes the set of loan and technical cooperation operations, knowledge products, and dissemination activities in recent years. This section also draws upon the contribution of Bank's experiences, lessons learned, and good practices in the sector, with comments regarding its comparative advantages as a provider of financing and technical assistance in decentralization and subnational governments.

Lastly, Section V describes the goals, principles, dimensions of success, and lines of action that will guide the Bank's operational and research activities in the sector. This SFD proposes that the Bank's goal be to foster the development of institutional capacities and a suitable incentive structure for more efficient and effective subnational management in Latin America and the Caribbean, thus helping to improve the quality of life for all citizens. It prioritizes the following principles for work in the sector: (i) developing institutional capacities, with emphasis on greater use of digital tools; (ii) consideration of stakeholder incentives; (iii) recognition of the interdependence of sector challenges; and (iv) adapting to variations among and within countries. The four established dimensions of success, together with the lines of action and the proposed operational and knowledge and dissemination activities, address the challenges in the sector and are guided by these principles.

I. THE SECTOR FRAMEWORK DOCUMENT IN THE CONTEXT OF EXISTING REGULATIONS AND THE INSTITUTIONAL STRATEGY 2010-2020

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

- 1.1 The Decentralization and Subnational Governments Sector Framework Document sets out the Bank's goals in the decentralization and subnational government sector ("the sector") and guides its operational, dialogue, and knowledge generation work with the countries and their governments. In accordance with the provisions of "Strategies, Policies, Sector Frameworks, and Guidelines at the IDB" (document GN-2670-1, which establishes the content of SFDs and stipulates that they be updated every three years), this Sector Framework Document (SFD) replaces the previous version approved by the Operations Policy Committee on 16 June 2015 (document GN-2813-3).
- 1.2 The Decentralization and Subnational Governments SFD is one of 20 prepared under the framework of document GN-2670-1, which together provide a comprehensive vision of development challenges in the region. This SFD acknowledges the multisector nature of the decentralization process, as partly manifest in the responsibilities and functions of the subnational governments. As a result, this SFD does not include any specific discussion of the individual sector policy dimensions affected by this process. From the Bank's perspective, these areas are addressed in the corresponding SFDs for the different sectors, including housing and urban development; fiscal management; justice and citizen security; health and nutrition; education and early childhood development; gender and diversity; transportation; tourism; agriculture and natural resource management; water and sanitation; integration and trade; and environment and biodiversity.
- 1.3 Instead, this SFD focuses on the crosscutting factors that are a necessary condition for subnational governments to effectively and efficiently perform the specific functions for which they are responsible, acknowledging that decentralization is not an end in itself. In particular, this SFD will emphasize two factors, considering the interdependent nature of each: (i) the incentive structure that characterizes intergovernmental relations; and (ii) institutional capacity development at the subnational level. In the context of this SFD, the Bank will seek to tailor interventions to the specific needs and requirements of each country, as well as the specificities of each case, taking into account the heterogeneity that exists in the region.

B. The Decentralization and Subnational Governments Sector Framework Document and the IDB Institutional Strategy

- 1.4 This SFD is consistent with the Update to the Institutional Strategy 2010-2020: Partnering with Latin America and the Caribbean to Improve Lives (document AB-3008), which acknowledges that strengthening institutional capacity and the rule of law are crosscutting issues that hinder development in the region. This SFD is also in keeping with the Bank's five sector strategies, particularly the Sector Strategy Institutions for Growth and Social Welfare (document GN-2587-2).
- 1.5 This SFD establishes that Bank actions will seek to foster the development of institutional capacities and structure incentives in a way that facilitates more efficient and effective subnational management in Latin America and the Caribbean, thereby helping to improve the quality of life for all citizens. To this end, the SFD pursues two

main objectives: (i) supporting interventions and institutional changes in the Bank's 26 borrowing member countries aimed at addressing: (a) weaknesses in intergovernmental arrangements; (b) deficiencies in the management of expenditure and service delivery by subnational governments; (c) challenges for subnational governments related to generating own-source revenue and securing access to financing; and (d) weaknesses in subnational governments' transparency and accountability mechanisms; and (ii) consolidating and deepening the knowledge agenda in the sector.

- 1.6 The rest of the document is structured as follows: Section II provides a selection of the international empirical evidence from programs in the sector; Section III presents the main sector challenges in Latin America and the Caribbean (LAC); Section IV contains the lessons learned from the Bank's experience in the sector; and Section V, lastly, includes the goals, principles, dimensions of success, lines of action, and concrete activities that the Bank will prioritize in the decentralization and subnational governments sector.

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

A. Context and evidence

- 2.1 Decentralization is an institutional reform process consisting of a set of policies that transfer responsibilities, resources, and/or powers from the central government to subnational governments. The process can take two main forms, depending on the objective of decentralization: (i) political decentralization, which includes reforms aimed at opening or activating spaces for representation and the popular election of authorities at the subnational level; and (ii) fiscal decentralization, which involves the process of transferring public expenditure and service delivery responsibilities to subnational levels of government, together with their sources of finance (own-source revenue, transfers, and borrowing). The scope of decentralization, in turn, varies depending on the level of autonomy enjoyed by subnational governments.¹ In its most limited version, decentralization takes the form of deconcentration, which involves the transfer of responsibilities to administrative units that are still part of the central government, but which are located closer to the population being served. At the other extreme, the most ambitious form of decentralization includes the devolution of responsibilities and functions to politically autonomous subnational governments (Baskaran, 2009; Cheema and Rondinelli, 1983).
- 2.2 Over the last 30 years, decentralization has usually been implemented in developing countries as a mechanism that, in bringing government closer to citizens, facilitates a more efficient allocation of public resources and fosters improved accountability (World Bank, 2004). Decentralization has also been promoted as a laboratory for subnational governments to develop and experiment with new forms of public policy (Oates, 2008), including in recent years the growing use of ICTs. Nonetheless, the impetus for decentralization in countries involves multiple factors: changes in political regime; the need to avoid and/or reduce internal conflict; and, more

¹ The literature identifies three types of administrative decentralization: deconcentration, delegation, and devolution. These are different methods of transferring responsibilities from the central government to subnational governments (Rondinelli, Nellis and Cheema, 1983). For the purposes of this document, these methods of decentralization are covered within the broadest approach to fiscal decentralization.

generally, the structure of political incentives affecting the main stakeholders in decentralization (Eaton, Kaiser, and Smoke, 2010).

- 2.3 Recognition of this fact means that there is no single approach to carrying out decentralization; the design, sequencing, and implementation of the process are subject to prevailing conditions in the countries, including historical circumstances and political economy factors. Nonetheless, international experience points to a series of principles or conditions that are the focus of this SFD, and which help to achieve the objectives of decentralization and mitigate its risks when followed by the countries. These include the clear definition of expenditure responsibilities by level of government (Bahl and Martínez-Vázquez, 2006); the assignment of own-source revenue to subnational governments (Bird, 2011); the coordination of transfer systems that cover the cost of providing the assigned services and compensate less developed subnational governments (Shah, 2007); effective implementation of a subnational fiscal responsibility framework (Rodden, 2006); the development of subnational government management capacities that are commensurate with their responsibilities (IDB, 2010b); and the creation of mechanisms that facilitate transparency and accountability at the subnational level (Faguet, 2012).
- 2.4 Evidence regarding the impact of decentralization is limited. Firstly, the process itself affects entire territories, complicating the identification of suitable control groups at the subnational level with a view to constructing a counterfactual. Secondly, it is usually part of a broad program of reforms, including democratization processes and/or market reforms.² Despite these constraints, a nascent literature geared toward evaluating decentralization processes and their impact at the subnational level has revealed mixed results, both in countries belonging to the Organization for Economic Cooperation and Development (OECD), which have more developed regulatory frameworks (OECD, Ahmad, Brosio, and Tanzi, 2008), and in developing countries (Mansuri and Rao, 2013; Smoke, 2013; Channa and Faguet, 2012; Ahmad and Brosio, 2009). A brief summary of this literature is provided below. Although this review does not claim to be exhaustive, it is illustrative of the main impact of decentralization processes on the provision of public goods and services, both in the region and elsewhere.³
- 2.5 Firstly, the decentralization process in some countries is associated with public expenditure allocations that more closely reflect local needs and preferences, together with a geographic reorientation of expenditure to relatively poor municipios and a shift in the composition of public investment toward greater investment in human capital (health and education). For example, prior to the decentralization process in Bolivia, the three largest, wealthiest districts received more than 85% of shared revenue, while the rest received less than 15%. Subsequent to decentralization, these shares were reversed to 27% and 73%, respectively (Faguet, 2012). As a result of decentralization, investment in education was higher in regions with lower initial literacy rates, and water and sanitation expenditure grew faster in municipios with larger infrastructure deficits.⁴ In other countries, however, decentralization had a limited impact on the degree to which public services reflected

² Additionally, as will be discussed later, the ambiguity in many countries regarding which level of government is responsible for providing certain services hinders the clear attribution of said responsibilities.

³ For an exhaustive review, see Martínez-Vázquez et al., 2016; Smoke, 2013; Faguet, 2012; and Treisman, 2007.

⁴ In the case of Colombia, the decentralization process has been associated with higher rates of school coverage and improved access to public health services for the poor (Faguet and Sánchez, 2014).

- the demands of the local population (Skoufias, Narayan, Dasgupta, and Kaiser, 2011; Akin, Hutchinson, and Strumpf, 2005), and the recent boom in natural resources-related transfers has led to marked inequities in the territorial distribution of resources, particularly in the Andean countries (Government of Peru, 2011; World Bank, 2009c).
- 2.6 Secondly, evidence shows that decentralization can improve policy outcomes due to the ability of local communities and subnational governments to leverage their informational advantages vis-à-vis other, higher levels of government (Mansuri and Rao, 2013). One area in which this advantage has been apparent is in the selection of strategies or mechanisms to improve the targeting and distributional impact of certain social programs, particularly in contexts where identifying eligible households is a challenge, and in which decentralized strategies facilitate the improved use of information regarding the local environment (Alatas, Banerjee, Chandrasekhar, Hanna, and Olken, 2013; Galasso and Ravallion, 2005; and Alderman, 2002). Nonetheless, the benefit of improved information may be diluted if the decision-making process at the local level has been captured (Bardhan and Mookherjee, 2000, 2005, 2006); if the powers delegated are used in an opportunistic manner (Camacho and Conoyer, 2011); or if local capacity is limited. In terms of capture, evaluations of social investment funds with community participation in selection processes, both in LAC and elsewhere, show that local inequality levels have a negative impact on the likelihood that pro-poor investment projects will be selected (Bardhan, Mookherjee, and Torrado, 2010; Araujo, Ferreira, Lanjouw, and Ozler, 2008). They also show that this process is sometimes dominated by more highly educated individuals and networks of contacts that tend to reduce the distributional impact of these instruments (Rao and Ibáñez, 2005).⁵
- 2.7 Thirdly, with respect to sector evidence,⁶ decentralization in the case of health services has allowed several countries to build and experiment with good practices by using different care models. For example, a pioneering approach that uses community agents as a nexus between the population and health services in Costa Rica (Rosero-Bixby, 1990) and Jamaica (Riley, 2005) points to the importance of these agents for altering behaviors and promoting the use of health services that have helped to increase average life expectancy. Likewise, evaluations of a decentralized program at the local government level in Brazil—Programa Saúde da Família [Family Health Program]—show a positive impact on changes in behavior and outcomes (Macinko, Guanais, and Marinho de Souza, 2006; Rocha and Soares, 2010). In municípios exposed to the program over a three-year period, infant mortality rates fell by 1.5 per 1,000 live births compared to those that did not adopt the program, with the greatest reductions in the most disadvantaged regions (North and Northeast).
- 2.8 As concerns education, although the evidence regarding school decentralization shows a positive impact on coverage levels and some impact on retention and graduation, the evidence regarding improvements in equity and in the quality of education (as measured by learning outcomes) is limited. For example, although

⁵ Evaluations of social investment funds are available for several countries in the region, including: Bolivia (Newman et al., 2002); Ecuador (Araujo et al., 2008); Guatemala (Ibarrarán, Sarzosa, and Soares, 2008); Peru (Paxson and Schady, 2002; Schady, 2000); Nicaragua (Pradhan and Rawlings, 2002); and Jamaica (Rao and Ibáñez, 2005).

⁶ Deeper sector analysis of decentralization is included in the SFDs for sectors in which relevant responsibilities have been assigned to subnational governments.

exam results in mathematics and Spanish improved by 3.5% and 5.4%, respectively, after five years of decentralized administration in Argentina, these improvements were achieved in schools of nonpoor municipios (Galiani, Gertler, and Shargrodsky, 2008). This indicates that the distributional consequences of decentralization need to be considered,⁷ together with the need to develop complementary policies that strengthen the ability of these communities to take advantage of the process. In this sense, the evaluation of a school decentralization program (Apoyo a la Gestión Escolar) in disadvantaged communities of Mexico provides evidence of a reduction of between 4% and 5% in the proportion of students failing or repeating the school year after parent associations were strengthened (Gertler, Patrinos, and Rubio-Codina, 2012).⁸ However, similar experiments in other contexts have found a mixed impact on learning (Duflo, Dupas, and Kremer, 2014; Glewwe and Maïga, 2011).

- 2.9 There is less evidence regarding the decentralization of infrastructure and basic services provision. In the case of transportation, however, the effectiveness and sustainability of the decentralization of rural road services management in Peru was enhanced by a gradual approach to transferring this function to the municipios, beginning with preinvestment studies and followed by the transfer of project execution itself once subnational capacities and the responsible institutions had been strengthened (IDB, 2014a).⁹ With regard to the impact of decentralization upon potable water and sanitation service provision at the municipal level, this has created excessive fragmentation in some cases, giving rise to problems of scale for the service companies in terms of recovering costs and providing quality service. The merger or consolidation of small and medium-sized service providers may help to generate economies of scale, with the potential for cost savings and improved service quality (IDB, 2014b; Economic Commission for Latin America and the Caribbean (ECLAC), 2011a).¹⁰
- 2.10 Lastly, subnational governments have made progress toward the adoption of digital technologies for improving revenue management and service delivery at the local level. In the Brazilian state of São Paulo, for example, companies submit their invoices electronically to the tax administration each month under the Nota Fiscal Paulista (São Paulo Tax Invoice) program, and an Internet-based rewards system provides consumers with an incentive to request these invoices. After four years of program implementation, revenues reported by companies rose 22%, thus helping to reduce evasion of the main state tax (Naritomi, 2015). Innovations to improve local service delivery include a program in the Pakistani province of Punjab aimed at improving the monitoring of health services in rural areas. It uses a mobile app to report in real time the number of inspections and medical staff attendance in health

⁷ Regarding the relationship between inequality and decentralization, see Goerling and Seiferling (2014).

⁸ Regional experiences that have been evaluated in the area of school decentralization (school-based management) include Chile (Vegas, 2002; Letelier, 2017), El Salvador (Sawada and Ragatz, 2005), Nicaragua (King and Ozler, 2005), and Mexico (Skoufias and Shapiro, 2006), among others. For a general review, see Gunnarsson, Orazem, Sánchez, and Verdisco (2009).

⁹ The Transportation Sector Framework Document (IDB 2016a) cites evaluations that conclude that government decentralization and changes in the ownership of infrastructure facilities (from a publicly-owned model to one with public-private partnerships and more decentralized development) have had a consistently favorable impact on total factor productivity in economies worldwide.

¹⁰ The Water and Sanitation SFD (IDB, 2017a, paragraph 2.17) highlights successful experiences involving regional companies in England, Holland, and Chile, together with departmental water and sanitation plans in Colombia.

centers, as well as an online dashboard to supply this information to provincial health authorities. An evaluation of the program shows that the app almost doubled the number of inspections, while medical staff absences were significantly reduced in those units with lower initial levels of attendance (Callen et al., 2017). The evaluation of biometric technology to verify staff attendance in an Indian state shows that improved monitoring can also affect health outcomes: the number of children born underweight fell in districts that used the technology (Dhaliwal and Hanna, 2017). A key finding in both evaluations is that technological solutions alone do not improve results; rather, these depend to a greater extent on the underlying incentives for key actors to use monitoring technologies in an appropriate manner, with results varying depending on the circumstances.

- 2.11 In summary, recent international evidence indicates that the results of decentralization are mixed, both across and within countries. This suggests the need to pay attention to both the details of implementation and the scope, sequencing, and speed of reform, together with institutional design factors, all of which help to identify the conditions under which the process can help to achieve the objective of improving expenditure allocation and transparency on the part of subnational authorities. Clearly, these outcomes are affected by variables related to the local context, such as poverty, inequality, and levels of education among the population; by political economy constraints linked to the different motivations of the stakeholders in decentralization (subnational governments and their associations, the central government, Congress, civil society, among others) (Tommasi, 2014; National Planning Department (DNP), 2017); and by existing levels of political development and institutional capacity (Smoke, Gómez, and Peterson, 2006). Given these variables and constraints, this SFD focuses on factors that can help improve subnational government performance, relating to the system of incentives for key stakeholders in the sector and the development of institutional capacities. These factors encompass the structure of intergovernmental relations, subnational government management capacities, and mechanisms to facilitate transparency and accountability at the subnational level.

B. Structure of intergovernmental relations

- 2.12 Both the theory and practice of fiscal decentralization suggest a number of general principles that should be observed in order to enhance benefits and minimize costs. Firstly, international experience indicates that expenditure responsibilities should be clearly defined across the different levels of government (Fedelino and Ter-Minassian, 2010).¹¹ Determination of who does what should be based on international good practice, observing the principle of subsidiarity (according to which countries assign expenditure responsibilities to the most decentralized level of government with the capacity to perform them). One should also take into account the possible existence of economies of scale and interjurisdictional externalities that would make more centralized delivery more preferable (Oates, 1999; Bahl and Martínez-Vázquez, 2006).
- 2.13 In practice, however, the considerations that determine the distribution of responsibilities across levels of government tend to be distinct from the optimal assignment of functions. As a result, many expenditure functions are concurrent,

¹¹ Specifically, this entails the determination of three issues: which level of government formulates the expenditure plan, which one finances it, and which one ultimately executes it (Ahmad, Hewitt, and Ruggiero, 1997).

allowing some degree of overlap between the different levels of government (Bahl and Martínez-Vázquez, 2006). When these overlaps are excessive, it is unclear which level of government regulates, finances, and implements each function. Such overlaps are accompanied by efforts to limit the level of subnational government authority over expenditure responsibilities, and this creates a perverse dynamic—known as partial decentralization¹²—that has potentially negative implications for accountability and the efficiency of service delivery (Devarajan, Khemani, and Shah, 2009; Khemani, 2010). Specifically, situations may arise in which citizens do not know who to demand improved services from, and in which public employees operate without clarity as to their scope of responsibility.

- 2.14 A second principle is that subnational governments should be provided with adequate own-source revenue bases that are commensurate with the expenditure responsibilities assigned (Bird, 2011). There is evidence regarding the benefits of granting greater autonomy to subnational governments in determining the level and composition of their revenues; these include budget predictability and improved accountability due to the strong relationship between the financing and delivery of goods and services at the subnational level (Faguet and Sánchez, 2014; Weingast and Poeschl, 2013). In effect, when citizens are responsible for funding their subnational governments they have a greater incentive to demand that their taxes are well invested (Paler, 2013). The historical experience of decentralization in developed countries shows the high degree of alignment between own-source financing and subnational service delivery, stemming from the delegation of tax powers to subnational governments (Gadenne and Singhal, 2014; Glaeser, 2013).
- 2.15 Nonetheless, the assignment of tax powers across levels of government is a complex process, particularly in developing countries where tax potential is limited and regional inequalities are high. The main taxes in the countries—such as the value-added tax (VAT) and the corporation tax—have broad, elastic bases, and are usually assigned to the central government due to both economies of scale in their administration and the high level of revenue generated (which gives them considerable potential for redistribution and macroeconomic stabilization). At the same time, although the taxes over which subnational governments generally exert authority are important, their revenue potential is lower. One of the main ones is the property tax, which is the local tax par excellence as its base is immovable and its yield stable, and it also is highly visible.¹³ Benefit-based taxes such as utility rates and user fees have clear local attributes, although they usually only cover the cost of delivering the service concerned. The recovery of capital gains created by public works or changes in land use is another potential source of resources, although its objective is to recover investment costs or limit public expenditure (Blanco, Fretes Cibils, and Muñoz, 2016; Smolka, 2013).
- 2.16 Aside from the type of taxes that are devolved, a fundamental issue is the degree of autonomy that subnational governments are allowed in exploiting them. Given the underlying motivations for revenue decentralization, and the existing political economy dynamics in intergovernmental relations, the level of autonomy enjoyed by subnational governments in determining policies and administering their taxes (in terms of their powers to set tax or utility rates, determine tax bases, and/or perform

¹² Partial decentralization is defined as decentralization reforms that do not allow citizens to hold local governments accountable for budgetary allocations and their outcomes (Devarajan et al., 2009).

¹³ See Slack and Bird (2014) for OECD good practices in property taxes.

collection and recovery functions) tends to vary (Bird, 2015; Martínez-Vázquez, 2010). Nonetheless, international experience shows that even in developing countries there is room to assign taxes to subnational governments, with a view to aligning own-source financing and the delivery of subnational services (Bahl and Bird, 2008). Levies such as sales and excise taxes are good candidates for decentralization as their administration is relatively simple. With respect to the VAT and the personal income tax, countries such as Canada apply subnational surcharges on top of national taxes with a view to resolving the administrative and coordination difficulties that arise from the application of different rates.¹⁴ This facilitates administration, which can remain the responsibility of the central government, while providing subnational governments with significant own-source revenues (Fedelino and Ter-Minassian, 2010; Fenchietto and Pessino, 2000; Fretes Cibils and Ter-Minassian, 2015).

- 2.17 A third principle involves well-designed systems of intergovernmental transfers. These should: (i) correct both vertical imbalances (the difference between subnational government expenditures and own-source revenues) and horizontal ones (differences between subnational governments in terms of fiscal capacity and spending needs);¹⁵ (ii) provide incentives for efficient service delivery; (iii) minimize levels of discretion; and (iv) at the same time, adapt to changes in circumstances (Shah, 2007; Bird and Smart, 2002). Given the fiscal disparities between subnational governments, several countries have introduced equalization transfers aimed at compensating less developed entities, so that all subnational governments have the opportunity to provide a standard range of public goods and services (assuming a similar level of fiscal effort) (Boex and Martínez-Vázquez, 2007). At present, several of the most decentralized OECD countries have transfer systems that are designed specifically to reduce regional fiscal disparities: evidence shows that these have been substantially reduced and, in some cases, practically eliminated (OECD, 2014, Muñoz, Pineda, and Radics, 2017).¹⁶ At the same time, the countries of the European Union have structural or convergence funds, which are capital transfers aimed at reducing development gaps between regions and the member states. These have helped to accelerate growth in less-developed regions, facilitating economic convergence (Becker, Egger, and von Ehrlich, 2010).¹⁷ The coordination that is facilitated by equalization and convergence transfers can help to consolidate the institutions responsible for defining and updating resource allocation formulas.¹⁸ In addition to the key role that these institutions perform in managing transfer

¹⁴ As analyzed in the following section, this problem affects Brazil's states, which set different rates for the Imposto sobre Circulação de Mercadorias e Serviços [goods and services circulation tax] (ICMS) depending on the origin and destination of purchases. This stimulates tax avoidance and tax "wars".

¹⁵ The fiscal capacity of subnational governments is their potential for generating own-source revenue, which is linked to their socioeconomic development. The expenditure needs of subnational governments are determined by the costs of service provision, which depend (among other things) on the geographical, demographic, and socioeconomic characteristics of the governments concerned (see OECD, 2014).

¹⁶ Of interest are the experiences of both Canada, where the central government provides equalization transfers to provinces with below-average fiscal capacity, and Australia, which in addition to compensating for fiscal capacity includes the spending needs of its states in the equalization formula (based on their socioeconomic profile and the different costs of providing public goods and services) (Boex and Martínez-Vázquez, 2007).

¹⁷ For a conceptual motivation of/argument for convergence funds, see Cai and Treisman (2005).

¹⁸ Of particular note is Australia's experience with its Commonwealth Grants Commission, which is responsible for managing the country's equalization transfers. With respect to developing countries, the experiences of India and South Africa are of particular interest.

systems, they also help to foster improvements in the various dimensions of intergovernmental relations (Ter-Minassian and De Mello, 2016; Srinivassan and Wallack, 2006; Watts, 1999).¹⁹

- 2.18 In this respect, international evidence points to the different incentive problems that are generated by certain transfer systems or revenue-sharing arrangements in developing countries. Design of these systems frequently diverges from good practice—according to which finance follows function (Bahl, 1999)—meaning that transfers are determined without adequate consideration of subnational governments’ spending needs. As a result, in some cases the expenditure responsibilities transferred end up underfunded, creating pressure on the central government to cover the resulting deficit (Bahl and Martínez-Vázquez, 2006). In contrast, many countries (particularly in LAC) begin decentralization reform by increasing transfers without clear definition of the spending functions to which the additional resources will be allocated. This greater dependence on transfers can, in turn, reduce accountability and the quality of expenditure (Weingast, 2009).
- 2.19 With respect to discretionary transfers, the distortions generated by these are well-known, as their volume and allocation are usually not determined on the basis of criteria of efficiency and/or equity (Muñoz, Pineda, and Radics, 2017; Brollo and Nannicini, 2012; Arulampalam, Dasgupta, Dhillon, and Dutta, 2009; Ansolabehere and Snyder Jr., 2006). This type of transfer has been used in some countries to cover subnational fiscal deficits, affecting macroeconomic stability. They also encourage rent-seeking by subnational governments, reducing their incentives to generate own-source revenue, and they are unstable and unpredictable, complicating planning at the subnational level (IDB, 2000).
- 2.20 Lastly, to promote fiscal sustainability there must be a credible commitment among higher levels of government not to bail out subnational governments that fail to meet their fiscal obligations (IMF, 2009; Rodden, Eskeland, and Litvack, 2003). This principle has been the subject of considerable attention in recent decades due to the fiscal crises that have been unleashed in some countries (particularly in LAC), partly as a result of subnational fiscal risks (Dickovick, 2014). These crises have led to conceptual developments that shed light on the risk that the incentive structure under decentralization will encourage behaviors among key actors that impact macroeconomic stability.²⁰ Part of this structure is aimed at establishing effective budgetary restrictions that foster medium-term fiscal sustainability in subnational governments, while also giving them the flexibility to deal with unexpected shocks. In this latter respect, international evidence shows that subnational governments in both developed and developing countries find it difficult to implement countercyclical policies (Sow and Razafimahefa, 2017; Rodden and Wibbels, 2010). To avoid abrupt shifts in fiscal policy in times of recession, some U.S. states, for example, have resorted to the use of budget stabilization or “rainy day” funds. The effectiveness of these depends on their specific design, such as the establishment of clear rules governing the accumulation and use of funds (Balassone et al., 2007).

¹⁹ There is room within the literature on the design of transfer systems to deepen analysis of specific aspects, such as the calculation of spending needs (within the framework of equalization transfers), the effectiveness of convergence funds, and alternatives to reduce the procyclical nature of transfer flows.

²⁰ This branch of conceptual developments is known as the second generation of fiscal federalism, as opposed to the first generation, which emphasizes the potential welfare gains of decentralization due to improved efficiency of resource allocation based on the government’s proximity to citizens (see Oates, 2008).

Escape clauses have also been adopted in fiscal rules and fiscal responsibility laws (Liu and Webb, 2011).

- 2.21 Another key feature of the incentive structure is the dependence of subnational governments on intergovernmental transfers. When subnational governments are mostly financed by taxes paid by the rest of the country, they have less incentive to internalize the cost of their fiscal decisions; this can cause them to increase their spending beyond budgetary limits in the expectation that they will receive additional funds from the common pool. International experience shows that this high dependence on transfers can lead to subnational fiscal deficits and/or an expansion in the size of the public sector (when accompanied by subnational government autonomy in borrowing); weak monitoring by the central government; limited transparency; an absence of clarity in expenditure responsibilities; the existence of discretionary transfers; and a history of central government bailouts of subnational governments (Asatryan et al., 2015; Vigneault, 2005; Rodden, 2002 and 2003; Bordignon, 2000; IDB, 2000; Stein, 1998; World Bank, 1999).
- 2.22 A number of instruments and design features can help to mitigate this risk as long as there is complementarity in their implementation and they are compatible with the broader structure of incentives: reducing the high dependence on transfers by increasing subnational governments' capacity to generate own-source revenue; improving subnational fiscal transparency; clearly defining expenditure functions by level of government; minimizing discretionary transfers; avoiding financial bailouts; and imposing controls on subnational borrowing by means of subnational fiscal rules²¹ accompanied by credible enforcement mechanisms (Kotia and Lledo, 2016; Aldasoro and Seiferling, 2014; Grembi, Nannicini, and Troiano, 2014; Rodden, 2006).²²

C. The management capacities of subnational governments

- 2.23 The existence of subnational governments with sufficient capacity to adequately perform assigned responsibilities is an important precondition for the goals of decentralization processes to be met (IDB, 2010b). These management capacities affect the scope of their responsibilities in the areas of revenue, service delivery and public spending, and borrowing.
- 2.24 **Revenue management.** Evidence points to the importance of seeking to ensure that subnational governments are responsible for financing any increase in their spending through own-source revenue. For example, the evaluation of a program to strengthen local tax administration in Brazil shows that increased revenue collection has a positive impact on the quantity and quality of investment in education infrastructure (Gadenne, 2017). Similarly, local tax effort in Colombia is associated with improvements in the quality and coverage of public goods provision in different sectors, such as health, education, and water and sanitation (Martínez, 2017; Sánchez and Pachón, 2012; Faguet and Sánchez, 2008). No effects of a similar magnitude are found in either country for alternative sources of financing such as transfer-related revenue, including transfers stemming from the exploitation of nonrenewable resources. In fact, the evidence indicates that exogenous increases in the latter have a negative impact on various outcomes, including the integrity of

²¹ Preferably with explicit quantitative targets or ceilings, such as limits on debt as a proportion of own-source revenues and operational deficit ceilings.

²² For a taxonomy of subnational fiscal rules in the OECD, see Fredriksen (2013) and Sutherland et al. (2005).

the subnational authorities (Martínez, 2017; Brollo, Nannicini, Perotti, and Tabellini, 2013); the quality of institutions (Gervasoni, 2010); the provision of local public goods (Ardanaz and Maldonado, 2016; Caselli and Micheals, 2013); and the technical efficiency of public spending (Ardanaz, 2014; Ardanaz and Tolsa Caballero, 2015; DNP, 2012).

- 2.25 Among the factors that dissuade subnational governments from making their own fiscal efforts is discretion in the distribution of transfers in some countries. This makes it easier for subnational authorities to secure funding from the central government through political negotiations, instead of increasing the tax burden on local taxpayers (Artana et al., 2015; Pineda, 2014). To reduce political influence on revenue-raising efforts and foster more client-oriented management, there have been experiences at the subnational level with semiautonomous tax administration agencies. In Peru, the tax administration services (SATs) implemented in nine of the country's municipios have yielded better collection performance results than similar municipios without these services (IDB, 2013a; von Haldenwang, 2010). In Honduras, the Central District City Hall (Tegucigalpa) chose to outsource the management of tax collection, reporting a doubling of collections from 2007 to 2012 (Pérez Rincón, 2014).²³ In the case of Uruguay, the country's departments agreed to centralize collection of the vehicle tax by means of a trust, thus resolving existing competition for tax bases, reducing political influence, and building administrative efficiency. This contributed to a 50% real increase in vehicle tax collections in the five-year period following implementation of the mechanism.²⁴ With respect to the property tax, the key factors affecting collection are rooted in local political economy dynamics and include the prevalence of tax exemptions and incentives, together with the quality of the land registry and the system for updating assessments. These factors, in turn, usually flow from the political economy of subnational taxation (Slack and Bird, 2014; Ahmad, Brosio, and Poschl, 2014; Bonet, Muñoz, and Pineda, 2014; Fretes Cibils and Ter-Minassian, 2015). Lastly, influencing taxpayer perceptions can help to improve local collection performance: experimental evaluations in municipios in Argentina and Peru show that the introduction of messages on bills for the main municipal tax is an effective tool for influencing taxpayer behavior and improving tax compliance (Castro and Scartascini, 2015; Del Carpio, 2013).²⁵ Likewise, the use of rewards as a tool for encouraging citizens to pay their taxes yields persistent positive effects at the local level (Carrillo, Castro, and Scartascini 2017; Gonzalez-Navarro and Quintana-Domeque, 2015; Naritomi, 2015).

²³ Experiences such as the creation of SATs or outsourcing tax collections require comprehensive evaluation on a case-by-case basis, with a view to fostering autonomy, effectiveness, and sustainability in tax administration.

²⁴ See the experience of the Single Vehicle Tax Collection System ([SUCIVE](#)).

²⁵ In Argentina, the most effective message listed the applicable fines and the potential administrative and legal steps available to the municipality in the event of noncompliance. This message succeeded in increasing the rate of tax compliance (calculated as the ratio of payments by taxpayers to the amount billed) by 7% (Castro and Scartascini, 2015). In Peru, tax compliance increased by 20% following the publication of information on previous compliance levels (Del Carpio, 2013).

- 2.26 **Management of expenditure and public services.** The implementation of public financial management (PFM) systems can enhance the operational efficiency and transparency of subnational governments (Fedelino and Smoke, 2013).²⁶ In the case of procurement, for example, implementation of a Bolsa Eletrônica de Compras [Electronic Procurement Exchange] in the State of São Paulo, Brazil, has helped to centralize information on government suppliers and procurement prices, leading to a 26% reduction in negotiated prices for purchases in 2013 when compared to the original projected amount (Alves-Ferreira, 2013). Other states in Brazil, including Amazonas, Rio Grande do Sul, Bahia, and Pernambuco, are using reference prices drawn from transactions registered as part of the ICMS collection process²⁷ as a source of information for public procurement. In the area of integrated financial management systems (SIAFs), implementation of these in all of Peru's municipios since 2007 has helped to correct irregular practices in the recording of public debt, facilitating detailed, real-time verification of budget execution in each entity (Llempén, Morón, and Seminario, 2010).
- 2.27 Along with PFM systems, development of the pillars of Management for Development Results (MfDR) and strategic management capacities can help improve subnational government performance (IDB, 2011a).²⁸ In Brazil, the State of Minas Gerais has made progress implementing MfDR by employing tools that establish contractual targets for the institutions responsible for programs and projects. This is achieved using formal monitoring and governance arrangements for resolving management issues, helping to make state management more efficient and effective (Lobato, 2014). In the State of Ceará, the introduction of transfers to municípios based on their performance in delivering education and health services has helped to improve results in those sectors (Holanda, 2014). In the State of Pernambuco, the implementation of strategic management through the Center of Government has allowed key government functions to be integrated, setting sector priorities, schedules for intensive monitoring, and mechanisms for resolving obstacles; these have contributed to the achievement of results such as improvements in basic education and reductions in crime and infant mortality (Alessandro, Lafuente, and Santiso, 2014). A similar experience to that of Pernambuco is being developed by the Buenos Aires Municipal Government, which has established a compliance management unit to monitor the policies and outcomes prioritized by the city government. In Peru, regional and local investment committees have improved the efficiency of public investment execution (Government of Peru, 2011b), while the Delivery Unit of the Presidency of the Council of Ministers is improving coordination between central and subnational governments in programs to reduce chronic child malnutrition, among others.
- 2.28 Subnational governments can help to create supportive conditions for economic development through improvements in economic governance (Jin, Qian, and Weingast, 2005; Zhuravskaya, 2000; Weingast, 1995 and 2009). This concept encompasses a range of interactions between the public and private sectors relating

²⁶ PFM refers to the different stages of budgetary management (formulation, approval, execution), focusing on the processes and procedures that cover all aspects of public expenditure management (Cangiano, Curristine, and Lazare, 2013). This includes government accounting, treasury single accounts, budgetary processes and procedures, integrated financial management systems, open and electronic procurement systems, and systems for managing assets, payroll, and public investment.

²⁷ The ICMS is the VAT for the individual Brazilian states.

²⁸ These pillars include strategic and operational planning, financial management, results-based budgeting, program and project management, and monitoring and evaluation systems.

to the protection of property rights, contract performance, and the exercise of collective action for the provision of suitable physical and organizational infrastructure (Carcach, 2012; Dixit, 2009). Economic development, in turn, helps to increase fiscal resources for improving public service delivery, creating a virtuous circle of public-private interaction. One area in which subnational governments can facilitate business development is administrative simplification (World Bank, 2015a). In Mexico, the creation in several municipios of the Sistema de Apertura Rápida de Empresas [Rapid Business Opening System] (SARE) reduced the average time for registering a business from 30.1 days to 1.4. This increased the number of new business registrations by 5% and the proportion of wage earners in eligible industries by 2% (Bruhn, 2011).

2.29 Lastly, human resource management systems that promote merit and transparency are—together with improvements in the technical capabilities of employees—important factors that support effective subnational management. In particular, the nature of training and technical assistance programs has an influence on the results achieved. In one intervention aimed at increasing the efficiency of local service delivery in Russian municipalities, the use of prolonged, intensive, and resident technical assistance helped to increase user satisfaction to a greater extent than short-term informational training. These improvements were recorded in municipalities that had been providing services in a decentralized manner for a longer period, and in which there was greater accountability to the population (Beuermann and Amelina, 2014).

2.30 **Debt management.** In the OECD countries, numerous subnational governments are able to access long-term, low-cost financing for investment projects by issuing domestic bonds (Freire, 2014; Platz, 2009). This is possible in large part because the framework for decentralization and subnational financing is aligned with the principles outlined in the previous section. In particular, the ability of subnational governments to generate own-source revenue, their sound financial administration and project management, and the environment of macrofiscal stability and developed subnational capital markets are all factors that underpin the credit solvency of subnational entities and their access to favorable financing conditions. A key lesson drawn from the experience of robust subnational debt markets, such as the United States, is the importance of avoiding financial bailouts for subnational governments; this, in turn, facilitates the development of bankruptcy mechanisms that allow insolvent subnational entities to reorient their relationship with their creditors (Martell, 2017; Darche and Gallo, 2012). In the developing countries, in contrast, the World Bank has estimated that only 4% of the 500 largest cities are solvent in the international markets, and 20% in [domestic markets](#). To improve these numbers and ensure that more subnational governments are able to access low-cost, long-term financing, the World Bank highlights the importance of assisting subnational governments to improve their own-source revenue generation, financial management, ability to design and implement good projects, and public debt management systems, all of which are factors that underpin external credit assessments of solvency and sustainability. This, in turn, contributes to the comprehensive strengthening of subnational government finances. In addition, and as discussed in paragraphs 2.20 to 2.22, the history of financial bailouts in various countries in the region means that effective implementation of a subnational fiscal responsibility framework, together with a system of ex ante alerts providing timely warnings of emergent fiscal risks, would help subnational governments to access financing in a sustainable manner.

D. Mechanisms to facilitate transparency and accountability

- 2.31 An institutional framework that fosters transparency and accountability across all levels of government is a precondition for obtaining better results from decentralization. With citizens, or their organizations, obtaining more information on subnational government performance, and politicians, in turn, having greater incentive to learn about local preferences and act upon them, the ability of voters to reward or punish their representatives is strengthened (Cruz and Keefer, 2016). In the context of decentralization in developing countries, the availability of information has been useful for detecting problems involving the opportunistic management of different types of intergovernmental transfers. For example, one study found that only 13% of capital transfers in education were effectively received by schools; the rest were captured by local authorities (Reinikka and Svensson, 2004). In other cases, at least 20% of cash transfers were not received by beneficiary households due to problems of local capture (Olken, 2006); similar issues meant that almost 60% of subsidies for certain inputs (fertilizers) were appropriated by local authorities (Pan and Christiansen, 2012). In these examples, vulnerable groups are the ones most affected by the lack of transparency and accountability, highlighting the importance of providing information with a view to fostering efficiency in the use of public resources.
- 2.32 The evidence shows that mechanisms that provide greater transparency to citizens—and thus improve the visibility of government actions—can foster accountability at the local level.²⁹ Specifically, there are two types of instruments: centralized (top-down) and decentralized (bottom-up).³⁰ Of note in the first category is Brazil's audit program, under which the federal government (via the Office of the Comptroller General and the National Court of Auditors) monitors the use of transfers at the subnational level. This program reduced the likelihood of reelection by more than 20% in the case of mayors whose administrations were discovered to have committed irregularities in the use of federal funds (Ferraz and Finan, 2008; 2011).³¹ Likewise, an increase in the probability of being audited is associated with a lower level of irregularities *ex post*: corruption is around 10% lower in municípios that have previously been audited compared to those that have not (Avis et al., 2017; Lichstig and Zamboni, 2013; Allingham and Sandmo, 1972).³² Similar experimental evidence regarding the effectiveness of monitoring is to be found in other decentralized countries, such as Indonesia (Olken, 2007).³³
- 2.33 As regards greater empowerment of local communities (bottom-up instruments) the results are mixed. For example, the evaluation of a campaign to inform citizens of the value of education transfers found a reduction in the opportunistic management of funds by local authorities, with a positive impact on education coverage and, to a

²⁹ Even where citizens are informed, their ability to mobilize in support of their collective interests may be limited by factors such as distance, poverty levels, and the presence of crime and violence, among other things. For a discussion of the organizational arrangements that facilitate or inhibit collective action, see Keefer, 2013.

³⁰ See Finan et al. (2017) and Khemani et al. (2016) for recent reviews of both mechanisms.

³¹ In Mexico, where immediate reelection is not allowed, an evaluation of the impact of disseminating information on spending irregularities found a significant reduction in voter turnout (Chong et al., 2014).

³² To put this number in perspective, the average municipio in the study receives 15 million *reais* in transfers, of which 30% are normally the subject of irregularities (Avis et al., 2017).

³³ Comptrollers are increasingly involved in results-based audits at both the national and subnational levels. See Lonsdale, Wilkins, and Ling (2011).

lesser extent, on education quality (Reinika and Svensson, 2005; 2011). With regard to health, an intervention that distributed newsletters with quantitative information on the performance of service providers while also encouraging participation in an action plan to address local problems led to greater use of preventive services and long-term reductions in child mortality (Bjorkman and Svensson, 2009; Bjorkman et al., 2014). However, results in other contexts and sectors indicate that community involvement had a limited impact on the desired outcome (Banerjee, Banerji, Duflo, Glennerster, and Khemani, 2010; Casey et al., 2012); this points to a need to generate additional evidence regarding mechanisms to make governments more accountable to their citizens.³⁴

III. MAIN CHALLENGES FOR THE REGION

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

3.1 The decentralization process in the Latin American and Caribbean countries has gathered momentum since the 1980s. As a result, subnational governments have become increasingly important in the provision of public goods and services that are critical for economic and social development. In fact, the subnational governments' share of consolidated public expenditures in the region's countries almost doubled between 1985 and 2010, from 13% to 25%, and it has remained at this level up to the present time (2015) (see Figure 1).³⁵ Political decentralization has followed a similar path: since 1997, municipal mayors in all Latin American and Caribbean countries have been elected by popular vote, whereas in 1980 this was the case in only six countries.³⁶ With respect to intermediate levels of government, the number of countries with popularly elected authorities rose from just one in 1980 to nine since 2005 (Daughters and Harper, 2007);³⁷ Chile is set to join this group in 2020.

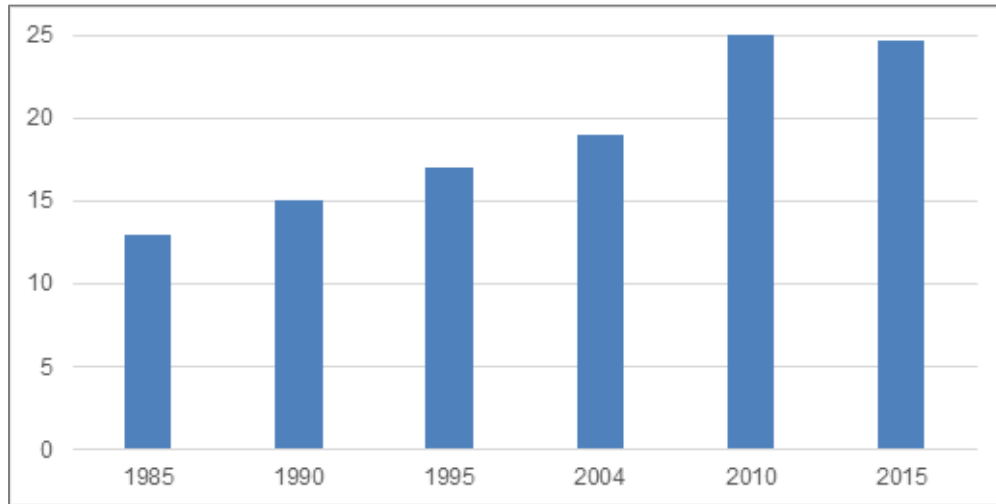
³⁴ Another mechanism with the potential for a positive impact on transparency and accountability is the involvement of civil society organizations. Such is the case of the "Cómo Vamos" programs established in several Colombian cities to monitor municipal government plans. Nonetheless, the evidence regarding the results attributable to these programs remains insufficient.

³⁵ For purposes of illustration, the share of consolidated public spending by subnational governments in OECD countries averages 33% (2014). As will be pointed out further on, however, their financing structure includes a greater proportion of own revenue than their counterparts in Latin America and the Caribbean (OECD 2016). As noted throughout this document, the growing relevance of subnational governments must necessarily include improvements in their institutional capacities.

³⁶ There are no municipal mayors in Barbados or Suriname as this level of government does not exist.

³⁷ There are eight other LAC countries with intermediate levels of government in which the authorities are appointed by the central government.

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



Source: Prepared by the authors based on IDB (1997), Daughters and Harper (2007), a survey of IFD/FMM specialists, IMF staff who prepare that organization's Government Finance Statistics, and the IDB's subnational government fiscal information platform.

- 3.2 Thus, practically all LAC countries have made efforts over the past three decades to bring government closer to the citizens through greater decentralization to subnational governments and/or territorial deconcentration of the central government. The motives behind fiscal decentralization have been diverse and, in certain cases, concurrent. They include democratization, which created demands for greater political and fiscal autonomy at the subnational level (Arzaghi and Henderson, 2005); the economic crisis of the 1980s, which led some countries to transfer spending functions to subnational governments within a context of structural adjustment (Rezende and Veloso, 2012); and second-generation institutional reforms, particularly since the mid-1990s, which transferred responsibilities to subnational governments in an effort to make the public sector more efficient (Lora, 2007).³⁸ An important contributing factor in the growth of subnational expenditures during the first decade of this century was the boom in the extractive industries, primarily mining and hydrocarbons, which boosted transfers of tax revenue from these industries to subnational governments, particularly in Andean countries (ECLAC, 2012). These transfers are characterized by high levels of volatility, which are directly associated with changes in international prices for natural resources.
- 3.3 Average spending by subnational governments in LAC conceals pronounced differences among countries based on historical patterns and economic, population, and geographical size.³⁹ While more than 40% of consolidated expenditures in Brazil and Argentina were executed at the subnational level in 2015, the equivalent figure in Costa Rica and Honduras was below 5% (see Figure 2).⁴⁰ The region offers a variety of experiences, including insular decentralization in The Bahamas; territorial deconcentration by the central government in Suriname; the recent creation of a

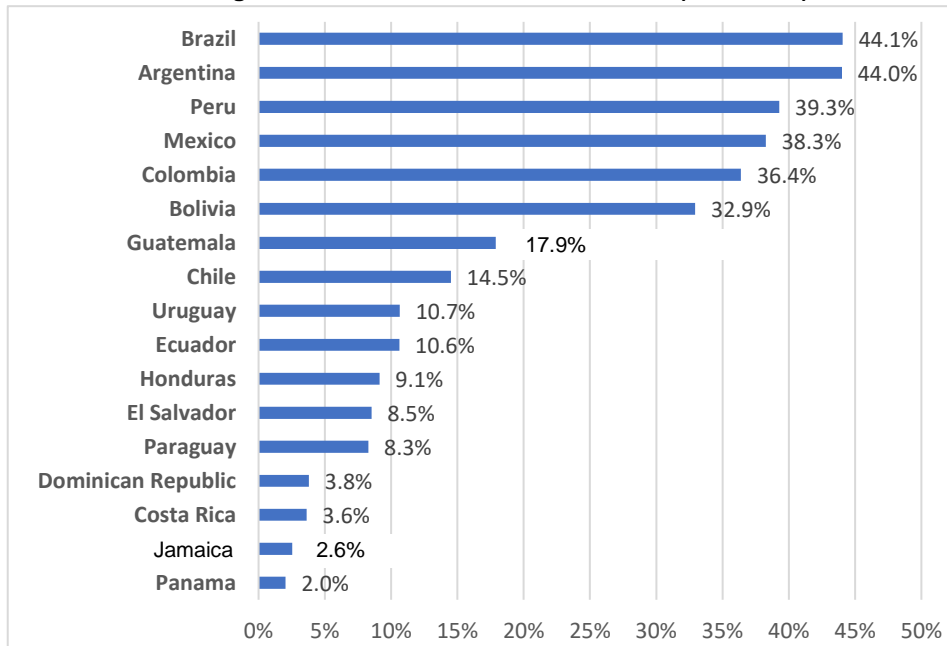
³⁸ For the more structural determinants of fiscal decentralization (e.g. geography), see Canavire et al. (2017).

³⁹ The size of the subnational public sector tends to be greater in larger countries, yet subnational governments in small countries perform essential government functions for the well-being of the population.

⁴⁰ For a comparative examination of the size, structure, and financing of subnational governments worldwide, see OECD/United Cities and Local Government (2016).

municipal government level in Uruguay; and innovations in results-based transfers to municipios of certain states in Brazil.⁴¹ In general, the countries of the region can be classified into three main groups: federal, such as Argentina, Brazil, and Mexico; unitary with a high level of decentralization, such as Bolivia, Colombia, Ecuador, and Peru; and unitary with a lower level of decentralization, such as Chile, Paraguay, Uruguay, and the Central American and Caribbean nations.⁴²

Figure 2. Public expenditure: subnational government as a percentage of total government in selected LAC countries (circa 2015)



Source: Survey of IFD/FMM specialists, IMF Government Finance Statistics, and the IDB's subnational government fiscal information platform.

3.4 The region has roughly 17,500 subnational governments offering a variety of public management experiences. Of this total, a mere 2% fall into the intermediate level of government, the rest being municipios (see Table 1).⁴³ The intermediate level has greater relevance with respect to the delivery of services in the region's largest countries, particularly in Argentina and Brazil, which have significant own-source revenues.⁴⁴ In the rest of the countries of the region, the delivery of subnational services is primarily the responsibility of local government.

⁴¹ See Holanda (2014) for the case of the State of Ceará.

⁴² Under a federal system, the constitution guarantees the permanence and independence of subnational governments and grants them their own legislative, executive, and judicial powers. Under a unitary system, subnational governments usually lack constitutional sovereignty, and the central government determines which decision-making powers are devolved to them. Both concepts are ideals in a continuum within which countries are classified on the basis of the constitutional sovereignty granted to subnational governments (Britannica, 2014).

⁴³ In six of the region's countries there are two levels of local government, and in Haiti there are three.

⁴⁴ Bolivia, Chile, Colombia, Mexico, Peru, and Venezuela are examples of other countries where intermediate governments are responsible for important subnational services, despite being highly dependent on central government transfers.

3.5 Although women’s representation in subnational government is gradually increasing, it remains low with respect to the national sphere.⁴⁵ Women account for only 12% of mayors and 27% of elected council members. In the case of Brazil, empirical evidence shows that women mayors are less likely to commit acts of corruption and, on average, achieve better results in sectors such as health (Brollo and Troiano, 2016).⁴⁶

Table 1. Number of subnational governments in LAC by level of government and country

	Number of intermediate governments	Number of local governments	Number of subnational governments
Argentina	24	2,218	2,242
Bahamas	0	32	32
Barbados	0	0	0
Belize	0	203	203
Bolivia	9	339	348
Brazil	27	5,570	5,597
Chile	15	345	360
Colombia	33	1,101	1,134
Costa Rica	7	81	88
Dominican Republic	32	392	422
Ecuador*	22	221	243
El Salvador	14	262	276
Guatemala	22	340	362
Guyana	10	146	156
Haiti*	10	182	192
Honduras	18	298	316
Jamaica	0	14	14
Mexico	32	2,464	2,496
Nicaragua	17	153	170
Panama	14	78	92
Paraguay	18	254	271
Peru	26	1,871	1,897
Suriname	0	10	10
Trinidad and Tobago	0	15	15
Uruguay	19	112	131
Venezuela	23	337	360
Total	392	17,037	17,429

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

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

⁴⁵ See Gender and Diversity SFD, IDB, 2017b.

⁴⁶ For a link to this study, see the [Ideas Matter Blog](#).

- 3.6 The sector is highly diverse, with differences not only among but also within countries. This is particularly pronounced at the municipal level. As described in the Urban Development and Housing SFD (IDB, 201b), Latin America and the Caribbean is an increasingly urban region, with eight out of every ten inhabitants residing in cities. However, just 11% of municipios in the region—all of them urban—account for more than two thirds of the entire population, while roughly 50% of local governments have less than 10,000 inhabitants each (Eguino, Porto, Pineda, Garriga, and Rosales, 2010). This reality poses challenges not only for urban municipios, which manage services that must be coordinated with other subnational entities, but also for rural areas, where most of the region's municipios are concentrated, and which have small populations and limited administrative capacity (Martínez-Vázquez, 2010).⁴⁷
- 3.7 Subnational governments in the region are increasingly important for the delivery of public goods and services that are essential for economic and social development. The majority of municipios are responsible for services that include garbage collection and street sweeping and cleaning; local transportation; maintenance of parks and gardens; public lighting; and the issuance of construction and operating licenses (Eguino et al., 2010). In addition, both municipios and intermediate-level governments (if any) carry out public investment projects in sectors such as roads and transportation, water and sanitation, productive infrastructure, tourism, health, and education, and are subsequently responsible for the operation and maintenance of these projects.⁴⁸ In fact, the share of subnational governments in the execution of public investment has grown over the past decade in several countries in the region, and now exceeds 50% of consolidated public investment in some Andean countries (IDB, 2012a and 2014c).
- 3.8 Health and education services significantly affect the size of the subnational public sector, accounting on average for more than 40% of total expenditures (ECLAC, 2011b).⁴⁹ The largest countries in the region are the ones that have assigned these functions to subnational governments.⁵⁰ In Argentina and Peru, these services are for the most part provided by intermediate levels of government; in Colombia, primary responsibility falls to the local governments; in Brazil, Mexico, and Venezuela, different levels of government have concurrent responsibilities (Martínez-Vázquez, 2010). Subnational government autonomy in managing these services tends to be related to the governments' capacity to generate their own revenue. However, this is not the case in all countries: the provinces of Argentina, which have significant own revenues, have greater control over management than

⁴⁷ The number of municipios has proliferated in some countries, partly due to the incentive of a guaranteed minimum level of transfers. This has been the case in the Dominican Republic in particular, where the total number of local governments has increased by more than 150% over the last 20 years. This creates difficulties in leveraging economies of scale and delivering services efficiently ([Martínez-Vázquez, Radics, and Pérez-Rincón, 2017](#)).

⁴⁸ In several of the region's largest countries, subnational governments also have responsibilities in the area of citizen security. See Citizen Security and Justice SFD (IDB, 2017c).

⁴⁹ Several of the region's larger countries have even designed models for coordination between central and subnational governments in the implementation of social protection systems. In Brazil, for example, the Bolsa Família" [Family Grants] program is run by the municípios, while in Colombia the central and local governments sign formal joint responsibility agreements that define the obligations of each party (see Social Protection and Poverty SFD, IDB, 2017d, paragraph 3.17).

⁵⁰ The Health and Nutrition SFD (IDB, 2016c) highlights the high level of decentralization in Bolivia's health sector, in the context of the challenge of strengthening subnational management in that sector.

Peru's regional governments, which are funded almost entirely through transfers. In Mexico, however, states have traditionally been largely autonomous in the management of education services, despite being highly dependent on transfers.⁵¹

B. Recent advances and challenges

- 3.9 Over the last three years (2015-2017), several Latin American and Caribbean countries have made headway in the processes of decentralization. In Chile, for instance, the constitution was reformed in late 2016 to allow the democratic election of regional governors from 2020 onwards (intermediate level of government), thus replacing the institutional figure of the provincial governor (*intendente*) appointed by the central government's executive branch. That country also passed two laws in late 2017 governing the popular election of regional government authorities, accompanied by the transfer of powers to those entities.⁵² In October 2015, Panama enacted a law that decentralizes public administration, with the following key features: the transfer of real property tax revenue to the municipios based on redistributive criteria; the strengthening of capacities in the area of public investment management; the gradual transfer of functions to the municipios through the accreditation of capabilities; and institutional piloting of the process by the National Decentralization Department.
- 3.10 A second characteristic of the period has been the end of the boom in transfers to subnational governments linked to extractive industries, particularly in Andean countries. This phenomenon helps to explain the recent stagnation in growth in the size of the subnational public sector (see Figure 1). Thirdly, in terms of the fiscal sustainability of subnational governments, Mexico has made progress by approving, firstly, a legal fiscal responsibility framework for federal and municipal entities, which is helping to boost transparency in the recording of subnational debt through the Registro Público Único [Single Public Registry], and, secondly, through an Alerts System that will help mitigate the incipient fiscal risks that certain subnational governments have exhibited (Rasteletti and Acosta, 2016). In Argentina, the Fiscal Responsibility Law was reformed at the end of 2017 with the imposition of a ceiling on growth in current expenditure; this complements the signing of a fiscal pact between the three levels of government, aimed at ensuring fiscal sustainability and reducing distortionary taxes.
- 3.11 Expanding the analysis to encompass the last 15 years, advances have been made but the traditional challenges that have characterized the decentralization process in the region have also intensified. On one hand, there has been significant improvement in the fiscal sustainability of subnational governments, particularly in Argentina, Brazil, and Colombia, where subnational debt contributed to bouts of macrofiscal instability in the late 1990s and early 2000s. In particular, the implementation of fiscal rules for subnational governments in Brazil and Colombia served as a model for the development of subnational fiscal responsibility frameworks in other countries of the region. On the other hand, and despite these advances, there is still a need to continue the timely monitoring of subnational fiscal

⁵¹ By implementing the Fondo de Aportaciones para la Nómina Educativa y Gasto Operativo [Conditional Transfer Fund for Education Payroll and Operational Expenses] (FONE), the central government has asserted greater control over the teacher payroll it finances (see IDB, 2014b).

⁵² New powers have been transferred in the areas of productive and industrial development, social and human development, and transportation and infrastructure; a procedure has been established allowing the regions to require new powers in future from the central government; and metropolitan areas can now be created in the country's main conurbations.

risks—for example, in countries experiencing higher volatility in their transfers (Andean region, due to the high growth of volatile transfers associated with natural resources) or in which subnational debt is growing (Argentina and Brazil).

- 3.12 In addition, one of the traditional challenges in the sector persists: the subnational governments' high dependence on transfers within the financing structure (ECLAC, 2011c). Between 2000 and 2015, average expenditures by subnational governments rose by more than two percentage points of GDP (see Table 2).⁵³ However, this rise was primarily due to higher transfers and, to a lesser extent, to the subnational governments' own resources. From a comparative viewpoint, the financing structure of subnational governments in the LAC region stands in contrast with its counterparts not only in OECD countries but also in other regions with a relatively similar development level, such as Asia (see Figure 3).

**Table 2. Amount and financing of subnational expenditure in LAC countries
2000 vs. 2015¹ (as a percentage of GDP)**

Country/Variable	Expenditure (in %)			Own-source revenue (in %)			Vertical imbalance ⁴ (in %)			Subnational debt (in %)		
	2000	2010	2015	2000	2010	2015	2000	2010	2015	2000	2010	2015
Argentina ²	15.4	17.1	14.5	3.6	5.6	7.8	11.8	11.5	6.7	21.9	6.8	9.8
Bolivia	5.8	9.7	13.1	2.5	2.7	5.6	3.3	7.0	7.5	4.6	1.7	n/a
Brazil	19.8	21.5	20.7	12.7	13.1	10.5	7.1	8.4	10.2	18.1	10.5	11.9
Chile ³	2.3	2.2	2.8	1.6	1.3	1.9	0.7	0.9	1.0	n/a	n/a	n/a
Colombia	9.1	8.7	12.3	3.0	3.7	3.9	6.1	5.0	8.5	3.0	1.4	1.3
Ecuador	2.1	5.2	4.6	0.8	1.1	1.0	1.3	4.1	3.6	n/a	2.6	1.5
El Salvador	1.3	1.8	2.4	1.1	1.5	1.1	0.2	0.3	1.3	0.8	1.3	n/a
Honduras	2.3	2.8	4.3	1.3	1.5	3.6	0.9	1.3	0.6	0.1	1.0	n/a
Mexico	7.6	10.6	12.8	1.1	2.0	1.4	6.5	8.6	11.4	1.8	3.0	2.7
Nicaragua	3.0	4.0	3.9	3.1	3.7	2.4	-0.1	0.3	1.5	n/a	n/a	n/a
Panama	0.8	0.6	0.5	0.7	0.4	0.4	0.1	0.2	0.1	n/a	n/a	n/a
Peru	4.2	8.4	8.3	1.0	1.0	1.4	3.2	7.4	6.9	1.3	1.4	2.8
Uruguay	3.5	3.0	3.1	2.3	2.0	1.9	1.2	1.0	1.2	n/a	n/a	1.9
Simple average	5.9	7.4	7.9	2.7	3.0	3.3	3.3	4.3	4.6	6.4	3.3	4.6

¹ Closest available year to 2000 and 2015.

² Does not include municipios.

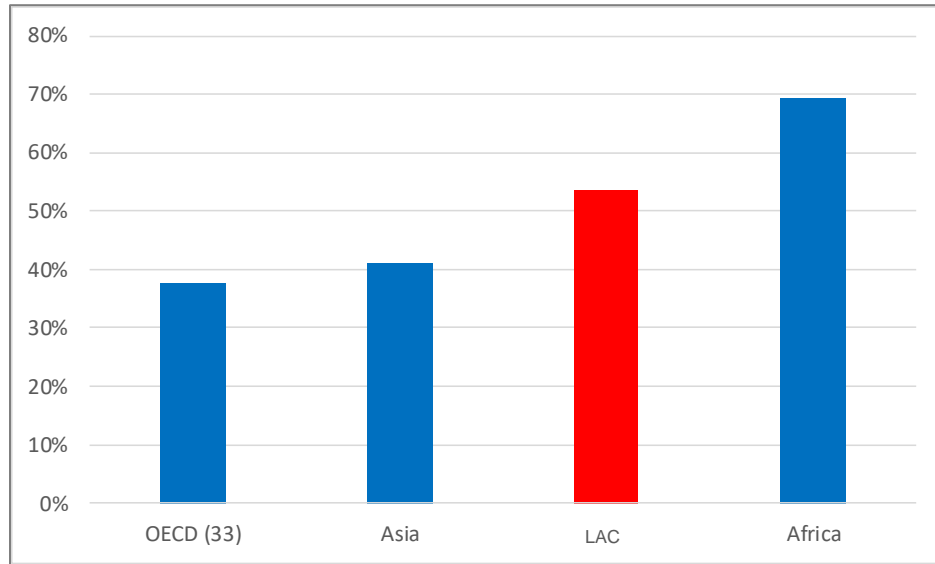
³ Subnational governments in Chile cannot issue debt.

⁴ Vertical imbalance: difference between expenditure and own-source revenue.

Source: Questionnaire completed by Bank specialists in the region, and the IDB's subnational government fiscal information platform.

⁵³ The information in Table 2 is a specific contribution of this SFD in view of the limited transparency of subnational finances in the region. It draws on the subnational fiscal database that IFD/FMM has been developing in recent years, as well as a questionnaire completed by specialists in that division who live and/or work in the vast majority of countries in the region. This has made it possible to describe and analyze recent decentralization trends in those countries.

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



Source: IMF Government Finance Statistics, 2016.

- 3.13 As set out in the following paragraphs, this high dependence on transfers reduces subnational governments' incentives for accountability, efficient management, and fiscal responsibility, and it reflects weaknesses in the relationship between the different levels of government. At the same time, the performance of subnational governments is also affected by the context of low institutional capacity, limited transparency, and weak capacities for monitoring subnational management. Accordingly, the main challenge for the decentralization and subnational governments sector is to foster the development of institutional capacities and a suitable incentive structure for more efficient and effective subnational management in LAC, thus helping to improve the quality of life for all citizens. This requires supporting interventions and changes that systematically address the institutional weaknesses in the sector as manifested in the following four major problems: (i) weak intergovernmental arrangements; (ii) subnational governments with deficient expenditure management and service delivery; (iii) subnational governments with low generation of own revenue and poor access to financing; and (iv) subnational governments with limited management transparency and accountability.
- 3.14 **Weak intergovernmental arrangements.** First, coordination among the different levels of government is deficient. In some cases, the spending functions of each level of government are not clearly defined, and this gives rise to concurrent expenditures in key sectors such as education, resulting in a lack of transparency and duplication of expenditures (Martínez-Vázquez, 2010). In addition, the defined spending functions by level of government and the concomitant financing are not properly matched: in some cases, central governments have transferred spending functions to subnational governments without providing sufficient resources to carry them out. Conversely, in several countries significant resources have been transferred to subnational governments without clear definition as to how to apply them (World Bank, 1999; ECLAC, 2001). As a result of these circumstances, voters lack basic information as to which level of government does what, and political

responsibility is often diluted. For example, in a survey on subnational public spending in Mexico, fewer than half of those interviewed were able to correctly identify that mayors are responsible for sewerage systems, water supply, and lighting (Chong, De La O, Karlan, and Wantchekon, 2014). In the area of citizen security, planning and coordination between the different levels of government is weak (IDB, 2017c). In large cities, service delivery and regulation are fragmented across several jurisdictions and there is often no entity responsible for organizing them (IDB, 2016b); in some cases, this limits the ability to leverage economies of scale that could yield cost savings and improved service quality.⁵⁴ This fragmentation is also apparent in the ability to coordinate regional development planning strategies with subnational governments.⁵⁵ Collaboration between different levels of government aimed at capitalizing on shared technological solutions can help to reduce asymmetries in institutional capacity at the subnational level.⁵⁶

- 3.15 Second, with the exception of Argentina and Brazil (where the provinces and states, respectively, have broad tax bases), the assignment of tax powers to subnational governments has barely begun, particularly with respect to intermediate levels of government. This exacerbates the dependence on transfers.⁵⁷ Even in Argentina and Brazil, the main taxes for which intermediate-level governments are responsible—namely the gross receipts tax (Argentina) and the ICMS (Brazil)—create distortions that are related to their design.⁵⁸ The assignment of tax bases at the subnational level is complex and requires exhaustive cost-benefit analysis. Nevertheless, there is an opportunity to evaluate reform options, particularly for those intermediate-level governments with greater ability to raise own-source revenues (IDB, 2013a; Fretes Cibils and Ter-Minassian, 2015).
- 3.16 Third, there is room for improvement in the design of intergovernmental transfer systems, especially in terms of addressing the horizontal imbalances that are

⁵⁴ See World Bank (2009a) for an analysis of the problems involved in transportation service delivery and regulation in the Buenos Aires metropolitan area and other major cities in Argentina. The Water and Sanitation SFD highlights this issue for service delivery and describes how it has been addressed in countries such as Bolivia, Brazil, Chile, Colombia, Mexico, and Peru (IDB, 2017a, paragraphs 3.23-3.24).

⁵⁵ Problem identified during implementation of the Emerging and Sustainable Cities Initiative (ESCI) as part of the development of Haiti's northern corridor (IDB, 2013b). It also comes into play with other issues that require coordination among subnational governments, such as watershed management. In the case of Peru, territorial fragmentation has been addressed through attempts to leverage economies of scale by creating commonwealths (for local governments) and macroregions (for intermediate-level governments). These attempts have yielded limited success, restricted primarily to the joint management of certain projects by different subnational governments. In Colombia, there has been some initial success in the implementation of "Contratos Plan" [plan contracts], which are mechanisms for coordinating the investment plans of several public entities.

⁵⁶ In Peru, the Bank is assisting the central government in developing a platform for the submission of municipal digital paperwork. See Loan 4399/OC-PE, Project to Improve and Expand Support Services for National Service Delivery to Citizens and Enterprises.

⁵⁷ The tax powers assigned to subnational governments are usually enshrined in national law and, in certain cases, the constitution (for example, in Brazil) (see Martínez-Vázquez, 2010).

⁵⁸ The gross receipts tax levied by the Argentine provinces is applicable to all stages of all sales activities, leading to multiple taxation and encouraging vertical integration (Artana et al., 2015). For its part, the Brazilian ICMS sets different rates depending on the origin and destination of purchases, thereby encouraging tax avoidance and tax "wars." These carry high administrative costs for taxpayers, requiring coordination with the central government (Ter-Minassian, 2012). Lastly, the payroll tax imposed by the Mexican states has low revenue-raising potential and also leads to distortions in the formal labor market, encouraging an expansion of the informal labor market and adversely affecting productivity and economic development (Díaz-Cayeros and McLure Jr., 2000).

characteristic of the region. LAC is a region of high territorial inequality: the average gross geographic product ratio between the richest and poorest regions is twice as high as in OECD countries. This economic inequality translates into major differences in the ability to generate own-source revenues: the Gini coefficient for own-source revenues in LAC is three times that of the OECD countries. Transfers, however, provide only a limited offset to the inequalities among subnational governments (Beramendi, 2012). While many transfer systems incorporate redistributive criteria related to population, rurality, and/or poverty, these criteria are insufficient to close regional gaps (Muñoz, Pineda, and Radics, 2017; Beramendi et al., 2017). Specifically, no country in the region has adopted a system of equalization transfers that would compensate subnational governments for their differing fiscal capacities and spending needs, with a view to giving each subnational entity an equal opportunity to provide basic public goods and services in fulfillment of its functions, assuming comparable levels of fiscal effort (Martínez-Vázquez and Sepúlveda, 2012). In fact, some common transfers—such as those resulting from the exploitation of nonrenewable natural resources⁵⁹—tend to exacerbate territorial inequalities and negate the equalizing effects of revenue-sharing arrangements (Muñoz, Pineda, and Radics, 2017; Loayza, Mier, Teran, and Rigolini, 2013; Sanguinetti, 2010).⁶⁰

- 3.17 Faced with the political difficulty of modifying their transfer regimes, such as by updating distribution criteria, countries often create new mechanisms and thereby add to the systems' complexity. Indeed, decentralization in many LAC countries has been driven by the creation and/or expansion of transfers without clear definition of the spending functions for which they are to be used (Martínez-Vázquez and Sepúlveda, 2011). As a result, in some Central American and Caribbean countries for example, legal transfer mandates with respect to subnational governments are not being fulfilled (Martínez-Vázquez, Pérez-Rincón, and Radics, 2017).⁶¹ As part of this trend, discretionary transfers have also increased in recent years. These are characterized by high volatility and uncertainty, and are known to discourage efforts to raise own-source revenue (Pineda, 2013). In view of this, the creation of spaces for discussion and periodic updating of the distribution criteria for transfers—based on simple systems with clear operating rules—would be an important step toward improving intergovernmental coordination institutions.
- 3.18 Along more general lines, it is worth noting that despite the progress seen in decentralization processes in several countries in the region, many have failed to establish institutional procedures or mechanisms for coordinating the various dimensions of the process.⁶² In view of this, the introduction of equalization transfer systems would not only address regional gaps but would also create a platform for determining and periodically updating resource allocation formulas in the territory. This would help to consolidate the institutions responsible for coordinating decentralization, guiding transfer allocations based on technical criteria relating to the revenue raising potential and expenditure needs of subnational governments. Among the countries that have established channels for coordination, the progress

⁵⁹ Their allocation mainly benefits the entities in which the extractive activities take place.

⁶⁰ In the case of certain specific transfers, such as those aimed at supporting innovation and competitiveness systems in Mexican states, more federal resources are allocated to entities that have greater institutional capacities, thereby deepening existing regional inequalities (Stezano and Padilla-Pérez, 2013).

⁶¹ For one such case, see this [Dominican Republic blog](#).

⁶² With respect to this dimension, LAC would benefit from the analysis of good practices in other regions.

made in Brazil is of note. In that country, thematic networks of subnational governments have improved collaboration with the central government on strategic issues such as financial management and tax administration.⁶³ In the case of Uruguay, the [Congress of Governors](#) (which has had constitutional status since 1996) and the central government's Department of Decentralization and Public Investment⁶⁴ have worked together to build institutions for several years now.

- 3.19 Lastly, a significant aspect of intergovernmental coordination is the development of a subnational fiscal responsibility framework. The experience of Colombia in this area, which relies to a large extent on lessons learned from the over-indebtedness of many of the country's subnational governments in the late 1990s and early 2000s, shows that the success of subnational fiscal rules depends on developing institutional capacities to ensure effective compliance. Accordingly, it is critical that rules be simple, transparent, and consistent with the compliance capacities of subnational governments. In addition, there should be exhaustive and continuous monitoring by the central government, with credible and timely corrective action (Urrea, 2010), including operation of an insolvency system (Canuto and Liu, 2013). For the latter to be effective, it is essential that the central government express a credible commitment to not bail out subnational governments in the event of insolvency. Monitoring should include contingent liabilities (arising, for example, from subnational public enterprises and public-private partnerships) and projected expenditures such as public pension liabilities (Moody's, 2014a and Moody's, 2014b), with particular emphasis on subnational governments that have received high and volatile transfers linked to natural resources. Likewise, transfer systems and the coordination of subnational government borrowing could support improved subnational fiscal policy management throughout the entire economic cycle: subnational finances in LAC have been strongly procyclical on average, despite the fact that recent stimuli have been relatively small compared to the size of stimuli implemented at the national level (Jiménez and Ter-Minassian, 2016). In this respect, linking transfers to structural revenue (rather than central government current revenue) could help to reduce procyclicality, ensuring a stable, predictable flow of funds to subnational governments.
- 3.20 **Deficient expenditure management and service delivery by subnational governments.** Citizens in Latin America and the Caribbean have a negative perception of the quality of subnational management. In a survey conducted in 25 LAC countries, more than two thirds of those surveyed in 16 such countries indicated that municipal services were fair to very poor. Only in one country did more than half of those surveyed indicate that the quality of such services was either good or very good (Latin America Public Opinion Project, 2012). In a survey conducted in 17 cities of the region, a majority in 12 cities answered in the negative when asked whether local taxes are used to improve welfare through better public services (Andean Development Corporation, 2010).
- 3.21 Many subnational governments in the region are deficient in managing expenditures and providing services. This is partly the result of very disparate initial conditions (DNP, 2017).⁶⁵ For example, municipios that have larger populations and more

⁶³ The Bank has helped to create and develop these thematic networks in Brazil.

⁶⁴ The Department, which is attached to the Office of Planning and Budget, administers one of the Bank programs with greatest institutional continuity in the sector (see Section 4).

⁶⁵ In this regard, shortcomings tend to exist to a greater extent in less developed subnational governments and countries, including many of the Bank's Group C and D borrowing member countries.

average years of schooling (and therefore a trained workforce) typically show higher levels of public investment execution (Loayza, Rigolini, and Calvo-González, 2011) and better indicators of public expenditure efficiency (Herrera and Franke, 2007). Similarly, in municipios with lower literacy levels and higher levels of poverty and inequality, the productivity of public spending on education is relatively lower (Tavares and de Cavalcanti, 2014, and Machado, 2013). In Colombia, among municipios that in 2016 presented complete information for a comprehensive performance evaluation, average performance improved in local governments with more favorable initial conditions (measured by economic activity, demographic characteristics, and own-source revenue). Nonetheless, large variations in management capacity and development results—even between municipios with similar initial conditions—reveals the usefulness of differentiated policies and the identification of good practices for subnational governments that lag behind (DNP, 2017).⁶⁶ In the Brazilian states there is a weak correlation between the relative efficiency of spending on education and both state spending per capita on education and state GDP per capita. This suggests that simply having more funds does not guarantee better outcomes, unless they are accompanied by improvements in the management of service quality (Boueri, Mac Dowell, Pineda, and Bastos, 2014).

- 3.22 Management of the subnational public investment cycle (planning, formulation, execution, and ex post evaluation) is deficient. This expenditure category is of growing importance for subnational governments in Latin America and the Caribbean, with considerable potential for helping to reduce territorial gaps in socioeconomic development. Intermediate-level governments have an important role to play in this area by adopting a territorial approach to coordinating their own investments with those of the municipios. In Peru, more than 80% of public investment projects prepared by subnational governments in 2007 failed to properly apply the formulation criteria of the National Public Investment System (SNIP) (IDB, 2012a). These shortcomings are also evident in the execution stage, resulting in delays and cost overruns. In Bolivia, 42% of the investment projects prepared by subnational governments between 2005 and 2013 required reformulation (IDB, 2014d). In addition, the subnational scope of the SNIP is limited. In Nicaragua, for instance, very few municipios are covered by the system, despite the fact that between 2007 and 2013, subnational public investment increased from 1.6% of GDP to 2.4% of GDP (Bartels and Muñoz, 2014).
- 3.23 The ability of subnational governments to attract investment is affected by constraints that limit opportunities for economic development, including export promotion. For example, little use is made of digital solutions for facilitating service delivery to individuals and enterprises, due in part to the limited development of broadband infrastructure.⁶⁷ There is also a need to expand initiatives for simplified procedures and physical integration of face-to-face services through the use of one-stop shops.⁶⁸ For example, setting up a business in Central America or the Dominican Republic, including subnational processes, requires twice as many procedures on average as in high-income OECD countries and takes three times

⁶⁶ Colombia is notable for having spent more than ten years consolidating the annual evaluation of the comprehensive municipal performance index, which is performed by the DNP. Since 2016, this index has evaluated municipios by dividing them into segments based on their initial conditions.

⁶⁷ Ninety-six percent of LAC municipios have a broadband penetration rate of less than 50% (Digilac, 2014).

⁶⁸ In this regard, it is worth noting the experience of the Bogotá Mayor's Office with the CADE network of centers that deliver integrated services to individuals and enterprises (IDB, 2012b).

longer, raising the costs to the private sector (World Bank, 2015b). In 2013, a competitiveness index was used to assess the business climate in 41% of El Salvador's municipios. It found below-average scores in subindexes such as the quality of municipal services and proactiveness in developing initiatives to attract investment (United States Agency for International Development, 2013).⁶⁹ The poor quality of services helps to create transaction costs in the relationship between subnational governments and citizens. In Cochabamba, Bolivia, transaction costs for a set of procedures were estimated at more than 4% of departmental GDP.⁷⁰ With the exception of Brazil and Mexico, the development of public-private partnerships and the private sector's role in providing services to the subnational government level is incipient (Infrascope, 2013), limiting its potential to promote capacities, contribute to poverty reduction, and generate equity. In all these respects, central government support is critical, particularly for subnational governments with limited capacity and high poverty and inequality rates.

- 3.24 Significant constraints on improving the quality of subnational expenditures include the weak development of the MfDR and PFM pillars and limited implementation of management models to strengthen centers of government,⁷¹ which foster coordination of government priorities by directly supporting subnational government authorities. In many subnational entities there are also weaknesses in administrative processes, which usually lack the support of basic management tools.⁷² In particular, despite advances in the region in modernizing national PFM systems over the past two decades, development of these systems at the subnational level lags behind. In terms of coverage, worth noting are the cases of Peru, where the SIAF has been implemented by all subnational governments (IDB, 2010a); Guatemala, where all municipios are connected to SICOIN GL (including an own-source revenue management module); and Brazil, where a SIAF is in operation in all states⁷³ and has recently been modernized in half of them (Pimenta, 2015).⁷⁴ This limited development extends to other PFM systems, such as electronic public procurement (aimed at simplifying procedures and improving

⁶⁹ The index was measured through individual surveys of business owners and managers, mayors, and municipal officials. Eight business climate features derived from the concept of economic governance were measured in each municipality: transparency, municipal services, proactiveness, unlawful payments, public safety, compliance periods for regulations, assessments and taxes, and entry costs.

⁷⁰ See technical cooperation operation ATN/AA-15036-BO/ATN/FI-15035-BO, Open Government for Citizen Service.

⁷¹ Centers of Government are the organizations and units that provide direct support to the head of the executive branch (Alessandro, Lafuente, and Santiso, 2014).

⁷² See IDB, 2012a with reference to regional governments in Peru.

⁷³ The state of São Paulo, in particular, has a cost management system that makes it possible to obtain the unit costs of priority services. Developments such as this require other modern PFM systems that few subnational governments in LAC have at their disposal, such as asset accounting and alignment with international standards, as well as modern, integrated budgetary and financial management (Chan, Holanda, and Pessoa, 2012; Pimenta, 2015).

⁷⁴ Bolivia also has high coverage, reaching 96% of municipios for the various systems currently in operation (Lora, 2014). Other examples include Nicaragua, where the municipal integrated financial management subsystem covers 65% of municipalities (Bartels and Muñoz, 2014); Chile, where the municipal financial information subsystem covers 35% of entities (Uña, 2013); and Honduras, where the integrated municipal management system reaches 20% of municipios (Pérez-Rincón, 2014).

subnational capacities), payroll, and asset management (including real estate).⁷⁵ In addition, only a few countries require and supervise the effective implementation by subnational governments of medium-term budgetary frameworks, together with their linkage to MfDR. There is also the challenge of ensuring that the PFM systems are used by the subnational authorities as a management tool rather than primarily as a central government control mechanism.

- 3.25 There is limited development of a professionalized civil service, including competitive staff compensation policies that can better attract, retain, and motivate skilled employees in the context of a fiscally sustainable payroll. This problem tends to be more pronounced in recently decentralized countries. For example, in a representative sample of municipios in the Dominican Republic, a diagnostic assessment found that there were no personnel policies in place and that transfers were being used to a considerable extent to support a large and generally poorly compensated workforce (World Bank, 2009b). In Belize, it was found that the roles and responsibilities of municipal employees were poorly defined and there were no procedural manuals covering local management processes (World Bank, 2010a).
- 3.26 Development of the civil service should be accompanied by a sustainable improvement in the technical capacities of public officials, which in many LAC countries are limited as regards both subnational government officials and the government teams that manage the decentralization process at the central level.⁷⁶ In this respect, the resident technical assistance approach used in Peru's subnational governments—including capacity evaluations and the transfer of skills and knowledge through daily work with subnational officials—was ultimately more effective in the area of public investment management than short-term informational training. This effort has been accompanied by a deconcentration of central government technical officials to the regions, helping to make the improvement in subnational capacities more sustainable (IDB, 2012a).
- 3.27 **Weak generation of own-source revenue and limited access to financing among subnational governments.** If subnational governments are to reduce their dependence on transfers, they must improve their capacity to generate own-source revenues. This hinges on the allocation of tax bases and tax rates at the subnational level (part of intergovernmental arrangements) and on the subnational governments' efforts to maximize their tax bases, service charges, and other sources of funds. In this regard, own-source revenue collection by subnational governments in LAC falls short of its potential. This is evidenced by the limited development of instruments to capture increased property values stemming from public investments, as well as low recovery of service costs and weak management of subnational government assets and real property for sale and lease.⁷⁷ Also worth noting is undercollection of the real

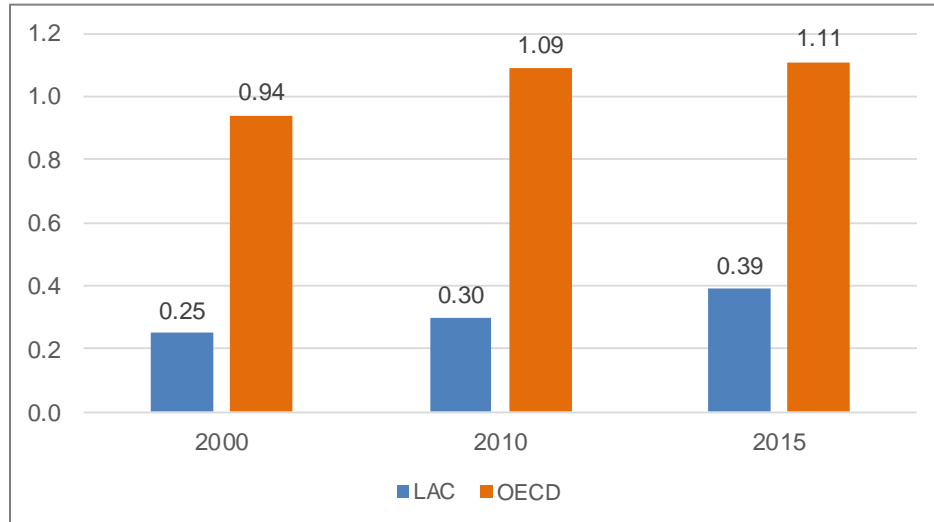
⁷⁵ As indicated in the preceding section, transparency and accountability can be improved by implementing the SIAF at the subnational level, while at the same time bringing public accounting practices into compliance with international standards (including an accounting of assets and liabilities). With regard to public procurement, cost overruns due to the inefficient management of health, education, and security procurement exceeded 8% of the budget for these functions in one Brazilian state (IDB, 2013c).

⁷⁶ At the central government level, there is a crucial need for a group of officials with technical knowledge of decentralization challenges and subnational governments. At the subnational level, it is important to adopt a differentiated approach to the challenges of these governments based on their initial circumstances (see DNP, 2017).

⁷⁷ As an example of the potential inherent in real estate management, the sale of an old bus station and administrative site in Istanbul, Turkey, generated US\$1.5 billion in revenue, which was equivalent to 1.5 times total municipal investment spending for 2005 (Peterson, 2009).

estate property tax, for which average revenue barely amounted to 0.4% of GDP in 2015—just over one third of the OECD figure (see Figure 4; Sepúlveda and Martínez-Vázquez, 2012; Bonet, Muñoz, and Pineda, 2014).

**Figure 4. Property tax collection, 2000 and 2015
LAC vs. OECD (as a percentage of GDP)**



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

3.28 This problem has been brought about by factors specific to subnational management, as well as by central government restrictions. The former include outdated land registries and taxpayer records; limited automation of revenue collection functions; limited capabilities for calculating tax and municipal levy amounts; and insufficient oversight efforts. With regard to the last of these factors, the political cycle influences local fiscal efforts in several countries, particularly in election years. Consequently, there is a need to reinforce the autonomy of tax administration at the subnational level and to promote its digitization. In addition, there is scant central government support for subnational governments in their management of own-source revenue, partly because in many countries this function is not sufficiently prioritized. As a result, and with regard to property taxes, the periodic appraisals designed to bring real estate values closer to market value are outdated. Similarly, public records are not integrated with municipal property records (IDB, 2013a).⁷⁸ Furthermore, subnational governments receive limited technical assistance, which is focused on urban entities with greater revenue collection potential and low management capacity, and possibly also rural subnational governments with high per capita income (Sepúlveda and Martínez-Vázquez, 2012). In view of the gap in revenue collection between LAC and OECD countries, especially with regard to property taxes, there is a need to strengthen the payment culture, improve land registry and tax administration systems, and undertake the investments required to bring subnational revenue collection closer to its potential.

⁷⁸ By superimposing layers of information, cadastral updates and the development of multi-purpose cadasters not only help to improve property tax collection, but also provide useful tools for prioritizing public-private investments (Erba and Piumetto, 2013).

- 3.29 An additional challenge facing subnational governments is their limited access to financing, which restricts their ability to quickly roll out the social benefits of public investment and expand their opportunities for development.⁷⁹ Indeed, there are subnational governments that, while having access to debt financing in a context of fiscal responsibility, are constrained by a lack of capacity, institutional limitations, and an absence of institutional mechanisms.⁸⁰ Weaknesses in PFM—including planning, budget management, public investment, and debt management capacities—have an impact on this challenge (as does the limited generation of own-source revenues). In some cases, subnational governments accumulate old debts to other public entities (for example, social security) that prevent them from accessing the market (Llompén et al., 2010). In most cases, weak generation of own-source revenue limits the amount that can be borrowed. In addition, many subnational governments are too small to be considered eligible for credit, despite the existence of instruments that make it possible to pool the resources of multiple entities into a single transaction.⁸¹
- 3.30 Moreover, central government support is insufficient in some countries to provide subnational governments with the technical assistance they require to be restored to financial health and subsequently access the market.⁸² This is largely due to a lack of information and monitoring capacity in the Ministries of Finance, which limits the ability to classify subnational governments according to their creditworthiness. In this regard, one of the benefits of the effective implementation of fiscal responsibility frameworks in Brazil and Colombia is the central government’s increased ability to understand the state of subnational public finances—particularly in the case of the larger subnational governments. This makes it possible to approve debt transactions with a low risk of default.
- 3.31 **Limited transparency and accountability by subnational governments.** First, there is limited management transparency in subnational governments. Only two countries, Brazil and Peru, make subnational financial information available that is considered sound. In the majority of countries, the availability of information is either incipient or restricted.⁸³ In Argentina, despite a recent improvement in budget transparency at the provincial level, less than 40% of provinces in 2016 published budget execution information for the preceding year (Centro de Implementación de Políticas Públicas para la Equidad and el Crecimiento [Center for the Implementation of Public Policies for Equity and Growth], 2017) In Mexico, an index that encompasses the quality and quantity of information contained in state budgets shows that half of states exhibit fair, weak, or very weak compliance, despite the

⁷⁹ For an analysis of the conditions required to develop the subnational credit market in LAC, see Martel, 2017.

⁸⁰ The next section describes how this challenge has meant that Bank loans to subnational governments are channeled almost exclusively to Brazil.

⁸¹ Mexico has implemented mechanisms that make it possible to use transfers and pool small municipios into a single transaction (Gama, 2014). It is important that these mechanisms be closely supervised by the central government, including an analysis of the subnational governments’ fiscal sustainability. In addition, the securitization of federal transfers requires a solid regulatory framework for secured transactions to ensure the effectiveness of the established guarantees.

⁸² In this regard, credit evaluations of the subnational governments can help to identify and address areas of their institutional capacity requiring improvement.

⁸³ This information is drawn from the subnational fiscal information platform that is under development by IFD/FMM (Economic and Sector Work RGK1363).

significant progress made in recent years (Instituto Mexicano para la Competitividad [Mexican Competitiveness Institute], 2017).

- 3.32 The problem of opacity at the subnational level is well recognized by citizens and carries a considerable cost. For example, a survey of megacities (IDB, 2014e) reveals that those interviewed in four of the five cities surveyed consistently cite the lack of municipal government transparency as one of their most serious problems (together with a lack of citizen security). In terms of costs, it is estimated based on information contained in Brazilian audit reports that irregularities in the use of local funds affected between 2% and 8% of all transfers audited over the last decade (Ferraz and Finan, 2011; Brollo et al., 2013). In particular, in municipios where education transfers were improperly used, basic school supplies are scarce, the quality of education (as measured by standardized tests) is lower, and students are more likely to drop out (Ferraz, Finan, and Moreira, 2012). More generally, there is evidence to suggest that when audit results reveal irregularities, property tax collection declines, with the effect more pronounced in local governments with lower initial revenue collection levels (Timmons and Garfias, 2015).
- 3.33 These outcomes demonstrate not only the costs of a lack of transparency at the local level but also the importance of accountability tools for the timely correction of problems related to a lack of transparency and improper government actions. Yet despite growing decentralization in the region, programs to promote accountability are still either uncommon or their scope extends only to the municipal administration or executive branch. Such programs are particularly necessary in view of the increase in transfers linked to nonrenewable natural resources, where the evidence points to greater problems with irregularities in the municipios that benefit most from these resources (Caselli and Michaels, 2013; Ferraz and Monteiro, 2010; Maldonado, 2011).⁸⁴ In this respect, it is worth noting the experience of Colombia with the royalties mapping system: this has helped to improve the transparency of subnational governments in executing royalty funds linked to the extractive industries.⁸⁵
- 3.34 There is insufficient monitoring and evaluation of subnational management.⁸⁶ Implementation of a management-for-results survey in nine capital cities in the region, as part of the Evaluation System for PRODEV (Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness), shows that of the four pillars assessed the score for monitoring and evaluation is lowest (García-López, 2014). The survey also underscores the challenge of improving the contribution of Supreme Audit Institutions (SAIs, which are responsible for external control) to the enhancement of subnational results-based management, transparency, and accountability. This includes expanding the territorial coverage of SAIs to reflect the growing importance of subnational governments in the execution of consolidated public expenditures. In Peru, for

⁸⁴ Over the 2009-2011 period, more than 5,000 irregularities were detected in the management of royalty funds at the subnational level in Colombia, representing 20% of the value of royalties issued in that period (DNP, 2012). Accordingly, the recent development (with Bank support) of a [royalties mapping system](#) should be noted. This allows monitoring of the public investment plans of subnational governments financed with royalty funds.

⁸⁵ This experience received Bank support through project 2977/OC-CO (Program to Strengthen the Public Investment System).

⁸⁶ This challenge includes coordinating and monitoring compliance with tools such as subnational development plans.

example, financial audits by the Comptroller General's Office barely cover 2.4% of the municipios (IDB, 2013d). In El Salvador, despite the fact that all municipios are required to undergo external financial audits, only one out of a representative sample of 10 municipios fulfilled this requirement (World Bank, 2010b). In this respect, it is worth noting the experience of Brazil, where federal and state auditing offices supported implementation of the Fiscal Responsibility Law, created communities of practice, and expanded their audit activities to include operational audits and audits to evaluate efficiency in the use of funds.⁸⁷

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

A. Reports issued by the Office of Evaluation and Oversight

- 4.1 The analysis of the Office of Evaluation and Oversight (OVE) consists mainly of the publication "Approach Paper: Review of IDB Support to Tax Policy and Administration, 2007-2016" (IDB, 2017e), which evaluates the sector in the context of Bank interventions in the area of tax policy and administration. It also includes the evaluation of the Emerging and Sustainable Cities Initiative (ESCI), together with the analysis included in the most recent Country Program Evaluations (CPEs) for countries in which these documents indicate the sector's relevance to the country strategy concerned. The most relevant conclusions and recommendations for the sector made by those studies are as follows:
- a. According to IDB (2017e), the Bank made significant efforts between 2007 and 2016 to address the important challenge of improving tax collection capacity at the subnational level, particularly in South America. This was part of a strategy aimed at increasing property tax collection and reducing the dependence on central government transfers. The evaluation found that the Bank's approach at the subnational level exhibited substantial capacity for learning and innovation, using technical cooperation operations to address key challenges for subnational tax administration.
 - b. The ESCI evaluation (IDB, 2016d) indicates that technical cooperation operations promoted under the initiative had better results in cities where political decentralization was more advanced, and where subnational fiscal capacities and planning capacities were greater. It also underlines the need to strengthen the analysis of fiscal and governance issues, together with linkages between priority programs and possible sources of financing.
 - c. With respect to country analysis, the most recent CPE for Brazil (IDB, 2015a) notes the implications of a Bank financing model that is centered on the subnational governments. In this respect, long-term partnerships with a select number of subnational governments can enhance the efficiency and effectiveness of the portfolio. In the particular case of the Program of Support for the Management and Integration of Finance Administrations in Brazil (PROFISCO), this yielded satisfactory results in terms of disseminating experiences and optimum practices in the states. With respect to support for policy reforms, funding provided to the states under Fiscal Stability Consolidation Programs for Development (PROCONFIS) has helped to establish a reform agenda and improve fiscal management. The evaluation

⁸⁷ The Bank provided support for this experience through the Program to Modernize the Brazilian State, Federal District, and Local External Oversight System (BR0403).

recommends continuing to work with states and municipios to deepen reform of the public finances, with multiple Bank divisions helping to provide assistance to clients for identifying some of the most pressing spending rigidities and inefficiencies and formulating appropriate solutions.

- d. The Colombia CPE (IDB, 2015b) highlights the fact that a series of policy-based loans supported fiscal stability through the consolidation of subnational fiscal responsibility, based on greater efficiency in the funds transferred to these governments, improved quality of subnational fiscal data, and increased subnational tax collections. The two supporting technical cooperation operations helped to produce important inputs for the technical and policy work of the Fiscal Support Department (DAF) of the Ministry of Finance.
- e. In the case of the Argentina CPE (IDB, 2016e), this recommends strengthening the capacity of provincial governments as a potential area for reform. It also indicates that improving the quality and equity components of operations to deliver basic services necessarily entails the inclusion of provincial governments as full participants in the design and implementation of projects, as well as developing federal-level incentives and results-based management mechanisms for provincial governments.
- f. The Guatemala CPE (IDB, 2016f) reports that progress in fiscal decentralization in Guatemala between 2012 and 2016 was slow. The evaluation highlights the fact that the Bank was the main instigator of policy actions to strengthen fiscal capacity in the municipios, as part of the execution of a policy-based loan. It also highlights the Bank's support for operationalization of the Department to Assist Municipal Financial Administration. The main challenges in the sector relate to the need to continue developing the institutional framework at the local level, as well as at the national level (with particular reference to strengthening of the Municipal Development Institute (INFOM), which remains pending).
- g. Lastly, the Ecuador CPE (IDB, 2017f) indicates that the Bank provided significant support to subnational entities to improve production-related infrastructure (irrigation and roads) and expand access to basic services (potable water and sanitation). Implementation of these programs came up against institutional weaknesses in the subnational entities, however, and the systems financed face risks to their long-term sustainability. Recommendations included continuing to strengthen the capacity of subnational entities and exploring new mechanisms to improve the delivery and financing of the productive and social services for which they are responsible.

B. Results of the development effectiveness matrix

- 4.2 The development effectiveness of projects in the sector continued to improve over the 2015-2017 period, attaining scores similar to the rest of the Bank's portfolio and higher than the average in 2014. Specifically, the most significant improvements were observed in the design logic of the programs. This demonstrates a better understanding of the actions that should be undertaken to address the sector's main problems.

C. Lessons learned from experience with Bank operations

- 4.3 Working jointly with the Fiscal Management Division, the Knowledge and Learning Division (KNL/KLD) has conducted a study of a sample of 25 of the sector's sovereign-guaranteed investment operations in eight countries.⁸⁸ This analysis was based on documentation related to the selected projects,⁸⁹ as well as interviews with project team leaders. The main lessons drawn from the aforementioned analysis are highlighted below.
- 4.4 **The importance of uninterrupted dialogue, technical support, and the role of networks.** The Bank's programmatic vision regarding the processes of decentralization in the region, together with the presence of specialists of the ground, have been the right formula for addressing needs by means of fluid, continuous interaction with the governments.⁹⁰ The Bank has been a strategic partner in countries such as Uruguay and Brazil, where the specialists' understanding of the country context—coupled with more than 30 and 15 years of ongoing support, respectively—have positioned the Bank as one of the leading partners in the process of decentralization and modernization of fiscal management instruments, successfully executing multiple operations at the federal, state, and municipal levels. In Uruguay, several factors have helped to underpin this uninterrupted work: (i) a tradition of institutional continuity led by the Office of Planning and Budget; (ii) the existence of central government authorities that are recognized by subnational governments as being technical experts with experience in the area; and (iii) the autonomy of subnational governments, which raises the importance of this issue to another level. At the same time, the Bank has spearheaded an important sector dialogue with the Brazilian authorities by means of credit and technical cooperation operations, seminars, and studies, in addition to forming developing knowledge networks within the framework of the National Fiscal Administration Program for the Brazilian States (PNAFE), the Fiscal Stability Consolidation Programs for Development (PROCONFIS), the Program to Support the Management and Integration of Finance Administrations in Brazil (PROFISCO), and the Program to Support the Administrative and Fiscal Management of Brazilian Municípios (PNAFM). Networks were also created to integrate the tax authorities, together with the modernization of fiscal, financial, and asset management in Brazil's municípios and states, thus facilitating the development, harmonization, and dissemination of fiscal management policies. This also constituted a space for building consensus on effective technical solutions and sharing technological innovations for implementation in the different states.⁹¹
- 4.5 **Multisector work.** The Bank's multisector work in decentralization operations has proven effective in responding to decentralization processes, which demand a comprehensive system of response due to their complexity. Strategic monitoring and support has been provided by multisector project teams with a view to achieving

⁸⁸ Eighteen sovereign-guaranteed operations were analyzed for the first cycle of this SFD. In the case of this updated SFD, this was supplemented by a further 17 loans.

⁸⁹ The documents analyzed include loan proposals and loan contracts, results matrices, risk matrices, institutional capacity assessments, operating regulations, project execution plans and annual work plans, technical cooperation operations that support loans, project monitoring reports, midterm and final evaluations, and project completion reports.

⁹⁰ Operations 2448/BL-BO, 2593/BL-BO, 2341/OC-CO, 2744/OC-CO, 2520/OC-BR, 2841/OC-BR, 3139/OC-BR, 2248/OC-BR, 1744/OC-ME, 1079/OP-NI, 1425/OC-UR, and 2668/OC-UR.

⁹¹ Operations 2044/OC-BR, 2520/OC-BR, 2841/OC-BR, 3139/OC-BR, and 2248/OC-BR.

results in the different dimensions of decentralization; this was the case in Mexico where urban, strategic investment, and climate change components were included.⁹² In the case of Bolivia, contributions and synergies achieved through the joint work of different divisions had a positive impact in terms of transparency and greater citizen participation.⁹³ In Peru, the Bank's multisector work has facilitated the inclusion of financing for subnational government projects in the areas of social and economic infrastructure (specifically in education and transportation, respectively).⁹⁴

- 4.6 **Improved capacities in the framework of interventions.** Given that decentralization processes tend to be lengthy and complex, the Bank should supplement its financial instruments—such as policy-based loans and Conditional Credit Lines for Investment Projects (CCLIPs)—with knowledge instruments such as technical cooperation operations, international seminars, funding for the services of international experts, and exchanges. These complementary tools have helped to maximize the Bank's response capacity when faced with unexpected or changing needs of its clients. In the case of Brazil, for example, the Bank supported fiscal reform by means of a technical cooperation operation, with the objective of building consensus among the different stakeholders through diagnostic assessments, seminars, and workshops.⁹⁵ In Mexico, resources have been used to finance improvements in the capabilities of subnational government officials, strengthening management for results in the states.⁹⁶ In the case of Colombia, international experts have been hired to support studies that have been instrumental to the decentralization process.
- 4.7 **High-level support and resistance to change.** Key to institutional strengthening of subnational governments are the existence of political will and officials with high prestige at the national level who also share the vision of fostering development in their own territory. This was the case of the intervention in Yucatán, Mexico, where the Secretary of Planning and the Economy was able to give unique impetus to the project based on his knowledge and vision of financial and fiscal issues.⁹⁷ Additionally, it is important in the design phase to closely monitor the implementation process in subnational governments so that it is not perceived as an imposition, but rather a complete strategy that aims to improve capacities. This was particularly relevant in the case of Argentina, where resistance to change affected execution periods.⁹⁸
- 4.8 **Strengthening of subnational executing units.** The Bank's intervention has focused not only on supporting central government executing units, but also on achieving the creation and strengthening of executing agencies at the subnational level. In the case of Argentina, an institutional design was achieved in which decentralized executing units were created in the provinces, mirroring the unit at central government level; this facilitated the strengthening of capacities in the subnational governments, which need greater support.⁹⁹ Likewise, in the case of

⁹² Operation 2550/OC-ME.

⁹³ Operations 1701/SF-BO, 2317/BL-BO, and 2971/BL-BO.

⁹⁴ Operations 1437/OC-PE and 2703/OC-PE.

⁹⁵ Support for comprehensive fiscal reform in Brazil (ATN/FI-12544-BR).

⁹⁶ Operations 2520/OC-BR, 2841/OC-BR, 2841/OC-BR, 2248/OC-BR, 1383/OC-ME, and 744/OC-ME.

⁹⁷ Operation 2550/OC-ME.

⁹⁸ Operation 1855/OC-AR.

⁹⁹ Operation 1855/OC-AR.

Bolivia it was found that capacity strengthening needed to be focused not only on the main executing unit, but also on those responsible for the specific components in the program, leading to the inclusion of specific training activities.¹⁰⁰ In Mexico, the State Investment Management Unit was created to select investment projects on the basis of technical criteria; training was provided to university students over a period of several months, who then went on to staff the unit.¹⁰¹ In Peru, subnational government strengthening focuses not only on preinvestment, but on the entire project cycle. Accordingly, support has been provided for all stages of prioritization, including execution, monitoring, and evaluation, with a view to bridging gaps.¹⁰²

4.9 Monitoring, sources of fiscal information, and evaluation of interventions.

Problems of transparency and a lack of indicators at the subnational level hinder measurement of the impact of Bank operations, as well as the development and implementation of innovations to support improvements in decentralization processes. With Bank support, a number of the operations analyzed have implemented systems that have improved reporting at the regional level,¹⁰³ in addition to developing portals that encourage communication and transparency with citizens.¹⁰⁴ This was the case in Guatemala, with the Open Government initiative supported by the Bank.¹⁰⁵ In Argentina, Mexico, Uruguay, and Central American countries, Public Expenditure and Financial Accountability (PEFA) assessments were conducted at the municipal level,¹⁰⁶ facilitating identification of the main bottlenecks in municipal fiscal administration, while integrated financial management systems were also implemented at the subnational level.¹⁰⁷ The Bank has also created a Subnational Fiscal and Local Development Information Platform with the aim of assisting the authorities of member countries in collecting, managing, processing, analyzing, and disseminating subnational fiscal information, as well as providing indicators on development and the legal and regulatory framework for fiscal federalism in the region.¹⁰⁸

4.10 Incentive-based intergovernmental transfers. Bank support through programs that allocate resources to subnational governments based on incentives has been an important option for subnational governments that want to improve their fiscal management quality within the framework of decentralization. This type of program has fostered regional competition and is a financing mechanism for subnational governments that demands transparency and accountability. In the case of Mexico, the Bank provided support to subnational governments under the Institutional Strengthening and Financing Program for States and Municipios (FORTEM) to improve features such as the investment planning system, the budget system, revenue sources, and improved quality of expenditure. These actions have helped to foster robust financial performance, as well as improved

¹⁰⁰ Operations 2448/BL-BO and 2593/BL-BO.

¹⁰¹ Operation 2550/OC-ME.

¹⁰² Operations 2550/OC-PE and 2703/OC-PE.

¹⁰³ Operations 2341/OC-CO, 2744/OC-CO, and 1744/OC-ME.

¹⁰⁴ Operations 1437/OC-PE, 2703/OC-PE, 1343/OC-SU, 2087/OC-SU, 1489/OC-UR, and 2668/OC-UR.

¹⁰⁵ Operation 2764/OC-GU.

¹⁰⁶ The PEFA methodology evaluates public financial management performance: fiscal discipline, the strategic allocation of resources, and efficient service delivery.

¹⁰⁷ Operations 1855/OC-AR, 2550/OC-ME, and 2668/OC-UR.

¹⁰⁸ Technical cooperation operation ATN/KR-14069-RG: Subnational Fiscal and Local Development Information Platform.

administration, and have led to better credit ratings for the targeted states and municipios.¹⁰⁹ This pioneering operation in Mexico served as a model for similar programs—some using the CCLIP credit modality—that combined improved subnational management with investments in Argentina (3835/OC-AR), Brazil (3412/OC-BR), Colombia (CO-X1018), Peru (2703/OC-PE), and Uruguay (UR-O1148). In the case of Peru, the Bank supported the Fund for Regional and Local Public Investment (FONIPREL) as a mechanism for improving the quality of subnational public investment projects.¹¹⁰

- 4.11 **Subnational governments' revenue-generating capacity.** Regional experience reflects the need to continue working to increase subnational revenue generation to cover growing expenditure obligations. Economic policy and country context are important variables that can explain the low mobilization of own-source funds by subnational governments, which often lack the necessary incentives to increase revenues and thus depend to a greater extent on intergovernmental transfers from the central government.¹¹¹ There are also weaknesses in local tax administrations' abilities in the areas of tax profiling, assessment, collections, and debt recovery.¹¹² Actions taken in the operations analyzed that may be considered in other interventions to support the strengthening of subnational revenues include the modernization of registries;¹¹³ the creation of inventories of property tax arrears, as well as improvements in tax systems; integrated financial management, procurement, and human resources systems at the subnational level;¹¹⁴ and the development of methodologies to measure the fiscal cost of tax benefits granted for municipal taxes accounting for the largest share of subnational governments' own-source revenues, with a view to building their administration capacities.¹¹⁵
- 4.12 **Strengthening of decentralization.** Decentralization processes require political will to maintain ongoing dialogue between the central government and the subnational level, as well as the establishment of regulatory frameworks that facilitate the delimitation of actions and responsibilities at each level. Support has been provided for coordination mechanisms, such as the creation of the Department of Assistance to Municipal Financial Management¹¹⁶ in Guatemala's Ministry of Finance and, in the case of Uruguay, the Office of Decentralization and Public Investment, which has the legal mandate of coordinating with subnational governments.¹¹⁷ Legislation has also been pursued, such as the Financial Discipline Law for States and Municipalities in Mexico (which promotes accounting harmonization and responsibility in state and municipal borrowing, in addition to issues such as transparency and controls on financial entities)¹¹⁸ and the budget law in Bolivia (which seeks greater efficiency in the distribution of transfers to subnational

¹⁰⁹ Operations 1383/OC-ME and 1744/OC-ME.

¹¹⁰ Operations 2550/OC-PE and 2703/OC-PE.

¹¹¹ Operations 1744/OC-ME, 1079/OP-NI, 2341/OC-CO, 2550/OC-PE, and 2703/OC-PE.

¹¹² Operations 1744/OC-ME, 1489/OC-UR, and 2668/OC-UR.

¹¹³ Operations 1383/OC-ME and 1744/OC-ME.

¹¹⁴ Operations 1855/OC-AR, 2448/BL-BO, 2593/BL-BO, 1701/SF-BO, 2317/BL-BO, 2971/BL-BO, 2078/OC-BR, and 2668/CO-UR.

¹¹⁵ Operations 2341/OC-CO and 2744/OC-CO.

¹¹⁶ Operation 2764/OC-GU.

¹¹⁷ Operation 2668/OC-UR.

¹¹⁸ Operation 2550/OC-ME.

governments).¹¹⁹ In Mexico, progress has been made in developing tools to predict subnational borrowing and medium-term fiscal sustainability; this supports management and helps to determine whether subnational governments have sufficient capacity to take on debt.¹²⁰

- 4.13 **Role of the private sector.** The private sector can support subnational economic development by generating investment opportunities and capacities, especially those associated with the design and implementation of investment projects. Accordingly, it is important to have a regulatory framework that is supportive of public-private initiatives, in addition to creating entities or agencies that examine the merits of establishing public-private partnerships. Such has been the case in Mexico, where the Investment Management Unit was created to perform evaluations of both public-private projects and public investment in general.¹²¹
- 4.14 **Areas of innovation: Climate change.** Recent years have seen greater progress in devolving new responsibilities to local entities. These include aspects of environmental management, given the interest of subnational governments in working with ecological or environmental taxes. Ecotaxes are an innovative source of subnational revenue, due to their ability to correct externalities and shift the development of cities onto a more sustainable fiscal and environmental footing.¹²² Fiscal incentives linked to environmental criteria should be structured in a harmonious and equitable manner. In Uruguay, CCLIP UR-O1148 (operation 3792/OC-UR) and operation 2668/OC-UR have helped subnational governments to make a crucial contribution to the climate change agenda by: (i) strengthening public officials' environmental risk management capacities; (ii) preparing methodological guidelines for project formulation; and (iii) promoting projects to prevent the erosion of coastlines or vulnerable areas.¹²³
- 4.15 **Modernization of property registries.** The strengthening of tax administrations requires greater investment in local property registries. In Bolivia, small and mid-sized municipios see this area as a great opportunity for enhancing their financial autonomy. A multipurpose cadaster is being developed at the subnational level in Colombia, while in Uruguay a single website and cadastral maps have been developed, combining satellite technology for rural areas and drones for urban areas.¹²⁴ One of the main lessons learned concerns the selection of low-cost, participatory, and innovative methodologies for the mass regularization of land tenure, namely: (i) use of global positioning system technology to carry out mass delimitations in a more expeditious and accurate manner; and (ii) adjudication processes that are based on community consultations and outreach, and supported

¹¹⁹ Operations 2448/BL-BO and 2593/BL-BO.

¹²⁰ Operation 2550/OC-ME.

¹²¹ Operations 1437/OC-PE, 2703/OC-PE, 2764/OC-GU, and 2550/OC-ME.

¹²² Congestion charges in cities are a tool that subnational governments can use to reduce the negative externalities of traffic, such as accidents and pollution. Thirteen of the region's countries receive revenues from the taxation of nonrenewable natural resources, accounting on average for 6.1% and 5.5% of their GDP in 2013 and 2014, respectively.

¹²³ CCLIP 3792/OC-UR (UR-O1148) and operation UR-L1038. This operation is the only one in the IFD/FMM portfolio to be prioritized by the Climate Change and Sustainable Development Sector as a project that contributes to the climate change agenda.

¹²⁴ Bolivia (1701/SF-BO; 2317/BL-BO; 2971/BL-BO), Colombia (CO-L1164), and Uruguay (ATN/KP-13942-UR, ATN/KR-15491-UR).

by dissemination campaigns carried out during previous phases.¹²⁵ Experience also shows that although central governments retain a prominent role in modernizing property registries (given the amount of investment required), good practices indicate that subnational entities—especially those with greater institutional capacity—should be the ones to update the registries. This should be carried out within an institutional framework that clearly specifies the functions and responsibilities of each of the participants in the cadaster management process. In addition, it is important to coordinate improvements in cadastral management with urban planning and territorial development activities.

- 4.16 **The digital economy and information technologies.** The digital economy offers opportunities for creating accountability mechanisms, and it requires governments to adopt a horizontal approach in order to leverage its benefits through collaboration with other stakeholders (citizens, private sector, or academia). The Municipios Portal in Argentina and the Executor's Portal in Brazil¹²⁶ are examples of forums that have been developed with Bank support thanks to information technology. The authorities have taken ownership of them, thus ensuring their continuity and sustainability. Among other things, these platforms facilitate the exchange of good practices, management models based on results or indicators, open-source software resources, and model terms of reference for contracts, as well as the dissemination of studies. Likewise, the modernization of administrative systems and expansion of their coverage is being carried out using open-source data and new digital solutions that can be quickly implemented, such as open source coding tools¹²⁷ that reduce costs and may be easily replicated by many subnational governments. In Brazil, the government prioritized adoption of the “Nota Fiscal Eletrônica” (electronic tax invoice) and “Nota Fiscal Eletrônica do Consumidor” (electronic retail tax invoice), the implementation of which leads to marked improvements in tax administration.¹²⁸ And in Uruguay, the creation of the Single Vehicle Tax Collection System (SUCIVE)¹²⁹ has increased subnational own-source revenue collection. The implementation of digital solutions should be supplemented with technical assistance and change management activities to ensure their ownership and effective use, particularly in the case of subnational governments.

D. The Bank's comparative advantages in the decentralization and subnational governments sector

- 4.17 Since approval of the sector framework in May 2015, the Bank has sustained a privileged position in supporting the sector in the region. Underlying this achievement have been continuous support and fluid dialogue with national and subnational authorities, broad country coverage, a track record of good practices and innovation, and high technical capacity in the sector.

¹²⁵ Land Regularization and Administration Projects: A Comparative Evaluation. op. cit., p.48.

¹²⁶ Operations 2044/OC-BR and 1855/OC-AR.

¹²⁷ In February 2018, the Bank issued its first call for open-source digital solutions applied to local taxation, which was answered by 34 developers. The aim of this initiative is to promote the greater exchange of open-source systems between subnational governments.

¹²⁸ Operation 2078/OC-BR.

¹²⁹ Operations 1489/OC-UR, 1668/OC-UR, and 3792/OC-UR. This is a mechanism that departments may join voluntarily, and it centralizes collection of the vehicle tax and any associated surcharges, fines, and arrears. The plan is to extend its scope to obtaining driving licenses and paying tolls and parking fees.

- 4.18 **Loans.** Between 2015 and 2017, the Bank approved 12 loans in the sector for more than US\$2 billion. In Argentina, a new cycle of operations to strengthen provincial management began (initially involving four provinces); this finances investment projects as an incentive for improving fiscal management.¹³⁰ In Colombia, two new tranches were approved under the CCLIP to improve fiscal management and public investment in eight of the country's city halls.¹³¹ Policy-based loans in Mexico supported important reforms to the decentralization framework, including the creation of a subnational fiscal responsibility framework.¹³² In Uruguay, a new CCLIP was approved for subnational development and management, meaning that the Bank will have been involved for more than half a century in supporting departmental investments and management in that country. This constitutes the longest continuous history of institution-building in the sector in the region.¹³³ Lastly, in Brazil—the country on which sector work was focused until 2014—the first four projects with states under the new CCLIP program of Support for the Management and Integration of Finance Administrations (PROFISCO II) were approved in 2017.¹³⁴ Over the next few years, PROFISCO II is expected to be expanded to the other 22 states.
- 4.19 The countries in which the Bank provides direct financing for subnational governments subject to a sovereign guarantee are Brazil and, most recently, Argentina. In the rest of the region, loan funds are usually channeled to subnational governments through central government lead agencies. This is due to economic policy constraints, where the central government does not guarantee subnational borrowing or chooses to act as an intermediary. It is also the result of legal restrictions: Mexico's constitution, for example, prohibits external borrowing by subnational governments.¹³⁵ Lastly, there are restrictions of scale: many subnational governments lack sufficient revenue to support loans of a significant size. In this respect, non-sovereign guaranteed operations offered by the Bank's private sector financing arm, IDB-Invest, provide an alternative source of funding, as indicated in the last SFD. Thus, from 2015 to 2017, IDB-Invest provided loans to subnational public enterprises in Argentina (Autopistas Urbanas S.A., in which the Government of the Autonomous City of Buenos Aires is the main shareholder) and Colombia (Empresas Públicas de Medellín, which is owned by Medellín City Hall). These non-sovereign-guaranteed operations reflect the important role that subnational governments can play in establishing this type of financing, and the opportunity that exists for these operations to include components aimed at strengthening subnational entities and their corporate governance (as in the case of Autopistas Urbanas).
- 4.20 Lines of action in sector interventions have encompassed improvements in subnational management of expenditure, investment, and service delivery;

¹³⁰ Operation 3835/OC-AR.

¹³¹ Operations 3596/OC-CO and 3842/OC-CO.

¹³² Operations 3676/OC-ME and 4071/CH-ME.

¹³³ Operation 3792/OC-UR. See the [audiovisual summary](#) of the Bank's work with Uruguay in supporting decentralization and subnational governments.

¹³⁴ Operations 4460/OC-BR, 4459/OC-BR, 4458/OC-BR, and 4436/OC-BR.

¹³⁵ This type of restriction explains the fact that in some countries the Bank channels loan funds to subnational governments through local development banks. Notable examples of this include FINDETER in Colombia and BANOBRAS in Mexico.

own-source revenue management; investment financing; and, to a lesser extent, debt management, transparency, and accountability.

- 4.21 In addition to the Bank, the World Bank has been a significant actor in providing support to the sector in the region.¹³⁶ From 2015 to 2017, the World Bank approved three policy-based loans for approximately US\$2.2 billion in Brazil, Colombia, and Peru. Bank interventions have historically been characterized by a higher proportion of investment projects than of policy-based loans, with broader country coverage.
- 4.22 **Technical cooperation operations.** Technical cooperation operations are an important instrument for supporting the sector. Over the last three years, the Bank has approved an annual average of 15 such operations for approximately US\$10 million per year.¹³⁷ Maintaining this flow of resources is important, since in many countries—especially the smaller ones—technical cooperation operations are the primary instrument of sector work. Key achievements under these operations have included support for decentralization reform initiatives in Chile, Mexico, and Panama;¹³⁸ diagnostic assessments and proposals for improving subnational public financial management in Argentina, Mexico, and the Dominican Republic¹³⁹ (in the first two cases supporting loan formulation); innovations in the area of cadastral management, such as the single website and [precise cadastral maps in Uruguay](#); improvements in service delivery to firms and citizens at the subnational level in Brazil;¹⁴⁰ and improvements in fiscal and information management in the province of Córdoba.¹⁴¹ Key regional technical cooperation operations have supported the creation of the Latin American Decentralization Network (which brings together the main sector entities in the region) and development of the subnational fiscal information platform (containing information on more than 13,000 subnational governments in the region). This platform aspires to become one of LAC’s main public repositories of subnational government financing.
- 4.23 **Sector knowledge products.** The Bank stands out for its broad range of sector knowledge products. Publications over the last three years include the following: (i) in relation to the subnational governments’ sources of revenue, the books *Decentralizing Revenue in Latin America: Why and How* (Fretes Cibils, V. and T. Ter-Minassian eds., 2015) and *Expandiendo el uso de la valorización del suelo – La captura de plusvalías en América Latina and el Caribe*, (Blanco, A., V. Fretes Cibils, and A. Muñoz, eds., 2016); (ii) concerning intergovernmental transfers, the book *Descentralización fiscal and disparidades regionales en América Latina – El potencial de las transferencias de igualación* (Muñoz, A., E. Pineda, and A. Radics, eds., 2017); (iii) regarding the delivery of services to citizens, the book *Governments that Serve: Innovations that Improve Service Delivery to Citizens* (Fariás, P. et al.), which includes case studies at the subnational level in Minas Gerais and Colima; and (iv) several sector-related documents, including a study of *Descentralización and la autonomía fiscal subnacional en América Latina* (Porto, A., C. Pineda Mannheim, and H. Eguino); a review of the *Panorama de las finanzas*

¹³⁶ The analysis of World Bank operations in the sector is based on information for the 2015-2017 period obtained from the [World Bank website](#).

¹³⁷ This includes technical cooperation operations approved under the ESCI.

¹³⁸ Technical cooperation operations ATN/FI-14517-CH, ATN/OC-15559-ME, and ATN/FI-15062-PN.

¹³⁹ Technical cooperation operation ATN/KR-15268-RG.

¹⁴⁰ Technical cooperation operation ATN/CR-15699-BR.

¹⁴¹ Technical cooperation operation ATN/OC-16183-AR.

municipales en América Central (Porto, A., H. Eguino, and W. Rosales); analyses of *Descentralización en República Dominicana: desempeño actual and perspectivas de reforma* (Martínez-Vázquez, J., A. Radics, and B. Pérez-Rincón); *Enfoque de género en proyectos de presupuestos subnacionales* (Aguilera, L.); *El Centro de Gobierno en la provincia de Buenos Aires – Diagnóstico de funcionamiento and propuestas de fortalecimiento* (Alessandro, M., M. Lafuente, J. Reyes, and F. Straface); and experiments that evaluate tax compliance behavior: *Do Rewards Work? Evidence from the Randomization of Public Works* (P. Carrillo, Castro, E., and Scartascini, C.). Many of these documents have been financed with funding for knowledge products (Economic and Sector Work, or ESW).

- 4.24 **Sector outreach work.** The Bank has also worked intensively to disseminate and promote the exchange of sector knowledge between countries, as well to generate learning opportunities in the preparation and execution of its programs by: (i) supporting subnational networks; (ii) publishing blogs; (iii) regional workshops and dialogues; and (v) organizing and participating in international seminars. Noteworthy achievements include the publication of more than 25 articles on the sector in the Collecting Well-Being blog; organization of two meetings of the Decentralization and Local Development Network promoted by the Bank, with the participation of national and subnational officials involved in the management of fiscal decentralization in the countries of the region; organization of 10 meetings of the Managing for Development Results network in subnational governments, which at the last meeting in Buenos Aires included 130 officials from 15 countries, representing 54 regional subnational governments;¹⁴² coordination and Bank financing of six annual awards for public management innovation in subnational governments—[GovernArt: The Art of Good Government]—and of three annual awards for management for results by subnational governments; joint organization of Ibero-American Workshops on Local Financing, which are in their sixth year and are becoming a leading forum for the discussion of research in the sector; and the first meeting of the Regional Policy Dialogue on Fiscal Management in the Digital Era: Progress and Future Challenges for Latin America, with presentations related to subnational management.
- 4.25 In summary, the Bank offers the following comparative advantages in the sector:
- a. **A team of quality specialists with a presence in the field.** This key factor has helped make the Bank the preferred multilateral institution in the sector in most of the region's countries, having provided practically all of them with sustained support over the years. In the case of Brazil, this advantage was decisive for implementation of the PROFISCO program, which has implemented investment loans in every state in the country, with the high demand for support that this entails.
 - b. **Diversity of instruments.** The availability of technical cooperation resources, together with resources for knowledge products and policy dialogue, improves the flexibility, timeliness, and relevance of the Bank's response to country demand, helping to identify needs that have been translated into new projects and innovative solutions.

¹⁴² This is one of the networks of the Latin American and Caribbean Community of Practice on Managing for Development Results (CoPLAC-MfDR), which is made up of officials from the countries of the region and is supported by Bank financing.

- c. **Adaptation to variations between and within countries.** The Bank has succeeded in tailoring its intervention modalities in the sector to the region's heterogeneity. For example, while Brazil is developing a broad program of direct work with the states (PROFISCO), Argentina alternates direct support to the largest jurisdictions with programs that provide support to the provinces through the central government. In Uruguay, support to municipios is channeled through the central government, while in Colombia and Mexico, local development banks act as intermediaries (FINDETER and BANOBRAS, respectively). In countries such as Chile, the Dominican Republic, and Panama, efforts to promote decentralization have been supported through technical cooperation operations and knowledge products.
- 4.26 In light of the above, the Bank will continue to prioritize the improvement of institutional capacities in the sector, in terms of both the incentives generated by intergovernmental arrangements and the subnational governments' own management capacities. The Bank will continue to tailor its interventions to the diversity of the region's countries. Thus in the larger countries, provided that their legislative frameworks permit, the Bank can work directly with specific subnational governments—as it has been doing with the states of Brazil and is beginning to do with the provinces of Argentina. In the smaller countries, the Bank will work primarily through the lead agencies of the central government; these efforts will include sector deconcentration alternatives, with the aim of bringing government closer to the citizens. With regard to the type of subnational entity, priority will be placed on working with intermediate levels of government and municipios in urban areas (both intermediate and large). In the context of the decentralization and subnational governments sector, this entails relegating to a second tier those areas in which the Bank has fewer comparative advantages, such as working directly with small municipios and reforming the policy framework for decentralization.¹⁴³

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

- A. Goals and principles underlying work in the decentralization and subnational governments sector**
- 5.1 The Bank's main goal in the sector is to foster the necessary conditions for developing institutional capacities and a suitable incentive structure for more efficient and effective subnational management in Latin America and the Caribbean, thus helping to improve the quality of life for all citizens. To achieve this, the proposed lines of action and operational activities respond to the diagnostic assessment in Section III, and to the Bank's comparative advantages as identified in Section IV. The SFD also presents knowledge and outreach activities that are the foundation for generating future innovations in the sector. Design of the interventions will include objectives that are measurable in relation to a baseline, specifying the appropriate methodology for evaluation of their expected impact and promoting access to information regarding interventions in the sector (in accordance with the Development Effectiveness Framework for sovereign- and non-sovereign-

¹⁴³ In the case of small municipios, the Bank will continue working with these through the central government and/or under regional clustering arrangements. In reference to the decentralization policy framework, although this is not a target of reform under Bank operations, it is a key input for understanding a country's political economy.

guaranteed operations, document GN-2489). Lastly, the Bank will design interventions based on specific conditions in each country and in accordance with the principles applied in sector work. These principles, which are drawn from an analysis of international evidence (Section II) and lessons learned (Section IV), include the following:

- a. **Institutional capacity-building.** Emphasis in the sector is on institutional capacity-building, in both the structure of intergovernmental relations (including coordination of the decentralization process) and the management of subnational governments, recognizing the importance of the specificity of each sector in the delivery of services at the subnational level. An issue of particular importance is the adaptation of subnational entities to the challenges and opportunities of the digital economy and the use of new ICTs.
- b. **Consideration of incentives for stakeholders.** In order to achieve legitimate, lasting results, the design and execution of interventions must take into account the various motivations and interests of stakeholders in decentralization (e.g. subnational governments and their associations, central government, Congress, and civil society), as well as more general constraints of a political economy nature. In this area, networks of subnational governments are of particular importance; their incentive is to share good practices aimed at resolving specific problems in a more expeditious manner.
- c. **Recognition of the interdependence of the sector's challenges.** Sector challenges are interdependent and must be evaluated as a whole in the context of the design and execution of interventions. For example, changes in intergovernmental transfer systems have implications for the incentives for key stakeholders, thus affecting the management of subnational governments.
- d. **Adaptation to variations between and within countries.** Different intervention modalities will be adopted based on the countries' degree of decentralization and the different characteristics of subnational governments.

B. Dimensions of success, lines of action, and activities¹⁴⁴

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

5.3 **Lines of action:** (i) strengthen the institutional framework for coordination of intergovernmental arrangements, including coordination of subnational government management; and (ii) support improvements in the determination of powers and functions across the different levels of government, as well as transfer systems, promoting principles of equity, efficiency, and sustainability while taking the political economy of each country into account.

¹⁴⁴ The lines of action and activities to be financed by the Bank will follow the guidelines of this SFD and others applicable to specific interventions.

- 5.4 To fulfill these two lines of action, financing is proposed for the following operational as well as knowledge-building/dissemination activities:
- a. **Operational activities:** (i) support programs to establish and/or consolidate the lead agencies in decentralization, responsible for the coordination, monitoring, and adjustment of intergovernmental arrangements, including the institutional framework for coordinating subnational government management and monitoring subnational fiscal sustainability; (ii) promote the development and/or consolidation of subnational fiscal information systems that provide updated information on the sector; (iii) promote reforms aimed at improving the definition and coordination of expenditure functions across the different levels of government, including arrangements for cooperation in the delivery and regulation of services and suitable methodologies for estimating the expenditure needs of subnational governments based on their responsibilities; (iv) support the generation and diversification of subnational governments' own-source revenue, with a view to increasing their fiscal autonomy; and (v) improve intergovernmental transfer systems based on fiscal capacity and criteria of efficiency, simplicity, and predictability, with the aim of covering the fiscal needs of subnational governments and creating territorial development opportunities.
 - b. **Knowledge and dissemination activities:** (i) generate knowledge regarding the effect of intergovernmental transfer systems on the efficiency of public expenditure and sustainable development of the regional economy; (ii) generate knowledge regarding different modalities of intergovernmental coordination and their effectiveness; (iii) develop methodological instruments to assess the level of preparedness on the part of the countries and their respective subnational governments in terms of the dimensions of success in decentralization; and (iv) consolidate the Latin American and Caribbean fiscal decentralization network, which is made up of officials from both central governments and subnational governments and their organizations who are responsible for managing intergovernmental arrangements and establishing mechanisms for strengthening subnational governments in their respective countries. This includes coordination of information exchanges with similar networks in other world regions, with the aim of building on the lessons learned in the sector with experiences from beyond LAC.
- 5.5 **Dimension 2: Subnational governments improve the efficiency and quality of expenditure and service delivery.** Sector interventions will seek to increase subnational governments' capacity to manage spending and deliver efficient and quality services, addressing the population's needs and demands and contributing to territorial development (prioritizing low-carbon, resilient development). Considering the broad range of services provided at the subnational level, this dimension is focused on the sustainable enhancement of institutional capacities for delivery of these services, via linkages with the different sectors (urban development, education, health, transportation, water and sanitation, citizen security, tourism, etc.) for the specific topic concerned.
- 5.6 **Lines of action:** (i) strengthen public expenditure management capacity and service delivery at the subnational level, aiming to improve their quality through the opportunities provided by the digital economy and the use of ICTs; (ii) strengthen core government functions to promote effective public policies, facilitate private sector development, and enhance the public and/or private delivery of citizen services at the subnational level; (iii) improve public investment management,

including public-private partnerships; and (iv) promote strategic public and/or private investments that contribute to sustainable territorial development.

5.7 To fulfill these two lines of action, financing is proposed for the following operational as well as knowledge-building and dissemination activities:

- a. **Operational activities:** (i) support improvements in subnational management processes and organization, including human resources management at the subnational level, promoting merit, transparency, and incentives to attract and retain qualified personnel in subnational governments in the context of strengthening civil service capacity; the technical capacities of officials at the central and subnational government levels, and the sustainability of such improvements; the pillars of MfDR, the strengthening of centers of government, administrative simplification, and leveraging the digital economy, with a focus on facilitating private investment and increasing efficiency and quality in the delivery of citizen services; (ii) promote the development, modernization, and integration of PFM systems at the subnational level, including budget, treasury, accounting, public procurement, cost management, and asset and property management modules, in coordination with the activities envisaged at the subnational level in the Bank's Strategy for Strengthening and Use of Country Systems (document GN-2538-14); (iii) strengthen public investment management at the subnational level, seeking to adopt good practices and incorporate information technology tools for project cycle management, with the aim of improving its focus on the population's needs and demands; and (iv) improve the institutional conditions for attracting strategic public-private investments by including joint activities with IDB Invest to promote local economic development.
- b. **Knowledge and dissemination activities:** (i) generate knowledge regarding the costs of providing the goods and services for which subnational governments are responsible, as well as their determinants and their linkages with spending needs; (ii) generate knowledge regarding the efficiency and coordination of decentralized public investment management; (iii) contribute to the development and/or dissemination of new methodologies and digital solutions in the area of PFM; (iv) contribute to strengthening of the subnational government and public-private investment networks, among others; (v) support competitions focusing on good practices and innovative solutions for subnational public management, such as GovernArt; (vi) strengthen the fiscal management and governance pillar of the ESCI; and (vii) generate diagnostic assessments and action plans to improve the service delivery and operational efficiency of subnational public enterprises, their financial sustainability, and their impact on local markets.

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

5.9 **Lines of action:** (i) support improved revenue collection performance by subnational governments, bringing it closer to its potential; and (ii) help subnational

governments access financing within a fiscal responsibility framework, with the support of the private sector.

5.10 To fulfill these two lines of action, financing is proposed for the following operational as well as knowledge-building and dissemination activities:

- a. **Operational activities:** (i) support improvements in the generation of own-source revenues by subnational governments through technical assistance, exchanges, modernization of systems, and strengthening of the institutions that regulate and administer subnational taxation; this includes support for the modernization of cadastral management as a tool for improvements in revenue collection, on one hand, and land planning and public and/or private investment planning on the other hand; (ii) promote the fiscal sustainability of subnational governments, their management of debt and contingent liabilities, and their capacity to access financing within a fiscal responsibility framework, bearing in mind the problem of incentives in a financing structure that is highly dependent on transfers; and (iii) support the creation of financing mechanisms for subnational governments and promote the issuance of credit ratings for subnational governments, both in coordination with the central government and while maintaining fiscal responsibility.
- b. **Knowledge and dissemination activities:** (i) generate knowledge regarding the impact of programs to improve subnational own revenue management, including evaluation of the impact of new information and communication technologies and shifts in behavior; (ii) with respect to subnational financing, support central governments in developing capacities for the monitoring and evaluation of subnational fiscal sustainability, with a view to developing subnational capital markets; (iii) generate knowledge regarding the evaluation of transfer arrangements with incentives based on improved subnational revenue collection; and (iv) identify and document innovative practices in the financing of subnational governments, including the use of private subnational capital markets, financing based on mechanisms to capture capital gains, social impact bonds,¹⁴⁵ climate financing and green taxes, and arrangements that group together small municipios.

5.11 **Dimension 4: Subnational governments operate with greater transparency and accountability.** The interventions will seek to improve subnational government transparency and accountability, as well as monitoring and control by citizens, civil society organizations, and other government bodies that finance, regulate, and monitor subnational management. To achieve these objectives, the following lines of action are proposed:

5.12 **Lines of action:** (i) strengthen transparency and accountability in subnational government management of budgets and service delivery; (ii) enhance the capacity for results-based monitoring and evaluation of subnational management; (iii) strengthen mechanisms for monitoring the use of subnational government resources through greater citizen participation; and (iv) promote inclusion of the dimensions of gender, diversity, and climate change.

¹⁴⁵ Social impact bonds (or contracts) are new “results-based payments” financing mechanisms that can be used for social services. With social impact bonds, private investors provide the initial capital for a social service, and the government pays investors based on the results of the service. The Multilateral Investment fund is supporting the pilot use of this mechanism.

- 5.13 To fulfill these two lines of action, financing is proposed for the following operational as well as knowledge-building and dissemination activities:
- a. **Operational activities:** (i) support transparency and accountability mechanisms and systems, providing easily understood, quality information so that citizens, civil society organizations, subnational legislatures, and lead decentralization agencies can participate and have an impact on improving management of the subnational budget and public services; this includes institutional capacity assessments for executing units at the subnational level, as well as promoting the inclusion of communication and change management activities in Bank projects; (ii) strengthen the instruments and institutions responsible for results-based monitoring and evaluation of subnational management, including the subnational governments' internal control bodies and their integrity and control mechanisms; and (iii) support improvements in the management of institutions that regulate and control the proper use of subnational public resources and prevent corruption (including legislatures and comptroller's offices), while also supporting channels that allow the population to report the improper use of funds by subnational governments.
 - b. **Knowledge and dissemination activities:** (i) generate knowledge regarding the effectiveness of interventions aimed at increasing subnational transparency and accountability, including the contribution to control systems and greater use of ICTs; and (ii) with respect to the supreme audit institutions' oversight of subnational governments' use of public resources, deepen work on external control with specialized international organizations to promote the sharing of experiences, innovation, and inclusion of new topics aimed at improving and modernizing SAI capacities, including accountability, the prevention of corruption, and a results-based approach.
- 5.14 The four dimensions of success that will guide sector operational and analytical activities will enable the Bank to respond to the demands of both public and private sector stakeholders in its 26 borrowing member countries. Under the working principles for the sector presented in this SFD, the Bank will coordinate the lines of action through the country strategies and will orient them toward the specific needs of each country and subnational government targeted for support. The primary aim of the range of policies, programs, and studies presented herein is to move toward a region in which subnational management helps to improve the quality of life of all citizens.

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